

## Comprehensive Regulatory Regime for U.S. Mutual Funds

Regulated U.S. funds are subject to comprehensive requirements under the Investment Company Act of 1940, other federal securities laws, and related Securities and Exchange Commission (SEC) regulations. These protections, both individually and collectively, serve to protect the interests of fund investors and to mitigate risk to the broader financial system.

This discussion focuses on the regulation of mutual funds, which are the predominant form of regulated fund in the United States. Daily redeemability of fund shares at net asset value is a defining feature of mutual funds and one around which many of the requirements applicable to them are built. The regulatory framework is slightly different—but no less stringent—for closed-end funds, which do not promise daily redeemability but rather list their shares for trading on a national securities exchange; for UITs, which are redeemable but are required by law to have a largely fixed portfolio that is not actively managed or traded; and for exchange-traded funds (ETFs), which are organized as mutual funds or UITs, but with shares that trade intraday on stock exchanges like closed-end funds.

For a more thorough discussion of the comprehensive regulatory framework applicable to regulated U.S. funds and their managers, see Appendix A to ICI's *2014 Investment Company Fact Book*, available at [www.icifactbook.org](http://www.icifactbook.org).

### *Daily Valuation of Fund Assets*

U.S. mutual funds must value all their portfolio holdings on a daily basis, based on market values if readily available. If there is no current market quotation for a security or the market quotation is unreliable, the fund's board of directors or trustees (a substantial majority of whom typically are independent of the fund's manager)<sup>1</sup> has a statutory duty to "fair value" the security in good faith.<sup>2</sup> The mutual fund uses the values for each portfolio holding to calculate the net asset value (NAV) of its shares each business day, using pricing methodologies established by the fund board. The daily NAV is the price used for all transactions in fund shares. As the SEC has observed, these pricing requirements are critical to ensuring that mutual fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted.<sup>3</sup> They also promote market confidence, because they allow investors, counterparties, and others to understand easily the actual valuations of fund portfolios.

Given the importance of the pricing process, mutual funds have extensive policies and procedures designed to ensure that fund portfolio securities are properly valued and that the fund's NAV accurately reflects the fund's net asset value per share. Valuation policies generally serve to: define the roles of various parties involved in the valuation process; describe how the fund will monitor for situations that may necessitate fair valuation of one or more securities; describe board-approved

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<sup>1</sup> For further discussion of the fund board's role and responsibilities, see *Independent Board Oversight* below.

<sup>2</sup> *Fair value* refers to the amount the fund might reasonably expect to receive for the security upon its current sale. See Accounting Series Release No. 118, SEC Release No. IC-6295, 35 Fed. Reg. 19986 (Dec. 23, 1970).

<sup>3</sup> See, e.g., Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003) (adopting Rule 38a-1 under the Investment Company Act).

valuation methodologies for particular types of securities; and describe how the fund will review and test fair valuations to evaluate whether the valuation procedures are working as intended. These policies are a critical component of a mutual fund's governance process and compliance program, and accordingly are a significant area of focus for the SEC during inspections and examinations.<sup>4</sup> Valuation is also a critical component of the audit process.<sup>5</sup>

### *Liquidity to Support Redemptions*

At least 85 percent of a mutual fund's portfolio must be invested in "liquid securities," which are defined as any assets that can be disposed of within seven days at a price approximating market value.<sup>6</sup> On an ongoing basis, mutual funds monitor the overall level of liquidity in their portfolios as well as the liquidity of particular securities, as circumstances warrant. Many mutual funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC guidelines. Although an unexpected market event potentially could cause certain previously liquid securities to become illiquid, the SEC has determined that the 85 percent standard should ensure a mutual fund's ability to meet redemptions.<sup>7</sup>

### *Leverage*

The Investment Company Act and related guidance from the SEC and its staff strictly limit mutual funds' ability to take on leverage. These limitations stem from Section 18(f) of the Investment Company Act, which prohibits a mutual fund from issuing a class of senior security or selling any senior security of which it is the issuer, but permits borrowing from a bank, provided that there is asset coverage of at least 300 percent for all such borrowings. As a result, the maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1.

### *Transactions with Affiliates*

The Investment Company Act contains a number of strong and detailed prohibitions on transactions between a mutual fund and affiliated organizations such as the fund's manager, a corporate

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<sup>4</sup> For more detail, *see generally* ICI, Independent Directors Council, and ICI Mutual Insurance Company, *An Introduction to Fair Valuation*, (Spring 2005), available at [http://www.ici.org/pdf/05\\_fair\\_valuation\\_intro.pdf](http://www.ici.org/pdf/05_fair_valuation_intro.pdf).

