MUTUAL FUNDS – FRANKEL SPRING 2011

INVESTMENT COMPANY ACT

1. WHAT IS AN INVESTMENT COMPANY?
    a. Broad definition with exclusions
    b. §3(a)(1)(A): Any issuer which is or holds itself to be engaged primarily, or proposes to engage primarily in the business of investing, reinvesting, or trading securities
        i. §2(a)(22): "Issuer" means every person who issues or proposes to issue any security, or as outstanding any security which it has issued
            1. §2(a)(28): "Person" means a natural person or a company
            2. §2(a)(8): "Company" means corporation, p-ship, . . . , trust, or any organized group of persons whether incorporated or not . . .
                a. ***Prudential Insurance Company v. SEC****:* "Organized group of persons", within Investment Company Act, does not refer only to recognizable business entities
                    i. Instrument offered by insurance company, which are exempted from regulation under ICA
                    ii. But court looked to nature of instrument – the Investment Fund, and not the insurance company itself was the "issuer"
                    iii. Issue arose whether separate account that the insurance company has for its variable annuity funds was an "investment company" to be regulated by the Act
                    iv. Insurance company argues that they've been doing this for years . . . just an account
                    v. Find that the definition of a company includes the word "fund"
                        1. "Fund" is nothing but a bundle of money – no organization, no formal entity, nothing . . . JUST AN ACCOUNT
                        2. SCOTUS found that this lack of formality does not matter
            3. BACKGROUND
                a. Variable Annuity
                    i. Pay-In Period: Either pay a lump sum to an insurance company, or pay as you go
                        1. I accumulate $100,000, and retire
                        2. No insurance component in the pay-in period
                    ii. Pay-Out Period:
                        1. The insurance company guarantees payment to death
                            a. Take risk that you will outlive the initial investment + interest
                            b. But spread the risk because they get to keep the money from those who die before the initial investment is exhausted
                            c. Sometimes no insurance component because the K can specify that the rest of the $ is payable to heirs
                        2. Special Accounts
                            a. Supposed BU has thousands of employees and wants to establish an annuity for them
                            b. Most of them are not physical workers
                            c. Can calculate the % that will die at certain time, according to this specific community
                    iii. Can invest the $ in stock, rather than in bonds, etc.
                        1. However, regulators would not allow insurance company to guarantee performance of stock
                        2. Risk must go to investors

            3. Prohibited annuity that would invest in stock but still promise a fixed return
    b. John Hancock asked for instrument – invest in stock and annuitants with receive more when stock goes up and less when stock goes down, but promise payments for life regardless
        i. Insurance component remained
        ii. But the amounts fluctuated with the market
    c. SEC said that this was creating a mutual fund
    d. SCOTUS decided that these were securities and not insurance
        i. Issues like this come up with hybrid instruments
        ii. Can't separate banking, investment, and insurance like we could in the past
    e. Question of whether these were securities
        i. SCOTUS said that what we will look at is who bears the investment risk
        ii. If the investor bears the risk, it's security
        iii. If the investor does not, then it's insurance
            1. The fact that there is another component of insurance is not enough
            2. That's because the losses will not be covered by insurance
            3. Insurance designed to cover risks that have some limits – i.e., people must die
    f. After that, insurance companies tried to guarantee some investment risk, but always below what the insurance commissioners were permitting
        i. Number of cases in which they kind of guaranteed but not really enough
            1. Went to SCOTUS again, and Court said that you must take an *investment* risk, and if you don't do that, and there is an investment risk, then it's a security
4. <u>Investment Advisor vs. Investment Company</u>
    a. Once an advisor's services become less and less personalized, can become an investment company (pp. 95-99)

ii. <u>§2(a)(36)</u>: "Security" (Stat. Supp. p. 7)
1. Definition covers entities by:
    a. Name – securities, bonds, debentures, etc., and
    b. Form – participation in profit sharing agreement
    c. Intention of buyer
    d. View of public
    e. *Howey Case: people in Florida that creates orange groves, and one of the businesses that drew people from other parts of the country . . . didn't want to issue securities; created rows with 18 orange trees in each; sold the trees and a K for maintenance of oranges, including boxing them and sending them to buyers; buyers got the right to 18 trees, but made profits*
        i. *Not just purchasing land or property, but rather pooling investment*
        ii. HOWEY TEST
            1. Investment of money
            2. Into a common enterprise
            3. In which profits come from the efforts of others
2. If you look at a mutual fund, you have a fund, but it issues securities and it invests in securities
    a. That is the basic definition of an investment company
3. ***Bank of America Canada (pp. 105-106)***: Doesn't fall under exemption for banks b/c under ICA bank is defined by being regulated by US authorities
    a. Tries to argue that notes aren't securities
    b. SEC makes distinction

i. If you hold notes for investment, the notes are securities. That is not necessarily the same as the definition for the 1933 or 1934 Acts

c. Why should an exemption under the other acts not apply to investment companies?
   i. Dealing with an institutional intermediary and not with the market
   ii. If you look at regulation of banks, find a lot of substantive regulation that doesn't exist in the markets

iii. ***Fifth Avenue Coach Lines***: Started out as operating company; shut down by NYC; city paid them back; received $11.5 million after four years; invested the $ while they were trying to figure out how to restart their business
   1. Court agrees that doesn't become investment company right away b/c they are entitled a reasonable time to decide what to do with the $
   2. But after a certain point w/o restarting operating activities becomes an investment company
   3. § 3(a)(1)(A): is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading securities
   4. "holds itself out": advertises its services to the public
      a. *Fifth Avenue: intends to make proper and advantageous investments for the benefit of the company*
   5. "primarily":
      a. Primary sources of revenue? Composition of assets?
      b. How many employees engage in managing investments?
      c. Types of employees
         i. *Fifth Avenue: started with employees that specialized in the bus service – drivers, etc.; all had to be let go because there's no role for them; then switched to lawyers, investors, broker-dealers, etc. as employee that have a different type of role*
   6. "investing, reinvesting or trading"
      a. Suppose we just invested . . . is that enough?
         i. *What if Fifth Avenue invested in another transportation company?*
            1. *If you're investing to get a controlling share, then not an investment company → rather a holding company*
         ii. *In Fifth Avenue, in actuality invested in a number of companies, and they managed in eight months to lose most of them*
      b. Suppose you hold a lot of non-controlling stock and they invest and reinvest, meaning that they either get more money from outside, or from the company, but they don't trade
         i. Question of interpretation
            1. If it's not trading, may find that the company still falls into the definition → (c)
         ii. Trading doesn't seem as important
      c. Does it matter that the management did not intend to be an investment company? Does intent matter here?
         i. Intent irrelevant
         ii. What about an operating company that all of a sudden sells everything, get a ton of money, and then start investing. Say they're looking for an operating company, but in the mean time they invested . . . what do you look at to determine whether or not they are really planning on investing?
            1. Disclosure to shareholders – in real world, it's dangerous to notify exactly how they are trying to buy
            2. To what extent do they support the companies they invest in – services, expertise, etc. or just money

c. §3(a)(1)(C): Any issuer which is engaged or proposes to be engaged in the business of investing, reinvesting, owning, holding, or trading in securities, AND owns or proposes to acquire investment securities having a value exceeding 40% of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis

    i. Incorporates companies that have no idea that they are an investment company
    ii. Don't find the language "holding itself out"
    iii. The test here is the *nature of the assets*
    iv. Here we have "owning" and "holding"
    v. Don't need to trade – if you're sitting on investment securities, but they comprise at least 40% of your assets, then you're in regardless
    vi. §3(a)(2): "investment securities" includes all securities EXCEPT
        1. Government securities
        2. Securities issued by employees' securities companies (unique)
        3. Securities issued by majority-owned subsidiaries of the owner, which
            a. Are not investment companies, and
            b. Are not relying on the exception form the definition of an investment company in paragraph (1) or (7) or subsection (c)
    vii. 1000 in assets, 900 in government securities, 100 investment securities
        1. This company will be an investment company both under (C), but also under (A)
        2. Like a money market fund → invest almost exclusively in government securities
    viii. Exclusion for cash → no definition of what cash is
        1. Operating companies keep cash
        2. What constitutes cash is not as simple as it seems
            a. Should include anything that can result in getting cash quickly and without restriction
                i. i.e., check
            b. Claim in court is not cash
            c. Claim in which the court made a decision that entitled person to money
                i. Could possibly be cash
                ii. Is it subject to appeal?
                iii. Does D have the $$ to pay?
            d. If there are too many conditions or costs to convert to cash, then it would be excluded

d. What happens to a company that is an investment company but does not register as such?
    i. § 7(a) requires a company to register, but the violation is backed by enforcement of the SEC
    ii. § 46(b) talks about contracts in violation of the law

2. EXCLUSIONS FROM DEFINITION (3(b) & 3(c)) – CHAPTER 4
    a. Exceptions are only for companies that fall under the Investment Company Act because of the 40% test, NOT because they hold themselves out to be an investment company
    b. ***Section 3(b)(1) & 3(b)(2): Fall into 3(a)(1)(C) definition BUT not an investment company nonetheless***
        i. § 3(b)(1): Any issuer primarily engaged directly or through *wholly-owned* subsidiaries, in a business or businesses other than of investing, reinvesting, owning, holding, or trading in securities
            1. i.e., a company like GM that wholly-owns its different subs for different cars
            2. Completely eliminates the burden of having to go to the SEC for an exemption, but puts the risk on the lawyer
                a. Can't hold itself out
                b. Needs to have wholly-owned subs, not majority-owned
        ii. § 3(b)(2): SEC finds by application and declares that issuer is primarily engaged in a business other than investing, reinvesting, holding, owning, or trading either directly or through a majority-owned subsidiary or controlled company conducting similar types of businesses
            1. Declaratory power to the SEC
            2. Company is not involved in investments and is either directly or through majority-owned subsidiaries
            3. Control company is even thinner →
                a. Control:

        i. <u>§ 2(a)(9)</u>: power to exercise a controlling influence over management or policies of the company
        ii. If someone owns 25%, you have to prove that they do NOT have control
        iii. If you own less than 25%, presumed not to control

iii. "Primarily engaged" judges by *Tonopah Mining* factors
    1. SEC exemptive rule (pp. 114-116)

iv. ***SEC v. National Presto Industries (Supp. pp. 11-18)***: Operating company that contracted out their work – no longer had the assets on their books for PPE, but instead had cash . . . outsourced production and just got a % → substantial operating income, but operating *assets* don't match
    1. SEC told Presto to ask for an exemption, even said they would grant the exemption, but Presto refused.
        a. This is a company that had real assets – through patents, human talent, etc.
        b. There was a similar situation with Yahoo – had to ask for an exemption.
        c. The SEC wanted Presto to get an exemption because if they made it a categorical rule that these companies were automatically not investment companies, that would become an easy way to circumvent the law
    2. In order to get out of registration, they had to invest everything in government securities and they didn't want to
    3. Goes through a variety of investments and then applies them to *Tonopah*
        i. Refunded Bond: backed by US securities as well as credit of the issuer
        ii. Municipality issues a bond and the interest rate drops
        iii. Didn't have a call right
            1. Usually issuer can call a percentage of the bonds at issuer's discretion
            2. Someone who has the bond will automatically have to sell whether they want to or not
        iv. So municipality issued new bonds at lower rate, and used the proceeds to buy Treasury bonds which are held in trust to pay the interest and principal of initial bonds
        v. Why are these not government securities?
            1. Not issued by federal government
            2. Not backed by full faith and credit of federal government
            3. Used as guarantee for another obligation
        vi. Also not cash
        vii. Therefore not excludable
        b. Variable Rate Demand Notes
            i. Riskier and pay more than cash/government securities
    4. Court found that it was not an investment company (using ***Tonopah Mining*** factors)
        a. (1) History of the company
        b. (2) How company represents itself
        c. (3) Activities of officers ad directors
        d. (4) Nature of the asset
        e. (5) Sources of income
        f. With a focus on (4) and (5)

v. <u>SEC Rule 3a-8</u>: Codifies *ICOS* order, confirming that *Tonopah Mining* factors are ill-suited to biotech companies (pp. 111-114)

vi. <u>SEC Rule 3a-2</u>: Excludes certain "transient investment companies" from regulation for up to a year (pp. 116-117)
    1. Start-ups
    2. Company selling large operating division and investing proceeds
    3. Company making a tender offer to stockholders of a non-investment company, and failing to obtain a majority of the target company's stock

4. RESTRICTIONS
    a. Must have bona fide intent to be engaged in a business activity other than investing by the end of the year
        i. Evidenced by issuer's business activities, and resolution of board of directors
    b. When year begins
    c. Issuer can only rely on this rule once in a 3-yr period

c. EXCLUDED GROUPS
    i. § 3(b) & § 3(c)(6): Holding companies that conduct, directly or through subsidiaries, either non-investment company business, or conduct businesses that are exempted from the definition of investment company (i.e., BHCs)
        1. Holding companies hold securities – question is what kind of securities?
            a. Calculate the assets of the subsidiary and the holding company separately
                i. Holding company owns 57% of the sub → that's the financial assets that we're looking at for the holding company
                ii. Subsidiary owns its own investment securities
    ii. Institutions s/t alternative regulation
        1. § 3(c)(2): Brokers
        2. (3): Banks, s&l's, insurance co.'s
            a. Exclusion for banks straightforward – have a claim to the $ you put in a bank so much safer
            b. *Trust Departments* (pp.141-42)
                i. Long ago there were lots of trust companies – they all went bankrupt.
                    1. In order to arrange trust arrangements, banks were allowed to have trust departments.
                    2. They were designed for small trusts.
                    3. Banks were allowed to pool all of their small trusts – created a number of pools with different investment purposes.
                    4. These trusts were not put under the ICA, they instead were regulated by trust law, so the ICA did not need to apply

[Banks get a cut of these pools as a management fee. Then they looked around and saw mutual funds. More people were putting money into them. Banks wanted to advertise their services. This would effectively allow them to be mutual funds.
Benefit: banks could take another layer of fees by making a fund of the pools. Banks also had all of the infrastructure in place to basically be a mutual fund so they had a better financial structure than competitors.
Investment Company Institute did not like the idea of competition and fought this. Could they take fees as trustees and as manager of mutual funds? Argument was that management fees were for personalized funds. Agreement at the end was that if you personalize the service you can charge the second fee, but if not you could only charge the trustee fee.
Banks are regulated to be financially sound. The bank regulators worry about the profitability of the banks. Safety and soundness are the key to regulation. There is no interest by the SEC to find out whether Fidelity is safe and sound. The reason for this difference is that banks must be safe in the trustee capacity otherwise their deposits will not be safe and FDIC would need to step in. The pursuit of safety conflicts with the goal of making sure that trust investors are not charged too high funds.]

            c. Insurance Companies (p. 145)
                i. Excluded, but variable annuities are not. Whenever you have excluded industry that wishes to enter mutual fund area that part becomes regulated.
        3. § (11): Pension funds (p. 148)
    iii. Investment companies sufficiently controlled by investors
        1. § 3(c)(1): "private investment companies" w/limited # of investors (pp.121-123); issuer whose outstanding securities other than short-term paper are beneficially owned by not more than 100 persons, and that is not making, or proposing to make, a public offering of its securities

a. One of the problems that arose very early on – what if you have 100 people and one dies, and leaves shares to 4 heirs?
    i. As a result, the 100 is usually limited to about 80 or 85 just in case too many people die and this happens
    ii. Pg. 122, FN B: this problem was solved because if you have one owner and the owner has either died or divorced and there are more owners, all of these owners will be considered as one
    iii. Assumption is that those people have the same type of relationship with the manager, and the same closeness, and usually the number is not so great
b. There is no publicity whatsoever
c. Hedge funds frequently rely on this
d. Rationale
    i. When you have a small group of people they can control those that control the money and they can ask questions and get involved
    ii. Can ask where people are getting information, etc. – ability to ask questions, so less worry about disclosure
    iii. Like "investment clubs" in which people get together and discuss investments
e. Becomes complicated → ability to use corporation, p-ships, any other legal form as one of the members
    i. Suppose you have this § 3(c)(1) company, the 80 members encompass huge companies
    ii. Have the image of a "club" but end with 100,000 investors
    iii. Congress considered this at the time of enactment, and had a provision to address it
    iv. (A): deemed ownership by one person, not passed through
    v. EXCEPT that if the company owns 10% or more of the outstanding voting securities of the issuer, *and is an investment company*, the beneficial ownership is deemed that of the investors of that company
        1. "outstanding voting securities" → § 2
        2. Any security presently entitling the holder to vote the election of directors of a company
        3. If you own more than half of bonds, is that a voting securities?
        4. It voting limited to the constitutional documents of the company, or is the ability to induce the choice of the directors?
        5. In the past, this definition worked . . . maybe not today
    vi. So if company that is, or would be, an investment company owns more than 10% of the shares of the 3(c)(1) company, then each owner of that company is counted separately
    vii. Allows for pension plans, insurance companies, and BHCs, among others, to be deemed one shareholder
    viii. Second change that has occurred has occurred with respect to the question of how do you count the beneficial ownership of an entity that has other beneficial owners (*** this will change in June*)
        1. At the beginning, the beneficial ownership went both ways
            a. If corporation owned 10% of 3(c)(1) company, then beneficial ownership of corporation counted towards the 100 people, AND 3(c)(1) companies couldn't be more than 10% of corporation's assets
        2. Pg. 122 FN A

f. Companies with under 100 people sometimes want to register for tax purposes
g. Companies with more than 100 people may be able to split depending on the circumstances
    i. SEC did not allow this for securities through Regulation D (section 502(a))→ integrate the distributions
    ii. Don't integrate every distribution . . . just integrate under certain conditions
        a. If it's the same financial purpose, same type of security, if they're popping up in close proximity to one another in terms of timing
        2. If the similarities are so close to make it reasonably clear that this is really just chopping off a large distribution, we're going to integrate
    iii. So if your client was trying to split like that, have to make sure that the funds are different enough
        1. Ask questions that relate to pooled assets for management
        2. Same manager? Same investment policy? Similar names?
        3. There is no Regulation D-type regulation for mutual funds (Reg D under 1933 Act)

