CHAPTER 4

Overview of Compliance Considerations for Advisers to Registered Investment Companies

By Alan R. Gedrich and David F. Roeber
Stradley Ronon Stevens & Young, LLP

I. INTRODUCTION

The Investment Company Act of 1940 (1940 Act) is the key statute under which U.S. investment companies (i.e., mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts) are regulated and governed.[1] Generally, all U.S. investment companies meeting the 1940 Act definition of investment company (and that cannot rely on an exception or exemption) must register with the U.S. Securities and Exchange Commission (SEC).[2] As of the end of 2015, U.S. investment companies held more than $18 trillion in assets, and approximately 44 percent of American households invested in such funds.[3] Investment companies are significant owners of corporate equity, commercial paper, government securities, and municipal securities. Such companies serve an important intermediary role in domestic and international financial markets.

The 1940 Act had its origins in the 1920s, when the idea of pooling funds to provide for diversification, economies of scale, and professional investment management began to gain some popularity with the investing public. However, the investment company industry was plagued with growing abuses and problems, and also was not immune to the devastating effects of the Stock Market Crash of 1929 and the Great Depression of the 1930s. In the mid-1930s, at the request of Congress, the SEC conducted a comprehensive analysis of the industry. Their results found that many investment companies were organized and operated to benefit the interests of their affiliates (such as sponsors), rather than the interests of their shareholders.[4] Following extensive hearings and testimony by

---

1 Unless otherwise indicated, all section and rule references herein are to the 1940 Act.

2 The Investment Advisers Act of 1940 (Advisers Act) is the primary law that regulates the activities of investment advisers, and all investment advisers (or subadvisers) to registered investment companies are also required to register with the SEC.

3 *See,* e.g., *2016 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry, 56th edition* (2016 IC Fact Book), Investment Company Institute (ICI), https://www.ici.org/pdf/2016_factbook.pdf

4 *Investment Trusts and Investment Companies: Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services,* Report of the SEC, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

regulators, government officials and financial industry leaders, as well as several preliminary bills, the 1940 Act was signed by President Franklin D. Roosevelt on August 22, 1940.

The 1940 Act established a comprehensive federal regulatory framework for the structure and operation of investment companies, and reflected congressional recognition that substantive shareholder protections beyond the disclosure requirements of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) were necessary due to the unique character of investment companies and their role in the national economy.

The core regulatory provisions of the 1940 Act are designed to, among other things:

- Ensure disclosure of full and accurate information about the funds and their sponsors;
- Prevent changes in the character of funds without shareholder approval;
- Prevent unsound or misleading methods of computing earnings and asset values;
- Prevent insiders from managing funds to their benefit and to the detriment of investors;
- Prevent the issuance of securities having inequitable or discriminatory provisions; and
- Prevent excessive leveraging.[5]

Thus, the 1940 Act requires:

- Extensive registration and disclosure requirements;
- Declaration of fundamental investment policies;
- Daily valuation and liquidity requirements;
- Internal and external oversight (including fund governance requirements);
- Limitations on leverage;
- Strict custody requirements with respect to fund assets; and
- Restrictions on transactions with affiliates.

The purpose of this chapter is to briefly discuss the general framework for mutual fund compliance programs and then provide an introduction to certain core substantive compliance areas required by the 1940 Act for investment advisers who manage mutual funds (i.e., registered open-end management investment companies). This chapter focuses on mutual funds because they are the largest segment of the investment company market by far.[6] These core compliance areas can all be traced back to the original, underlying regulatory principles of the 1940 Act.[7]

---

[5] *See* Section 1(b), included in the appendix. *See also* SEC, *Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management* (May 1992), https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf

[6] 2016 IC Fact Book.

[7] To be clear, this chapter is an introduction to certain 1940 Act compliance areas, but is not meant to provide an exhaustive list or overview of all required mutual fund compliance policies and procedures under the 1940 Act (or even meant to highlight all relevant subject areas generally). Furthermore, there are notable additional, or even alternative, compliance considerations for certain types of open-end investment company structures, the specifics of which are outside the scope of this chapter, such as for money market funds (most notably the requirements of Rule 2a-7), variable insurance funds, exchange-traded funds, index funds, or interval funds (which are technically closed-end funds but continuously offer their shares like open-end funds).

II. INVESTMENT COMPANY COMPLIANCE PROGRAMS (RULE 38a-1)

The SEC adopted rules establishing a mandatory institutional structure for mutual fund (and investment adviser) compliance functions in December 2003.[8] Rule 38a-1 requires each registered investment company to adopt and implement written policies and procedures that are "reasonably designed" to prevent violation of the "federal securities laws,"[9] including policies and procedures that provide for the oversight of compliance by each investment adviser (including subadvisers), principal underwriter, administrator, and transfer agent of the fund (the "primary service providers").[10]

The Compliance Rule Adopting Release outlines the minimum areas the SEC expects mutual funds (and advisers) to address in written policies and procedures.[11] Although such areas, together with the core substantive areas discussed below, may provide a starting point when developing a mutual fund compliance program, the 1940 Act, the other federal securities laws, and subsequent regulatory developments or SEC guidance since the adoption of Rule 38a-1, as mentioned earlier, require additional compliance policies and procedures.

Although not discussed in detail here, the 1940 Act and the other federal securities laws also impose significant obligations on mutual funds with respect to marketing and distribution of fund shares (including limitations on the use of fund assets for distribution), financial reporting and disclosure controls, codes of ethics/personal trading, recordkeeping, proxy voting, anti-money laundering (customer identification) programs, consumer privacy policies, and cybersecurity, to name a few. In addition, mutual funds are subject to the Internal Revenue Code of 1986 (tax code) with respect to their status as regulated investment companies. Mutual funds may also be subject to the Commodity Futures Trading Commission's (CFTC) regulatory requirements for commodity pool operators (CPOs).[12] Mutual fund compliance programs must be reasonably designed to prevent violation of the federal securities laws, and such programs are predominantly designed to facilitate compliance with all applicable legal and regulatory requirements.

In addition to requiring written policies and procedures, Rule 38a-1 also established a framework for board oversight, requiring that a mutual fund's policies and procedures, and those of each primary service provider, be approved by the fund board, including

---

[8] *See Compliance Programs of Investment Companies and Investment Advisers,* 68 FR 74714 (Dec. 24, 2003) (adopting new Rule 38a-1 under the 1940 Act and new Rule 206(4)-7 under the Advisers Act) (Compliance Rule Adopting Release), https://www.gpo.gov/fdsys/pkg/FR-2003-12-24/pdf/03-31544.pdf

[9] The scope of "federal securities laws" includes the 1933 Act, the 1934 Act, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), the 1940 Act, the Advisers Act, Title V of the Gramm-Leach-Bliley Act (1999), any rules adopted by the SEC under any of these statutes, the Bank Secrecy Act as it applies to funds, and any rules adopted thereunder by the SEC or the Department of the Treasury. Rule 38a-1(e)(1).