<sup>5</sup> A mutual fund's financial statements must be audited annually by an independent public accountant registered with the U.S. Public Company Accounting Oversight Board (PCAOB). Among other things, the independent accountant examines the fund's valuation policies and procedures to confirm that the prices used to value the fund's security holdings are consistent with generally accepted accounting principles. As required by SEC rules, the independent accountant must verify 100 percent of the security valuations applied to the fund's portfolio at the balance sheet date; the accountant also would typically review valuations for selected dates throughout the year. We note that the auditing of security values and fair value measurements is a significant area of focus in PCAOB inspections of public accounting firms.

<sup>6</sup> *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992); SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (Jan. 2014), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf> (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

<sup>7</sup> SEC Release No. IC-18612, *supra* note 6 (stating that the 85 percent standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies").

parent of the fund's manager, or an entity under common control with the fund's manager. Among other things, Section 17 of the Investment Company Act prohibits transactions between a fund and an affiliate acting for its own account, such as the buying or selling of securities (other than those issued by the fund) or other property, or the lending of money or property. It also prohibits joint transactions involving a mutual fund and an affiliate. In some cases, transactions involving an affiliate are permitted in accordance with SEC rules and exemptive orders, which impose conditions designed to protect investors and require the fund's board of directors, including the independent directors, to adopt and review procedures designed to ensure compliance with those conditions. The detailed and restrictive provisions of the Investment Company Act governing dealings with affiliates are no less stringent than those contained in Sections 23A and B of the U.S. Federal Reserve Act. These Investment Company Act provisions also prevent most types of sponsor support, absent prior approval by the SEC on a case-by-case basis.

### *Custody of Assets*

The Investment Company Act requires mutual funds to maintain strict custody of fund assets, separate from the assets of the fund manager. This requirement is intended to safeguard fund assets from theft or misappropriation. Nearly all mutual funds use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients.<sup>8</sup> Notably, under the Investment Company Act regulatory structure, collateral posted by a mutual fund must be placed with an eligible custodian and maintained as required under the Investment Company Act. The benefits of this approach were highlighted following the collapse of Lehman Brothers, as mutual funds with such custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than market participants with different custody arrangements.

### *Diversification Requirements*

All U.S. mutual funds are required by federal tax laws to be, among other things, diversified.<sup>9</sup> Generally speaking, with respect to half of the fund's assets, no more than 5 percent may be invested in the securities of any one issuer; with respect to the other half, the limit is 25 percent. In other words, the minimum diversification a fund could have is 25 percent of its assets in each of two issuers, and 5 percent of its assets in each of 10 additional issuers. If a fund elects to be diversified for purposes of the Investment Company Act (and most do), the requirements are more stringent—with respect to 75 percent of its portfolio, no more than 5 percent may be invested in any one issuer.

### *Transparency*

Under the federal securities laws and applicable SEC regulations, mutual funds are subject to the most extensive disclosure requirements of any financial product. Funds provide a vast array of

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<sup>8</sup> The Investment Company Act and rules thereunder permit other limited custodial arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository.

<sup>9</sup> See Subchapter M of the Internal Revenue Code.

information about their operations, financial conditions, contractual relationships with their managers, and other matters to regulators, the investing public, media, and vendors such as Morningstar. The marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks' balance sheets contributed to the spread and severity of the 2008 financial crisis.<sup>10</sup>

More specifically, mutual funds are required to maintain a current prospectus, updated at least annually, which provides investors with information about the fund and its operations, investment objectives, investment strategies, risks, fees and expenses, and performance, among other things. The prospectus also must describe all principal investment strategies and risks of a fund. The prospectus must be provided to investors in connection with a purchase of fund shares.<sup>11</sup>

Mutual fund investors receive annual reports containing audited financial statements within 60 days after the end of the fund's fiscal year, and semiannual reports containing unaudited financials within 60 days after the fiscal year midpoint. These reports must contain updated financial statements, a comprehensive list of the fund's portfolio securities including derivatives contracts, management's discussion of financial performance, and other specified information. Following their first and third quarters, funds file an additional form with the SEC, Form N-Q, disclosing their complete portfolio holdings. The SEC makes Form N-Q publicly available upon receiving it. These quarterly portfolio holdings disclosures include any assets earmarked against derivatives transactions, as well as any assets posted as collateral.<sup>12</sup> They also list open derivatives positions, including terms of the contracts, their notional value, and fair value. The SEC staff takes the view that for over-the-counter derivatives such as swaps, "terms" of the contracts include the identity of the counterparty.<sup>13</sup> This high degree of transparency allows investors and other market participants a clear understanding of a fund's investment strategy, holdings, and financial condition.

