

Specific Compliance Issues of Advisers to Mutual Funds

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Special Compliance Duties of Mutual Fund Advisers

- Additional investment restrictions
- Portfolio securities valuation role
- Personal trading restrictions
- Foreign custody responsibility
- Best execution
- Recordkeeping
- Reporting to fund boards

Sources of Additional Duties

- Investment Company Act of 1940
- Prospectus/SAI disclosure
- Board of Directors/Trustees policies
- Tax Code: Subchapter M

Special Investment Restrictions for Mutual Funds

When Investment Restrictions Apply

- All investment restrictions apply only at the time of acquiring a new security except:
 - Restrictions on illiquid investments
 - Restrictions on borrowing
- Later changes in the value of a fund's securities or total assets do not cause a restriction to be violated

Fundamental vs. Nonfundamental Policies

- Fundamental investment policies can be changed only by a majority of shares of the affected fund
 - Investment Company Act requires some policies (but not investment objectives) to be fundamental
- Changes in non-fundamental policies require board, but not shareholder, approval

Name-Related Investment Policies

- At least 65% (always 80% of net assets after 7/31/2002) of assets must normally be invested in securities indicated by fund name
- A new fund may not be able to comply with this test immediately, but SEC allows new funds a reasonable time to comply

Name-Related Investment Policies

- Examples of fund types and likely investment policies:
 - Money market funds: compliance with rule 2a-7
 - Tax free funds: at least 80% of assets in federally tax exempt securities that are not subject to the alternative minimum tax

Name-Related Investment Policies

- Examples of fund types and likely investment policies:
 - Many balanced funds: at least 25% of assets in senior fixed income securities
 - Sector, state or country specific funds: at least 80% of assets in issuers located in that sector, state or country

Name-Related Investment Policies

- Examples of fund types and likely investment policies:
 - Small, medium & large capitalization funds: at least 65% of assets in companies within the specified capitalization range
 - Funds with short, intermediate or long in their names: an average maturity consistent with the name

SEC Diversification

- 75% “basket”
 - Not more than 5% of assets in any one issuer
 - Not more than 10% of any issuer’s voting securities
- Does not apply to
 - U.S. government securities
 - Registered investment companies (but SAI restriction may not include this exception)