[10] One notable omission from the service provider list in Rule 38a-1(a)(1) is the fund's custodian.

[11] Such areas are included in Appendix A.

[12] The CFTC's amendments to CFTC Rule 4.5 in early 2012 essentially subjected registered mutual funds to the CPO regulatory scheme. As a general matter, mutual funds that meet a *de minimis* trading test and a marketing test with respect to their transactions in "commodity interests," which includes certain derivatives, are excluded from the definition of CPO and the related regulatory requirements under the Commodity Exchange Act and CFTC rules.

by a majority of its "independent directors" (defined below).[13] Furthermore, each fund must also designate a chief compliance officer (CCO) responsible for administering the fund's compliance program, who is also subject to board approval. The adequacy and effectiveness of implementation of fund and primary service provider compliance programs must be reviewed annually, and the CCO must provide a written report to the board.

A word of caution applies to series trusts. Many investment advisers and subadvisers to mutual funds are increasingly taking advantage of the series trust structure, which generally provides multiple unaffiliated advisers with the ability to have their own proprietary mutual funds (structured as series of the same registered investment company corporate entity) while certain core services are outsourced to a third party as part of the arrangement. Such services generally include accounting, administration, distribution, fund governance, legal, and compliance. Although the series trust structure may allow advisers primarily to focus on managing portfolios and gathering assets and address other needed services in a cost-effective manner, such advisers are still responsible for ensuring that their funds comply with all 1940 Act regulations (plus the federal securities laws and other applicable regulations).

III. OVERVIEW OF CORE SUBSTANTIVE COMPLIANCE AREAS FOR INVESTMENT COMPANIES

This section will highlight and briefly address substantive core compliance areas for mutual funds in light of the core regulatory principles of the 1940 Act.

Registration and Disclosure

One of the primary policy goals of the 1940 Act is to protect investors from purchasing securities issued by investment companies without adequate information. Thus, mutual funds are subject to extensive disclosure requirements that are designed to help investors make informed investment decisions. Offering materials must be updated at least annually (and more frequently if necessary) to keep disclosure current and accurate.

Such information must be filed electronically with the SEC.[14] The SEC staff uses it in connection with its regulatory, disclosure review, inspection, and policy-making roles. Furthermore, most of the information is publicly available to the investing public, media, and other interested parties. Thus, important compliance functions are to ensure that adequate and accurate information about funds are provided in the relevant disclosures, as well as to ensure that the funds operate on an ongoing basis in compliance with such disclosures.

One of the key disclosure areas with respect to fund portfolio management is investment restrictions. The 1940 Act mandates a number of investment restrictions that must be

---

[13] All references to "directors" or "independent directors" herein also include "trustees" or "independent trustees," respectively.

[14] Via the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

disclosed and followed, and which generally cannot be changed without a shareholder vote. These limitations are designed to prevent funds from changing the character of their business without shareholder approval.

Registration Process and Disclosure Documents. The initial registration process for mutual funds is outlined in Section 8 of the 1940 Act. Section 8(a) provides that a fund may register under the 1940 Act by filing a notification of registration (Form N-8A) with the SEC. The fund is deemed registered when the notification is received by the SEC. Section 8(b) and rules thereunder generally require the (now registered) fund to file a registration statement on Form N-1A with the SEC to register the fund's securities under the 1940 Act and the 1933 Act.[15] This registration statement is required to be amended at least once a year to ensure that financial statements and other information do not become "stale," as well as amended throughout the year as necessary to reflect material disclosure changes.

The registration statement is composed of a prospectus (Part A), statement of additional information (Part B) (SAI), and certain other information (Part C). The core of the mutual fund disclosure regime is the prospectus. The prospectus includes the fund's investment objectives, principal investment strategies and risks, fees and expenses, performance, investment adviser(s), methods available to purchase and redeem shares, as well as certain financial highlights. The SAI expands on certain matters discussed in the prospectus, as well as provides additional information on matters such as fund history, fundamental investment policies, fund management, and pricing of fund shares. Part C provides other information regarding the fund and includes exhibits that are filed publicly with the SEC such as the fund's charter documents, service provider contracts, and other material agreements.

The other primary disclosure documents are annual and semiannual shareholder reports (Form N-CSR) (which include audited or unaudited financial statements, respectively, and management's discussion of fund performance), quarterly schedules of portfolio holdings (Form N-Q), and an annual proxy voting report (Form N-PX).[16]

These disclosure documents require input from numerous fund stakeholders and are an integral component of the fund compliance program. There are myriad requirements regarding the form and content of each document (as dictated by the applicable form, SEC rules, and SEC staff guidance from various sources), as well as with respect to the timing of required filings with the SEC and mailings (of certain documents) to shareholders. Taken together, these documents describe a significant portion of any given fund's operations.

---

[15] In practice, Form N-8A and Form N-1A are generally filed together. Also, although mutual funds are typically registered under both the 1940 Act and the 1933 Act, some mutual funds are registered under the 1940 Act but *not* the 1933 Act when the fund's shares are issued solely in private placement transactions (i.e., are not "public offerings" under Section 4(2) of the 1933 Act).

[16] Portable document format (PDF) versions of SEC Forms are at https://www.sec.gov/forms

Reporting Modernization. In October 2016 the SEC adopted rule and form amendments to modernize and enhance the reporting and disclosure of information by registered investment companies.[17] Such amendments include:

- A new monthly portfolio reporting form (Form N-PORT) requiring registered funds (other than money market funds) to provide portfolio-wide and position-level holdings data to the SEC on a monthly basis (rescinding the abovementioned Form N-Q);[18]
- A new reporting form (Form N-CEN) requiring registered funds to annually report certain census-type information in a structured data format (replacing the current semiannual reports made on Form N-SAR); and
- Enhanced and standardized disclosures in registered funds' financial statements.

For Form N-PORT, "larger entities" (i.e., funds in a fund group with $1 billion or more in aggregate net assets) have a compliance date of June 1, 2018, and smaller entities have a compliance date of June 1, 2019. Form N-CEN will have a compliance date of June 1, 2018, and the new financial statement requirements will have a compliance date of August 1, 2017.[19]

Investment Restrictions

The investment policies and restrictions addressed by the 1940 Act take a few different forms. Generally, Section 8(b)(1) requires a fund to include in its registration statement its policies regarding certain types of activities, including whether the fund reserves freedom of action to engage in such activities, and Section 13(a) prohibits the fund from changing certain of those policies without a shareholder vote (i.e., "fundamental" policies). As noted, these requirements are intended to prevent funds from substantially changing the nature and character of their businesses without shareholder approval. Certain investment limitations are also mandated by the 1940 Act (subject to related rulemakings or SEC exemptive relief).