2. <u>§3(c)(7)</u>: Companies whose investors are sophisticated; issuer, the outstanding securities of which are owned exclusively by persons who are qualified purchasers, and who is not making and at the time does not propose to make a public offering
    a. 3(c)(1) limits number, while 3(c)(7) limits the nature of investors
    b. However, both are prevented from issuing public offerings
        i. In both cases, a public offering may undermine the constraining conditions
        ii. If public offerings were allowed, then this would be impossible to enforced
    c. Same provision where if qualified investor dies or gifts, those who gets his share are automatically qualified
        i. Protects recipients of large donations
    d. (E) what this section tells you is that you can't take and put take 3(c)(1) and 3(c)(7) and enjoy each other's exemptive features
        i. Can combine the two but have to impose all of the restrictions of both sections – both 100 and sophisticated investors
    e. 3(c)(7) company is an investment company for one particular section
        i. § 12(d)(1) prohibited funds of funds of funds etc
        ii. But limitations are small
        iii. For the purposes of a fund of fund 3(c)(7) IS an investment company
    f. POLICY
        i. Wealthy ($5 million) – does this protect them from lack of information and other problems? Questions about the assumption of the qualification
            1. Not necessarily – businessman who sold his company and advised to buy auction notes . . . 30-year notes that were auctioned by ML every 7 days
                a. Presumption is that you'll make $$ because people will want these notes when they're being auctioned off
                b. Every 7 day the wealthy person could receive his money +
                c. Trouble was that there came a point that nobody wanted to buy these notes, so the auction failed

d. For some months, ML bought the notes itself, but there was such a large amount that they had to stop
e. This man remained holding 30-year loans

ii. However, if wealthy people DO lose, these can afford and are not then a burden to society

iii. Also wealthy people can hire advisors so they don't need the kind of protection that is necessary for the rest of the populations

iv. Then the argument is what the minimal investment that is necessary to qualify

g. "Qualified purchaser" defined in § 2(a)(51) – basically > $5 million in investments

i. <u>Qualified Institutional Buyers</u> (p. 125)
1. We are looking at "investments"
a. Passive investment, but does not include the house in which someone lives
b. Not all ownership of assets constitutes an investment for purposes of the statute
c. If it was real estate that someone else managed, then that would be an investment
d. Develop techniques to find out what that someone else is doing
e. Develop an attitude of supervision

h. Must be a finding that the entity is not engaged in a public offering

i. ***Lamp Technologies No-Action Letter (pp. 126-128)***

ii. Company that created and administered websites

iii. Got $$ from their clients – investment advisors, who got $$ from their own investment clients
1. Why did the investment advisors want to pay the website?
a. Lamp was providing information to the potential clients for the investment companies
b. Investment advisors had hedge fund/private equity fund, so wanted their clients to know that they were managing these hedge funds
c. Lamp gets money only if both the advisor's name and the fund's name were on the website

iv. What should the focus be if you're trying to persuade the SEC that you're not an investment company?
1. Neither the hedge fund nor the advisor want to "hold itself out" to the public as selling securities – neither are registered
2. If Lamp Technology is "holding itself out" then it becomes an investment company as well because it would indirectly be making a public offering
3. Conditions that they put on themselves?
a. Screening process to make sure that the subscribers had the requisite income to be on the website – only 3(c)(7) persons can enter or open this website
i. Notice that the subscribers don't pay – it is the investment advisor that pays
ii. Cleared on the basis of 3(c)(7)
iii. If they open the website, then it's okay because it's not a pubic offering but a private placement

iv. If this is private placement then the advisors don't hold themselves out to the public as investment advisors and don't have to register
v. And the hedge fund remains a 3(c)(7) company
vi. How do we screen?
vii. Questionnaire to check qualifications
viii. However haven't said anything about enforcement . . .
ix. Password to use website

b. No-action is not exclusive
   i. May be better procedures (FN 4, pg. 127)

4. Who is enforcing them?
   a. Who is responsible for finding out whether the clients are truthful in the questionnaire?
      i. SEC added something about making sure that the people subscribing would not object to giving information to third parties
      ii. Presumably for a credit check, etc. so that someone can make sure that they are legitimate

3. <u>§3(c)(10)</u>: Charitable organizations whose investors are strongly motivated to donate rather than to invest for their own benefit (pp. 147-148
   a. Get money from donations and sometimes invest these like mutual funds. But these are not like mutual funds. Even though sometimes they set up charitable trusts fbo donors. Many large donations under wills because the moment you have a charity as a beneficiary they will fight for the validity of the will.

iv. Institutions that weren't an important part of the financial system when the ICA was enacted
   1. Mortgage bankers, industrial banks, oil and gas financial arrangements
   2. §§ 3(c)(4), (5) & (9)

d. HEDGE FUNDS (pp. 128-134)
   i. How did hedge funds make so much money?
      1. No diversification
      2. Long term
         a. Know how much money will be in the pool
         b. Don't have to keep cash on hand for redemption
      3. Can short sell
      4. Can borrow
         a. Hope that return on investment is higher than the borrowed money
      5. Charge performance fees
         a. Motivates manager to take more risks (could be a good or a bad thing)
   ii. From recent reports it seems clear that some hedge funds were accessing inside information
   iii. There was pressure from small investors to be able to invest in hedge funds. Advisors with both hedge and regulated funds. They wanted to move the regulated money into hedge funds.
   iv. Solution → Section 12(b)(1) limits the structure of fund of funds
      1. But the request was to allow us to have regulated funds invest in hedge funds.
      2. One of the reasons funds of funds were prohibited because managers took fees multiple times.
      3. Managers promised to only charge one fee. There were other conditions.
      4. One was that the advisor can invest in hedge funds that advisor manages.

a. Assumption was that the advisor will not shoot himself in the foot.
b. If he invests in funds that he manages he will not raid those funds.
c. If SH lose in the hedge fund they will run away from the regulated funds.

PROBLEMS WITH FRAUD → CANARY CAPITAL PARTNERS

Background:

The point of all of this is that even though it was started by hedge funds it ended up by 30% of regulated funds. Just because there is regulation doesn't mean that these funds are immune.
Sec 2a32 defines redemption. Before 1940 promise of getting money back was made by most funds. But then in small letters it said with X months, etc. What exactly does it mean by "your" money back. Result was that insiders bought for less than prorate share of what was in fund and sold for more than pro rata share. This hurts the rest of the SHs.
Congress added a section that required redemption within seven days. If you need more than that you need to go through SEC and get an exemption. That did not reduce insider trading (buy for less/sell for more). SEC made a rule against this, but nothing happened. After a lot of examination the SEC came up with a rule that said simply, you will not know how much you pay for what you buy and how much you get for what you sell. You buy before price is fixed and sell before price is fixed. Insider/Outsider you won't know.
If you place an order before 4pm, then you get the 4pm price. If you put in your order after 4pm you get the price of tomorrow's 4pm. The same applies to selling. If you don't it is a criminal offense.
That rule was complemented by another that deals with valuation. Who decides what the value is? If there is a market for these shares it is the market price. If there is no market then the board of directors (2a41) will have to establish some rules that will determine price. Question is usually is there a market? Do two people make up a market? No. 20? 50? Argument usually centers on whether there is a market. But once this is answered you are usually done.
This worked fine until globalization. Now, if I want to squeeze in to buy for less and sell for more. You can look at other markets and see how they are trading. If I see that the market rises overseas then I will sell. If it goes down, I will buy. First funds to be hit hard by this are funds that traded in foreign markets. Not everyone was hit, those that knew the difference in the price did not get it from an internal source. In order for this to work you need to know the contents of the mutual funds. MFs did not give out that information on an ongoing basis. They used to give it once a day. You would need a source on the inside.
Portfolio managers of the funds don't like the money going in and out because it makes it hard to plan. They were not happy with this kind of arrangement. The advisor doesn't like this either because this raises the cost.
You find that BOA is willing to give hedge fund manager the ability to do these things? Why would he do this? Hedge fund manager promises to leave a bunch money in another BOA fund for a long time – "sticky money." This produces management fees. Hedge fund managers got a link to see what was in the fund.
The people who made these decisions to allow this were not the mutual fund managers – they didn't like this. The bank higher-ups were the ones that wanted this.
Hedge fund managers also were able to cancel orders, which was a clear violation of law – whereas getting information is not clearly illegal, but only icky.
When pension funds and insurance companies have a lot of SH that wanted before 4pm, at like 355, to buy or sell the mutual funds said we will not receive that many orders close to then. They told the insurance companies and pension funds to tell them one aggregate number. To aggregate these numbers takes a few hours. Over that time things may change – hedge fund manager might get information about this aggregation by paying them. This all happened after 4pm.
Even though this all started with questionably legal things, it drifted into clearly illegal things. Then more and more mutual funds started doing this kind of deal with this hedge funds.
Did the SH of the hedge funds suffer from this arrangement? Probably not – they made money at the expense of the SH of the mutual funds.

This manger from this case paid a $40million fine. Other managers can't pull this anymore, the rules have changed. What happened to the other managers that did? They were not registered because they had less than 15 clients (funds). These clients (funds) may have had numerous investors, but no matter what number they include they still count as one. That was the rule.

There is a case (Goldstein?) that reiterates that these 14 are the clients, not the investors in those funds. (pp. 19-24 in supp.)
Right after that the SEC reacted with something very different. They took an anti fraud section 206, an built on it a new rule. That rule imposes on anybody – registered or not – fiduciary duties. We will come back to this. It doesn't matter if they have intent to violate law, they can negligently violate the law. The only thing that this rule does not apply to is that it cannot be enforced with a private right of action. This is a very broad provision applying to anyone who manages. It also applies to prospective investors who are deciding whether or not invest.

3. MUTUAL FUNDS GENERALLY
    a. Benefits:
        i. Expert management for small investors
        ii. Diversification (lowers risk but also lowers return)
        iii. If a fund is a redeemable fund, can get your money simply by asking for redemption, rather than having to go to the market
    b. Problems in the time of the market crash
        i. (started with $4000 million in assets and went to $8 billion)
        ii. Funds were highly leveraged
            1. Allows for higher returns –
                a. Example: Have $100 and borrow another $100 at 5% with a 10% expected return
                    i. With Debt: Make $20 from investment, pay $5 → $15
                    ii. Without Debt: Make $10 from the investment
            2. But also higher risk
                a. If the stock depreciates, still have to pay the $5 of interest regardless
        iii. Funds of Funds
            1. One mutual fund would fill up with investments of other mutual funds
            2. Mutual funds composed of shares issues shares themselves
                a. Somewhere at the top was the actual company
            3. PROBLEMS
                a. Creating the funds was costly, but every time advisors did this they collected underwriting and management fees
                    i. Charged % fees - % of money invested in the firm
                    ii. Started out following model of trusts
                        1. Investor gave $ to trustee and trustee issued participations
                        2. In a normal private trust, trustee charged a % of assets under management
                        3. Fixed assets in the trust; directives as to what to invest in
                        4. Fixed assets grow, but only by their investments – if you make a good investment, you make more
                        5. Good incentive to say to the trustee, if you invest and are successful, then we'll pay you a percentage
                        6. Mutual funds different –
                            a. Increase assets even if performance goes down through new investors
                b. At that time, these shares could not be traded on the NYSE
                c. Managers could do anything – not like a trust, but like a corporation
                    i. Corporate managers have a broad discretion to manage, while trustees are usually limited both in amount and in what they can invest in
            4. RULE: <u>§ 12(d)(1)(A)</u>: Restrictions on investing in securities of other investment companies
                a. (i): Can't purchase more than 3% of the total outstanding voting stock of a fund
                b. (ii): Can't purchase securities in one fund that are worth more than 5% of the asset value of YOUR fund

            c. (iii): Can't purchase securities in other funds that total more than 10% of the asset value of YOUR fund
c. Types of Funds
    i. OPEN-END vs. CLOSED-END
        1. *Open-End Fund*: Management company that is offering for sale or has outstanding any *redeemable security* of which it is the issuer
            a. *§ 2(a)(32), 15 U.S.C. § 80a-2(a)(32): Redeemable Security*
                i. Means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof
        2. *Closed-End Fund*: Management company other than a closed-end company
            a. At one point shares sold at higher price than what those funds contained
                i. Banking on the fact that when the funds will be redeemed, they will be worth a lot more → relying on appreciation of stock
    ii. UNIT INVESTMENT TRUST
        1. Broker puts together a group of bonds; trustee is usually a bank
        2. Bank receives all notes and gives broker-dealer participation
        3. Broker creates the market
        4. Fixed portfolio → effectively NO MANAGEMENT
        5. Redeemable securities
        6. AFTER THE CRASH, people preferred this to a managed fund because they didn't trust the managers → knew exactly what was in the box
            a. Also preferred redeemable shares because didn't have to rely on the market
        7. Still exist today
            a. § 26 takes care of problems in this area
                i. Trustee takes too much money – now can't take more than reasonable fees
            b. But not so popular today?
                i. Can put only bonds in a fixed portfolio – can't put stocks and wait 20 years
                ii. As soon as people wanted investments in stocks, they had to move to managed funds
                    1. Eventually managed funds became redeemable
d. STRUCTURE
    i. §12(d)(1)(A): Allows very small fund of fund
    ii. §10(a): All funds must have a board of directors (regardless of the organization type – corporation, trust, p-ship, etc.)
        1. 40% of directors must be independent directors
        2. In some cases, SEC requires 50% or 50% to be independent
            a. In exchange for giving mutual funds more freedom in certain areas
    iii. §8: Ever fund must be registered – *not only the securities but the fund itself*
        1. Must disclose in registration statement
            a. Policies for:
                i. Classifications and subclassifications in which registrant proposes to operate
                ii. Borrowing $
                iii. Issuance of senior securities
                iv. Underwriting activities by other persons
                v. . . .
            b. Investment policies
                i. Changeable only if authorized by shareholder vote
            c. Other policies that registrant deems matters of fundamental policy
            d. Name and address of each affiliated person

            2. <u>§13</u>: Need s/h vote for big changes
            3. <u>§35(d)</u>: Mutual fund cannot have a deceptive or misleading name
                a. i.e., can't say you're an equity fund unless you invest 80% of assets in equity
        iv. Conflicts of Interest
            1. <u>§17(a)</u>: Apples to affiliates AND affiliates of affiliates
                a. Five classes of affiliates
                b. Sometimes pierce the corporate veil so that the third party affiliate is also included
            2. <u>§10(f)</u>: Prohibits underwriters from using mutual funds to dump shares that they cannot sell
                a. If any director/officer of a mutual fund is also an underwriter, then not only that underwriter, but all of the members of the syndicate of the underwriter, can't sell shares to the mutual funds, until those underwriters have left the group

4. THE SUBSTANCE OF REGULATION – OVERVIEW
    a. Investment advisors are either directly regulated by the Investment Advisors Act or state securities laws. If an advisor manages investment company assets, the Investment Company Act will govern important aspects of the advisor's conduct. The main goals and corresponding substantive regulation of mutual funds are:
        i. <u>To prevent fly-by-night operators from creating investment companies</u>
            1. <u>14(a)</u>: Requires promoters to invest seed money in the companies
        ii. <u>To provide better disclosure regarding registration</u>
            1. <u>7, 8 & 24</u>: Require registration not only of the securities of the companies, but also of the companies themselves
            2. Registration also helps trigger the application of the Act
        iii. <u>To prevent managers from changing the level of risk of the companies' assets</u>
            1. <u>13</u>: Requires companies to describe their fundamental investment policies in their registration statements, and requires a vote of the majority of outstanding securities to change the policies
        iv. <u>To prevent conflict of interest transactions by insiders</u>
            1. <u>17(a)-(f)</u>: Restricts or prohibits such transactions by insiders except by the Commission's exemption
            2. Thus, the Act adapts fiduciary law to the environment of investment companies
        v. <u>To strengthen control over investment managers</u>
            1. <u>10 & 16</u>: Create a special governance structure vesting special powers in disinterested directors
            2. <u>36(b)</u>: Imposes on insiders fiduciary duties regarding the fees they may charge to the investment companies
            3. <u>9</u>: disqualifies persons who have been convicted of securities related wrongs or very serious crimes, or are subject to injunctions from serving as insiders of investment companies
        vi. <u>To prevent embezzlement of investment fund assets</u>
            1. <u>37</u>: Makes conversion of these assets a federal offense
            2. <u>17(f) & (g)</u>: Impose protective measures relating to safekeeping of investment company assets
        vii. <u>To ensure that investment companies that promise to redeem their shares will not later breach their promises</u>
            1. <u>22(c) & (e)</u>: Regulate the timing and pricing of redemption
        viii. <u>To prevent Ponzi schemes and fraudulent sales practices, and limit the sales loads which shareholders pay to brokers</u>
            1. <u>9 & 22</u>

5. THE STRUCTURE OF REGULATION – THE SEC
    a. Five Commissioners of the SEC
        i. Political unit in the sense that:
            1. Party that selected the President, can choose three of the five
            2. Minority party chooses two

    - ii. Serve for five years
        1. If change in political power, sort of an agreement that they leave
- b. Commission has divisions
    - i. Division of Investment Management
        1. Do the rules, no-action letters, and they recommend bringing action
        2. They're the ones that look at the filings of mutual funds
        3. General Counsel and two groups – one that deals with no-action letters and one that deals with exemptions
- c. EXEMPTIVE AUTHORITY
    - i. Through its exemptive powers, the Commission has enabled the industry to develop money market funds, variable insurance products, and new forms of fund structure that were not allowed before
        1. <u>§ 6(c)</u>: authorizes the Commission to exempt "any person, security, or transaction . . . from the provisions of the Act or any rule or regulation thereunder by rule or regulation or order" if and to the extent that such exemption is "necessary or appropriate in the public interests and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the" Act
            - a. VERY broad
            - b. Basically says that SEC can exempt with conditions or without conditions
        2. <u>§ 6(b)</u>: authorizes the Commission to exempt an employees' securities company if consistent with the protection of investors
        3. <u>§ 6(e)</u>: allows the Commission to apply certain provisions of the Act to otherwise exempt companies
    - ii. <u>§17(b)</u>: Gives SEC authority to say that conflict of interest in particular situation is good for the investment company so it should not be prohibited
        1. Have to show SEC that transaction is fair and equitable to both parties – NOT just to the mutual fund
        2. Can ask for exemptions only *before* entering into the arrangement – must be a "proposed" transaction
    - iii. Exemptive Orders: Specific to individuals and cannot be used as precedent
        1. Process includes going to the people responsible in the Commission and asking for exemptions to get a feel for response before writing a brief and going to court
            - a. Usually there's an agreement
            - b. Application includes all sorts of conditions that the applicant asks for that come from talking to the Commission
            - c. The most important thing for the lawyer is to make sure to put into the application ALL possible parties that will be involved
                - i. Application applies only to the parties listed
            - d. Once application is filed, it goes to Federal Registry, wait 30 days, if someone opposes, they're allowed a hearing
        2. Exemption is very strong/binding
            - a. Court cannot exercise its own judgment about whether or not an exemption should have been granted → can interfere only if the process or reasoning is faulty
                - i. Were attempts to go to court – arguments could be "you didn't have the authority" or that it was arbitrary
                - ii. Apart from that, courts are not going to interfere
        3. Does not set precedent
            - a. Gave exemption to one party, I'm in the exact same position, you have to give me an exemption too – if they don't, then the argument is that the difference in treatment is arbitrary
            - b. HOWEVER, if there are *any* differences, then there's no precedent
    - iv. Exemptive Rule: Issued by the Commission once there have been enough orders on a particular issue
        1. RULEMAKING
            - a. Sources of rulemaking power under the Investment Company Act
                - i. 6(c): Creating its general exemptive powers