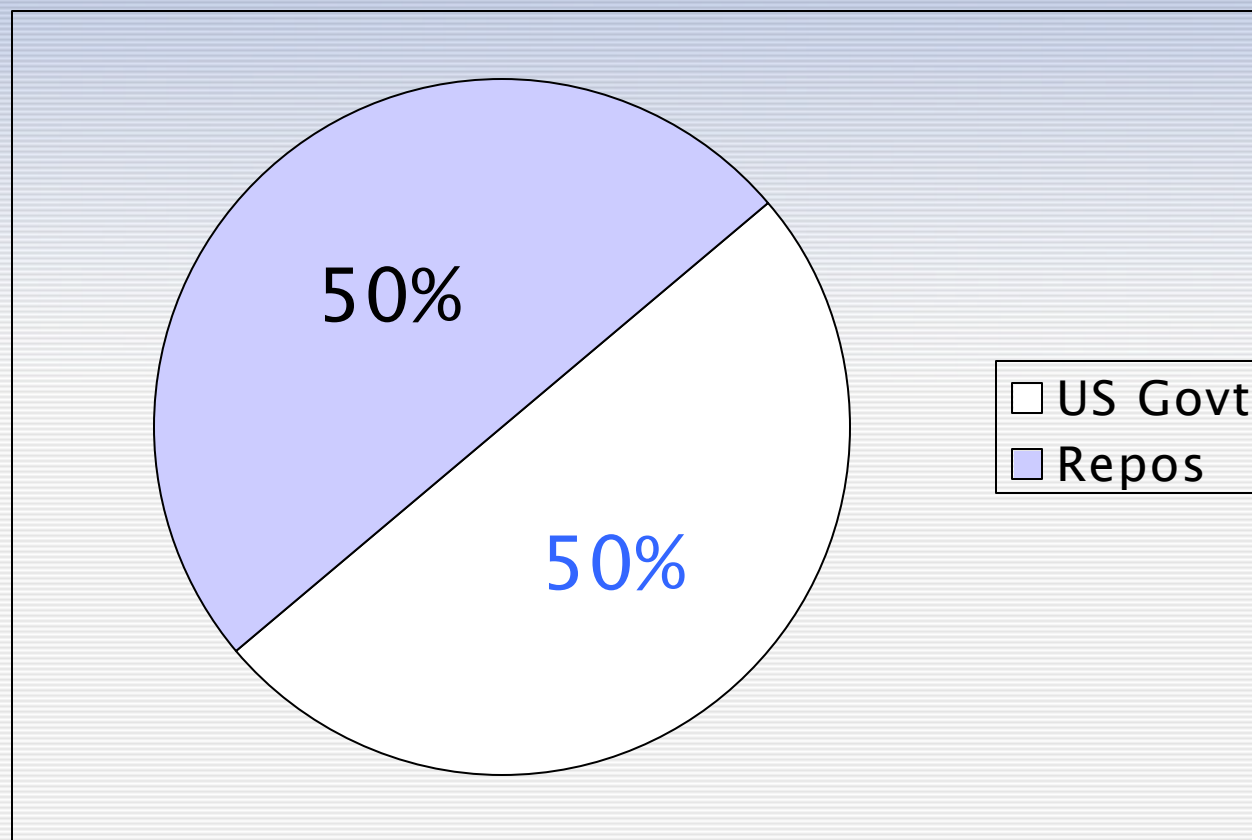
SEC Diversification

- 25% “basket”: may be all one issuer or up to four non-diversified issuers that together represent 25% or less of the fund’s assets
- Some funds may retain old state restrictions that required 100% diversification
- Diversification policies are usually fundamental

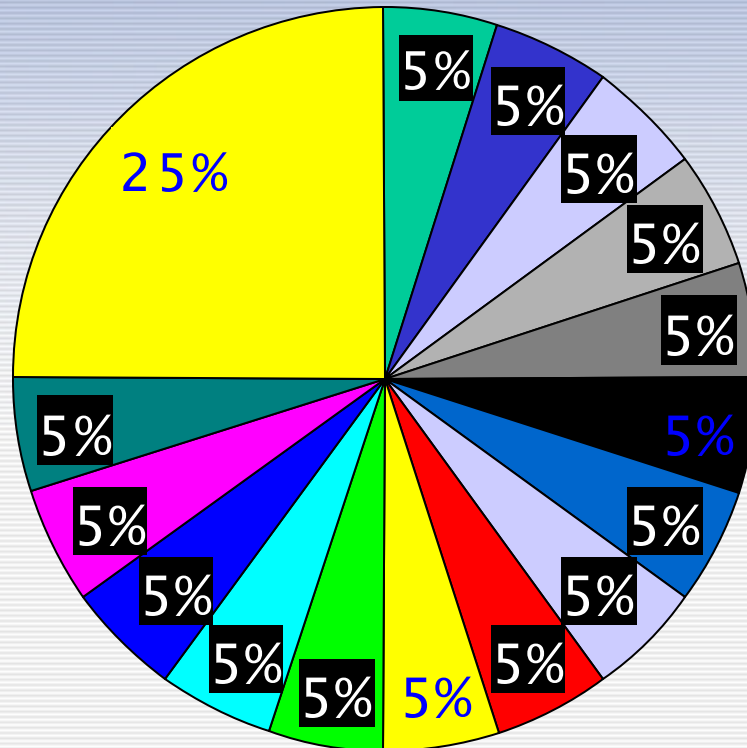
Changes in Diversification Status

- Shareholders must approve any change from diversified to non-diversified status
- A non-diversified fund that has a diversified portfolio for three continuous years automatically becomes diversified
- Shareholder approval is needed to change back