Diversification. One required fundamental policy is a mutual fund's classification and operation as a diversified or nondiversified company. Diversification is a core regulatory principle of the 1940 Act and the tax code.[20] Under Section 5(b), management companies, which include open-end and closed-end investment companies, are divided or classified into "diversified companies" and "nondiversified companies" as declared in their registration statements. Section 5(b)(1) limits the amount that a diversified fund may invest in the securities of any one issuer (other than U.S. government securities).

---

[17] *See Investment Company Reporting Modernization,* 81 FR 81870 (Nov. 18, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25349.pdf

[18] Information contained on reports for the last month of each fund's fiscal quarter will be available to the public after 60 days, except for certain information that is excluded from public disclosure.

[19] For more information about reporting modernization, see Stradley Ronon Stevens & Young, LLP, *Investment Company Reporting Modernization Amendments—A Summary of an Extensive Overhaul* (Nov. 2016), http://www.stradley.com/~/media/Files/Publications/2016/Fund_Alert_November_7_2016.pdf

[20] Although briefly mentioned below, the tax code's diversification standards for investment companies are outside the scope of this chapter.

Specifically, 75 percent of the diversified fund's assets must be limited in respect of any one holding to an amount not greater than 5 percent of the fund's total assets and not more than 10 percent of the outstanding voting securities of such issuer. Any fund not meeting this test is deemed to be nondiversified and retains the freedom to operate on a nondiversified basis. Note that both diversified and nondiversified funds must meet the asset diversification requirements under Subchapter M of the tax code to qualify as a regulated investment company (RIC). As a general matter, the 1940 Act sets higher standards than does the tax code for funds that elect to be diversified. In practice, most funds that elect to be diversified are much more highly diversified than required by Section 5(b)(1).

As a fundamental policy, a fund cannot change its classification from diversified to nondiversified without a shareholder vote, but the reverse may occur (with certain limitations). Also, the SEC staff has stated that an investment company that registers as a nondiversified company but operates as a diversified company for three years is a de facto diversified company and cannot operate again as a nondiversified fund without a shareholder vote.[21]

Concentration. Section 8(b)(1) requires that a fund include a recital of its policy regarding industry concentration of its investments in its registration statement. This requirement generally reflects the view that such a policy is likely to be central to a fund's ability to achieve its investment objectives, and that a fund that concentrates its investments will be subject to greater risks than funds that do not follow such a policy. A fund is considered to concentrate its investments if it invests more than 25 percent of its net assets (exclusive of certain items such as cash, U.S. government securities, securities of other investment companies, and certain tax-exempt securities) in a particular industry or group of industries. With limited exceptions, a fund may not reserve freedom of action to concentrate or not concentrate in a particular industry at management's discretion and without shareholder approval. A registrant generally may select its own industry classifications, so long as the classifications are reasonable and the companies within a single industry have materially similar primary economic characteristics. In some instances, the SEC staff has taken certain positions regarding particular industry classifications.

Investments in Other Investment Companies. Section 12(d)(1) significantly limits the amount of a mutual fund portfolio that may be invested in other registered investment companies (i.e., fund of funds arrangements). Such limitations relate both to the portion of the mutual fund (the "acquired fund") that is owned by the purchasing fund (the "acquiring fund"), as well as the portion of the acquiring fund's assets that are invested in the acquired fund (and other mutual funds). These limitations are designed to prevent potentially abusive practices such as the "pyramiding" of control and undue influence, fee layering arrangements, and complex fund of funds structures that are difficult for investors to understand.[22]

---

[21] *See*, e.g., SEC *Allied Capital Corp.* No-Action Letter (Jan. 3, 1989).

[22] See, e.g., SEC *Northern Lights Fund Trust* No-Action Letter (June 29, 2015) (Northern Lights Letter), https://www.sec.gov/divisions/investment/noaction/2015/northern-lights-fund-trust-063015.htm

Section 12(d)(1)(A) generally prohibits an acquiring fund from:

- Purchasing more than 3 percent of the outstanding voting stock of the acquired fund;
- Purchasing securities issued by the acquired fund representing more than 5 percent of the value of the acquiring fund's total assets; and
- Purchasing securities issued by the acquired fund and all other mutual funds that, in the aggregate, represent more than 10 percent of the acquiring fund's total assets.

Section 12(d)(1)(B) generally prohibits the acquired fund from selling its securities to another mutual fund (i.e., the acquiring fund) if, immediately after the sale:

- More than 3 percent of the outstanding voting securities of the acquired fund is owned by the acquiring fund; or
- More than 10 percent of the total outstanding voting securities of the acquired fund is owned by the acquiring fund and other investment companies.[23]

Section 12(d)(1)(F) and Section 12(d)(1)(G) create statutory exceptions from the Section 12(d)(1) limits for funds that invest in unaffiliated and affiliated funds, respectively, subject to conditions that fund sponsors have found generally burdensome, if not unworkable. Over the years, the SEC has addressed the ability of funds to invest in other funds in the form of exemptive orders, rulemakings, and/or no-action relief. Such relief (collectively) has permitted funds greater freedom to invest in other funds and securities. Under Rule 12d1-1 for example, investments in shares of money market funds are not subject to the Section 12(d)(1) limits if certain conditions are met. Also, Rule 12d1-2 permits funds that rely on Section 12(d)(1)(G) to invest in unaffiliated funds, subject to the limits of Sections 12(d)(1)(A) and (F), as well as in any other types of securities that are consistent with the funds' investment objectives and policies.[24]

Fund registration forms require all funds that invest in other funds (and in particular funds of funds) to disclose the acquiring fund's pro rata portion of the cumulative net expenses charged by the acquired funds, along with related transaction fees, as a separate line item in the fee table (i.e., "acquired fund fees and expenses"). The SEC has adopted highly detailed instructions for calculating the amount of acquired fund fees and expenses and provides a disclosure exception when such fees and expenses are less than 0.01 percent (one basis point), in which case the fees and expenses should be reflected in general fund expenses.[25]

Investments in Securities-Related Issuers. Under Section 12(d)(3), a mutual fund generally may not purchase any securities of an issuer that is a broker or dealer, is engaged in the business of underwriting, or is a registered investment adviser (collectively, "securities-related issuers"). Rule 12d3-1 provides an exemption from Section 12(d)(3)

---

[23] The Section 12(d)(1)(A) and (B) restrictions are referred to herein as the "Section 12(d)(1) limits."