        - ii. 38(a): Authorizes SEC by rule to prescribe forms for reports and applications, procedures, and definitions
        - iii. Other specific sections granting SC rulemaking authority (such as 17(b) and 10(f))
      - b. Investment Advisors Act provides a general rulemaking power for the SEC in § 211(a) and rulemaking power under general exemptive powers in § 206A
- d. NO-ACTION LETTERS
  - i. While the Commission itself issues exemptions, no-action letters are issued by the staff of the commission
  - ii. Mean that the staff would not recommend enforcement action to the Commission in the particular case, based on the facts presented by the applicant
  - iii. Essentially represent the staff's prosecutorial discretion
  - iv. Subject to reconsideration by the staff
  - v. Not regarded as precedents binding on the Commission
  - vi. BUT, letters are often considered precedents by parties other than the recipients
    1. The type of no-action letter determines how strongly it serves as precedent
      - a. *Interpretation of Law*:
        - i. No-action letter expressing the staff's interpretation of the law would constitute weighty precedent on legal issues
        - ii. Courts are likely to defer
        - iii. Commission likely to respect
        - iv. Other parties need not seek no-action letters on same issue, and lawyers usually give opinion letters based on such a no-action letter
      - b. *Disagree with Legal Analysis*:
        - i. Staff can disagree with the applicant's legal interpretations, and emphasize application to the facts of one particular case
        - ii. Far weaker as reliable precedent
    2. No actions letters are precedent in the sense that lawyers follow them without going to the SEC (although there is a risk that SEC might say no, not in this case)
      - a. Take the risk because the SEC has announced that it won't divert from anything that was in no-action letters in the past
      - b. People know that at least when they look at what the staff has done in the past, they won't sue
        - i. Even when staff doesn't believe in analysis, as long as facts are pretty much the same
  - vii. Can be viewed as administrative CL of the Investment Company Act
  - viii. ADVANTAGES
    1. To SEC and Staff
      - a. Provide information about proposed transactions in marketplace
      - b. Alert staff to possible legal barriers they might pose to investors
      - c. Help avoid or reduce enforcement by SEC and regulation by litigated parties
      - d. Leave some room for negotiations so that proposed activities may be restructured and legitimized
    2. To Public
      - a. Strengthen rule of law
      - b. Publicize staff's interpretation and application of securities laws
      - c. Help inform the industry about staff concerns, and often elicit industry response by voluntary self-enforcement or self-studies that provide information to the staff
    3. To Business Community
      - a. Many corporations depend on consistent application of staff's rulings in making business decisions

b. Facilitates business transactions, especially novel transactions that may not exactly fit the regulatory framework, when the application to them is uncertain
4. No action process is less costly than a formal exemptive application, an SEC administrative action, and far less costly than civil litigation
ix. Fundamental difference from exemptions:
1. Exemption: SEC gives you your law . . . no one can sue you
2. No-actions letters: bind the SEC but DON'T BIND THE PUBLIC SECTOR
a. Shareholders can still sue
x. Find no-action letters citing no-action letters . . . want to show consistency

6. SECURITIZED POOLS – CHAPTER 5
a. Financial products that are very similar to investment companies BUT they are not regulated by the Investment Company Act
b. Loans in their form are not marketable because they are not standardized, and are issued by various people, and the cost of finding someone that will buy one note is very high, so no market will exist. However, were various ways to bring to loans created by institutional intermediaries into the market → transferring loans to special purpose vehicles, or pools, that standardize all of the different types of loans that come in
c. This process involves different areas of law:
i. <u>Bankruptcy</u>: if lender goes bankrupt, then the investors want to make sure that they are not part of the bankruptcy proceeding
1. Don't want lender's creditors to say that they have claims to the loans that the securities are backed by
2. If bank gives loans, and goes bankrupt, under bankruptcy law, if amounts are segregated under the name of someone else, they don't belong then to the bank or to its creditors
a. Therefore, pooled assets must be put into special, separate account
ii. <u>UCC</u>: the transfer itself subject Article 9 provisions
iii. <u>Securities Laws</u>: the securities that come out are subject to the 1933 and 1934 Acts
d. *<u>ICA Release No. 19105</u>* (pp. 161-162): Structured Financings fall within the definition of investment company under 3(a), but cannot operate under the Act's requirements → exempted
e. Is the pool itself an investment company? Holding itself to be engaged primarily, or proposes to engage primarily in the business of investing, reinvesting, or trading securities?
i. Issues securities . . . BUT were the loans securities in the first place?
1. *Bank of America Canada* – loans can qualify as securities
2. Some financial assets that can be both securities and not securities
a. If you look at the definition if a security, it will include indebtedness, BUT there is an exception for notes
b. What the SEC has said is that depends on what their use is
i. If the use is commercial (i.e., buy something and pay with obligation to give cash in the future), then this is a note
ii. But if someone holds the IOU short-term, but not in connection with the actual commercial transaction, then it's treated as an investment
1. i.e., asset-backed securities, purchasing A/R
2. This is treated as a security because it is held for investment
3. NOT saying that it's a security because the IOU not is related directly to commercial arrangements . . . it could be
c. Why the distinction?
i. In the first instance, there's a relationship between the seller and the buyer outside of the obligation
1. Arm's length transaction
ii. In the second instance, there's no direct relationship with the issuer
1. Moves then from commerce to finance

            2. Viewed as a security
   ii. SEC began giving exemptions for certain arrangements
      1. Initially, mutual fund industry pushed for regulation of SPVs because they wouldn't really function if they were subject to all of the Investment Company Act requirements → would provide competition for mutual funds if they were allowed to function
      2. Mutual funds were interested in making a distinction so that the mutual funds could not move to SPVs for an exemption
      3. When you look at the regulation, find things that are particular to mutual funds and therefore allowed SPVs to function for their purposes, but not to get too close to mutual funds
      4. SEC was concerned that if this became close to a mutual fund, then there would be mutual funds that would want to function as SPVs to avoid regulation
   iii. RULE 3a-7 (Stat. Supp. p. 172)
      1. (a): Any issuer engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets, *and who does not issue redeemable securities* will not be deemed to be an investment company
         a. Definition of redeemable security is getting a pro rata share of the issuer
         b. Asset-backed securities are different because they are not tied to the $ coming into the issuer
         c. SPV cannot trade
      2. Types of Assets:
         a. (a)(1): Fixed income securities, or other securities that entitle holders to receive payments that depend primarily on the cash flow of the eligible assets
            i. No equity, just debt
         b. (a)(2): Must be rated at the time of the initial sale by at least one nationally-recognized rating agency by one of the four highest categories
            i. Open justification is that these securities are highly complex, and we need disclosure, but know that these are too complicated anyone to figure out
            ii. BUT, problems
               1. Conflicts of interest → company is paying for rating
               2. Rating agencies previously, rated corporate securities
                  a. One obligor that owed people money
                  b. Took that model and put it into an SPV model that had MANY borrowers
               3. Believed that they could reduce the risk by diversification
                  a. Took loans from various parts of the country, but loans of the same kind (i.e., mortgages, credit cards)
                  b. If you have different kinds, can't evaluate what they are
                  c. If you standardized the terms of the loans, more or less, and standardized the kind, you can take the same system that you use to evaluate one large corporate issuer, but this was NOT true
               4. Once they were evaluated, very difficult to reduce ratings
               5. When you require rating in the law, you give a legal monopoly
                  a. Can't do business without paying these companies
                  b. Chances are that you'll feel more relaxed
         c. Auction Notes
            i. Want to issue these types of securities but will create an auction every 7 days

            ii. Get money before payment date of security itself → get it within 7 days
            iii. Question is whether this is a redeemable security
                1. Not a redemption because the entity that pays is another investor that wants to buy and not the company who issued the security
                2. Liquidity does not come from the issuance, but it comes from the desire on the market
        3. (a)(3): RESTRICTING TRADING
            a. Eliminates as much as possible, the effects of the market on these securities
            b. Can't acquire or dispose of assets if it results in downgrade in the rating
            c. Can't acquire or dispose of assets if primary purpose is to recognize or reduce losses resulting from FMV changes
            d. NO TRADING, and no purpose in trading
                i. Shows the difference between the usual mutual fund and these SPVs, but it also fits into the SPVs design
        4. Some of the instruments are really linked to other measures – i.e., LIBOR
            a. Allows SPV to issue securities that are not linked to a specific return amount, but ONLY IF the security is linked to some objective measurement
    f. Question of to what extent government should interfere and be the innovator of the new arrangements . . .
        i. Ginnie May: first to securitize mortgages and back them by full faith and credit of the government
            1. Purchased from savings and loans associations → liquidity crunch in the savings and loans industry (didn't have cash, had 30-yr mortgage)
            2. Government came in and bought the mortgages, packaged them, and issued securities + government guarantee, and then gave them to the savings and loans associations
            3. Created the first, mass-produced securitization
        ii. Then Fannie Mae: government corporation established by statute, not guaranteed by full faith and credit, but had a very large amount of backup from the government
        iii. Then Freddie Mac: government created for competition
        iv. All of this was to encourage the acquisition of homes . . .
    g. Securitization took long term assets and created liquid assets, and the theory was that when you do that, you solve the banking problem in the sense that all assets were short term (more cash on hand) → was encouraged
    h. What went wrong?
        i. Junk loans
        ii. Implicit, if not explicit promises to buy back these assets
            1. Banks, Merrill Lynch, Citicorp, etc. bought back from good clients whom they didn't want to lose, but then there came a point when they didn't want to buy back anything
            2. Change in culture when the focus goes from income from loans, to fees from sales
    i. <u>Exemption that fell between the cracks → § 12(d)(1) allowed SPVs to invest in other SPVs</u>
        i. Prohibited under the Investment Company Act, but didn't put it as a condition in 95/96 when this exemption was granted for SPVs because no one thought about it then
    j. SEC eliminated the requirement for rating form the 1933 Act, but left it here – probably a recognition that no one will be able to find out anything about what these instruments actually are
7. REGISTRATION AND DISCLOSURE
    a. The most prevalent type of regulation that we have is disclosure
    b. Act regulates two types of registration
        i. Registration of the securities that the mutual fund issues
            1. The Securities Acts focus on these
                a. Securities Act: original issuance
                b. Exchange Act: secondary market

            i. § 12: requires some issuers to register themselves
    ii. Registration of the company itself, the mutual fund
        1. §8: Requirement that investment companies register
            a. Registration statement goes to the SEC and becomes public
        2. § 7(d): Prohibits foreign investment companies from publicly distributing securities unless Commission permits them to register
            a. Foreign companies may not register only if they make a public offering
                i. So for a long time, Canadian companies offered securities in the US but did not have to register because it was a private offering
                ii. Didn't exceed 500 s/h limit under 1934 Act, so didn't have to register there either
                    1. Even when people moved from Canada to US and still held the securities from Canadian companies
                        a. SEC specified that private offering has to mean private offering under § 3(c)(1) → 100 s/h's
                iii. Company that is registered abroad may not publicly offer its shares here to more than 100 s/h's
            b. Otherwise, the Act does not impose qualification requirements on sponsors seeking to register an investment company
        3. § 7(a): Prohibits transactions in interstate commerce by unregistered investment companies
            a. Criminal penalties for failing to register an investment company
        4. § 47(b): Provides that a K made in violation of the Act is generally unenforceable
            a. If company does not register, its contracts are voidable, or void subject to the approval of the court
                i. Sometimes if there is a mistake or something, the court will say that it's not fair to eliminate the binding effect of the K
                ii. Every security issued by an unregistered company is guaranteed
                    1. If the price goes down and the K is void, the people that bought the securities can come back and demand their $ back because there is no K
                    2. If the price increases, then the people that bought that securities will be happy and won't sue, so they'll still keep their $
        5. When it come to foreign companies, things are different
    iii. The registration of the company is much more constraining with respect to what it can do
c. If you were investing in a mutual fund, what would you like to know?
    i. Risk
        1. Overly pessimistic prospectuses
    ii. Strategy
        1. Types of securities
        2. How you're going to make $ → conservative vs. risky
        3. Manager doesn't like this
            a. Does not want to be locked in to some specific strategy
            b. Every strategy is open to attack
    iii. Fee Structure
        1. If I tell you that I charge 1% of the assets under management, that's not enough
            a. Want to know the $ amount
            b. Industry fought very hard to avoid having to give the $ amount
        2. One of the recent cases was a humungous mutual fund (billions of dollars) that charged less than 1%, and they agreed to split this into two funds so that the fees would not be so outrageous
d. §8: ELEMENTS AND POLICY
    i. Pre-Regulation
        1. During the 20s the managers of these companies did not manage the companies like trustees who had rules about investments or duty of care, but rather just invested in anything

        a. The description was that they were like corporations that could do whatever they wanted
    2. Congress noted this . . .
  ii. One of the main things that is important is when you look at 8(b)(1) – there must be recital of policy of registrant for each of the following (whether registrant reserves freedom of action to engage in activities of such type, and if so, the extent to which registrant intends to engage):
    1. Type of company – open end vs. closed end
    2. Borrow $
    3. Issue securities
    4. Engaging in business of underwriting securities issued by other persons (few do this)
    5. Concentrating investments in a particular industry or group – large cap, small cap
    6. Purchase and sale of real estate and commodities
    7. Making loans to other persons
    8. Portfolio turnover
  iii. (2): recital of all investment policies of the registrant not enumerated in ¶ (1) → pattern of investment
  iv. (3): recital of all investment policies of the registrant not enumerated in ¶¶ (1) & (2) in respect to matters that the registrant deems to be matters of fundamental policy
    1. In front of the court now → what is a matter of fundamental policy?
        a. Crucial because there are so many possibilities open
    2. Another question is who can sue, and what happens if you don't
  v. Must be not only disclosed, but also distributed (can now just see this on the SEC website)
  vi. Issue that is still not open completely is to what extent is there a private right of action when a shareholder argues that this section was violated
    1. Not so simple . . . words like "fundamental policy" can open the door to thousands of cases

e. REGISTRATION OF PUBLIC CO. vs. REGISTRATION OF MUTUAL FUND
  i. For regular corporations:
    1. Registration statements are written by the lawyers
    2. Sent to SEC
    3. Staff looks at it, and sends back a comment letter with questions
    4. Then company answers (could go back and forth for a while)
    5. Price is not placed in the registration statement because the price of the securities can go up and down → wait until final agreement is reached
    6. Can't sell these securities until the prospectus is put into effect – usually the price is telephoned the to the staff and then have sales
  ii. With mutual funds, it's a bit different → no one is going to buy shares of mutual funds before knowing some sort of number on performance
    1. Mutual funds register the funds and have 2 or 3 shareholders that are employees
        a. Invest some money and create an incubator fund
        b. Then those show performance for about a year (try things out until they find a good way to function)
  iii. Then register the company, and *then* register the securities to offer to the public
    1. Register the securities after registering the issuer itself
  iv. That way, there's some description of performance and shareholders buy
  v. Promoter must also put $100,000 of their own money (§14(a)) . . . now they put in between $800,000 and a million

f. PROSPECTUS AND STATEMENT OF ADDITIONAL INFORMATION (SIA – pp. 174-176)
  i. To what extent does the registration statement bind what the brokers later say when they go out to the public?
    1. Under the Exchange Act, the broker must offer the prospectus
    2. But the broker may say that you don't want to really read this long prospectus and just explain anyways . . . to what extent is the broker limited by what is being said?
  ii. The issue of long, tedious, unreadable prospectuses has been going on forever
  iii. Ways in which SEC has tried to create readable prospectuses (pp. 176-180)

1. The problem is that you want the prospectus to be cautionary as possible to avoid litigation
2. Q&A is okay if SEC says that it's not part of the prospectus and therefore subject to § 5 of Securities Act
3. What worked is the SAI, the supplemental materials
    a. Gave a shorter prospectus and added all numbers and analysis, etc. in the supplemental material, and then let the client/investor ask for it
    b. Problem was that even the shorter prospectus became longer because anytime there was any case, companies added more

iv. Some blame the SEC for the prospectuses being so unreadable (p. 179)
1. Three parties: Investor, Offeror, SEC
    a. Between SEC and seller, SEC wants to emphasize risk, while the seller wants to emphasize the rate of return
    b. The more risk is pushed, the more the prospectus becomes unreadable

v. SAI
1. ***White v. Melton (p. 174)***: ***SAI is incorporated by reference into the prospectus – the two are essentially one document (the fact that obtaining the SAI is more costly does not change that . . . have to call specifically and ask for it)***
    a. Freeze Rule
        i. Don't pay commissions right away → investor therefore keeps $ in the fund for a longer period of time, thereby benefitting the fund manager (fund manager gets a % of those assets – linked to fees)
        ii. Let's say there are three funds – equity, money market, and bond
            1. Buy equity, but see that equity goes down, so I want to move to money market fund
            2. Still staying with the same fund manager
            3. Okay to go to MMF, or bond fund, it's fine
            4. BUT, if you move from the MMF or the bond fund back into the equity (and especially if you do it all the time), then you have to pay the commissions that were postponed before
    b. This rule was placed in the SAI, while the rest of the fees were placed in the prospectus
    c. Court said that the SAI was incorporated by reference into the prospectus, and that it wasn't so necessary that it needed to be in the prospectus itself
    d. The two are essentially treated as one document
        i. Have to call and ask for the SAI – don't get it immediately
        ii. The fact that obtaining the SAI is more costly doesn't matter because it's all just one

g. The prospectus must be updated when major changes occur, and must have updated financial statements (pg. 185)

h. **Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies**

i. (Investment Company Act Release No. 28,584 (Jan. 13, 2009), 74 Fed. Reg. 4546 (Jan. 26, 2009))

ii. **SUMMARY:** The Securities and Exchange Commission is adopting amendments to the form used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933 in order to enhance the disclosures that are provided to mutual fund investors. The amendments require key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus. The Commission is also adopting rule amendments that permit a person to satisfy its mutual fund prospectus delivery obligations under section 5(b)(2) of the Securities Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site. Upon an investor's request, mutual funds are also required to send the statutory prospectus to the investor. These amendments are intended to improve mutual fund disclosure by providing investors with key information in plain English in a clear and concise format, while enhancing the means of delivering more detailed information to investors. . . .

- i. LIABILITY FOR MISLEADING PROSPECTUS
    - i. ***In re Hyperion Securities Litigation (pp. 187-190)***: Bespeaks caution doctrine applicable to mutual fund prospectuses
        1. Could be based on the facts – can't really anticipate that the value of a country's currency will drop
        2. Fund that invests in currencies
        3. Said that it was conservative, and targeted risk-averse investors, and that the returns are slightly superior to those available from US Treasury securities, and relatively NAV
        4. Represent that they diversify currencies → still be a plateau
        5. Instead the complain is that these took four the weakest Western European currencies and lost about 20% of the amount
        6. Have the vision on the one hand the bespeaks caution doctrine on the other hand
        7. What happened here was that the currencies were devalued
            - a. If you go to buy a bunch of currencies, should this possible devaluation be disclosed?

8. ADVERTISING (starting pg. 190)
    - a. Securities are registered under Securities Act of 1933, which has strict framework governing written communications used in the sale of securities
    - b. Advertising restrictions apply continuously for investment companies because they continuously offer and sell their securities
    - c. Investment company marketing material generally must fall within one of three categories to avoid being s/t all of the rules that govern a statutory prospectus
        - i. <u>Rule 482 Ads</u>:
            1. Does not limit the content of advertisements, provided the advertisement states from whom a prospectus can be obtained and advises the investor to read the prospectus before investing
            2. Therefore may have performance information if it's presented in a standardized format
            3. May contain information the substance of which is not contained in the prospectus
                - a. Allows more current information, and removal of boilerplate language from the prospectus (proposed rule pp. 199-203)
        - ii. <u>Generic Ads (Rule 135a)</u>:
            1. Advertisements that only contain general information about investment company securities and do not mention a particular investment company
        - iii. <u>"Supplemental Sales Literature"</u>:
            1. Communications that are preceded or accompanies by a statutory prospectus
            2. May have performance information if it's presented in a standardized format
    - d. DECEPTIVE OR MISLEADING NAMES - § 35 (Stat. Supp. pp. 81-82)
        - i. Can't have a name that does not reflect the policy of the mutual fund
        - ii. For example, if you call it an equity fund, then you have to invest at least 80% in equities
        - iii. If you say it's an open end fund, must have 15% of the assets in cash
            1. Show that you intend and are able to redeem without selling the stock
            2. If you sell the stock and sell a lot of it, you depress the market price
        - iv. One of the main arguments in this case is risk. The SEC thinks that the issuers of the securities want to buff these up
    - e. PAST PERFORMANCE (pp. 192-)
        - i. Advertising past performance used to be prohibited but now is okay as long as it is set forth in a standardized format
        - ii. Becomes difficult because unclear whether it's based on the fund itself or the management
        - iii. The argument that the performance is tied to a manager, and the performance of a manager is relevant because a manager who is continuously successful shows more ability than one that is not.
            1. The justification of allowing past performance was linked to the identity of the manager.