Example 1 of SEC Diversification



Example 2 of SEC Diversification



Identifying the Issuer for Diversification Purposes

- The issuer is the primary expected source of interest, dividend or principal payments
- There can be multiple co-issuers
- A guarantor is not the issuer unless there is reason to believe that the guarantor will be the actual source of payments

Diversification Status of Guarantors

- Diversification does not apply to a guarantor unless the fund invests more than 10% of assets in securities issued or guaranteed by that guarantor
- Forms of credit support that cannot be enforced by a fund are not guarantees (e.g. capital infusions from issuer's parent)

Stricter Money Market Fund Diversification

- No 25% non-diversified basket for taxable and national tax free funds
- 1% limit on investments in any one second tier issuer (5% aggregate limit)
- 10% limit on securities issued or guaranteed by the same institution (with 25% non-diversified basket for unaffiliated guarantors)

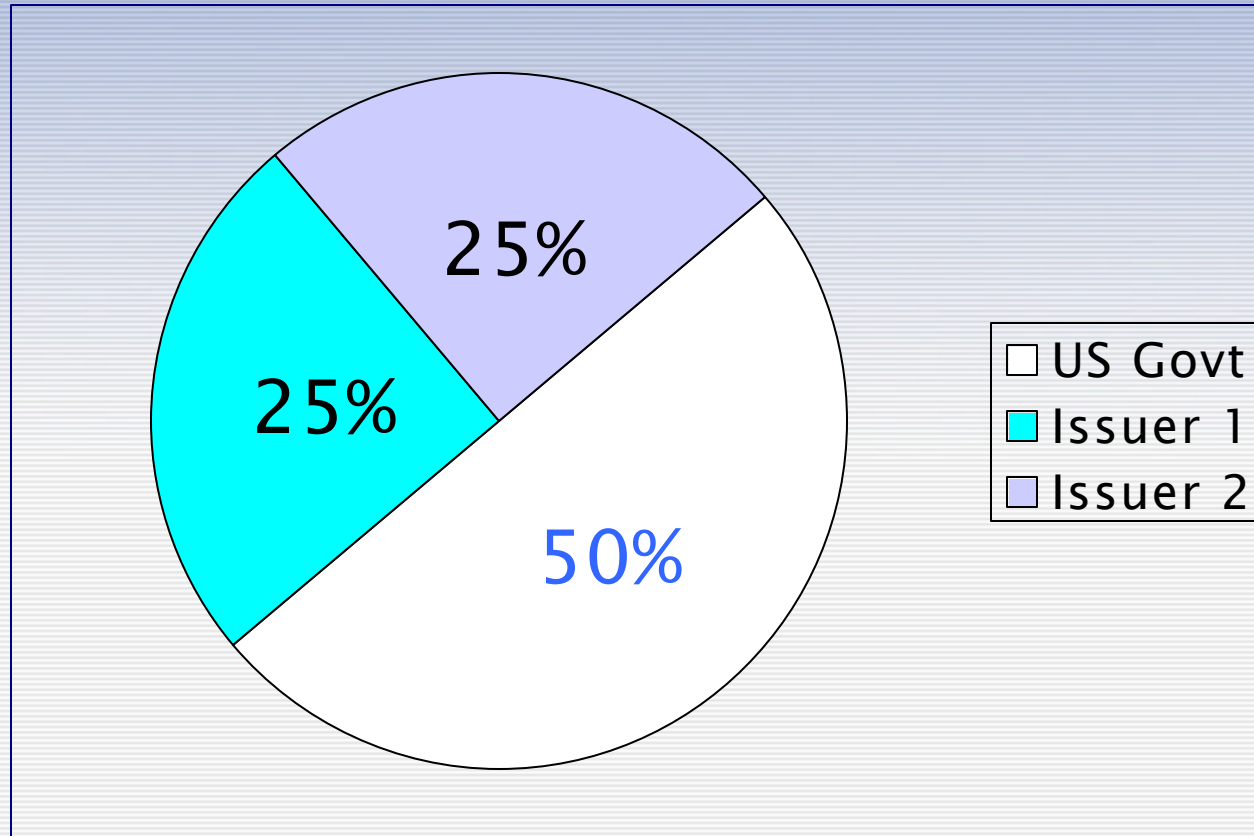
SEC vs. Tax Diversification

- Repurchase agreements
 - SEC: the issuer of the underlying security (e.g. U.S. government) of a fully collateralized repo is the issuer of the repo
 - Tax: the repo counterparty is the issuer of a fully collateralized or other repo