[24] The SEC's Division of Investment Management has also issued a no-action letter waiving the requirement that a fund of funds limit its investment portfolio to investments that qualify as securities under the 1940 Act. *See* Northern Lights Letter.

[25] *See* Item 3 of Form N-1A.

under certain circumstances. Under Rule 12d3-1, a fund may acquire securities of an issuer that derives 15 percent or less of its gross revenues from the business of being a broker-dealer, underwriter, or investment adviser ("securities-related activities"), unless the acquiring fund would then control the issuer. A fund may acquire securities of an issuer that derives more than 15 percent of its revenues from securities-related activities if:

- The acquiring fund will not own more than 5 percent of the outstanding securities of that class of the issuer's equity securities;
- The acquiring fund will not own more than 10 percent of the outstanding principal amount of the issuer's debt securities; and
- The acquiring fund has not invested more than 5 percent of its assets in the securities of the issuer.

Rule 12d3-1 does not exempt an acquiring fund's purchases of:

- Any securities issued by its investment advisers or distributors, or any affiliated persons of its advisers or distributors; or
- Any general partnership interest in a securities-related business.

Consequently, funds with significant positions in other mutual funds or securities-related businesses should implement policies to ensure that they regularly determine whether they are in compliance with the Section 12 limitations.[26]

Names Rule. Section 35(d) prohibits a mutual fund from using in its name any words that the SEC finds materially deceptive or misleading. Rule 35d-1 requires funds whose names suggest a particular type of investment or investment in a particular industry to have a policy that the fund will invest at least 80 percent of its assets in the type of investment suggested by the name (under normal circumstances). With respect to names suggesting investment in certain countries or geographic regions, funds must have an 80 percent policy regarding investments that are tied economically to the particular country or geographic region suggested by the name. Such 80 percent policies must be fundamental under Section 8(b)(3) (i.e., cannot be changed without a shareholder vote pursuant to Section 13(a)(3)), or the fund must adopt a policy to provide fund shareholders with at least 60 days prior notice of any change in the policy in the manner prescribed by Rule 35d-1.[27]

If a fund has a name that implies that its distributions will be exempt from federal income tax, or from both federal and state income tax (i.e., a tax-exempt fund), the fund must have a fundamental policy under normal market conditions to:

---

[26] *See also* Sections 12(d)(2) and 12(g) regarding limitations on investments in voting stock of insurance companies.

[27] Although fund names that include "global," "international" or "world" are excluded from the 80 percent requirement of the names rule, the SEC staff has informally taken the position that such funds must invest at least 40 percent of their net assets in a minimum of three countries (excluding the United States).

- Invest at least 80 percent of its assets in tax-exempt securities; or
- Invest its assets so that at least 80 percent of its income will be tax-exempt.

Daily Valuation and Liquidity

Certain regulatory provisions of the 1940 Act are designed to prevent funds from employing "unsound or misleading methods" in computing the asset value of their outstanding securities, as well as to subject funds to adequate independent scrutiny regarding such valuations.[28] In addition, one of the defining features of mutual funds is that their shares are required to be redeemable on a daily basis at their "current net asset value" (NAV) per share. Mutual fund shares are continuously offered for sale. Thus mutual funds price their shares at least once daily and must maintain liquidity adequate to convert a portion of their portfolio holdings into cash on a frequent basis.[29]

Under Section 22(e), mutual funds are required to pay redeeming shareholders within seven days of shares being tendered. In practice, mutual funds (or broker-dealers) typically pay proceeds within three business days of a redemption request.[30] The right of redemption can be suspended only in limited circumstances, such as when the New York Stock Exchange (NYSE) is closed (other than customary weekend and holiday closings), or when trading on that exchange is restricted.

Determining Valuation. With respect to valuation, the price of each portfolio security must be determined either by a market quotation, if a market quotation is "readily available," or by assigning a "fair value" as determined in good faith by the fund's board. This two-pronged approach has been in place since 1940, and there has been a multitude of SEC releases, staff letters, enforcement actions, and accounting publications since then providing guidance around fund valuation and associated board responsibilities, notably in the area of fair value.[31]

This daily valuation process results in the NAV per share of the fund. That is, the current market value of the fund's assets (minus any liabilities), divided by the number of shares outstanding. This NAV per share is the price used for mutual fund share transactions occurring that day, including new purchases, sales (redemptions), and exchanges between funds.[32] As required by Rule 22c-1, the specific time for pricing is set by the fund board (usually 4:00 p.m. Eastern time, when the NYSE closes). Such timing is disclosed in the fund's prospectus. Rule 22c-1 also requires "forward pricing," which

---

[28] *See* Section 1(b)(5).

[29] *See* Rule 22c-1 and Rule 2a-4. In order to meet a large redemption request, a redemption in-kind may also be permitted in certain circumstances.

[30] Due to the requirements of Rule 15c6-1 under the 1934 Act, broker-dealers must meet open-end fund redemption requests within three business days.

[31] The ICI has created an indexed and searchable compendium of valuation and liquidity guidance for mutual funds. *See SEC Valuation and Liquidity Guidance for Registered Investment Companies* (2015). *Volume 1*, https://www.ici.org/pdf/pub_15_valuation_update_vol1.pdf; *Volume 2*, https://www.ici.org/pdf/pub_15_valuation_update_vol2.pdf

[32] Investors may pay additional charges in connection with the purchase or sale of mutual fund shares (e.g., sales charges upon purchase or contingent deferred sales charges or redemption fees upon redemption).

means that shares are purchased or redeemed at the next-calculated NAV per share after the request is received by the fund (or financial intermediary).

As noted in the Compliance Rule Adopting Release, pricing of portfolio securities and fund shares is a critical fund (and service provider) compliance function. The fair valuation process in particular receives enhanced scrutiny from funds, boards, regulators, and independent auditors, because such good faith determinations are widely recognized to be more art than science, depending on the circumstances of each particular case.

Liquidity. Closely tied to the valuation of daily redeemable securities is liquidity (and liquidity risk management generally). If a mutual fund holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of a fund to fairly establish daily NAV or pay proceeds to redeeming shareholders within the requisite time period after shares are tendered. Thus, mutual funds are required to maintain adequate liquidity.