2. But that opened a pandora's box for a number of reasons.
3. Suppose that you have a mutual fund with a big department, i.e., 50 people, how do you know that it is the boss that is producing the results?
4. ***Philadelphia Fund No-Action Letter (pg. 192)***: see quite a change in the structure of the funds
    a. The money and the assets follow a variety of structures and a variety of advisors
    b. One person that is employed by all of them – Baxter is the boss, sole portfolio manager in all three organizations
    c. Say they want to take his performance and apply to another organization → want to say his performance from first fund is tied to performance in later funds
    d. Staff says that this is okay
    e. What about when the people leave but the organization stays the same?
        i. Staff also allows this – allow attribution of performance to the organization
    f. Now the door is open to combinations

f. ***In re Van Kampen Investment Advisory Corp. (pp. 196-99)***
    i. Period of IPO's (tech bubble)
        1. IPO's were relatively low, and then price shot up but the companies really had nothing
        2. General idea was to flip the stocks really quickly to take advantage of the jump in price after the IPO
    ii. Mutual funds don't spring automatically – had a period of incubation
        1. The price that the portfolio management succeeds to gain is afterwards described to public
        2. Incubation of a fund, fed it IPOs
        3. Within a year they had a 61.9% rise
            a. Because of IPOs
            b. And because the amounts were relatively small
                i. With large fund, impact of IPOs is not that great
                ii. But if you have only IPOs and they rise tremendously, then there's 61% growth in one year
        4. Advertise the growth percentage and go public
        5. Result is that people bought but then did not get 61.9%
        6. Period when there were public offerings
        7. The issue here is disclosure . . . what did they have to disclose?
            a. Found that it was a violation of a material fact → had to disclose that you invested in IPOs
    iii. Same idea with FB
        1. Goldman Sachs sold limited number of shares and jumped in value to billions → HUGE compared to income and expenses of FB
            a. Enormous rise through trading between owners of the stock, but does not reflect production of the company
        2. Not publicly offered
    iv. Amendments to Investment Company Advertising Rules (pp. 199-203) address this

g. Rule 482 advertisements are s/t antifraud provisions of securities laws
    i. BUT, compliance with the "four corners" of Rule 482 does not alter the fact that the funds, underwriters, and dealers are subjects to the antifraud provisions of the federal securities laws with respect to fund advertisements
    ii. Each fund, and its underwriters and dealers, are responsible for analyzing the particular facts and circumstances

h. DISCLOSURE OF ABUSIVE TRADING PRACTICES
    i. In response to the *Canary Capital* and other similar cases, the SEC adopted revisions to enhance disclosure with respect to:
        1. Market timing policies and procedures;
        2. Practices regarding "fair valuation" of portfolio securities; and

            3. Policies and procedures with respect to the disclosure of portfolio holdings
        ii. Release pp. 218-224
9. ADVISORY FUNCTION
10. FEES
11. THE ADVISORY CONTRACT – SECTION 15 (starting p. 256)
    a. Safeguards in § 15 as to management contracts
    b. <u>§ 15(a)</u>: It shall be unlawful for any person to act as investment advisor of a registered investment company, except pursuant to a written contract
        i. <u>(1)</u>: K must describe the compensation to be paid thereunder
        ii. <u>(2)</u>: K must continue for a period of more than two years, and must be approved at least annually by the board
    c. <u>§ 15(c)</u>: It shall be unlawful for the investment company to enter into, renew or perform a contract or agreement, unless the majority of independent directors on the board of the investment company approve it
    d. <u>§ 15(a)(4)</u>: Automatic termination in the event of an assignment
        i. Fiduciary relationships cannot be assigned b/c the relationships are personal
            1. Investors rely on the specific advisor
            2. Transfer to unscrupulous people could open the door to looting assets
        ii. BUT, automatic termination present problems
            1. Investment company shareholders may have greater difficulty in hiring another advisor, and assuring continuity of management
            2. Problematic for advisors as well – finance the costs of creating the investment companies
                a. The problem for advisors is that advisors may be creating a whole business for a long time, but they can't liquidate it – it will die with them, and that is an issue
                b. There is a problem here because you want to give liquidity to people who create a good business
        iii. <u>§ 15(f)</u>: Assignment of the advisory K is permissible, s/t two conditions
            1. Assignment must be approved by 75% of independent directors
            2. Two years after the assignment the investment company will not suffer undue burden
            3. Advisor can sell the shares, and even control, but the K remains
                a. New Board, and this Board must be 75% disinterested directors
                    i. NEW Board must approve
                b. Within two years of transaction, the new owner of the shares (even though advisor stays the same) may not create burdens on the fund
                    i. More fees, expenses, less services, etc.
                    ii. Like taking and causing the shareholders to pay for the buyer's transfer
            4. Have to go to the shareholders to change the K
    e. ***Rosenfeld v. Black***: Lazar Brothers is a VERY respected underwriter/investment banker, who, unlike ML, doesn't have a sales force. They created a good fund based on their expertise, which people really wanted. They also wanted the fund to be open ended so that it was redeemable. They couldn't sell anymore so the fund began to shrink – shrinkage brings costs up. Lazar Brothers did not change their own structure. Instead they decided to sell the whole structure. They went to an organization that had sales people and contacts to sales people, and they notified the shareholders and told them that they wanted to sell the K to Moody's. So they go to the lawyers, and the lawyers kind of tried to skirt around the issue of sale and say Lazar Brothers are going to be advisors for 5 years, and will get paid with 75,000 shares of Moody's (LOTS of $$) – tried to go around the prohibition
        i. Situation in which advisor sold/transferred the advisory K and received remuneration but also promised to advise for another 5 years. As a result also suggested to s/h's to eliminate their K with Lazar and create another one with Moody's (good company – no question about that). Lazar got 75,000 shares – large reward
        ii. ICA § 15(a)(4): must be a K, and upon transfer it evaporates – does NOT require the advisor to return the money

iii. <u>§ 46(a)</u>: Provides that a K which is in violation of the law is void (Stat. Supp. p. 90)
    1. UNLESS Court finds under the circumstances that enforcement would lead to a more equitable result (added later)
    2. Covers situations in which it would be unfair to eliminate the K, thereby giving the other party some benefit
iv. Where does Rosenfeld take its law?
    1. Equity trust law (state law) → court looking at both sources and adds the common law
        a. Advisor is by definition (in state law) a fiduciary
        b. Therefore the court draws on both
    2. D's argue that this should be decided under federal law → violation of the ICA doesn't say Lazar should return the $ - just says that the K evaporates
    3. Court responds that the statute impliedly incorporated the elements of trust law
v. In terms of equity principles, what did Lazar do wrong?
    1. Conflict of Interest → Lazar sought personal benefit from the transaction
        a. $75K was more than value of continuing services, therefore more than just consideration for assignment
        b. $ was primarily for the use of procuring shareholder approval of the successor
        c. Conflict based on the benefits that they received from the merger
    2. Why shouldn't they receive benefit for assisting in the merger?
        a. Distinction between compensation for work done, and receiving a profit
        b. The "work" that Lazar does:
            i. Advisory function
                1. Advised the s/h's to merge
            ii. Use of proxy mechanisms
                1. No one else – not shareholders – can used a proxy machinery
                2. Before going into a proxy fight, have to go to court and compel management to hand over a list of shareholders
                3. This is not a simple thing – if someone wanted to interfere and say that he is a better advisor, he would not be able to do
                4. Controlling the proxy mechanism is extremely valuable, so using it and having conflicts is a bog deal
vi. <u>§36(a)</u>: Authorizes SEC to bring suit for gross misconduct of gross abuse of trust, and if the court found that the Commission's allegations were established, it should enjoin the person found guilty from acting in its prior capacity either permanently or for a time period the court deemed appropriate
    1. Discussion of § 36(a): there was a case before this one in which the court told the SEC that it cannot introduce equity into that section → section that introduces fraudulent behavior with intent to do so
    2. Court is careful to:
        a. Say we don't think Lazar Brother are sleazy – very respectable firm, and we don't want to suggest that they are subject to §36(a)
        b. Court still says we do not wish to be understood as accepting the views of the previous case
            i. Not sure that if there is a violation of §36(a), there's automatically no violation of common law
vii. Important because this case has not been overruled to this day. But at the same time, this implication of state law being embedded in the federal has shrunk over the years (might be shifting back a little)

f. Connections to 10b-5
    i. § 10(b) that leads to the rule
    ii. Criminal section – "it shall be unlawful"
        1. So where does implied private cause of action come from?

        a. For a long time, the CL had a theory which said that if you have a wrong, you must also have a remedy
            i. Punishment does not compensate private parties for the harm done
        b. This approach was then introduced to the US as well
      2. What is interesting is that SCOTUS has opened the door to a lot of claims on the basis of 10b-5
    iii. Federal law (statute and rule) on which state law theory was built
    iv. At the beginning, there were many sections of the ICA into which the court had grafted a private cause of action, but those were eliminated

12. CORPORATE GOVERNANCE – CHAPTER 8
  a. Regardless of the legal form that the sponsor chooses for the investment company, the ICA superimposes a uniform structure, thereby creating a federal corporate law with respect to investment companies, with the primary purpose of checking abusive management
  b. Popular forms of organization under state law:
    i. Corporations
    ii. Business trusts
      1. Legal title to the assets of the trust held by a trustee while the beneficial interest is divided into transferable units or shares
      2. Form is flexible, simple and economic in organizing and operating
      3. Differ from corporations in that trustee is the legal owner of the trust property
        a. Poses questions of liability for the trustee and for the beneficiaries-investors, if they exercise control over the operations of the trust
        b. MA courts have minimized these liabilities
        c. DE has eliminated liabilities by providing trustees with same protection as is granted to corporate directors
    iii. Partnerships
    iv. Can even arise without any corporate form whatsoever – simply as unincorporated group of people (*Prudential case*)
  c. Client (advisor) wanting to attract shareholders would probably gravitate towards
    i. Limited liability
      1. Good for advisor, and for investors because neither is personally liable
      2. Trust
        a. Trustee is liable to some extent because he is the fiduciary
        b. Beneficiaries: give $$
            i. To a certain extent they are also liable
            ii. Mass. started a business trust in contradiction to a private trust
              1. Business trust recognized the type of beneficiary that is really just trustor as well
        c. On everything that business trusts send, there's a notice that says that beneficiaries are not personally liable for liabilities of trust
        d. Delaware has passed Business Trust statute in which they specifically held that beneficiaries are not liable
    ii. TAX
      1. Mutual Funds: pass through taxation – shareholder pay tax but mutual fund does not
        a. Conditions
            i. Registered investment companies
            ii. Diversified
            iii. End of each year, must distribute over 90% of its income (Congress is trying to change this)
              1. Distribute the net of profits over the entire year
              2. Shareholders can get hit
    iii. In general, will find either corporations or business trusts – DE, MA, and MD
  d. ICA REGULATION OF CORPORATE STRUCTURE
    i. Investment companies must have board of directors
    ii. Each share issued by investment companies must have a voting right

iii. Generally directors can't serve unless they're elected by s/h's
iv. § 10: No more than 60% of directors can be "interested persons"
    1. The criteria for disinterest are far stricter than those established under state corporate law
    2. The disinterested directors function as a board within a board
        a. Advisory and underwriting contracts, including fees and expenses, must be approved by a majority of such directors and by majority of s/h's periodically
        b. Increasing responsibilities to supervise the activities of the investment advisor and the insiders managing the company
    3. Disinterested directors CANNOT approve conflict of interest transactions (unlike corporate law)
        a. Only the Commission can exempt conflict of interest transactions
    4. § 2(a)(19): "interested persons" → LONG LIST
        a. Affiliated persons of the investment company
            i. § 2(a)(3): "Affiliated person" means
                1. (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person;
                2. (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;
                3. (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person;
                4. (D) any officer, director, partner, copartner, or employee of such other person;
                5. (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and
                6. (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof
        b. Members of the immediate family of affiliated persons – spouse, children, parents
        c. Any interested person of any investment advisor
        d. Principal underwriter, and interested persons of principal underwriter
        e. Partner, employee, or any person who at any time since the beginning of the two past years has acted as legal counsel
        f. SEC can determine that someone is an interested person → material business or professional relationship (not a simple concept)
    5. Some situations in which you need 51% but not dealing with that
        a. When vulnerability of investors is higher because underwriters and brokers are really controlling this pool of investors' $ the % goes up to 51
    6. Why only 40%?
        a. Recognition that advisor has a business, so unlike a normal corporation in which the corporation owns the infrastructure of the management, here is an advisor that owns the infrastructure and that's its business. Therefore, to impose upon that advisor the full power of too many people who don't have a skin in the game would be too much
    7. Funds that want to take advantage of certain widely relied-upon exemptive rules need to comply with certain requirements, including (pg. 273):
        a. Independent directors need to constitute majority of board
        b. Independent directors would be required to select and nominate other independent directors

    c. Legal counsel for independent directors must be independent of fund management (requirements p. 274)
8. Continuous pressure by the SEC to increase 40% to 50% or 51% and pressure against it by the industry
    a. Proposed rule to increase to 75% to rely on exemptive rules → did not pass
    b. In 2004, the SEC wanted to take these ten exemptive and add other structural changes. The theory in the SEC at the time was that if we can put these structural changes into conditional exemption, we could change the conditional exemptions again
    c. The industry wanted these exemptions, so did change composition of directors
    d. DC Cir said that SEC had the authority to write the regulation, BUT said that the SEC did not calculate the cost of changing the structure
    e. SEC, within a week, they produced a calculation, claiming that they calculated it in the past but simply did not put it in the proposed rule
    f. Didn't go through, and the result was that the proposed rule did not pass (requirement of 51% for all boards and for independent chairman)
9. ***TEN EXEMPTIVE RULES***
    a. 10f-3: Permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate
    b. 12b-1: Permitting use of fund assets to pay distribution expenses
    c. 15a-4(b)(2): Permitting fund boards to approve interim advisory K's w/o s/h approval where the advisor or controlling person receives a benefit in connection w/the assignment of the prior K
    d. 17a-7: Permitting security transactions between a fund and another client of the fund investment advisor
    e. 17a-8: Permitting mergers between certain affiliated funds
    f. 17d-1(d)(7): Permitting funds and their affiliates to purchase joint liability policies
    g. 17e-1: Specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on the exchange
    h. 17g-1(j): Permitting funds to maintain joint insured bonds
    i. 18f-3: Permitting funds to issue multiple classes of voting stock
    j. 23c-2: Permitting operation of interval funds by enabling closed-end funds to repurchase their shares from investors

v. § 16: Requirement that directors are elected (Stat. Supp. pp. 44-46)
1. Annual or special meeting called for the purpose
2. EXCEPT that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately filing any such vacancy, at least 2/3 of the directors then holding office shall be elected to such office
    a. In regular corporation, vacancy filled by other directors
    b. Recognition that you can't always immediately fill in a vacancy
3. Can resign one by one and have board appoint new directors, up to the point here 2/3 of the appointing board members were elected – after that must go to shareholder vote
4. ***John Nuveen & Co., Inc. No-Action Letter (p. 272): Connected to § 16 but also to balance between corporate law and ICA***
    a. ICA required s/h meeting in two situations:
        i. To elect initial board of directors
        ii. To elect directors to fulfill existing vacancies on the board in the event that less than a majority of directors were elected by s/h's
    b. In either case, the Act requires s/h meeting, irrespective of the requirements, or lack of requirements, under state law
    c. 16(a) is ambiguous regarding whether, as a matter of federal law,

            i. Investment companies require s/h meetings to elect directors, notwithstanding the language requiring them only in the two situations, OR
            ii. Applicable state law should govern timing of s/h meetings in situations other than the two set forth in the Act
         d. SEC decides on (ii) → State law governs timing of s/h meetings
   vi. <u>§ 36(a)</u>: Extends fiduciary duties involving personal misconduct to a number of insiders of the investment companies
      1. Commission can sue
      2. Shareholders can sue
   vii. <u>§ 15(c)</u>: It shall be unlawful for any registered investment company to enter to or renew any K or agreement, written or oral, whereby a person undertakes to act as advisor or principal underwriter, unless the terms have been approved by a vote of independent directors
      1. Requirements for disclosure regarding approval of K's (ICA Release pp. 293-97)
      2. Duty to furnish information as may reasonably be necessary to evaluate the terms of any K
         a. Twist in K law – which says that you have to ask, because here the advisor has to offer
         b. The reason is that the advisor has all of the information and the board does not have any, and can't even ask
         c. Lawyers for the independent directors and lawyers for the advisor ask a lot of questions and create materials. If you have to prepare those materials, it's a full-time job
      3. What do you do with a board that does not know a variety of new instruments, etc.? Does it mean that the board has to know all of that?
         a. What you find now is that you have one or two experts that have all of the requisite information
         b. Always new problems, so some argue that the board should be directed towards them, but that is a difficult thing
            i. Generally lawyers send information that they read about in the newspaper, etc. so that directors can be more attune to what is happening
e. CONNECTION BETWEEN STATE AND FEDERAL LAW
   i. ***Strougo v. Scudder (p. 279): Board members sitting on boards of multiple investment companies with the same advisor***
      1. What happens when a shareholder is unhappy with the corporation but doesn't want to get rid of his shares? The shareholder cannot sue on behalf of the corporation because suits are business decisions that are for the board. However, there's a question about the Board's loyalty. Therefore, the shareholder can sue derivatively, BUT must go and make demand on the Board first. Suppose the board is disloyal and its decision is therefore questionable. Then the shareholder can sue but not on behalf of the corporation.
         a. In § 36, an action may be brought by a security holder on behalf of the company
            i. Therefore different from regular corporate law
      2. Potential conflicts of interest when directors sit on multiple board → different funds may have different interests
         a. BUT don't have enough potential directors to satisfy all boards
         b. The amount of learning to be on these boards is enormous as well, so it works better to have directors to sit on multiple boards (get compensated separately from each)
      3. This case said that we can't rely on the directors to be loyal when they're getting so much money – advisor decides how many boards they sit on, so directors favor the advisors and can't favor the shareholders
         a. b/c only one of the board members did not serve on multiple Scudder boards, the Board could not appoint a committee of sufficiently

disinterested directors to consider a demand by the s/h to institute litigation

b. Rule would not eliminate multiple directorships, but require a sufficient number of directors that w/o such multiple directorships to serve on a board so that a litigation committee could be convened

4. Demand is excused here the questions over duty of loyalty
5. The result of this decision was a change in state law, in which the legislatures have given specific directives that demand must be addressed even if directors sit on more than one board
6. This case shows that we have inherent conflicts of interest as a result of sitting on so many boards, and that state law has become more accommodating to the federal law

ii. ***Burks v. Lasker (pg. 269): Can disinterested directors terminate a derivate suit brought against other directors under the ICA and IAA?***

1. Assume that respondents have implied, derivative cause of action under ICA and IAA
2. Although there are many conflicts of interest in the relationship between advisors and mutual funds, this DOES NOT justify a flat rule that directors may never terminate non-frivolous derivative actions involving co-directors
    a. Overwhelming evidence that Congress did not intent to require such an absolute rule
    b. Congress addresses conflict-of-interest problems through independent-director section
        i. Act designed to place unaffiliated directors in role of independent watchdogs – check on management
        ii. Congress entrusted to independent directors, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the fund's shareholders
    c. *See pp. 285-291 for role of board and independent directors*
3. CLASS NOTES
    a. Court first makes it clear that this is a federal cause of action – no *Erie* issue
    b. Next go to the process – question is whether the board, under state law, has the same kind of rules?
        i. Even though it's a federal claim, is demand still required?
            1. On the one hand is the argument that if it's a federal claim, then demand is not required – can't create power to eliminate a federal claim by directors
            2. The other extreme was that federal law did not create corporate law
    c. Majority balanced this by saying that nothing shows here that the federal claim is in some ways harmed or limited
        i. Blackmun says that we should be very careful to see that federal claims should not be trumped
    d. Start by asking what the clear federal directive is, and then ask to what extent state law allows the parties to limit the reach of federal law
        i. The theory that federal law has incorporated state law into it is not really the case