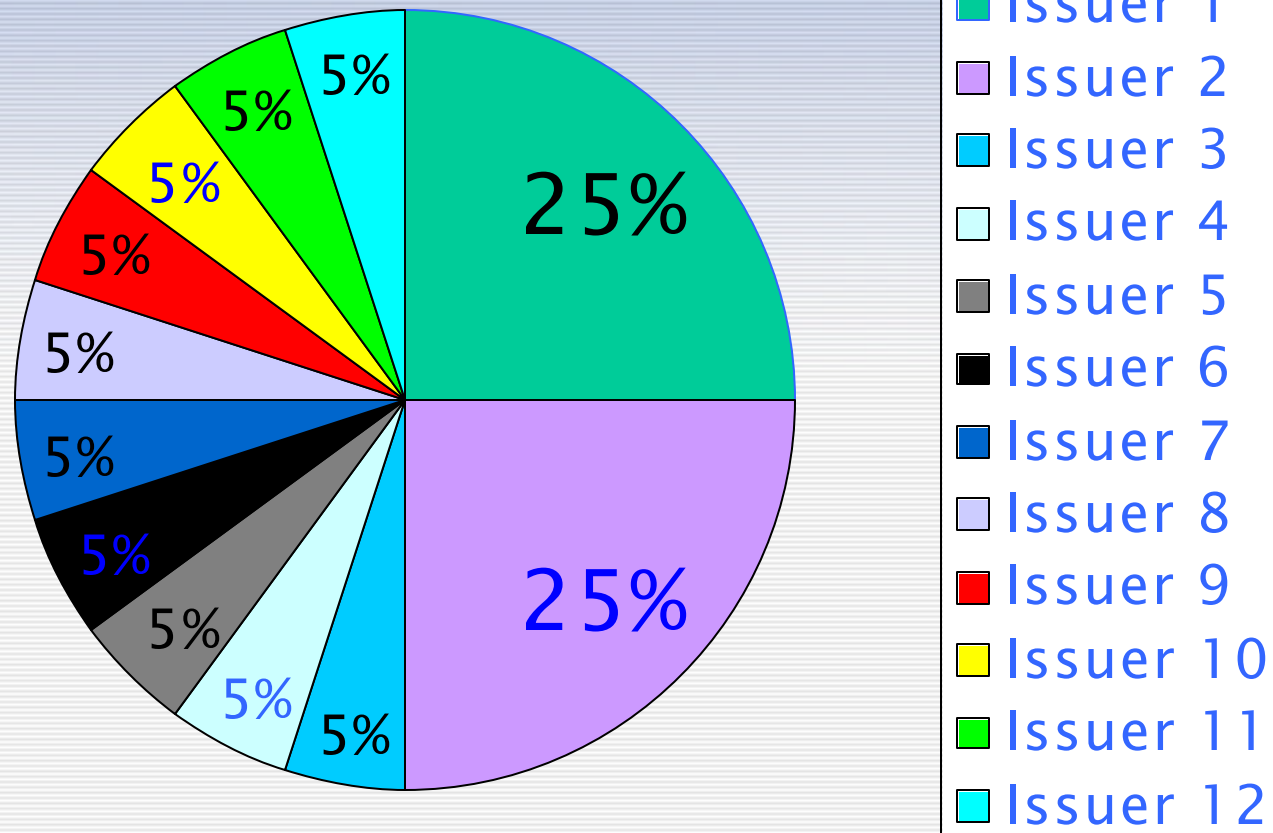
Tax Diversification: Subchapter M

- 50% basket: not more than 5% of assets in any one issuer
- Two 25% baskets: as few as 2 issuers
- Tax diversification does not apply to
 - U.S. government securities
 - Registered investment companies