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<sup>10</sup> *The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (Aug. 2009).

<sup>11</sup> Additional information must be made available to investors upon request in a statement of additional information, commonly referred to as the SAI.

<sup>12</sup> Funds typically do not post substantial portions of their portfolios as collateral.

<sup>13</sup> See Letter from Barry Miller, Associate Director, Office of Legal and Disclosure, Division of Investment Management, SEC to Karrie McMillan, General Counsel, ICI (July 30, 2010).

### *Independent Board Oversight*

Mutual funds are required by statute to have a board of directors (or trustees), which generally must have at least a majority of members who are independent of the fund's investment manager.<sup>14</sup> Fund directors are subject to duties of care and loyalty under state law, and the U.S. Supreme Court has said that the independent directors serve as “watchdogs” for the interests of fund investors.<sup>15</sup> In broad terms, the fund board oversees the management, operations, and investment performance of the fund. Directors also have significant and specific responsibilities under the federal securities laws, including signing the fund's registration statement (and assuming strict liability for any material misstatements or omissions therein), approving the contract with the fund's investment manager and overseeing the manager's provision of services under that contract, and overseeing potential conflicts of interest as well as the fund's compliance program.<sup>16</sup>

### *Mandatory Compliance Programs*

While compliance has always been a cornerstone for mutual funds, the adoption of the fund compliance program rule (Rule 38a-1 under the Investment Company Act) in late 2003 introduced formalized practices and new requirements for funds and their boards, and presented fund boards with new tools for overseeing compliance. Under the rule, mutual funds must adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. These policies and procedures must provide for the oversight of compliance by the fund's key service providers—its investment manager(s), principal underwriter(s), administrator(s), and transfer agent(s). At least annually, funds must review the adequacy, and the effectiveness of the implementation, of their own policies and procedures and of the policies and procedures of fund service providers.

Rule 38a-1 also requires mutual funds to designate a chief compliance officer (fund CCO) who is responsible for administering the fund's compliance policies and procedures.<sup>17</sup> The rule contains provisions designed to promote the independence of the fund CCO from the fund's investment manager. Specifically, the fund board, including a majority of the independent directors, must approve the appointment and compensation (and, if necessary, the removal) of the fund CCO. At least annually, the fund CCO must provide a written report to the fund board that addresses, among other things, the operation of the fund's (and its service providers') policies and procedures and each material compliance matter that occurred since the date of the last report. Although the rule requires

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<sup>14</sup> In fact, the number of independent directors on a fund board is typically far higher than required by law. As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes. See Independent Directors Council and Investment Company Institute, *Overview of Fund Governance Practices, 1994–2012*, available at [http://www.idc.org/pdf/pub\\_13\\_fund\\_governance.pdf](http://www.idc.org/pdf/pub_13_fund_governance.pdf).

<sup>15</sup> *Burks v. Lasker*, 441 U.S. 471 (1979).

<sup>16</sup> For a more complete discussion of the oversight role of fund boards, see *Frequently Asked Questions About Mutual Fund Directors*, available at [http://www.idc.org/pubs/faqs/faq\\_fund\\_gov\\_idc](http://www.idc.org/pubs/faqs/faq_fund_gov_idc); *Fundamentals for Newer Directors*, available at <http://fundamentals.idc.org/>; and American Bar Association Section of Business Law, *Fund Director's Guidebook* (3rd ed. 2006), available at <http://apps.americanbar.org/abastore/index.cfm?pid=5070526&section=main&fm=Product.AddToCart>.

<sup>17</sup> Rule 206(4)-7 under the Investment Advisers Act of 1940 imposes similar requirements on all federally registered investment managers (including managers of mutual funds).

compliance reviews and reports to be undertaken at least annually, such reviews and reports may occur on a more frequent basis, or on an ongoing basis throughout the year.

### *SEC Oversight*

The SEC is tasked with monitoring and enforcing mutual funds' compliance with the Investment Company Act as well as all other applicable federal securities laws and regulations. The SEC staff promotes compliance with the federal securities laws through outreach, publications, and inspections of mutual funds and their managers conducted by SEC examiners, accountants, and lawyers. These inspections include a detailed review of the funds' advertisements, books and records, capital structure, fee structure, investment management contracts, corporate governance, best execution, and sales practices. In addition, as part of its robust disclosure review, the SEC reviews all mutual fund registration statements. This disclosure document includes, among other things, the funds' investment objectives and goals, capital structure, risk disclosures, fee table, financial highlights information, and financial intermediary compensation.