13. CAPITAL STRUCTURE – CHAPTER 9
    a. PROVISIONS OF ICA DEALING WITH ISSUANCE OF STOCKS AND BONDS BY A MUTUAL FUND
    b. Unlike state law, which allows corporations to design capital structure as long as it's specified in corporate charter, ICA imposes limitations on nature of securities issued by an investment company
    c. § 22(g): No registered open-end company can issue securities for services, or for property other than cash or securities
        i. Exception for dividends
    d. ***REDEEMABILITY***

i. ICA does not require investment companies to issue redeemable securities, but if they do so, the Act requires them to conform to standardized terms of redeemability
ii. If a company offers redeemable securities, it must comply with 22(c) and 22c-1 w/respect to evaluation of securities
iii. Unless exempt by the SEC, must effect redemptions w/in seven days of the investors' demand (w/some exceptions) as prescribed by section 22(e)
iv. DEFINITION OF REDEEMABILITY
    1. § 2(a)(32): "Redeemable security" means any security, other than short-term paper, under the terms of which the *holder* . . . is entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof
        a. ***Brown & Wood No-Action Letter (p. 302): Whether securities are redeemable depends on strictness of restrictions on investors' ability to withdraw funds (see book for conditions)***
v. PRICING OF SHARES
    1. 22c-1: Requires that purchase and redemption of redeemable shares be effected at current NAV that is next computed (i.e., next price after order is received) after the receipt of the purchase or redemption request
    2. Have only little idea of how much money you will get when you redeem
    3. Order redemption first and get the price later
    4. PROBLEMS → Long history behind this in trying to prevent insiders from buying shares for less and redeeming for more – insiders should know the price only after they choose to redeem
        a. Market timing problems: Short-term sales (redeeming and buying frequently)
            i. No violation of the law, but hurting the long-term holders
                1. Transaction costs that those who are long-term investors pay for those who are buying and selling
                2. Managers want to invest all of the $$ possible, but because there is an obligation to redeem, the fund holds a certain % in cash – holding additional cash reduces the returns
                3. Managers don't know how much cash they need – if they invest too much, then they'll have to sell
                4. These funds do not sell their securities. If they do, they're going to dump so much on the market that they'll shoot themselves in the foot
                5. Therefore, they'd rather hold extra cash than have to sell securities later
                6. Holding this additional cash, leads to lower returns in the long run → redeemers force long-term shareholders to keep cash for someone else
        b. Principal concern w/backwards pricing was that it could lead to significant dilution of the investments of existing fund s/h's (p. 306)
        c. Backwards pricing also encouraged questionable sales and trading practices in fund shares (speculation, arbitraging)
    5. Determining NAV includes pricing underlying assets → s/t great deal of potential abuse
        a. Fund is generally required to price its portfolio securities using readily available market quotations
        b. If market quotes are not available for particular security, fund permitted to value securities at fair value, determined in good faith by, or under direction of, fund's board
        c. Fund may (but is not required to) price portfolio securities trade don foreign exchange using fair value, rather than the closing price of the securities on the exchange

i. When an event occurs after the close of the exchange that is likely to have changed the value of the securities

d. BUT, the SEC can trump any such evaluation and decide how to do it

6. ***Mitchell Hutchins Asset Management (p. 302)***
   a. Prospectus stated that the fund would not invest in certain types of mortgage-backed securities, etc.
   b. However, fund manager ended up investing in these types of instruments
   c. VALUATION – Good-faith determination
      i. Custodian was the one that valued → get orders from various managers, and talk to brokers with whom they made arrangements to find discrepancies, etc.
         1. Custodian has NO INTEREST whatsoever in the price
            a. Get a certain fee that has nothing to do with the price
            b. At the same time, want to be very careful that they don't make a mistake
            c. Reliable
         2. Custodian is a good evaluator because they see more than just the one fund so they really have a lot of access to information
      ii. HOWEVER, the portfolio manager was able to substitute his own opinion for that of the custodian
         1. He *constantly* did this without any explanation to his technique for pricing
         2. Portfolio manager can legitimately override because sometimes the custodian (bank) can take a lot of numbers and come up with an average, when the portfolio manager had agreed to a higher price for the specific fund
         3. Many examples in which accountability must be shifted to another party from the party that has an interest in the result
   d. Where were his bosses??
      i. Overall, performance created a reduced supervision
      ii. Fired him when they found out what was going on
      iii. But first thing they did was go to the SEC

vi. PAYMENT OF REDEMPTION
   1. <u>§22(e)</u>: Redemption cannot be postponed more than 7 days
      a. In a MMF it's more immediate – basically on demand
   2. <u>§ 22c-2</u>: Redemption fees for redeemable securities
      a. On the one hand, the SEC did not want to say don't redeem because the whole idea is to allow redemption
      b. It's not the case that every redemption is unjustified – that's the reason for investing in an open-end fund to begin with
      c. There were many arguments about to what extent the SEC should tell the fund managers exactly how to do it
      d. In this rule, the SEC ended up with allowing more flexibility, but unshakeable principles → Leave the rules to the boards
         i. Some mutual funds that invest in real estate, or in American securities, will probably be less exposed to market timing. Those who invest abroad may be exposed to more. Therefore there isn't a bright line rule that would cover all fairly.
         ii. That is why they leave it to the board to decide to approve a redemption fee in an amount not more than 2% of the value of the securities redeemed.
            1. Judgment of the board is necessary to recoup for the fund the costs of quick redemption

                2. Can say that a certain redeemer caused so much trouble that he must pay 2%, and that compensates the long-term investors that stayed
                3. The rule now is that it is costly to churn . . . 2% per transaction ends up being a lot
            iii. Board can decide that imposition of redemption fee is not necessary or not appropriate
                1. If you do that, then there must be a disclosure
            iv. What you see is that the SEC in recent years has passed more principles than rules, and allows boards to make decisions, provided that there is recordkeeping and disclosure

14. RESTRICTIONS ON INVESTMENTS OF INVESTMENT COMPANIES (pp. 341-44)
    a. The entire § 12 of the Investment Company Act is about investments that the company cannot make, or that that are extremely limited
    b. <u>§ 12(d)(1)</u>: investments in other investment companies
    c. <u>§ 12(d)(3)</u>: prohibition on investment in broker-dealer or underwriters
        i. Also includes a prohibition on investment in insurance companies
        ii. Therefore, in general, this is a prohibition on investment institutions
    d. Started because there was a prohibition on investment in partnerships → unlimited liability
    e. Also because broker-dealers are interwoven in sales
        i. All open-end companies have continuous sales in order to support redemption
        ii. And then broker-dealers may have their own conditions . . . may require certain things for sales that may not be as desirable to the investors
    f. These limitations have been reduced to some extent over the years, but they still have some bite
15. PERSONAL INVESTMENT ACTIVITIES OF INVESTMENT COMPANY PERSONNEL – SECTION 17(j) (starting p. 377)
    a. <u>17(j)</u>: Prohibits persons affiliated with a fund, investment advisor, or principal underwriter, from engaging in fraudulent, deceptive or manipulative practices, in connection with purchase or sale of securities held or to be acquired by the fund
        i. *Affiliated person under § 2(a)(3)*
    b. Authorizes Commission to adopt rules to address conflicts of interest presented by personal securities trading by these persons, including rules involving codes of ethics
    c. <u>Rule 17-j</u> (Stat. Supp. 260):
        i. <u>(i)</u>: Requires 17j-1 organizations to adopts codes of ethics containing provisions reasonably necessary to prevent "access persons" from engaging in such fraudulent, etc. acts
        ii. <u>(ii)</u>: Requires access persons to report person securities transactions to the company at least quarterly
        iii. <u>(iii)</u>: Requires maintenance of certain records, which must be available for inspection by Commission
        iv. <u>*SEC recognized that no single set of guidelines would be appropriate for all funds → ethical constraints best left to directors of investment company*</u>
    d. CLASS NOTES
        i. What happened was that a portfolio manager knows that he's going to invest in X securities. When he invests 100,000 shares, the price is going to go up. He buys the shares first for himself, and then buys for the investment company. If he finds out that things are not going so well, he'll sell his shares first, and then sell those of the company. Therefore, there is an inherent conflict.
        ii. Then why did the SEC not say that portfolio managers, or other people with information, cannot trade in securities?
            1. Would not be able to enforce it → if a person's entire personhood is dependent on trading, cannot prevent them from trading in their own funds
            2. Therefore, they were allowed to do it, but look at how . . .
                a. Who really has the burden of making sure that insider trading does not happen?
                    i. SEC required a code of ethics

1. From time to time, see a shift to self-regulation and this is one of those cases
2. Not merely leaving it to advisor to self-regulate, but SEC still regulating just how the self-regulation will take place
    a. Not all cultures are the same; not all internal rules, people, histories are the same, and therefore leave it to the company but give guidance through rules

iii. Similar language to § 10(b) and 10b-5
iv. Adoption of codes of ethics
v. Gives SEC very broad authority; in the rule that the SEC came up with:
    1. Find a demand for recognition by the employees
    2. Definition that is very broad about which employees are subject to this rule (access employees)
        a. Someone who manages, advises, BUT what about the typist who knows what is going on because she has to type, or the policeman who has the key and can access the materials?
        b. Limitations –
            i. If access persons want to trade, can trade only through particular brokers, who are given permission to show what they traded to the person that is in charge
    3. Criminal violation
vi. Mosaic theory: keep taking bits of insider information – which alone are very little and mean nothing – and put it together, it *becomes* material

e. SELECTIVE DISCLOSURE AND INSIDER TRADING – REGULATION FD (pp. 383-388)
    i. Regulation FD: Disclosure rule that addresses selective disclosure – provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (generally people who will trade on the info), it *must make public disclosure of that information*
        1. Disclosure must be simultaneous for intentional disclosure, and prompt for non-intentional disclosures
    ii. Addresses concerns about disclosure of advances warnings of earnings results and the like to securities analysts or selected institutional investors or both before making those disclosures to the public
    iii. Until Rule FD existed, large investors, etc. would meet with CEO's or second in command and get all kinds of information that was not tied to certain events (like mergers) but close to the type of information other people might get.
        1. The other thing is that those analysts were part of a conglomerate that had brokers, so the analysts would come back and talk to the brokers.
        2. So this was a reaction to complaints and to some cases of insider trading.
    iv. However, whatever happened afterwards – the product of this (pg. 383-85) – is a very unclear and confusing type of regulation.
        1. The focus is on the CEO and top executive, leaving out all of the other actors that may have insider information.
        2. The question is that if you single these people out, does that mean that the rest don't have this duty?
            a. Well . . . they do, but it's under 10b-5, not FD.
            b. Therefore, top management is subject to two regulations, while lower management is subject only to one.
        3. The next question is what is material. Is the atmosphere of the corporation material?
            a. The first instinct is no, but maybe it would affect the stock price is someone died in the company, etc.
    v. In practicality this regulation has had no effect on how things run – CEO's still meet with analysts in the same way that they used to. Unless something happens (like article Prof. Frankel sent us) where one party is paying for specific information about a merger, or something of the sort, this rule is kind of a dud.

16. PROTECTION AGAINST CONFLICTS OF INTEREST – CHAPTER 12
    a. Distinguish between corporate and here.
        i. In corporate law, conflicts of interests are resolved with disclosure.
        ii. This is NOT the case here – conflicts of interests are resolved by a substantive rule.
            1. Even in exemptions it's resolved by shifting the decision to management or to the board, but there is a whole list of requirements that influence the decision-making process.
    b. 1940, this started with four main sections.
        i. § 17(a): focuses on buying and selling of property, and borrowing
        ii. § 17(d): focuses on fiduciary and the mutual fund becoming partners but not equal ones
        iii. § 17(e): focuses on kickbacks (services appear here and not in (a))
        iv. § 10(f): focuses on dumping – advisor or underwriter has shares which it cannot place, and dumps them on a captive buyer
    c. All of these activities were disclosed and discussed in the hearings in 1940. Throughout the years, however, some of the reactions have been watered down, in part because of the enormous growth of mutual funds. The SEC can no longer deal with the amount of exemption requests. And also because there is a growing feeling that a mutual fund should be able to do something that does not present a problem
    d. These are criminal offenses (no private right of action). Also, the intent that is required is to KNOW – not necessarily scienter. You have to know that you're buying or selling property, and have to know your position that puts you in violation (not knowing that you're violating the law).
    e. § 17(b): Application for exemption of proposed transaction from certain restrictions
        i. § 6(c) does not use the word "proposed"
        ii. SEC sometimes combines the two
        iii. Commission SHALL grant the application if the transaction meets certain specifications
            1. Terms of proposed transaction, including consideration, are reasonable and fair and do not involve overreaching **on the part of any person concerned**
                a. NOT just asking whether it's good for the investment company
            2. Proposed transaction is consistent with policy of each registered IC involved
            3. Proposed transaction is consistent with general purposes of subchapter
        iv. SEC has adopted rules . . .
            1. Shift from decision of Commission to decision of board of directors
                a. Number of rules or conditions that appear wherever this shift occurs so it still doesn't look like a corporate board
                    i. More power in various ways to the disinterested directors (might be only with respect to the decision but sometimes it's more fundamental)
                    ii. Specific conditions
                    iii. No conflicts by the decision-makers
                        1. If the advisor, or people who work for the advisor, etc. have any interest in the transaction, there's a very good chance that they will not fit into any of these exemptions
                    iv. Proof – don't mess with the minutes of the meeting (minutes must be open to examination)
            2. If there's a violation, the directors don't get sued, but the transaction because unlawful under 17(a)
        v. Broad exemptive power
            1. ***Vanguard Municipal Bond Fund (pp. 436-47)***
                a. Have two investment companies
                b. One is a normal IC, ie., equity company, and the other is a money market fund
                c. Problem is that the equity fund from time to time has a lot of cash – wants to move the cash to the MMF, and then if they need to withdraw from the MMF, they can do so immediately
                    i. Assume that Vanguard knows that the MMF will not break the $
                    ii. So good arrangement to invest in the MMF

d. Now we have a problem because both IC's are managed by Vanguard and therefore are affiliated (Vanguard controls both)
e. Go to the SEC and ask for a § 17(b) exemption
   i. First have to meet conditions then go to the SEC and ask
   ii. No fees – waive all management and admin fees under K
f. Beneficial arrangement, no cost to shareholders, get exemption

f. <u>§ 17(a)</u> – prohibition on buying and selling of property, and borrowing

i. <u>PROHIBITED PARTIES</u>: Prohibits transactions in which one party is an investment company, or a company controlled by an investment company, and at least one of the other parties is
   1. An affiliated person of the investment company, or an affiliate of the affiliate,
   2. <u>A</u> principal underwriter for the investment company, or an affiliate of the underwriter, or
   3. A promoter of the investment company or an affiliate of the promoter
      a. <u>§ 2(a)(30)</u>: "Promoter" is a person who, acting alone or in concert with other persons, is initiating or directing, or has within one year initiated or directed, the organization of such company
   4. *NOTE: promoters and affiliates of principal underwriters are not affiliates under 2(a)(3), but section 17(a) applies to them*
   5. <u>PG. 428 DISCUSSION TOPICS</u>
      a. Company A owns 5% of Investment Company (IC), and IC owns 5% of Company B
         i. A is an affiliate of IC
            1. Don't have to show control – 5% is sufficient for statutory control
         ii. B is an affiliate of IC
         iii. But what about a sale from A to B?
            1. Ask whether the investment company has any role in the transaction?
            2. Here the investment company is not involved, so this transaction would be fine
         iv. What about if Company B is controlled by the investment company?
            1. Language of statute → prohibition on a sale between an affiliate and a company CONTROLLED by the investment company
            2. Therefore, in this case B cannot transact with A
      b. Company B owns 5% of Company C
         i. Can Company A transact with Company C?
            1. If there is no control, then the transaction is fine
               a. Again, the IC itself is not involved
            2. If there is control, then it is prohibited
      c. Director of IC sold property to company in which he has 5% of voting securities (affiliate of the company)
         i. Director is an affiliate of the IC, but the IC is not an affiliate of the director, so the IC is not taking part in the transaction
            1. If company was an affiliate of the IC, then it would lock out the director from doing any sort of business just from sitting on the board
      d. (f) Let's now look at the issue of a bank. Have a bank that establishes a corporation through which it can sell loans, and then in return, the corporation's stock is transferred and the bank holds all of the common shares. The bank then causes the corporation to sell preferred shares to the market. Whenever the bank sells additional loans to the corporation, it gets preferred stock. So the first batch of loans is exchanged for common stock (with votes), and later loans are exchanged for preferred

stock. What is the relationship between the bank, corporation, and its shareholders?

i. Status of the players
    1. Investment company must issue stock AND invest in stock
        a. Issues preferred shares to the public
        b. Invests in loans (holding loans for investment makes them securities) – these loans are not in connection to any commercial agreement . . . the commercial agreement happened at the bank level
    2. Therefore, this corporation is an investment company

ii. PROHIBITED TRANSACTIONS:
    1. (1): knowingly selling any security or other property, unless the sale involves solely
        a. (A): securities of which the buyer is the issuer (repurchase)
        b. (B): securities of which the seller is the issuer and which are part of a general offering to the holders of a class of securities
        c. (C): securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof
    2. (2): knowingly purchasing any security or other property (except when seller is issuer)
    3. (3): borrowing
        a. Borrowing interpreted *broadly*
        b. ***Sierega & Co. (p. 427): excess expenses were supposed to be reimbursed by the advisor to the fund – failure to reimburse construed as prohibited borrowing by advisor***
            i. The SEC sues the advisor
                1. There's a K that says that the advisor promises not to charge more than 1%
                    a. Can the SEC sue the advisor under § 15? Nothing in this section that allowed the SEC to enforce the K
                    b. Lot of arguments about the power of the SEC to enforce this section
                2. Therefore the SEC sues under 17(a)(3) because this constitutes a loan → gives the SEC a way of enforcing this
    4. (4): lending

iii. EXEMPTIONS (p. 429 -)
    1. Coverage is quite broad, so SEC has provided exemptions for certain transactions that would be covered by 17(a) but don't present issues of overreaching
    2. RULE 17a-7: Exempts transactions when the parties are affiliated *solely by reason of having a common investment advisor or investment advisors which are affiliated persons of one another, common directors, and/or common officers*, provided that certain conditions are met
        a. Transaction must be a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
        b. Offered at current market price;
        c. Consistent with policy of each company;
        d. No brokerage commission fee;
        e. Board of directors (including majority of disinterested directors:
            i. Has adopted procedures for such transactions, reasonably designed to make sure that (a)-(d) have been complied with;
            ii. Reviews these procedures as necessary;
            iii. Determines at least quarterly that transactions of past quarter were in compliance with procedures

f.
    i. A majority of directors are disinterested directors, and they select and nominate other disinterested directors of the company
    ii. Independent legal counsel
g. Certain recordkeeping requirements are met