Example 1 of Tax Diversification



Example 2 of Tax Diversification



Industry Concentration

- A fund must have a fundamental policy requiring it *either*:
 - To always invest less than 25% of assets in any one industry *or*
 - To always invest at least 25% of assets (concentrate) in a specified industry or group of industries
- A fund can use any reasonable industry classification system if it is consistently applied

Industry Concentration

- A fund cannot reserve discretion about whether or not to concentrate
 - A fund can use an objective mechanical formula to determine whether or not to concentrate
 - Money market funds can reserve discretion to concentrate (or not) in U.S. banks and U.S. branches of foreign banks

Industry Concentration Exemptions

- U.S. government (but not foreign government) securities are exempt from industry concentration limits
- Municipal debt securities (except private activity bonds) may be exempt
 - Fund policies vary widely
 - Check each fund's specific policy

Securities-Related Issuers

- Securities-related issuers are:
 - Broker-dealers, investment banks and U.S. registered investment adviser
 - Any entity that, directly or through subsidiaries, derives more than 15% of its gross revenues from these businesses
- Conglomerates and foreign banks are often securities-related issuers

Securities-Related Issuers

- Limits on investments in securities-related issuers. A fund may not:
 - Acquire more than 5% of any class of the issuer's equity securities (including warrants, convertibles and purchased options on issuer's stock)
 - Acquire more than 10% of the issuer's outstanding debt securities (including written options on issuer's stock and all OTC derivatives)

Securities-Related Issuers

- Limits on investments in securities-related issuers. A fund may not:
 - Invest more than 5% of assets in the issuer's securities
 - Acquire a general partnership interest in a securities-related issuer
 - Purchase securities of any securities-related issuer affiliated with the fund's adviser, its distributor or their affiliates

Other Investment Companies

- A fund may not:
 - Acquire more than 3% of the voting securities of any one fund
 - Invest more than 5% of assets in any one fund
 - Invest more than 10% of assets in all funds; includes SPDRs, WEBs, DIAMONDS and other ETFs
 - Invest in affiliated funds (without an SEC exemption)

Insurance Companies

- If a fund does not own at least 25% of an insurance company's voting securities, it may not acquire more than 10% of these securities

Illiquid Investments

- A mutual fund may not invest more than 15% of *net* assets in illiquid securities
 - A 10% limit applies to money market funds
 - A security is illiquid if it cannot be disposed of in 7 days at approximately the price the fund is valuing it at

Illiquid Investments

- Examples of illiquid securities
 - Securities subject to contractual or legal restrictions on transfer, including those sold in reliance on a private offering exemption
 - But not rule 144A securities or section 4(2) commercial paper that the adviser determines to be liquid
 - Repos with a term exceeding 7 days that do not have a demand feature

Illiquid Investments

- If changes in the market value of a fund's illiquid investments or net assets cause illiquid investments to exceed the 15% limit, the fund must sell enough illiquid investments to comply with limit
- A fund need not sell immediately at distress prices but may dispose of these investments in an orderly way

Leverage and Senior Securities

- A mutual fund may borrow only
 - From banks or through reverse repos and
 - Up to 1/3 of total assets
- If changes in market value make a fund exceed this limit, it must reduce borrowings to below the limit within 3 business days

Leverage and Senior Securities

- A fund must have a fundamental restriction about borrowing
- Many restrictions allow borrowing only for temporary or emergency purposes and prohibit leverage
- Many funds have nonfundamental policies prohibiting purchases of additional securities while borrowings exceed 5% of assets

Leverage and Senior Securities

- CAUTION: Overdrafts with a fund's custodian are considered borrowing
- A fund may not buy securities on margin
- A fund may have a restriction either prohibiting or limiting the amount or purpose of short sales