Long-standing SEC guidelines generally limit an open-end fund's aggregate holdings of "illiquid assets" to 15 percent of the fund's net assets (interpreted to mean that a fund is limited from acquiring any illiquid asset if, immediately after such acquisition, the fund's holdings of illiquid assets would exceed 15 percent). A security is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment.[33]

Liquidity Risk Management Rule. The SEC's historical emphasis on the importance of adequate liquidity in light of Section 22(e) was underscored in October 2016 when the SEC adopted a comprehensive, multilayered set of new and amended rules and forms designed to promote effective liquidity risk management throughout the open-end fund industry.[34] Such liquidity rules (including new Rule 22e-4 and related actions) are intended to reduce the risk that funds will be unable to meet shareholders' redemption requests or other legal obligations and mitigate dilution of the interests of fund shareholders. The liquidity rules are also intended to give investors better information to make investment decisions, and to give the SEC better information to conduct comprehensive monitoring and oversight of the fund industry.[35]

Rule 22e-4 will require all open-end funds (except money market funds) to adopt and implement a written liquidity risk management program that is reasonably designed

---

[33] *See,* e.g., *Investment Company Liquidity Risk Management Programs, 81 FR* 82142 (Nov. 18, 2016) (Liquidity Risk Management Release), https://www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25348.pdf. This 15 percent limit is essentially codified by the new liquidity risk management rules, discussed below, but the new standard is more demanding because funds must assess liquidity on an ongoing basis (not only upon acquisition of an illiquid investment).

[34] *See* Liquidity Risk Management Release. This action was taken in conjunction with the reporting modernization amendments discussed above, as well as amendments permitting open-end funds to use "swing pricing" to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. *See Investment Company Swing Pricing,* 81 FR 82084 (Nov. 18, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25347.pdf

[35] *See* Liquidity Risk Management Release.

to assess and manage its liquidity risk, which is the risk that the fund could not meet requests to redeem shares without significant dilution of remaining investors' interests in the fund. Larger entities are required to comply with Rule 22e-4[36] and related amendments to Forms N-PORT and N-CEN by December 1, 2018 (smaller entities by June 1, 2019). The compliance date for amendments to Form N-1A under the liquidity rules is June 1, 2017.[37]

Oversight and Accountability

All mutual funds are subject to oversight from internal sources, such as boards of directors (including independent directors) and written compliance programs overseen by CCOs; and external sources, such as the SEC, the Financial Industry Regulatory Authority (FINRA), and external service providers, such as the independent auditor or independent legal counsel. This subsection will primarily focus on fund governance requirements and the role of the board.[38] As noted in the Compliance Rule Adopting Release, compliance with fund governance requirements is a critical compliance function.

As a general matter, fund directors play an important and active oversight role under the 1940 Act regulatory framework. Directors, particularly independent directors, act as "watchdogs" who perform the vital role of representing and guarding the interests of shareholders.[39] The external management of mutual funds presents inherent conflicts of interest (e.g., between fund managers and shareholders) and potential for abuses that the 1940 Act attempts to reduce. Fund boards are responsible for monitoring these potential conflicts of interest and have a fiduciary duty to represent the interests of fund shareholders. Thus, the 1940 Act establishes certain fund governance requirements and imposes significant responsibilities on fund directors, including specific responsibilities on independent directors.[40]

Independence Determination. Fund board members are considered "independent directors" (or "disinterested directors") if they are not an "interested persons" of the fund as defined in Section 2(a)(19).[41] This definition can be highly technical, but, as a general matter, independent directors are precluded from having (or recently having) any significant business relationships with the fund's adviser, principal underwriter

---

[36] Including new Rule 30b1-10 and new Form N-LIQUID, which generally require a fund to confidentially notify the SEC when the fund's level of illiquid investments exceeds 15 percent of its net assets or when its highly liquid investments fall below its stated minimum for more than a specified period of time.

[37] More information about the liquidity rules appears in Stradley Ronon, *What You Need to Know About the SEC's New Liquidity Risk Management Rule* (Nov. 2016), http://www.stradley.com/~/media/Files/Publications/2016/Fund_Alert_November_2_2016.pdf

[38] Funds affiliated with a bank may also be overseen by banking regulators and all funds are subject to the antifraud jurisdiction of each state in which the fund's shares are offered for sale or sold.

[39] *See,* e.g., *Role of Independent Directors of Investment Companies,* 66 FR 3734, 3736 (Jan. 16, 2001) (final rule) (Governance Rule Adopting Release), https://www.gpo.gov/fdsys/pkg/FR-2001-01-16/pdf/01-536.pdf; Correction, 66 FR 13234 (Mar. 5, 2001).

[40] Among other responsibilities and as discussed above, Rule 38a-1 established a framework for board oversight of mutual fund compliance programs and fund CCOs.

[41] Note that "interested person" of another person is a defined term in the 1940 Act; "independent director" and "disinterested director" are not (though the latter two terms are used in certain SEC rules and forms).

(i.e., distributor), or certain affiliates; and precluded from having any direct or indirect ownership of the adviser or certain related entities.[42]

Board Composition. Under Section 16, at all times 50 percent of fund directors must have been elected by shareholders and, to fill any board vacancies, at least two-thirds of directors must have been elected by shareholders (counting the new director(s)).

Section 10(a) generally provides that at least 40 percent of the members of an investment company's board of directors must be independent directors.[43] However, the SEC adopted a set of governance standards in 2001, including Rule 0-1(a)(7) that must be satisfied for funds to rely on certain exemptive rules (e.g., Rule 12b-1, permitting the use of fund assets to pay distribution expenses, and rules that permit funds to engage in certain types of transactions with affiliates).[44] Among other things, these governance standards require that a majority of a fund's board be made up of independent directors. Few funds can operate without relying on one or more of these exemptive rules. Thus, as a practical matter, a majority of the members of a board must be independent directors for most funds.[45] In practice, most fund boards have far higher percentages of independent directors (i.e., more than 75 percent).

Board Approval of Advisory Agreements and Distribution Agreements. Investment advisory agreements and distribution agreements establish the legal and contractual relationships between the fund and its investment adviser(s) and any principal underwriter(s) (i.e., the firm that serves as the distributor of the fund's shares), respectively. Under Section 15, these agreements must be approved by the fund's board and separately (in person) by a majority of the fund's independent directors. Advisory agreements must also be approved by a majority of the fund's outstanding voting securities.[46]

---

[42] *See also Interpretive Matters Concerning Independent Directors of Investment Companies,* 64 FR 59877 (Nov. 3, 1999) (statement of staff position) (discussing the SEC staff's views on the types of professional and business relationships that may be considered material for purposes of Section 2(a)(19)), https://www.gpo.gov/fdsys/pkg/FR-1999-11-03/pdf/99-27443.pdf. In addition, Item 3 of Form N-CSR imposes certain additional requirements for Audit Committee members who are determined to be audit committee financial experts to qualify as "independent."

[43] Also, Section 10(b)(2) requires, in effect, that independent directors comprise a majority of a fund's board if the fund's principal underwriter is an affiliate of the fund's adviser; and Section 15(f)(1) provides a safe harbor for the sale of an advisory business if directors who are not interested persons of the adviser constitute 75 percent or more of the fund's board for at least three years following the assignment of the advisory contract.