3. <u>RULE 17a-8</u>: Exempts certain mergers of affiliated investment companies
    a. When a merger involves investment companies which are affiliated persons exclusively by virtue of having a common investment advisor, directors, and/or officers, no person who is responsible for evaluating and approving the terms of the transaction on behalf of the various participating investment companies would have a significant financial interest in improperly influencing the terms
    b. Requires board of directors (including majority of disinterested directors) to:
        i. Determine that the transaction is in the best interest of investment company, and
        ii. Will not result in diluting the financial participation of any investment company s/h
        iii. (in making findings, consider all material info – pg. 431)
4. <u>RULE 17a-6</u>: Exempts transactions between investment company and certain "portfolio affiliates"
    a. As long as certain other affiliated persons of the fund (i.e., fund advisor, person controlling fund, persons under common control with the fund) are not parties to the transaction and don't have financial interest in a party to the transaction
    b. Portfolio affiliate means any person that is an affiliate of the fund solely because the fund, a fund under common control with the fund, or both:
        i. Controls such person (or affiliated person of such person), or
        ii. Own, controls, or holds the power to vote 5% or more of outstanding voting securities of such person (or affiliated person of such person)
5. <u>SEE pp. 432-36 – portfolio affiliates, second-tier affiliates, subadvisors</u>
    a. Addresses the fact that we now have huge conglomerates, like CitiCorp or Bank of America, that encompass all of the actors within one entity
    b. <u>SUBADVISORS</u>: something that arose recently . . . with the creation of more and more complicated instruments, wanted subadvisors to focus specifically on those instruments. Otherwise, the advisor would have to have expertise in every area. For example, if an IC were international, it would need subadvisors who know what the situations were in other countries, because the international fund pulls together stocks and bonds from different countries. Therefore, you have subadvisors that specialize in each country. If the specific advisor does not have a subadvisor with a specialty in the specific country, can borrow from someone else (i.e., broker-dealer).
        i. The SEC was therefore pushed by the change in the environment to move away from 17(a) – from a clear categorization – for two reasons:
            1. They couldn't handle any more requests for exemptions
            2. They wanted to give some directives but make it possible to borrow subadvisors
    c. So they got permission to do this, BUT with a list of conditions.
        i. They shifted the decisions to the boards – to a majority of disinterested directors – and given directions.
        ii. Also, there is the requirement to report to the SEC (in increments usually less than a year).
            1. The SEC probably doesn't actually look at the reports, but if the reports are not true, then that is a criminal offense.

d. Therefore the result is that you have shifting to the board with much more specific enforcement than you would in the usual case of business in general.

g. ***<u>§ 17(d)</u>: "catch-all" provision relating to conflicts of interest; terms of transaction in question must be equal***
   i. Not self-executing provision but enabling provision – SEC can prohibit certain activities by rule
   ii. Not relating to direct transaction between IC and its affiliates
   iii. Relates to parallel transactions where
      1. IC and its controlled company are on same side of the transaction as affiliate, or affiliate of affiliate, and
      2. Third party is on the other side
   iv. Prohibits transactions in which
      1. The investment company (or company controlled by IC) is a joint, or joint and several participant with the other party, and
      2. The participation of the IC (or controlled company) is on a basis different, or less advantageous than that of the other participant
   v. Exemptions under 17d-1

<u>SEC v. Talley Industries, Inc. (pp. 438-442)</u>

Actors:
- American: IC
- Talley: American owns 9% of Talley's shares (limit is 5% to be affiliates)
  - Didn't want to acquire more than 10% because of 16(a)
    - § 16(a): Directors, officers and 10% shareholders have to return profits to corporation for round-trip transactions within 6 months
- General Time: takeover target
  - Talley wanted to take over, but didn't have enough $$
  - GT was a much larger company
  - Aimed at offering a merger, and in order to offer a merger, must have enough $$
- Kimelman: broker
  - Both of them had to go through the broker, and the broker has all of the documents

Talley contacted American and said it wanted to take over/merge with GT
Chestnutt (president of American) broke off the conversation and said that he needed to go to his lawyer.
Chestnutt said that it would remain independent, as long as there is no agreement and no promise.
- Lawyer was wrong, but there was no precedent
- However, without precedent should have gone conservative
- Probably took this from corporate law, but in mutual funds NEVER GO TO CORPORATE LAW

Next, American begins to buy the stock. So now both American and Talley are buying GT – did so on a "not held" basis (gave the broker the order and the broker purchased the shares over a few months).
- American wants to buy GT stock low (pushing the price down before they buy),
  - Then they want to buy, then want price to go up, then want to sell for a higher up once there's a bidding war.
  - Want to keep the price low until they buy enough shares – don't want to execute a sufficient amount to drive price up
  - Also don't really want public to know that there is some sort of purpose here, and certainly don't want GT to know
- Talley doesn't want the price to go up immediately either because they want more shares so that they can merge
- Therefore, instruct broker to buy when the price is low

At some point, there is another company – Seeburg – that offers American $40/share (this is the company that ultimately did merge with GT). The chances are that the IC won't lose money, and that it probably will gain. The CEO said that he would have to compare this with what anyone else might offer (doesn't say yes and doesn't say no) . . . clearly what he wants is a higher price. When he refused the $40, he takes the additional risk that he'll be locked in for 6 months (if the holdings exceed 10%).

GT files for an injunction but does not succeed in getting one.
The IC went to the SEC to ask for an exemption under 17d-1. The SEC did not give them an exemption, and they appeal to Judge Friendly.

- SEC decide if there's a violation, and court decides what the remedy will be

Looking at the statute itself . . .

- "It shall be unlawful" – CRIMINAL CASE, the next section does not say this
- "joint or joint and several participant"
    - Justice Friendly looks at § 1(b)(2) of the statute to see what Congress found was wrong with the mutual fund industry
        - One of them was this – insiders went together with the mutual fund, but not as equal partners
        - i.e., IC put in 80% and got 20% and affiliate put in 20% and got 80%
        - Problem was reduced by 17(d)
    - Interesting that court went to the list of problems that Congress wanted to reduce or eliminate
    - And then said this is the way that we will interpret the joint and several
    - Court recognizes that sometimes the mutual fund can be dragging on and on until it becomes locked in – doesn't necessarily need to be "joint" from the beginning
        - See an evolution of the IC becoming more and more involved – keeps buying more and more at a time, and then even breaks the 10% barrier
    - Court lists as "joint and several" information
        - When Talley went and talked, he referred to the two of them as "we" showing that there was some sort of understanding, collaboration, desire to achieve the same objective
    - The court does something that is wonderful, and less prevalent today, and leaves a grey area
        - Result is that he didn't give them the remedy but struck down the acquisition

vi. Is section 17(d) violated if the directors of an investment company that invest sin stocks of biotech companies invest in such stock in tandem with the company, but sells the stocks before the IC does?
   1. Know what happens and can bail out first, so violation.
   2. What about if the directors and the investment company both buy shares in IBM on the same day?
      a. If they just happen to both buy on the same day, then it's probably okay.
      b. IBM is so large that they can't really purchase with the intention of affecting the policies of IBM – very unlikely that there will be any impact from the purchase and the sale.
   3. Suppose I go to the mutual fund and I'm an affiliate and at the same time, I want to give the mutual fund special services, so I make a K to pay me x dollars for my services. I'm a director. Both of us want to achieve for the mutual fund a certain purpose. Would § 17(d) apply? Do I fit into a joint and several participant? And does the arrangement fit into that?
      a. NO, because the transaction here is an exchange of services
      b. Unclear from section whether it covers services to begin with (although it is sort of a catch-all)
      c. There is a section about service, and that is § 17(e)
      d. If someone has problems with that, then go for a no-action letter

vii. (proposed amendment to 17-d was withdrawn (pp. 442-444)

h. ***<u>§ 17(e)</u>: addresses conflicts of interest that arise when an affiliated person (or affiliate of an affiliate) serves as an agent in the IC or its controlled companies***
   i. Agent is a party who has the authority to bind the principal to a legal obligation
   ii. Most agency conflicts of interest arise when affiliated person obtains some benefit from acting as agent for IC
   iii. Applies to SERVICES

iv. §17(e)(1): It shall be unlawful for any affiliated person of an IC, or affiliate of an affiliate, acting as agent, to accept from any source compensation (other than regular salary or wages) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in course of such person's business as underwriter or broker
    1. NO KICKBACKS
v. ***United States v. Deutsch (pp. 444-449)***
    1. FACTS
        a. Actors:
            i. Deutsch: Realty Equities Corporation (real estate, not mutual fund)
            ii. Mills: Fidelity
            iii. Chapin: insurance company in MA (becomes a director of Realty – insurance companies at that time dealt a lot with mortgages of real estate . . . very connected at that time)
        b. See the network . . . talk amongst themselves although the entities are very different. Deutsche needs cash for a merger – wants to sell bonds (hundreds of thousands of dollars). He didn't succeed in selling at first. After a lot of attempts, Mills helps Deutsche and the result is that the bonds begin to sell → stock rises → bond value rises because the assumption is that the risk is not as great, and then it goes down.
        c. When Real Estate issued bonds to the insurance company in TX, they said they undertake to buy back seven bonds. In addition, we may buy back one bond. Clearly the obligation to buy back reduces the risk of the buyer. BUT, the right to buy back is at the price of issuance. So suppose the issuance was $1 for 100, then the obligation to buy back would be $700. But the real estate entity would buy back only if the price went to 200, then they buy back at 100.
        d. What happens next is that Deutsche offers Mills for Fidelity certain of these bonds at the price of issuance, NOT at the price of the market. And the difference is almost a million dollars. And Mills decides to buy it for himself. He simply took an opportunity (tries to hide it – receives a sheltered bank account), but the case is about Deutsche – charged with aiding and abetting Mills. Today it would be much harder to get a conviction but this is still good law. What about the aiding and abetting is about is Mills cheating Fidelity. Deutsche did not cheat Fidelity or Real Estate, but rather he helped Mills cheat Fidelity out of about a million dollars.
    2. RESULT
        a. Compensation does not have to actually cause the fund to purchase or sell securities → 17(e)(1) does not explicitly make it an element of the offense that the recipient of the compensation take any action the result thereof
        b. More reasonable interpretation is that the offense is complete when the compensation is delivered and received with forbidden intent
        c. Given the nature of the IC industry, it would be very difficult to prove in any given case that the payment of compensation actually caused a particular purchase
        d. Affiliated person is acting an agent within the meaning of 17(e)(1) in all cases when he is not acting as broker for the IC
        e. Requisite Intent – NOT intent to influence
            i. Only intent required is that the payment be given and accepted in appreciation of past, or in anticipation of future, conduct
vi. §17(e)(2): Prohibits brokerage fees that exceed the usual and customary commission on the sale, or 2% of the sales price
    1. Advent of negotiated commissions may make is impracticable for IC to determine whether commissions satisfy the standard of usual and customary brokerage commissions

2. Commission doesn't want to have to decide what's fair and customary
3. RULE 17e-1: Brokerage fee is deemed usual and customary if:
    a. It's reasonable and fair compared to the fee received by other brokers in similar transactions
    b. Board of directors, including majority of disinterested directors:
        i. Adopt procedures that are reasonably designed to provide that fees are consistent with (a)
        ii. Makes and approve changes and board sees necessary
        iii. Checks at least quarterly that all transactions were effected in compliance with such procedures
4. The last thing that the SEC wanted was to have companies and ask if specific % were fair
5. That is how the power shifted to the boards of directors
6. Don't know what will happen next
    a. Will be the board of the directors that decides how much is too much
    b. Board not just free to make a decision without guidelines – design is going to be that the board is going to have to go through a series of steps dictated by the SEC
    c. And then will need some notification to the SEC that the board has in fact gone through those steps
    d. If the information to the SEC is incorrect, then there is a criminal violation, and this is what keeps the board more on its toes than in corporate law
7. There is NO mention of underwriters in 17(e), and the reason is that underwriters must receive as agents securities from the investment company and must sell them – that's their function in an open-end company and even in a small closed-end company, so Congress has left them out of this section, NOT the section where they buy from the investment company
    a. With respect to broker, Congress is ambivalent – need brokers but not as much, so Congress didn't let them work as freely as underwriters

vii. SOX amended 10A of the 1934 Act to prohibit auditor from performing certain non-audit services, including broker-dealer, etc. (p. 450)

i. ***§ 10(f): prohibits dumping of unsold securities by underwriters***
    i. § 10(f): Registered IC cannot knowingly purchase or otherwise acquire, during the existence of an underwriting or selling syndicate, any security, if an officer, director, IA, etc. of the IC is the principal underwriter
        1. Extends to purchasers from any member of the underwriting or selling syndicate, even if that member is not an affiliate of the IC
    ii. Meant to address the issue of "dumping" – underwriters that also managed IC's used to dump unsold securities onto the IC's portfolio at the offering price, which by that point was much higher than the market price
        1. Shares are priced by discounting earnings per share to PV
    iii. BACKGROUND

[When the advisor of a mutual fund allocates shares that have no clear current value, but only projected value because they have just appeared in the market, then the price in the market and the price that they might be charged differ. When underwriters have an enormous amount of shares, and the market won't swallow those shares, the underwriters commit to providing their "best efforts" to sell all shares. However, if they dump all of these shares on the market at once, the price is going to go down, and the underwriters would not be able to rev the market up. So now you have an underwriter that is taking on the risk.

So what underwriters do is form a syndicate of 3/5/7 underwriters who get together, have a leading/managing underwriter who gets a bigger %, and each undertakes to sell a certain amount. In the 1940's Congress focused on the syndicate. The first proposal was for Congress to prohibit directors, officers, employees of the investment company from engaging in underwriting. This brought problems because you couldn't bring in a director who would be liable for an enormous amount of $ if he does this part time and is really in another line of business. Therefore, in the section the prohibition is on the INVESTMENT COMPANY – can't purchase any security that an affiliate offers. The result is that not only is the investment company prohibited from buying shares from ITS affiliate, but it's all prohibited from buying shares from any member of the syndicate unless and until the affiliate is no longer in the syndicate. There were no requirements about the terms of the transactions. If you want to dump, go to the SEC for an exemption.

This was the starting point and since then we have had personal exemptions and rule exemptions. Now the limitation on buying as far as the whole syndicate is concerned is eliminated. And what remains is the prohibition on the relationship between the investment company and its underwriter.]

i. <u>RULE 10f-2</u>: Permits purchase of securities pursuant to exercise of warrants or rights
   1. Also look to see if they are offered to other shareholders. If I have an affiliate that is underwriting the warrants, and the investment company already has the shares then it is unfair and unnecessary to prevent it from buying all of the warrants that other shareholders get. The same applies to municipal bonds that don't have to register.

ii. <u>RULE 10f-3</u>: CONDITIONS FOR EXEMPTION (Stat. Supp. & pp. 452-455)
   2. Type of Security
   3. Timing and Price
   4. Reasonable Reliance
   5. Continuous Operation
   6. Firm Commitment Underwriting
   7. Reasonable Commission
   8. Percentage Limit (w/exception)
   9. Prohibition on Certain Affiliate Transactions
   10. Periodic Reporting
   11. Board Review
   12. Board Composition
   13. Maintenance of Records

iv. Rule 10f-3 has undergone a number of amendments, reflecting changes in mutual funds business and underwriting business (p. 455)

j. DISCLOSURE REGARDING PORTFOLIO MANAGERS (pp. 456-457)
   i. Require a fund to identify in the prospectus each member of a committee, team, or other group of persons associated with the fund or investment advisor of the fund that is jointly and primarily responsible for day-to-day management of the funds portfolio
      1. Including brief description of each person's role in the group
   ii. Must disclose in SAI number of accounts managed w/in each of three categories, and total assets by category
   iii. Fee structure
   iv. Want to manage conflicts of interests, and to manage violations. Also the manner in which you incentivize people is important.
   v. All of the disclosure appears in the SAI (Statement of Additional Information) that can be incorporated in the prospectus, but it's a separate thing that you have to ask for – didn't want to pack the prospectus with more information

<u>Merrill Lynch Asset Management, LP (pp. 457-461</u>

Merrill Lynch was sitting on top of everything – was more specialization than there is now; at that time i-bankers were really i-bankers and didn't do much of the other things

- Had underwriters, with brokers underneath them
- Had investment advisor that manages investment companies

The broker can sell to the investment company

IC create portfolios of securities and sell THOSE securities to investors. It's the same advisor, and why impose on the advisor the cost of creating more and more companies. If the portfolios are small, but really they are just sets of assets being sold in the market (specialized and therefore wanted expertise). They get experts by having subadvisors from the outside. When he becomes a subadvisor, he becomes an affiliate to the IC, and then becomes a second-tier affiliate to the investment advisor, who is an affiliate to the underwriter and broker-dealer. When the subadvisor needs to buy certain securities, and here is this broker that wants it.

Which sections?

- 17(b) and 6(c)
- but also looked to 17(e) – had a broker-dealer
- why 6(c)?
    - Want an exemption so the focus is not on persuading the SEC, the focus is also on whether the SEC has authority to give them what they want
    - Wanted the subadvisors to be able to deal with the broker-dealer
    - One of the requests that they had was to get a prohibition in the future – didn't want to have to get a specific exemption every time the subadvisor wanted to deal with the broker
        - 17(b) gives exemptive power for a particular transaction
        - 6(c) gives a more broad exemption
            - exempt any class of persons from any provision
            - policy-wise were they right?
                - In 1940, functions were separated → rightly or wrongly we have now allowed and sometimes encouraged the conglomeration of functions, providing for more efficiency
                - The difficulty is to identify where the problem lies and deal only with that and not the whole structure

17. MONEY MARKET FUNDS
    a. Two features of MMF's raise problems under the 1940 Act
        i. Valuation of portfolio securities
            1. MMFs issue redeemable securities, which must be sold and redeemed at NAV
            2. One share for one dollar
            3. Wanted to value on amortized cost basis, rather than FMV (to reduce possible volatility of the dollar base)
                a. During the period market price may change, but not reflected in fund's valuation
                b. The longer the maturity date, the more susceptible to the market
                c. Therefore may result in over-valuation or under-valuation of portfolio securities → investors purchase or redeem shares paying more or less than *actual value* of their proportionate share in current net assets → dilution of the assets and returns of existing s/h's
            4. RULE 2a-7 allows MMF's to use either amortized cost or penny method s/t determination by board
        ii. Daily distribution of income and capital gains which the funds make to their shareholders
            1. 19(b) of the Act prohibits daily distributions
            2. SEC, recognizing that purchasers are not misled by these distributions into believing that the fund is unusually profitable, granted exemptions
    b. Problems for sponsors – don't want runs so if fund breaks the dollar, sponsors and advisors purchase the securities that caused that (at face amount)
        i. Creates a "market guarantee"
        ii. Could be problematic b/c it could create a wrong impression of fund's invulnerability
        iii. The fact that people take their $ out is not in and of itself a run – depends what triggers it. When the economy crashes, the trigger is not that someone else did it. In banking, a run is based on the fact that taking $ out is not really based on individuals opinions, but just looking at what others are doing

    c. BACKGROUND

[There are lots of arguments about where these funds will end in terms of business/finance and in terms of law. But in order to understand this, focus on why they're here in the first place. MMF's were the offspring of regulation in the sense that they were a reaction to regulation. At that time, the environment a high-inflation (12-15%) and at the same time Reg Q did not allow banks to pay on deposits more than 5.25% and didn't allow S&L's to pay more than 5.5%. Banks were happy – charged borrowers 20-22%. The S&L's had long-term borrowers with a fixed interest rate, which was not high enough to cover the payments for savings accounts. They therefore failed because the mortgages were not liquid – result was a push towards securitization . . . creating a market in non-tradable mortgages. In mutual funds, it led to an entirely different approach.

Mutual funds had a different problem – in the 1970's they were dwindling because they offered pools of equity, pools of debt, and pools of trusts that held even longer-term obligations (i.e., municipal bonds). They weren't rich in offering various pooled investments. So here was an opportunity and they took it. Mutual funds were the first form of diversification, but then different kinds popped up, and now we have a variety of types of investment.