Leverage and Senior Securities

- Restrictions on lending. A fund may not:
 - Lend money or securities with a value exceeding 1/3 of assets
 - Lend to the fund's adviser, its distributor or any of their affiliates
 - Lend to affiliated funds without an SEC exemption
- Investments in debt securities and repos are not considered lending

Leverage and Senior Securities

- Derivative contracts are prohibited senior securities unless they are:
 - Short positions used for hedging purposes or covered by owning the underlying securities or offsetting long derivative positions
 - Long positions covered by a segregated account containing cash or liquid securities and marked to market daily

Leverage and Senior Securities

- Derivatives are not subject to a fund's borrowing and lending restrictions
- Derivative securities with imbedded leverage (e.g. inverse floaters) are not senior securities, but may be restricted by a fund's investment policies

Special Restrictions on Futures

- A fund cannot trade futures and options on futures until it has filed a rule 4.5 notice of eligibility with the CFTC
- Initial margin on non-hedging positions in futures and written options, and premiums paid for non-hedging purchased options, may not exceed 5% of a fund's *net* assets

Commodities and Real Estate

- Funds must have fundamental policies about transactions in commodities and real estate
 - Before trading futures, make sure the commodities policy has an exception for financial futures
 - Real estate restrictions usually apply only to direct ownership, not to securities backed by real estate

Prohibited Transactions with Affiliates

- Buying or selling securities or other property in principal transactions with affiliates
- Buying securities of a 5% owned portfolio company directly from the company
- Joint transactions with affiliates

Trades Between Funds or with Advisory Clients

- Rule 17a-7 conditions
 - Board approved procedures in place
 - Cash consideration only
 - No commission (but customary transfer fee allowed)
 - Only securities with readily available market quotes

Trades Between Funds or with Advisory Clients

- Rule 17a-7 conditions
 - The trade must be executed at the independent current market price
 - Detailed rules for type of security (e.g. closing price for exchange-traded securities)
 - Otherwise, average of highest bid and lowest ask quotations from three independent dealers

Trades Between Funds or with Advisory Clients

- Rule 17a-7 conditions

- No disqualifying affiliation between fund and other party
 - No affiliation except common board, officers or adviser (or related advisers)
 - No common 5% shareholders
 - No 5% proprietary ownership by adviser or its affiliates

Trades Between Funds or with Advisory Clients

- Rule 17a-7 conditions
 - Best interest of each party (no parking)
 - Consistent with each party's objectives and policies
 - Quarterly review and ratification by each fund's board

Using Affiliated Brokers

- Section 17(e)(2) limitations on payments to affiliated brokers
 - 2% limit for sales of securities in a secondary distribution
 - 1% limit for other transactions not on a securities exchange
 - Not more than usual and customary broker's commission for transactions on an exchange

Using Affiliated Brokers

- Rule 17e-1

- Is a safe harbor for establishing that brokerage commissions are usual and customary
- Requires commissions to affiliated brokers to be comparable to commissions paid on similar transactions through unaffiliated brokers

Using Affiliated Brokers

- Rule 17e-1 conditions--a fund's board must:
 - Adopt written rule 17e-1 procedures
 - Make and approve changes to these procedures when necessary
 - Determine at least quarterly that all applicable transactions through affiliated brokers complied with these procedures

Using Affiliated Brokers

- Rule 17e-1 conditions--a fund's adviser must monitor and report to the board the following:
 - Commissions charged by unaffiliated brokers on comparable transactions
 - Size and difficulty of executing order
 - Price and quality of execution obtained on the trade compared to those of unaffiliated brokers

Using Affiliated Brokers

- Rule 17e-1 conditions--a fund's adviser must monitor and report to the board the following information about the affiliated broker:
 - Access to particular trading markets
 - Ability to execute trades promptly
 - Attention to and treatment of trades regardless of size
 - Financial integrity