[44] *See* Governance Rule Adopting Release.

[45] The SEC adopted amendments to the governance standards in 2004 that would have required fund boards to have at least 75 percent independent directors (66 percent if there are only three board members) and for the board's chair to be an independent director. These two requirements were challenged and a federal appeals court ultimately invalidated them. The SEC sought additional comments on such governance standards in 2006 but has not taken further action. *See Investment Company Governance*, 69 FR 46378 (Aug. 2, 2004) (final rule), https://www.gpo.gov/fdsys/pkg/FR-2004-08-02/pdf/04-17460.pdf; 70 FR 39390 (July 7, 2005) (SEC response to remand by court of appeals), https://www.gpo.gov/fdsys/pkg/FR-2005-07-07/pdf/05-13314.pdf; 71 FR 35366 (June 19, 2006) (request for additional comment), https://www.gpo.gov/fdsys/pkg/FR-2006-06-19/pdf/06-5493.pdf

[46] In practice, the initial shareholder approval of an investment advisory agreement could be the vote or consent of the sole shareholder (e.g., fund sponsor) holding the initial seed capital shares.

Advisory and distribution agreements may only have initial terms of up to two years and may continue from year to year thereafter only if approved by a majority of the independent directors (in person), and must provide for their automatic termination in the event of an assignment.[47] Advisory agreements may be terminated, without penalty, by the board or by vote of a majority of the outstanding voting securities of the fund at any time (on not more than 60 days' written notice to the investment adviser). The advisory agreement must also describe the precise amount of the compensation to be paid to the investment adviser.[48]

In connection with the initial approval and the annual review of advisory agreements, Section 15(c) imposes on the board a duty to request and to review all information that may be necessary in order to evaluate the terms of the advisory agreements, and there is a corresponding duty of the investment adviser to provide the requested information. Each advisory agreement must be considered separately. Funds must provide reasonably detailed disclosure in shareholder reports and in certain proxy statements describing how their boards evaluate and approve their investment advisory arrangements.

Subadvisory agreements are treated the same as advisory agreements under the 1940 Act (i.e., required to meet the Section 15 requirements). However, the SEC has granted exemptive relief to a number of funds that permit the funds to implement a manager-of-managers structure. Such relief permits those funds, subject to a variety of conditions, to hire new subadvisers without obtaining shareholder approval (although board approval is still required).

Fund Audit Committees. A mutual fund must have an audit committee of its board of directors. Before an independent auditor is engaged by the fund to render audit or nonaudit services, the engagement must be approved by the audit committee.[49] Under Section 32(a), selection of the mutual fund's independent auditor must also be approved annual by the fund's independent directors. Section 32(a)(2) requires that such selection be submitted for ratification to shareholders, but Rule 32a-4 (relied on by most mutual funds) exempts funds from the shareholder ratification requirement when all of the members of the audit committee are independent directors and the board has adopted an audit committee charter.

Limits on Leverage

Two of the core policy concerns of the 1940 Act involve excessive borrowing by investment companies and the issuance of excessive amounts of senior securities (which

---

[47] *See* Section 15(a) and (b). *See also* Section 2(a)(4) (definition of "assignment").

[48] Section 36(b) imposes a fiduciary duty on the adviser with respect to the receipt of compensation for services, or of payments of a material nature, paid by the fund to the adviser or its affiliates. Section 36(b) also authorizes actions by shareholders and by the SEC against an adviser for breach of this duty. *See,* e.g., *Jones v. Harris Associates L.P.,* 130 S. Ct. 1418 (2010) (essentially upholding the longstanding "Gartenberg standard" that courts have consistently used to evaluate whether an adviser violated its fiduciary duty by receiving an excessive fee).

[49] Rule 2-01(c)(7) under Regulation S-X.

increase unduly the speculative character of the fund's junior securities).[50] Section 18 addresses the capital structure of mutual funds and generally limits the issuance of such "senior securities" and borrowing, subject to certain exceptions and further conditions. These restrictions are intended to prohibit complex capital structures, limit funds' use of leverage, and minimize the possibility that a fund's liabilities will exceed the value of its assets.

Mutual funds are generally prohibited from issuing senior securities by Section 18(f). Section 18(g) defines "senior security" to mean "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." This essentially includes any debt that takes priority over the fund's shares, such as a loan or preferred stock, but does not (by definition) include a borrowing from a bank which is for temporary purposes and which does not exceed 5 percent of the fund's assets at the time the loan was made.

Section 18(f) permits mutual funds to borrow from a bank (i.e., explicit leverage), provided the fund has "asset coverage" as defined in Section 18(h) of at least 300 percent for all borrowings. That is, the fund's total net assets are at least three times the total aggregate borrowings. Many funds voluntarily go beyond the 1940 Act prohibitions and adopt fundamental policies that further restrict their ability to issue senior securities or borrow. As noted above, such fundamental policies would require a shareholder vote to change. The SEC has as also issued exemptive orders permitting certain fund complexes to participate in an interfund lending facility (i.e., where funds lend to and borrow from each other for temporary purposes) subject to compliance with the conditions of the order.

Leverage can also be achieved implicitly through the use of certain types of portfolio investments. Although Section 18 on its face refers to explicit indebtedness, the SEC staff has taken the position that Section 18 covers certain other transactions, notably derivatives.[51] That is, such transactions may involve the issuance of a senior security subject to the prohibitions and asset coverage requirements of Sections 18(f)(1). However, the SEC and the staff have indicated that they will not object to mutual funds engaging in such transactions without complying with the asset coverage and other requirements of the Section 18(f)(1), provided that funds segregate assets or otherwise "cover" their obligations under the instruments, consistent with SEC and staff guidance.[52] A fund generally can cover an obligation by owning the instrument underlying that obligation. The fund also can generally cover a leveraged transaction by earmarking or segregating liquid securities equal in value to the fund's potential exposure from the transaction. The

---

[50] Section 1(b)(7).

[51] Specifically: reverse repurchase agreements, firm commitment agreements, standby commitment agreements, short sales, written options, forwards, futures, and certain other derivatives transactions.

[52] *See,* e.g., SEC Division of Investment Management, *Registered Investment Company Use of Senior Securities—Select Bibliography* (modified June 17, 2016), https://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm

assets set aside to cover the potential future obligation must be liquid, unencumbered, and marked-to-market daily. They may not be used to cover other obligations and, if disposed of, must be replaced.