What did money markets do?

1. Started by offering to take $ out with a check
2. They knew precisely how much $ they could have to pay with a check
    a. If I have an equity pool, I don't know how much money I have at each stage
        i. Could have check bounce, or not take out as much as I want
    b. Important to have a way to know precisely how many dollars are available at every stage

It was very important to make the instrument look as close to the bank account as possible. And the reason that they did this is that mutual funds were not subject to Regulation Q. Before regulation, invested in CD's. The CD's were really like bank accounts because they were backed by the government, BUT they paid more. So you have the use of checking, definitive amounts you can take out, more in terms of returns, fairly stable amount b/c of the CD's – pays more but looks like a bank account.

What kind of assets did MMF's invest in??

- Short-term commercial paper issued by corporations. Corporations could go to the bank and get quick cash, but they found out that MMF's were more acceptable, less costly (in the whole operation), more efficient – so companies left the banks and took their working capital in MMF's.
- There was another source
    - Cash that traders in securities had either before they invested in securities or after they sold
    - Gardenburg: case in which ML established sweep account – whenever client had cash, swept it into MMF, and whenever he needed cash, he swept it out
    - Instead of putting $ in bank, which would require ML to go throw many steps, ML said that it will be the equivalent of the bank for the client and in addition, pay more

Even with the financial crisis in 2008, not a lot of $ left mutual funds. MMF's created an opportunity to diversify offerings for the investor but keep them under the same roof for the manager – manager not only earned more but had economies of scale and other benefits.

MMF's did not until recently look at depositors' demand as a basis for how much cash to keep on hand – just had a 15% requirement. This is unlike banks, that keep track of figures based on different times of year. For a long time the requirement was % of the assets because it's much easier for the regulators.

There is a system for avoiding runs on MMF's

Assume fund holds $100, you put in $100, each share is $20, so you own 5 shares of the mutual fund. If the fund amount goes up to $120, then your 5 shares are worth $1.20 each, not $1

Assume that it's a MMF that holds $120, you put in $100, it's shown as $1 + $.20x100

- The $1 is the 'dollar that gets broken';
- The .20x100 is the dividend]

    d. REGULATION of MMF's is much more substantive b/c they look like bank accounts, so if they were managed like other mutual funds, they' be misleading
    e. "Risk-limiting" conditions on maturity, quality, and diversification of fund investments
    f. <u>RULE 2a-7</u>: pp. 465-467
        i. Limit investment in securities of any issuer to 5%
        ii. Limit investments to securities with minimal credit risks and that meet certain rating requirements
            1. Limit investment in all securities without highest rating to 5% of total assets; limit investment in one such issuer to 1%; does not apply to government

a. Rating of "risky" securities, and no requirement for rating for less risky securities
b. Relate to reduced risk *from the issuer*

iii. Limit investments in securities w/a remaining maturity date of not more than 13 months
1. Longer maturity is more risky, but return goes down
2. Applies to security being issued

iv. Derivatives (pp. 468-470)
1. K between two people – one thinks interest rates with increase, other thinks it will decrease
2. MMF's don't really need derivatives to reduce risk, and if they're investing in them it's probably because they're trying to take advantage of the speculative nature, which is actually more risky

v. Disclosure
1. That funds are neither insured nor guaranteed by US government
2. No assurance that fund will be able to produce NAV of $1

vi. Name
1. Can't use "money market" in your name or similar names holding yourself out as a MMF unless you meet risk-limiting conditions

g. VALUATION (p. 467)
i. MMF's generally invest in short-term debt securities so requiring normal valuation would be difficult or costly
ii. Amortized Cost: Portfolio securities valued based on acquisition cost and adjusted for amortization
iii. Penny-Rounding Method: Value securities at FMV or amortized cost, and then round NAV to the nearest one cent on share value of one dollar

Valuation:
- Banks
  - For a long time, value of the assets of the banks were valued at cost
    - If market drops so that there's almost no value at all, then what the banks have on the BS is irrelevant
  - Then the argument was that banks should value their assets by market value, and not historical cost
    - If the value of the loans as a whole changes, then the value of the bank's assets change
    - This would be a lot of work for the bank
    - The argument for market valuation was that it reflected liquidity
  - Suddenly it became clear that the market was not very accurate – depends on investors' hysteria and a number of other things
    - So there really is a problem with both
- The same applies now to MMF's
  - Forms of Valuation
    - Possibility of saying that you bought this short-term paper for X and value them as X on your BS, and then report the $1 to your investors
      - Even though in the market it may be 50 cents
    - The other possibility is to link the value to the market and then find out whether there is a dollar there, or whether you broke the dollar
    - SEC said that it will allow MMF's to round the dollar when using market value
      - If the dollar is really 99.5 based on market valuation, they allow rounding to the dollar
  - The decisions between these three forms was left to the managers of the funds – in the past may took the FMV and the ability to round
  - When they broke the dollar, the fund advisor bought the faulty instruments and jacked up the price
    - Until the new rule arose, the fund advisor had to call the SEC because of 17a
      - Gave permission on the phone in order to avoid breaking the dollar
    - Under last rule, there's an exemption from 17a to allow investment advisor of the funds to buy those assets that have gone down in value significantly and buy them only at the price that was paid for them
      - It's not that they can buy anything – not by a longshot

Rule 2a-7 refers to § 19(a) – a section designed to prevent Ponzi schemes

- At that time, the managers distributed the investors' money as dividends
  - What they're doing is just returning what they had
- 19(a) required that dividends are distributed from net income and not from assets

Recent changes require disclosure, and require knowing your customer . . . change some of the rating organizations and Frankel thinks they will go even further BUT also introduced requirements on how to manage stress tests . . . movement towards banking which requires the same thing

There were economists that said that the time has come to forget about all of these valuations and have NAV of any share in the same way that you have them for any other mutual fund. That was NOT accepted. The SEC retained the image of a bank account. On the other hand, it did something in between. It said you can continue to value the fund assets the way you do, but you have to disclose what the market value (just disclosure and no more). Such a disclosure is a red flag though. The SEC also said you have to disclose what it is in the portfolio after 60 days. What this does is make the fund think twice before it pushes the envelope in the types of assets that it chooses to invest in.

18. UNIT INVESTMENT TRUSTS (pp. 473-484)
    a. Serves a certain kind of client and invests in certain assets
    b. One of the oldest types of instruments
    c. <u>Characteristics</u>
        i. No board
        ii. Offers redemption (similar to open-end funds)
        iii. Not managed (portfolio stays static)
        iv. Not invested in equity
        v. Mostly invested in debt
            1. Don't need active management of debt because market volatility is much lower. Assumption is that debt is more stable. Equity is more risky.
            2. Although it is not required by law, most UIT hold instruments issued by states or other government issuer. They are supposed to be least tradable.
    d. <u>How Are They Serviced?</u>
        i. Unlike open-end funds that can organize in any legal form, UIT must be in trust form
            1. Must have trustee
            2. Must have beneficiary
            3. Usually trust document narrows the powers of the trustee to specific directives.
            4. Unlike in open-end companies there is no proxy statement.
            5. On the one hand there are specific functions given to trustee, but no beneficiary powers to direct.
        ii. Many of these trusts hold just one issuer's securities. But it is specific so the trustee looks and sees exactly what the powers are.
    e. <u>Background</u>
        i. After 1929 trust people did not trust managers. They did not trust investment banks.
        ii. So, the industry came up with something that tied its hands. That is how they gained back some trust.
        iii. It allows beneficiaries to decide what to invest in. The portfolio is frozen, "what you see is what you buy."
        iv. This was not required by law, it was just what the SEC found when it looked into the market. This was one form the SEC found in the market and they just started regulating parts that may have been susceptible to problems.

[Two things that restrict managers – fixed portfolios, the other is redemption. So, if I come for my money you must get it to me in 7 days. Now for the issues:

Congress did not change what was acceptable to the public, but they enforced promises given to the public.
Sec 14a – Congress wanted to avoid fly by night operations. Rule was that you cannot borrow to open an IC. 14a required to put up 100K (which was a lot in 1940). This rule applied to all ICs in every form.

Sponsor/Broker/Underwriter of the UIT serves the following roles

- They act as trustee – can't manage, but does have title to the property and distributes and receives the property. Bank must have the property and have custody of it.
- Bank must have at least 500K (a lot back then). At that time banks were already tightly regulated so they were trusted.
- Trustee gets fees from setting up the portfolio of debt securities. If you are a broker/UW there are two ways to sell security.
    - First way is __(I think just having the UW sell shares)?__
    - The second way it to pool the funds and set up a MF.
- They make their money on the sale.
- The pool of assets must also be redeemable within 7 days.
- The whole portfolio is invested in the debt so there must be a secondary market for these or you would have to sell the underlying assets in the UIT.
- Usually the UW will redeem the security and sell it to someone else.
- If the redemption occurs then the UIT will shrink – this is one way of liquidation.
- Also, in these UITs they cannot keep cash so if there is extra cash from a redemption it must be distributed, further shrinking the pool.
- If UW redeems at NAV, then they may hold hoping interest rates change and the value goes up and then would resell for a profit.
- Trustee receives the money, is custodian, makes money on commission from sales and on redemptions/resale.
- UWs are also the evaluators that sets NAV, the promoters are brokers create secondary market but also the people doing the valuation.

f. <u>Other Fixed-Portfolio, Non-Managed Funds</u>
   i. Index funds, these are fixed but can be in the form of open-end funds, that would have redemption but no management (just because there is possibility of management does not mean you need to have management).
   ii. You could also have a closed-end fund with fixed portfolios, these have management but no redemption.

g. <u>Regulation</u>
   i. Like open-ended companies,
      1. Issue redeemable securities:
         a. Provisions of the ICA relating to redemption, including valuation and timing of valuation, apply equally to UIT's
      2. Must continuously sell securities to avoid net redemptions, both employ principal underwriters
         a. Provisions of ICA relating to principal underwriters apply to UIT's
   ii. Unlike open-ended companies,
      1. Not managed
         a. Regulation of portfolio management functions relating to both open-ended and close-ended companies don't apply to UIT's

h. <u>§ 26</u>:
   i. Trust instrument must provide that during life of trust trustee (if not otherwise paid) can charge against and collect from the income of the trust and from the corpus of the trust (if no income) fees for services as provided in the instrument. No such charge or collection will be made except for services. 26 goes on to describe services that can be compensated…
      1. Today SEC won't decide what is reasonable payment for bookkeeping, etc. Shows difference between then and now. But, what does exist is the specificity of what you get, not so much the payment.
      2. Trustee must segregate the funds – taken from trust law.
      3. There is also a long list of conditions…Frankel says read through them.
      4. Conflict of interest guidelines, there are clear directives…
   ii. <u>Charges to UITs</u>
      1. Depositors could gain from charges not clearly disclosed to public
      2. UIT only s/t charges and collections allowed under (a)(2)(A), (B), & (C)

iii. Protection of Assets
   1. (a)(1): restrictions on sales
iv. Orphan UITs
   1. Addresses problem of abandonment
   2. (a)(3) imposes requirements for resignation
v. Substitution of UIT's Assets
   1. Can't substitute underlying securities of the trust w/o SEC approval
   2. S/h don't have recall otherwise if they're unsatisfied with their shares
      a. Can sell, but that involves transaction costs
      b. Remove trustee?
         i. You would need a court order granted most likely because of fiduciary breach. You can't do it by a majority. This goes to trust law, the trustee is hard to remove, after all they are named in the trust document
vi. Affiliated Transactions
   1. § 17
vii. Minimum Size
viii. Switching of UIT Units
   1. Sponsors pressured investors to exchange their units for new UIT units or mutual funds which the sponsors created
   2. 11(c) prohibits this w/o SEC approval
   3. When would an investor be better off switching from one UIT to another?
      a. What would be objectionable? Who benefits from the moves?
      b. The broker would usually be the one who would benefit. If a broker says to someone, sell this and buy this there is a commission. This sometimes gets lost. People who do this a lot churn their assets.
      c. Sec 11 – allows and kind of imposes free exchange under one advisor.
ix. Distribution of UIT Securities

Merrill Lynch (pg. 481)

They paid a huge amount for this. They have an error in the valuation of their UIT, the error benefited ML, to the detriment of the investors. They had a UIT and ML was an UW. It was beneficial for them to bring in a portfolio to then distribute. In this case it had 570 unit holders. It was not doing so well – ML could not sell any additional units. More people were redeeming then buying. There was also no good secondary market for these. Problem – you don't want to liquidate the fund, but it is losing assets and no one wants to buy on the primary or secondary market.
They tried to solve this by something called lag. They had 90 days to distribute the money, so they would pay redemptions with dividends that were coming in. This is money that should have been going to beneficiaries who redeemed, but they would not give the redeemers the lag portion. This meant that people were getting NAV less the lag money when they bought. But when people bought they paid full NAV including lag, so ML was winning on both sides.
This shows us that something that starts innocently and maybe justifiably can wind up costing people on both sides. How did ML benefit? It did not benefit by taking the money, it benefitted by showing to buyers a higher value so when it benefitted was through sales commission. Its commission was higher on the higher value. In the end ML got more money because it sold for a higher price, but this price was high because it was not paying out full amount for redemptions.
They paid a HUGE fine, not just repayment, but because finding out how many people redeemed over five years was very costly.

Frankel: I had another case with something similar there was a $2.5million in money that was owed to SH, but it cost 8million to find the transactions this came from and finding the people.

19. CLOSED-END INVESTMENT COMPANIES
   a. DO NOT offer or issue redeemable securities
   b. ARE actively managed by advisors

c. Structure usually used when fund holds illiquid securities that can't back redemption requirements, or when a fund doesn't offer redeemable securities because it aims at long-term investment, but cannot be left w/o management
d. Don't offer securities to public continuously, so have very different relationship w/underwriter than open-end companies do
e. REGULATION
    i. ICA does not regulate
        1. Distribution
        2. Advertising
        3. Pricing
    ii. ICA does regulate
        1. Issuance
        2. Sale
        3. Repurchase of their own securities
        4. *Reflection that these are s/t different set of abuses – namely that they can discriminate against outside investors, or dilute s/h equity by repurchasing shares or by selling or issuing at certain prices*
    iii. Certain provisions apply both to open-end and closed-end but applied differently
    iv. § 23
f. DISCOUNT PROBLEM
    i. Ever since the crash, closed-end companies have been selling for a discount
    ii. May reflect investor awareness of the extra risk
        1. Not only risk that portfolio might perform badly, but additional risk that investors in the future may like funds less
    iii. May reflect transaction costs
        1. Underwriter sells a bunch of shares that has a value of $100 and immediately after that, the $100 are used to pay 7%, so without anyone doing anything wrong, because the payment was discounted from the NAV, investors were not willing to pay $100, they were willing to pay $100 minus expenses
        2. So immediate there was that discount
        3. The promoters were not willing to pay this 7%, and the result was that the price of the shares was immediately discounted
        4. Assets are not liquid, but there is a secondary market. Why are these funds not attractive?
            a. Other issues that may pose problems
                i. In the market there may be tax issues if people trade
                ii. Moment the managers sit on this amount of $$ and investment they don't care that much about the market price – they don't have the incentive to maintain that price, so long as they maintain control over the assets
                iii. In an open end fund, if the price goes down, they will have redemptions
            b. Wanted to be able to charge the shareholders for fund shares – SEC gave that rule only to open-end funds.
    iv. <u>RULE 23c-3: INTERVAL FUNDS </u>(pp. 488-491)
        1. Closed-end funds that offer s/h's periodic repurchases of their shares at the NAV of their portfolios
        2. Idea is that if investors know that they will be able to tender their shares to the fund at NAV, they won't fear losses due to deeper discounts, demand for fund's shares will increase, and prices will rise
g. EXHANGE-TRADED FUNDS (ETFs)
    i. <u>*SPDR*</u>:
    ii. Open-end fund that offers securities to institutional investors
        1. Issues securities that are a million a piece
        2. Instead of managing the fund, have a machine that will give a certain index of the securities
        3. If the index changes, we will buy or sell, if it doesn't change, it stays fix

4. Portfolio will represent an index
5. Huge securities (creations) can be divided into smaller pieces, and they are broken into pieces of like $40 each
6. THOSE smaller pieces are not redeemable
7. The buyers of these pieces get liquidity from secondary market

iii. Market will resolve the discount here
   1. If there is a discount, and the shares are being sold at the discount the institutional investor will buy the shares at a lower price, and go to the open-end fund
   2. The expectations that someone is going to buy up the shares removes the discount
   3. So discount is removed
   4. Differential of ETFs shares as compared to the NAV became very very small - but because the amounts were so large, the institutional investors remained interested and continued to buy

iv. Who got benefits from this design?
   1. Arbitrageurs – borrowing and buying at the same time with the hope of getting the difference
   2. BROKERS
   3. Obviously now the small investors can trade on the market, with an open-end fund shares, without going through redemption which is established one time a day, at 4 o'clock and has all of the rules that come with it → gives them the opportunity to trade
      a. The assumption is that the small investors should have the opportunity to trade their mutual fund securities
      b. Restrictive type of trading at the top level (creations), and then at the lower level everything goes

h.