Using Affiliated Brokers

- Rule 17e-1 conditions--a fund's adviser must monitor and report to the board the following information about the affiliated broker:
 - Experience and reputation
 - Capitalization
 - Communications and back office systems
 - Discounts to most favored clients

Using Affiliated Brokers

- Caution: Don't assume that Rule 17e-1 procedures authorize agency cross transactions
 - Many rule 17e-1 procedures cover only open market transactions, which excludes agency crosses
 - Get express board permission for agency cross transactions

Buying from Certain Underwriting Syndicates

- Section 10(f) prohibits a fund from buying securities from members of an underwriting syndicate that includes an affiliate of the fund
 - Sometimes affiliates join syndicates at the last minute without the adviser's knowledge
 - Rule 10f-3 provides an exemption if all conditions are met

Buying from Certain Underwriting Syndicates

- Rule 10f-3 covers only the following types of securities:
 - Securities issued by a U.S. issuer
 - Securities offered in a public offering conducted under the laws of another country that meets certain regulatory, fixed price and financial statement conditions

Buying from Certain Underwriting Syndicates

- Rule 10f-3 covers only the following types of securities:
 - Municipal securities that have an investment grade rating or, if the issuer has existed less than 3 years, a rating of A or better
 - Rule 144A securities sold and believed eligible for resale to one or more qualified institutional buyer(s)

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions
 - The fund buys the securities
 - At not more than the public offering price
 - Not later than the day after they are first offered to the public and
 - From a syndicate member that is not affiliated with the fund or its adviser

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions
 - The underwriting is a firm commitment underwriting
 - The underwriters' compensation is comparable to that received in similar underwritings
 - For non-municipal securities, the issuer and predecessors have at least 3 years of operating history

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions--the fund and other funds managed by the same adviser buy not more than:
 - 25% of the sum of the principal amount of a rule 144A offering sold to QIBs plus the principal amount of any concurrent public offering
 - 25% of the principal amount of any non-rule 144A offering

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions
 - If a fund purchases from a syndicate manager:
 - No affiliate benefits from the purchase
 - No purchases of municipal securities are designated as group sales or otherwise allocated to the affiliate's account

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions--the fund's board:
 - Adopts written rule 10f-3 procedures
 - Makes and approves changes to these procedures when necessary
 - Determines at least quarterly that all applicable transactions complied with these procedures

Buying from Certain Underwriting Syndicates

- Rule 10f-3 conditions
 - The fund reports all rule 10f-3 transactions on its next Form N-SAR
 - The fund complies with the rule's record keeping requirements

Hazards to Watch Out For

- Lingered, outdated restrictions that were once imposed by state regulators on investments in:
 - Warrants and options
 - Other investment companies
 - Companies with an operating history of less than 3 years
 - Companies with stock held by fund trustees and officers

Hazards to Watch Out For

- Restrictions that are buried in the lengthy investment disclosure found in many fund SAs. Examples include restrictions on:
 - Forward currency contracts
 - Options and futures contracts
 - Supposedly illiquid swaps and OTC options
 - Credit quality of debt securities

Hazards to Watch Out For

- Percentage restrictions that apply to net assets, not total assets
- Ambiguous or irrational restrictions
- Promises to fund boards to comply with internal policies that
 - Don't appear in the prospectus or SAI and/or
 - Weren't communicated to the compliance department

Hazards to Watch Out For

- Investments that aren't expressly prohibited, but that violate shareholders' reasonable expectations about the amount of risk the fund is taking
 - For example, highly leveraged mortgage derivatives in short term U.S. government funds sold as safe CD alternatives

Other Special Compliance Duties of Mutual Fund Advisers

Valuation Responsibilities

- Mutual fund portfolio securities are usually priced by a custodian or pricing agent
- However, fund advisers are often responsible for
 - Pricing illiquid securities
 - Correcting or overriding prices that are blatantly wrong