Funds should have established detailed written policies and procedures in place that are designed to ensure compliance with Section 18, including policies to address coverage procedures with respect to derivatives and other transactions that have the effect of leveraging a fund's portfolio.[53]

Custody

Section 17(f) governs the custody of a mutual fund's assets, including its portfolio securities. A fund is required to maintain its securities and other investments with certain types of custodians (i.e., separate from the assets of the adviser) under conditions designed to assure the safety of the fund's assets. The strict rules on the custody (and reconciliation) of fund assets are designed to prevent theft and other fraud-based losses. Shareholders are further insulated from these types of losses by Section 17(g), which requires all mutual funds to have fidelity bonds designed to protect them against possible instances of employee larceny or embezzlement.

Custody of Fund Assets with Securities Depository. Section 17(f) permits a fund to maintain its securities in a system for the central handling of securities (commonly referred to as a "securities depository"). The SEC adopted Rule 17f-4 to establish conditions for the use of securities depositories or intermediary custodians (i.e., subcustodians) by funds. Rule 17f-4 provides that a fund's custodian may place and maintain financial assets with a securities depository or intermediary custodian only if the custodian is obligated to exercise due care in accordance with reasonable commercial standards in acting as a securities intermediary to obtain and maintain financial assets. Rule 17f-4 also requires the custodian to provide, upon the fund's request, available reports concerning the custodian's internal accounting controls and financial strength. In addition, Rule 17f-4 holds any intermediary custodian to the same duty of care as required of the custodian.

Custody of Fund Assets Outside the United States. Rule 17f-5 governs the custody of fund assets located outside the United States. Under that rule, a fund's board has the authority to select, contract with, and monitor foreign custodian banks. However, Rule 17f-5(b) permits a board to delegate those responsibilities to a "foreign custody manager." Normally, the foreign custody manager selected for this purpose is the custodian for

---

[53] In December 2015 the SEC proposed rules designed to modernize the regulation of derivatives usage by mutual funds. If adopted, the rules would replace certain SEC and staff guidance developed over the years on mutual fund use of derivatives and impose new limits on fund use of derivatives. *See Use of Derivatives by Registered Investment Companies and Business Development Companies,* 80 FR 80884 (Dec. 28, 2015), https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf. *See also* Stradley Ronon, *What You Need to Know About the SEC's New Proposal on the Use of Derivatives by Registered Investment Companies and Business Development Companies* (Dec. 2015), http://www.stradley.com/~/media/Files/Publications/2015/IMG-Client-Alert-December-2015.pdf

the fund because fund custodians customarily maintain networks of foreign custodian banks and are best suited to select, contract with, and monitor foreign custodian banks.

In order to meet the conditions of this delegation, the board must find it reasonable to rely on the selected foreign custody manager to perform the delegated responsibilities.[54] Also, the foreign custody manager is required to provide written reports to the board giving notification of the placement of fund assets with a particular foreign custodian bank and of any material change in the status of a fund's foreign custody arrangements (at such times as the board deems reasonable and appropriate).[55] Finally, the foreign custody manager must agree to exercise reasonable care, prudence, and diligence appropriate to its safekeeping responsibilities or such higher standard as the board may require.

Rule 17f-5 requires the foreign custody manager to consider certain factors in selecting foreign custodian banks to be "eligible foreign custodians" for fund assets, and that the fund's foreign custody arrangements with a foreign custodian bank be governed by a written contract.[56] Rule 17f-5 also requires the foreign custody manager to establish a system for monitoring both the appropriateness of continuing to maintain the fund's assets with a particular foreign custodian bank and the terms of the foreign custody contract.[57] If an arrangement no longer meets the requirements of Rule 17f-5, the fund must withdraw its assets from the custodian as soon as reasonably practicable. The monitoring requirement is specifically designed to permit the fund to react promptly to negative developments.

Custody of Fund Assets with a Foreign Securities Depository. Rule 17f-7 governs a fund's use of foreign securities depositories. Each depository must qualify as an "eligible securities depository" under the rule. Rule 17f-7 allows a fund to arrange for its primary custodian to do preliminary and ongoing risk analysis regarding the use of particular foreign securities depositories.[58] The primary custodian must agree to exercise reasonable care in performing its duties under Rule 17f-7. If a custody arrangement with an eligible securities depository no longer meets the requirements of Rule 17f-7, a fund must withdraw its assets from the depository as soon as reasonably practicable. Although Rule 17f-7 does not assign a specific role to either the board of trustees or the investment

---

[54] Factors relevant to making this determination include: the expertise of the proposed delegate, its intended use of third party experts, the board's ability to monitor the proposed delegate's performance, and the proposed delegate's financial strength.

[55] The SEC has indicated that "material changes" would include changes in foreign custodians and could include events affecting a foreign custodian's financial status, such as a change in control. The SEC has also indicated that the foreign custody manager should include a discussion of its reasons for changing or maintaining a foreign custodian.

[56] Rules 17f-5(c)(1) and (2).

[57] Rule 17f-5(c)(3).

[58] Although Rule 17f-7 does not prescribe specific factors to assess risk, the adopting release provides that, generally, this analysis should cover: a depository's expertise and market reputation; the quality of its services; its financial strength; any insurance or indemnification arrangements; the extent and quality of regulation, and independent examination of the depository, its standing in published ratings, its internal controls, and other procedures for safeguarding investments; and any related legal protections. *See Custody of Investment Company Assets Outside the United States*, 65 FR 25630 (May 3, 2000), https://www.gpo.gov/fdsys/pkg/FR-2000-05-03/pdf/00-11000.pdf

adviser, the adopting release indicates that the decision to use a depository, based on the risk analysis information provided by the custodian, would likely be delegated by the board to the fund's investment adviser, subject to the board's general oversight.[59]

Fidelity Bond. Section 17(g) authorizes the SEC to require bonding of officers and employees of registered management investment companies who may singly, or jointly with others, have direct or indirect access to securities or funds of such investment companies by a reputable fidelity insurance company against larceny and embezzlement. Pursuant to this authority, the SEC adopted Rule 17g-1, which requires such coverage for investment companies in certain minimum amounts.

Rule 17g-1 provides that the coverage may be in the form of:

- An individual bond for each covered person or a schedule or blanket bond covering all such covered persons;
- A blanket bond that names the investment company as the only insured ("single insured bond"); or
- A bond that names the investment company and one or more other parties (the other parties that are permitted to be named as insureds under the bond are limited by Rule 17g-1 and include, among others, the investment adviser or distributor of the investment company) (a "joint insured bond").

Under Rule 17g-1, the board initially approves, and periodically reviews and considers renewal of such coverage. The rule requires a majority of the independent directors to review the coverage and determine that the fidelity bond is reasonable in form and amount, after considering all relevant factors including, but not limited to:

- The value of the aggregate assets of the investment company;
- The type and terms of the arrangements made for custody and safekeeping of assets; and
- The nature of the securities in the company's portfolio.