INVESTMENT ADVISORS ACT

1. Regulation of investment advisors had five basic flaws
    a. Two persist:
        i. No financial qualifications or educational requirements for investment advisors
        ii. Permits verbal contracts, resulting in vague agreements
    b. Three eliminated by subsequent regulation
        i. Absence of requirement for maintaining full records and authority for SEC investigations
        ii. Anti-fraud section, which did not apply to unregistered investment advisors
        iii. Failure to regulate advisors who have custody of their clients' funds
2. Even today, regulation of investment advisors is not rigorous
3. Advisors are fiduciaries to their clients
    a. Services they render are personal and cannot be transferred without the client's consent
    b. Many conflicts of interest between clients and advisors must be avoided in some situations and fully disclosed in others
4. FOUR BASIC KINDS OF ADVISORS
    a. A gives B advice
    b. A gives advice to B, and also accepts control over the client's $ and actually implements the advice
    c. A gives advice to B, C, D, etc. (usually by letters)
    d. **A gives advice to the B, C, D, etc. and also accepts control over their $ and actually implements the advice**
5. <u>§ 202(a)(11)</u>: Investment Advisor
    a. 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 part of regular business, issues or promulgates analyses or reports concerning securities . . .
    b. EXCLUSIONS IN (A)-(F)
        i. Banks and BHCs
        ii. Lawyer, accountant, engineer, teacher
        iii. Broker/dealer who doesn't receive special compensation for the advice
        iv. Publisher of newspaper, news magazine
        v. Any person giving advice about purchasing Treasury bonds
        vi. Nationally recognized statistical rating agency
        vii. Catch-all
6. <u>*APPLICABILITY TO FINANCIAL PLANNERS, PENSION CONSULTANTS, AND OTHER PERSONS THAT PROVIDE ADVISORY SERVICES AS A COMPONENT OF OTHER FINANCIAL SERVICES*</u> (IAA Release # 1092 – PG. 50)
    a. Apparent that a person who gives advice or makes recommendations or issues reports or analyses with respect to specific securities is an investment advisor
    b. Staff believes that a person who provides advice, or issues or promulgates reports or analyses, which concern securities, but which do not relate to specific securities, generally is an investment advisor
    c. Persons who advise clients about the relative advantages and disadvantages of investing in securities in general as compared to other investments is an investment advisor
    d. "Business" standard
        i. In the business of providing advice if the person:
            1. Holds himself out as an investment advisor or as one who provides investment advice,
            2. Receives any separate or additional compensation that represents clearly definable charge for providing investment advice about securities, regardless of whether the compensation is separate from, or included in the overall compensation, or receives transaction-based compensation if the client implements that investment advice, or
            3. Anything other than rare, isolated and non-periodic instances, provides specific investment advice
    e. Why should the SEC seek to regulate advisors that give only general advice?
        i. There was a small crash in 1987, so people were afraid . . . this can be one of the reactions to this – having 22,000 financial planners seemed risky

7. COMPENSATION (pg. 72)
    a. Depends on the types of services being offered
        i. % of assets under management
            1. general form of compensation for advisors who manage their clients assets
        ii. Flat fee (once or periodically)
        iii. % of gain – performance
        iv. % of commissions
            1. Percentage linked to the amount of the transaction
                a. i.e., invest $1000 in IBM, take 1% of that
    b. SECTION 205(a) – NO PERFORMANCE FEES
        i. Advisors Act does not really regulate structure of advisory fees except for this section
        ii. Give incentive to invest in more risky investment
        iii. BUT, RULE 205-3 ALLOWS ADVISORS MORE FLEXIBILITY IN CHARGING PERFORMANCE FEES
            1. 4 situations (pg. 73, 337 Stat. Supp.)
    c. Disclosure of fees
        i. ADV requirement straightforward
        ii. SEC has adopted two rules
            1. Advisor may breach fiduciary duty if he doesn't disclose that he's charging more than normal fee for such services
                a. Generally 3% unless advisor provides extra services
            2. Disclosure required when advisor receives two fees by investing client money into mutual funds managed by the advisor
                a. SEC permits this if advisor furnishes distinct services for each fee
                b. And must disclose to advisory clients
8. BROKER-DEALERS
    a. In 1975, the fixed commission rate that was imposed upon brokers in the NYSE was eliminated.
        i. Advisors then could negotiate with broker-dealers for lower commissions for its client, including investment companies
        ii. Brokers thought that this was the end of the world but it's quite the opposite – trades have become much more common and brokers gain much more.
    b. Led to rebated in "soft dollars" for favored clients (pg. 75)
        i. Could be a breach of fiduciary duty by advisor if full benefit of rebate does not inure to the advisor's client
            1. i.e., broker pays rebate by covering obligations that should be borne by the advisor, or by someone other than the client
        ii. <u>*Section 28(e) of Securities Exchange Act (pp. 76-78)*</u>
            1. *Advisors are provided with e safe harbor when they pay more than the lowest available brokerage commission and receive research and benefits from the broker*
            2. At that time, large brokerage firms would send research done in-house to select clients. There was a real evaluation of issuers. These were sent to wealthy, institutional clients. These large brokers said it doesn't make sense for us to stop doing that. Some people thought that the research was usually tips
            3. Incentive for broker
                a. Hoping that the client will keep trading with them – focusing on the clients with the most $ to trade
                b. Interest is in finding institutional investors → mutual funds have an enormous amount of capital and securities
                c. What developed is that the broker would give research to the advisor in the hope of trading in the mutual fund
                d. Broker couldn't just give $25,000 to the advisor and just say give me the business → This is a clear kickback/bribe
            4. OLD STANDARD: Safe harbor did not protect products and services that are readily available and offered to public on commercial basis
                a. Not very clear sometimes

        5. NEW STANDARD: Considered research under protection of the safe harbor if it provides lawful and appropriate assistance to the money manager in the performance of his investment-decision responsibilities
            a. Must allocate costs with mixed-use products
    iii. Why didn't the broker just give $25,000 to the advisor and just say give me the business?
        1. This is a clear kickback/bribe
    iv. What if you have manufacturer that says the car is $35,000 – take it or leave it. But if customer goes to dealer, can bargain his way down to $26,000
        1. Notice car manufacturer does not want change in prices? For the car manufacturer it is not efficient to have varying prices
        2. Dealer doesn't mind if he starts with higher price and negotiate it down to get the payment
    v. How is this market different?
        1. In this case, the *client* gets the rebate
        2. In the first situation, the *fiduciary* of the client gets it –advisor
            a. The argument is that the client will also indirectly get something
            b. Any dealing between broker and advisor is in his business
                i. If he gets more rebate from the broker, that's fine
            c. What are the real reasons for feeling like this arrangement is not okay? What kinds of conflicts of interests are involved?
                i. Advisor is not performing its fiduciary duty to client . . . duty of care is not fully performed; not doing the research himself
                ii. Who really benefits?
                    1. Mutual funds have domestic and foreign funds
                    2. Domestic are the most profitable
                    3. Yet, the cost of trying to find out and analyzing various parts of the world and their businesses is (was) much greater
                    4. Fund that invested in foreign investments received the benefits from the fund that had really produced the research, and that was a serious problems
                    5. The board of directors realized that and tried to ameliorate it
                iii. Churning
                    1. Trading more and more within an account
                    2. Costs the client through fees
                    3. Advisor allows this because it wants more research
                    4. Not merely a book about a certain corporation . . . seminars, travel with family, etc.
                    5. Became all sorts of entertainment
                iv. Performance
                    1. If the advisor attempts to please the broker who is beneficial to the advisor, the advisor might not pick the best performer
                    2. Client cares – if you have a very large trade, how do you maximize the return without dumping the trade on the market and decreasing price
                    3. Need to be able to best execute these kinds of trades to do so – need connections, expertise, etc.
    vi. Small brokers complained that they could not create the research in-house, but could buy it . . . complained of discrimination because they also wanted to be favored by the advisors
        1. The small broker brings sales to the advisor – desirable to advisors to sell more and more shares
            a. To cover redemption, so that the funds would not shrink
            b. To make the funds bigger, and as a result to the increase the fees that depended on the assets of the funds

        2. Must understand incentives of advisors when they pushed for benefits for brokers, and to select the brokers that would sell more
        3. In about 1986, SEC opened the gates to allow, not only the in-house research, but also the bought research
            a. This is when market really developed

c. Why should a registered representative rely on the broker-dealer exclusion if the advice is given in the scope of employment of the broker-dealer?
    i. Registered representative is the cold caller that works for the broker-dealer
    ii. About 5200 broker-dealers
    iii. Over 460,000 representatives . . . not all of them are knocking on doors; some of them took exams to qualify them and give them the right to sell shares
    iv. Why aren't they saying – I'm selling shares? Why should I be subject to only the broker-dealer exclusion
    v. The way that the staff saw it as that everyone knew what broker-dealers did . . .
        1. Broker can be considered a fiduciary – acts an agent (holds my $, and instead of my going to the market, he goes to the market)
            a. If a broker has special knowledge, where is his conflict of interest?
                i. Can benefit himself from the knowledge
                ii. Once he has the special knowledge, has duty to avoid conflicts
        2. Dealer is not a fiduciary because he's just offering an arm's length service – buying and selling for his own account
            a. Has every right to be self-serving
        3. In the past, there were situations in which broker-dealers were treated as fiduciaries
            a. Brokers were breaking trust and confidence, so courts (especially state courts) were imposing duties of fiduciaries
        4. The SEC never said that they were fiduciaries – the SEC viewed them as buyers and sellers, but added to the contract an element of fairness
            a. Fairness, more than it is imposed through K law
            b. Fairness focused on unfair treatment of broker-dealers, and through the years the rules were not simply fairness, there were about 2500 rules on how they should behave
                i. Sometimes the rules were specific – can't take more than x%
                ii. Sometimes more general
        5. Had a regulatory system that is not fiduciary, but specifically close to fiduciary
        6. Assumption is that people understood that brokers get nothing if they don't sell
            a. Because they understood, any sales advice was sales talk
            b. And if you have sales talk, you know that you have to take it with a grain of salt
            c. What would turn it into advice?
                i. Special and separate compensation
                ii. Assumption was that this was a package
        7. Change occurred when brokers did three things:
            a. Posed as advisors
            b. Said that they are going to also give financial planning
            c. Changed the form in which they charged
                i. No longer only commissions; it was also, and sometimes only, a percentage of assets
                    1. Looks like advisory services
                    2. Commissions charge looks more like trade
        8. Changed people's view, and they became far more confused – the idea that a broker-dealer had an image became more mixed
        9. Study on how investors view brokers, and whether investors make distinction between broker and advisor
            a. Not only did investors not know the distinctions, but the brokers themselves didn't really make any distinction
            b. Most did not know the difference

vi. Brokers are regulated, but also one of their duties is to supervise registered reps, and if registered reps can do things that the brokers don't have to supervise then they're free
    1. SEC decided to let them do only those things for which they could be supervised
    2. Doesn't mean that the registered reps are fiduciaries, but that is the problem because they are the ones that have the contact and do things to gain the trust of clients

d. CHANGE OF FEE STRUCTURE FOR BROKERS (Supplement pp. 1-10)
   i. Broker-dealers began to charge asset-based fees or fixed fees rather than commissions
   ii. This would have eliminated the exception for broker-dealers, and required them to register as investment advisors
   iii. In April 2005, the SEC adopted a rule that excluded broker-dealers from the application of the IAA – notwithstanding their asset-based fees – under certain conditions
       1. Advise must be solely incidental to brokerage services
       2. Broker-dealer must make certain disclosures about the nature of services
   iv. Financial Planning Association sued the SEC seeking a judicial decision that the SEC has extended its authority (Supp. 1-10)
       1. D.C. Cir agreed and struck down the rule
           a. (F) says *other*, which Court interpreted to mean not already mentioned in the exemption (which b/d's are)
   v. *(From Online Supp pg. 10)* In July 2009 the Obama Administration delivered to Congress the proposed Investor Protection Act of 2009.2
       1. Continuing its push to establish new rules of the road and make the financial system more fair for consumers and investors, the Administration today delivered proposed legislation to strengthen the SEC's authority to protect investors. The legislation outlines steps to establish consistent standards for all those who provide investment advice about securities, to improve the timing and the quality of disclosures, and to require accountability from securities professionals. The legislation would also establish a permanent Investor Advisory Committee to keep the voice of investors present at the SEC.

          * * *

          . . . Under current law, different standards apply for broker-dealers and investment advisers – even though many investors rely on the investment advice of broker-dealers in the same manner as an investment adviser. The Administration's legislation would give the SEC authority to require a fiduciary duty for any broker, dealer, or investment adviser who gives investment advice about securities, aligning the standards based on activity, instead of based on legal distinctions that are no longer meaningful.3 In addition, the SEC would be empowered to examine and ban forms of compensation that encourage financial intermediaries to steer investors into products that are profitable to the intermediary, but are not in the investors' best interest.4
   vi. Dodd-Frank told SEC fix the rule
       1. Broker-dealers are fiduciaries, but only with respect to retail customers
           a. Individuals, families and business
           b. Then if SEC wants, can impose such fiduciary duties also on other broker-dealers
       2. Unify the enforcement
           a. Not less than the duties under 2 sections of the advisors act (prohibition of cheating)

9. SECTION 206(4) – ANTI-FRAUD PROVISION
   a. ***SEC v. Capital Gains Research Bureau, Inc.***: SCOTUS noted that in applying the anti-fraud provision, an advisor is held to a fiduciary standard
      i. Advisor in this case did not control people's money but people followed him. He would buy a security, tell people to buy for long-term, price got high, and then he would sell – didn't disclose that he was going to gain financially from this.
          1. Fact is that his buying before is fine, and he could say that he wanted to share good stock with others
          2. BUT he sold immediately thereafter because he was the one that pushed the price up for a short while
              a. This is called "scalping"

        ii. Disclosure is required
            1. Make potential clients weary if knew about this conflict of interest
            2. Essentially, the price will eventually go down
            3. Disclosure has to be to the point so that clients will understand what is going on
        iii. Put the other party on a contractual basis, not on a reliance basis
    b. This is different from the investment guru that said that municipal bonds were going down
        i. Although she did the same thing – sold short, and told everyone that the price would decrease, so that the price would in fact go down.
        ii. The only difference is that everyone knows that municipalities are in trouble, no secret
        iii. The statement was not that she advised people to sell; it was her prediction about where municipal bonds are going (didn't have information that no one else had)
        iv. It wasn't something as hidden as in the case of *Capital Gains*
10. OTHER DISCLOSURE – ADV (pp. 66-68)
    a. Description of services,, % revenues from each, fee schedule and whether it's negotiable, etc.
    b. Disclosure required of institutional structure that can create conflicts of interest
        i. Advisor also has a brokerage function, and also trades for his account
            1. May have to disclose any transaction which creates a conflict
            2. Every time the advisor wants to sell or buy to himself or for himself or for another client, the advisor has to receive the consent of the advisory client
            3. Becomes problematic because of timing – the client may not be available in the few minutes in which the advisor needs to make a transaction.
        ii. Different from when the advisor says that I think that you should buy or sell this, and the advisor either buys or sells from his own account, or from the account of the client
            1. Much more specific conflict of interest that is transactional. (206(4))
            2. Client has to know and agree that the advisor will engage in conflicts of interest
    c. 206(3): disclosure required if investment advisor effects a transaction as principal with a client (sell or buy security from a client) (pg. 79)
11. ATTRACTING BUSINESS – REFERRAL AND ADVERTISING (pg. 68)
    a. REFERRALS – RULE 206(4)-3
        i. Advisors rely on referral from stockbrokers, insurance agents, and financial planners → solicitors
        ii. In return:
            1. Cash payments, OR
            2. Non-cash arrangement
                a. i.e., advisor directs brokerage to a broker who refers clients to advisor
        iii. Generally allowed
    b. ADVERTISING – RULE 206(4)-1
        i. Specifies certain types of advertisements as "fraudulent, deceptive, or manipulative"
            1. Four specific categories of misleading advertisement and one catch-all
                a. No testimonials concerning the advisor or advice
                b. No referral to past specific profitable recommendations made by the advisor (unless the ad includes ALL past recommendations)
                c. Can't have a representation that any chart, graph, etc. offered may be used in making decisions about investing (unless there's a disclosure as to the limitation of the graph)
                d. Can't advertise free services unless the services actually are offered for free WITHOUT conditions
                e. Can't contain any untrue statement of a material fact, or be otherwise false or misleading (catch-all)
        ii. Defines "advertisement" broadly (pg 69)
12. INVESTMENT ADVISOR CODE OF ETHICS (pp. 378-381)
    a. <u>Rule 204A-1</u>: Requires registered advisors to adopt codes of ethics
    b. Code of Ethics must:
        i. Set forth standards of conduct
            1. More than a compliance manual
            2. Set out ideals of ethical conduct → challenge employees to live up to not only the letter of the law but also to ideals of organization

        ii. Require compliance with federal securities laws
        iii. Address personal trading
            1. Require advisors' personnel to report their personal securities holdings and transactions, including those in affiliated mutual funds
            2. Require personnel to obtain pre-approval of certain investments
    c. Advisors must keep copies of their codes of ethics and records relating to the code
        i. (in book says Congress amending in 2004, so not sure if this is in effect)
    d. Advisors must describe code of ethics in ADV

Two kinds of intermediaries that transfer money from savers to borrowers
1. Institutions that takes money from savers and lends to borrowers
2. Direct interactions (needs standardized obligations)

Issue obligations on the one side and turn around and sell obligations on the other side – investing, reinvesting and trading, which investment companies have.

(Look at section 206 of the Investment Advisors Act and at the rule under that section in the supplement – pg 126)
- Features specific to this rule
    - No requirement to prove scienter → SEC can just show fraud and that's enough without showing specific intent
    - The definition itself is very broad (fraud encompasses a lot of things)
    - Wrongful act is directed not only to the client, but also to prospective advisees
        - Model of fiduciary duties of lawyers to prospective clients
    - Cases in which aiding and abetting was covered by this rule
- If you compare this rule to 10b-5 you see immediately that it is so much broader
    - But unlike 10b-5, it has a limitation, and that is that there is no private right of action

SEC SPEAKER

Areas of the SEC that deal with mutual funds:
1. OCIE – including examination staff (sort of adversarial)
2. Investment Management (IM) – rulemaking, disclosure review, dealing with the industry
    a. OCIE used to be a pat of IM, but separated because of fear of capture
    b. Sometimes OCIE and IM differ in opinions on how to deal with a large investment advisor
    c. Challenge is that now have these offices looking at the same issues and coming out in different ways, and having to resolve disagreements if the issue is large enough
    d. If you're a registrant, you're filing major documents with IM
3. ENF

Investment advisors have to deal with:
1. Examinations
2. Investigations
3. Litigation

Boston Regional Office

Examination Process:
- Conducted on all registered entities – broker-dealers, transfer agents – not just investment advisors and investment companies
- WHY are you conducting an examination of a particular entity?
    - Typically fall into three categories
        - Routine
            - Have thousands of registered investment advisors in the country, and want to hit a certain percentage each year
            - Around 10%
            - As a practical matter don't really get to each one
            - Conduct exam of an entity that may or may not have been examined before

            - No particular reason except that maybe they haven't been examined, or fall into priority that Washington created (i.e., specific risk involved – conduct business a certain way . . . maybe use derivatives, or maybe they're a hedge fund advisor, or are large, etc.)
        - Cause
            - Probably the most interesting
            - Typically an examination that is based on a tip or a referral – not usually based on a generic notion that the entity is large
            - Usually an investor or an employee of a firm that calls in
            - Tip comes in to office . . .
                - Can be assigned to regulation (conduct examinations)
                    - Examination to decide whether tip stays in regulation or goes over to enforcement
                - Can be assigned to enforcement (conduct investigation)
                    - Litigation occurs in enforcement (easier to subpoena documents)
                - Can be left to both
        - Sweep
            - Issue out there that we're concerned about and want to find out more about, so conduct sweep examination to get information to decide how to handle these issues
- HOW do you conduct an examination?
    - Primarily through the request of documents
        - Statutory right
            - Rule 204-2 under Advisors Act
            - Rule 31a-1 under Investment Company Act
        - What documents are we going to request? What are we really trying to accomplish?
            - Dictated by a number of factors
                - Public research (understand the company more through newspapers, etc.)
                - Non-public info (previous examination reports)
                - Call IM and ask for opinion
                - Look at programmatic priorities
                    - Insider trading
                    - Soft dollars
                    - Conflicts of interest (affiliated service providers being the biggest)
                        - Brokers, distributor, transfer agent are often affiliates, and that then creates the further challenge of how do you make sure that you're not overpaying
                    - Corporate governance (15c process, are independent directors truly independent, etc.)
                    - 12b-1 fees
                    - Material compliance issues
    - And conducting interviews
        - Interview is a term of art
            - Enforcement also conducts "interviews" but only if it's not on the record
            - If it's on the record then it's testimony
            - And if it's in a litigation context it's deposition
        - No statutory authority here
            - Registrant may say we'll give you the docs but won't let you talk to anyone
                - RARELY happens
                - Because noncompliance will probably lead to investigation – send subpoenas where people have to sit for 8 hours of on-the-record questioning
                - Reputational concerns
                - Want to think of how to conclude the examination without having to move forward to enforcement investigation
- Not generally geared towards uncovering fraud – NOT an audit

    - Spend 1-2 weeks conducting interviews and requesting documents
    - Then spend a short time after that fleshing out the issues
- Exam Conclusion
    - No Findings (10% or less)
    - Deficiency Letter (80+%)
    - Enforcement Referral (10%-ish)
        - Firm doesn't always know that there's a referral
        - Referral doesn't necessarily mean investigation
    - *Sometimes both a deficiency letter and enforcement referral*

<u>Investigation Phase</u>

1. Inquiry
    a. Expires after a certain number of days, and either converts to informal investigation, or closes
2. Investigation (informal or formal)
    a. Don't need Commission approval
    b. If it's formal, have subpoena power
3. Litigation
    a. Need Commission approval here – get on calendar and ask them to vote