Valuation Responsibilities

- Fund valuation failures can cause catastrophic liability to advisers
 - Purchasing or redeeming fund shares at the wrong price violates rules 2a-4 and 22c-1 under the Investment Company Act of 1940
 - Advisers who negligently provide bad prices may have to reimburse funds

Personal Trading Restrictions

- Advisers Act record keeping rule requires investment and other advisory persons to report personal securities transactions at least quarterly
- Rule 17j-1 under the Investment Company Act imposes additional requirements and restrictions

Rule 17j-1 Requirements

- Adviser must adopt, and fund board must approve, code of ethics
- Adviser must have procedures to review reports
- Adviser must have, and certify to board that it has, reasonable procedures to prevent violations
- Adviser must report code violations to board

Rule 17j-1 Requirements

- Fund access persons must report securities holdings when first hired and at least annually afterwards
- Fund investment personnel must preclear investments in IPOs and private placements
- Many codes impose on fund access persons additional preclearance requirements, blackout periods and restrictions on short term trading

Foreign Custody Duties

- A fund's board, adviser or custodian must evaluate whether a fund should even invest in a particular country
- Fund advisers usually make this evaluation based on many factors
- Fund custodians usually supply custody and depository information relevant to this evaluation

Best Execution

- There may be higher SEC and board scrutiny of execution quality and commission rates for funds than for other advisory clients
- Practices that may increase scrutiny:
 - Allocating brokerage to firms that sell fund shares
 - Using high volume fund brokerage to generate soft dollar credits

Best Execution

- Advisers usually provide detailed reports to fund boards about:
 - Allocation of transactions among brokers (top ten or complete lists)
 - Brokerage commissions paid by funds
 - Use of brokerage to pay fund expenses
 - Use of brokerage to generate soft dollar credits

Additional Mutual Fund Records

- Quarterly records showing basis for allocating brokerage transactions and compensation reflecting consideration given to:
 - Sales of fund shares by brokers
 - Research or other soft dollar benefits to fund, adviser or affiliates
 - Factors other than execution capability of the brokers

Additional Mutual Fund Records

- Quarterly brokerage allocation records should also show:
 - Nature of soft dollar benefits received
 - Application of any formula for allocating brokerage transactions and compensation
 - Names of persons responsible for determining allocations

Additional Mutual Fund Records

- Records of each brokerage order or other securities transaction containing:
 - Name of broker
 - Terms and conditions, and any change or cancellation
 - Time of entry or cancellation
 - Execution price and time
 - Name of person placing the order

Additional Mutual Fund Records

- Records of each contractual commitment to purchase or sell securities or other property, including options, containing:
 - Identification of security
 - Number of units
 - Option price
 - Issuance and maturity dates
 - Person to whom issued

Additional Mutual Fund Records

- Memorandum identifying the persons or members of committees authorizing portfolio securities transactions must be created and retained
- Any memorandum, recommendation or instruction supporting or authorizing a transaction must be retained

Longer Record Retention Period

- Keep all records pertaining to funds managed by the adviser:
 - In an easily accessible place, for at least 6 years after the end of the fiscal year in which the transaction covered by the record occurred
 - In the adviser's office for at least the first 2 years

Reporting to Fund Boards

- A fund adviser has to provide more detailed information to fund boards than to most other types of clients
 - About investment strategies and performance
 - About all of the above compliance issues
 - About compliance violations

Reporting to Fund Boards

- Fund boards have to approve the continuation of fund advisory contracts at least annually
- A fund adviser has to provide all information requested by fund boards, including data about:
 - The adviser's finances and profitability
 - The adviser's personnel, services and capabilities

Reporting to Fund Boards

- Never lie to or mislead a fund's board
- Don't try to conceal material compliance violations or performance problems from a fund's board
- Expect to pay for compliance mistakes that cause losses to a fund

Things to Remember

- A fund's board, not its adviser, is ultimately in charge of the fund
- The SEC rigorously inspects advisers to mutual funds, especially when they are new to the fund management business
- Managing funds often requires a more intense commitment to compliance than managing other types of accounts