Rule 17g-1 contains certain required provisions for fidelity bonds and provides guidelines for the minimum fidelity bond coverage amounts that should be maintained based on the amount of aggregate assets of the investment company. The rule also requires certain SEC filings.

Prohibitions on Transactions with Affiliates

The 1940 Act contains a number of strong and detailed prohibitions on transactions with, and activities of, affiliated persons. Preventing the operation of a mutual fund for the benefit of affiliated persons is a core policy concern of the 1940 Act and funds should have established detailed written policies and procedures in place to address such transactions.

---

[59] *Id.*

General Guidance for Affiliated Transactions. Under Section 17(a), an affiliated person of a mutual fund (i.e., first-tier affiliate), or any affiliated person of such person (i.e., second-tier affiliate), is generally prohibited from "knowingly" selling securities or other property to, or buying securities or other property from, the fund. Thus, a mutual fund cannot engage in principal transactions in securities with affiliated persons.[60] An affiliated person also generally cannot borrow money from the fund.[61] As an initial matter, properly identifying affiliated persons is a critical compliance function.

There are a number of statutory and regulatory exemptions from the Section 17(a) prohibitions. For example, Rules 17a-1 through 17a-6 exempt certain minor transactions between a mutual fund and its affiliates. Rule 17a-7 exempts a purchase or sale transaction between affiliated mutual funds, and between funds and other advisory accounts that affiliated solely by reason of having a common investment adviser, common directors, and/or officers, provided the transaction meets certain requirements. Among other provisions, Rule 17a-7 requires such transactions to be effected at the independent current market price of the security, without any brokerage commission or other remuneration (except for a customary transfer fee), and the directors of the investment company adopt procedures for such purchase and sale transactions.[62] Rule 17a-8 exempts certain mergers of affiliated funds.

Under Section 17(b), a person may file an application with the SEC for an order exempting a proposed transaction that is covered by Section 17(a) (and not covered by any of the exemptive rules) from the provisions of Section 17(a).

Joint Insurance Policies. Section 17(d) and Rule 17d-1 generally prohibit an affiliated person of a mutual fund (and affiliated persons of such persons) from participating in or effecting any transaction in connection with any joint enterprise or joint arrangement in which the mutual fund is a participant, unless an application for exemption from Section 17(d) has been approved by the SEC. The provisions are meant to minimize or prevent a fund from entering into a transaction on a basis that is different from, or less advantageous than, that of another participant. Rule 17d-1 includes certain exemptions for such joint arrangements as long as certain conditions are met; e.g., with respect to the investment advisory contract (subject to Section 15) between a fund and its investment adviser, and joint liability insurance policies.[63]

Affiliated Brokers. Section 17(e) generally prohibits a broker from effecting transactions for an affiliated fund on a securities exchange unless the broker's commission does not exceed the "usual and customary broker's commission." Rule 17e-1 is a safe harbor that establishes that an affiliated broker's commission, fee, or other remuneration will be deemed not to exceed the usual and customary commission if, among other things,

---

[60] Section 17(a)(1) and (2).

[61] Section 17(a)(3).

[62] As discussed above, a fund's reliance on certain 1940 Act exemptive rules requires the board of directors of the investment company to satisfy the fund governance standards in Rule 0-1(a)(7). Such rules include Rule 17a-7.

[63] Rule 17d-1(c) and (d)(7), respectively.

the commission is "reasonable and fair" compared to the commission received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on a securities exchange during a comparable period of time.

Affiliated Underwritings. Section 10(f) prohibits a fund from purchasing any security during the existence of any underwriting or selling syndicate if the fund has certain relationships with a principal underwriter of such security. Prohibited syndicates generally include those in which an officer, director or trustee, investment adviser (including a subadviser), or employee of a fund or an affiliate of such persons is a member. Section 10(f) would prohibit a fund's purchase of such security from another member of the selling syndicate, absent compliance with the provisions of Rule 10f-3. Rule 10f-3 provides an exemption to this prohibition, subject to certain conditions, and permits a fund to enter into securities transactions that would otherwise be prohibited by Section 10(f).

IV. CONCLUSION

These core compliance areas have been supporting the underlying regulatory principles of the 1940 Act for more than 75 years. But, as noted above, these are only a starting point. The regulatory framework to which mutual funds are subject—both under the 1940 Act and other applicable regulations—is extensive and continues to evolve and adapt in order to protect the interests of mutual fund investors and mitigate risks to the broader financial system.

APPENDIX

Section 1(b) of the 1940 Act—Declarations of Policy

Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission…and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) When investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) When investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

APPENDIX

(3) When investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) When the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) When investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) When investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) When investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) When investment companies operate without adequate assets or reserves.

It is hereby declared that the policy and purposes of [the 1940 Act], in accordance with which the provisions of [the 1940 Act] shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

Minimum Compliance Policies Outlined in Compliance Rule Adopting Release

The release notes that the fund's, or its adviser's, policies and procedures should address, at a minimum, the following issues identified for investment advisers:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;

APPENDIX

- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

The release also states that the SEC expects the fund's, or its service providers', policies and procedures to cover, at a minimum certain, other "critical" areas:

- Pricing of portfolio securities and fund shares;
- Processing of fund shares;
- Identification of affiliated persons;
- Protection of nonpublic information;
- Compliance with fund governance requirements; and
- Market timing.

ABOUT THE AUTHORS

Alan R. Gedrich is a partner in the Philadelphia, Pennsylvania, office of Stradley Ronon Stevens & Young, LLP, and a member of the firm's Investment Management Group. He represents investment companies, investment advisers, private funds, exchange-traded funds (ETFs) and fund sponsors on a wide range of matters, including all aspects of their organization, registration and operation, compliance matters, and acquisitions. In addition, he also serves as counsel to independent trustees of investment companies.

Mr. Gedrich graduated from the Pennsylvania State University and received his juris doctor degree from the University of Pittsburgh School of Law, where he served as managing editor of The Journal of Law and Commerce. Prior to attending law school, he worked for Coopers & Lybrand, CPA (presently, PricewaterhouseCoopers, LLP) and is a certified public accountant (inactive).

He is a frequent author and lecturer at investment management conferences on a variety of industry topics.

David F. Roeber is a senior associate in the Philadelphia, Pennsylvania, office of Stradley Ronon Stevens & Young, LLP and a member of the firm's Investment Management Group. He counsels investment companies, investments advisers, and independent directors/trustees to investment companies on a wide variety of regulatory, compliance, and corporate governance matters. In addition, he serves as the lead attorney for the UrbanPromise Legal Clinic in Camden, New Jersey.

Mr. Roeber graduated from Taylor University in Upland, Indiana, with degrees in Management/Systems and Political Science, and received his law degree from Rutgers School of Law in Camden, New Jersey.