Compliance Corner

So You Want to be a Mutual Fund Manager

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So you are an investment adviser registered with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940, as amended ("Advisers Act"). You currently manage separate accounts and, perhaps, one or more private funds, but you are interested in getting into the registered fund business. As an SEC registered adviser, you have already adopted compliance policies and procedures pursuant to Rule 206(4)-7 of the Advisers Act and you are certainly eligible to advise a registered investment company.[1] So you're good to go? . . . Not so fast.

In addition to the business questions relating to managing a registered fund, which are significant,[2] you will likely need to reorient your compliance policies and procedures from the principles-based approach that generally defines the Advisers Act to the more structured rules-based system under the Investment Company Act of 1940, as amended (the "Investment Company Act"). This article seeks to:

- summarize the differing regulatory approaches of the Advisers Act and the Investment Company Act, while also showing how SEC rulemaking and the exercise of its regulatory and enforcement authority has made these two statutes more alike; and

- provide a non-exhaustive list of certain compliance requirements that advisers will need to address to serve as an adviser to a registered fund.

Comparing the "Principles-Based" Advisers Act with the "Rules-Based" Investment Company Act

Congress passed both the Investment Company Act and the Advisers Act in 1940, with the aim of protecting investors; however Congress took different approaches with these two statutes, mandating a number of substantive requirements for investment companies but generally relying more on registration, disclosure and general fiduciary-based principles for investment advisers.

Recalling the circumstances prior to 1940 is helpful in understanding the reason for Congress' approach. During the 1920s and 1930s, many investment companies had engaged in practices that served to benefit advisers or other interested parties at the expense of fund investors, often by using non-transparent and complex structures that were difficult, if not impossible, for investors to understand. To address these abuses, Congress designed the Investment Company Act around a number of specific requirements that aimed to prevent similar abuses from reoccurring. In addition to prohibiting specific conduct by investment companies, Congress also mandated that independent directors would make up at least 40% (later changed to a majority) of each investment company's board of directors. The independent directors would serve to protect the investors' interests, and address the types of conflicts of interest that had contributed to past abuses.

In the view of many commentators, Congress passed the Advisers Act as a supplement to the more substantive Investment Company Act. According to this view, the Advisers Act would serve primarily as a disclosure and anti-fraud statute. Disclosure by advisers would backstop the Investment Company Act and also provide a broader scope of protection by requiring advisers to refrain from fraudulent activity when dealing with all their clients including, but not limited to, registered investment companies.

While the Advisers Act is still perceived as a disclosure-based statute,[3] many advisers who do not advise registered funds know that this view is less connected to the current reality of complying with the Advisers Act.

The Advisers Act and its Drift Towards More Substantive Regulation

The SEC has gradually used both its indirect and direct rule-making authority, as well as its enforcement and regulatory authority,[4] to expand the substantive requirements of the Advisers Act.

For example, Section 206 of the Advisers Act essentially prohibits fraud, and paragraph four of the same section gives the SEC the authority to adopt rules defining acts, practices and course of business that are fraudulent, deceptive or manipulative. Pursuant

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to that authority the SEC adopted Rule 206(4)-1 specifically defining certain advertisements as fraudulent, deceptive or manipulative. These requirements have been further expanded by numerous SEC staff interpretations. Thus, while the Advisers Act is still largely a principles-based statute that broadly defines fraudulent practices and generally allows advisers to develop their own methods of compliance, it has been evolving into a more rules-based regime for some time.

Understanding Compliance Obligations Under the Investment Company Act

The public policy interests that Congress seeks to protect via the Investment Company Act are explicitly set forth in the Act's first section and cover such areas as (i) providing investors with complete and accurate information; (ii) serving the best interests of all classes of shareholders and not the advisers' interests; (iii) not employing ownership and governance structures that plainly conflict with the best interests of shareholders; (iv) engaging in appropriate accounting practices, including independent auditing; (v) obtaining shareholder approval before certain major events; (vi) restrictions on borrowing or issuing senior securities to the extent that doing so would make junior securities unduly speculative; and (vii) undergoing continuous operation and providing daily liquidity to shareholders. Accordingly, advisers entering the registered fund business should be aware that they are consenting to a regulatory regime that very specifically defines how to act in the best interests of shareholders.

Compliance Policy Approaches: Moving from the Advisers Act to the Investment Company Act

All SEC-registered investment advisers are required to have a compliance program and a chief compliance officer ("CCO") under Rule 206(4)-7 of the Advisers Act. In the release adopting the compliance requirements for the Investment Company Act and the Advisers Act,[5] the SEC stated that it expects advisers' policies and procedures to address, among other items, equitable allocation of investment opportunities, preventing proprietary or personal trading that would conflict with client interests, safeguarding client assets and personal information, best execution practices, the use of "soft dollar arrangements," valuation procedures and business continuity (*i.e.,* disaster recovery) plans. The Compliance Rule Release further stated that areas where Investment Company Act Rule 38a-1 would likely require compliance polices for registered funds include: preventing self-dealing with affiliated persons, protecting non-public information, complying with investment company governance requirements, preventing market timing, and installing specific valuation procedures for portfolio instruments without readily ascertainable market values. Whether these policies are classified as "fund policies" or "adviser policies" for the purposes of Rule 38a-1 is irrelevant. The important thing is that an adviser to a registered fund would be expected to comply with these requirements. In particular, valuation policies for registered funds may be more detailed than those used by private funds and incorporate the registered fund board's statutory role to oversee the valuation process. Registered fund valuation policies have competing aims of utilizing the adviser's specific knowledge of security values and market conditions, while protecting against the conflicts inherent in portfolio management personnel participating in the valuation process.

Further, depending on the adviser's role in managing a registered fund, adding an investment company as a client may not only result in requiring compliance with specific Investment Company Act rules such as Rule 17a-7 (cross trades), Rule 17e-1 (trading with an affiliated broker) and Rule 10f-3 (purchasing in an affiliated underwriting), but the fund CCO (who is often an adviser employee) may also be responsible for overseeing compliance of the fund's distributor, administrator and transfer agent. Accordingly, the compliance personnel of an adviser to a registered fund should have an understanding of these non-investment areas and an infrastructure to ensure that it can meet any compliance oversight obligations. Even where a registered fund chooses to utilize a third party administrator or specialty compliance firm to oversee these non-adviser areas, the adviser's compliance and operational personnel should have some familiarity with the compliance activities of these other service providers.

Addressing Investment Company Act Investment Restrictions

In addition to building out compliance programs to comply with Rule 38a-1 of the Investment Company Act, advisers may need to modify their strategies and accompanying investment policies to comply with certain investment restrictions set by the Investment Company Act. Advisers should consider the following restrictions when assessing whether their particular strategies can be successfully translated to a registered fund. Please note that the discussion below is necessarily brief and does not capture a number of nuances and applications, for example, how to address derivatives for the purposes of meeting these requirements.

Daily Redemptions and Liquidity

Open-end funds must offer daily redeemable securities. Under Rule 22c-1, shares must be priced each day markets are open. As a result of this daily

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liquidity, an open-end investment company may not hold more than 15% (5% for money market funds) of its assets in illiquid securities. Liquidity is defined as the ability to dispose of an asset at approximately its carrying value in seven days (not business days). This requirement is not applicable to closed-end funds.

Senior Securities and Leverage

Section 18 limits a registered fund's ability to issue senior securities and leverage its portfolio. It permits borrowing from a bank provided that there is 300% asset coverage. The SEC has also taken the position that Section 18 limits a fund's ability to utilize certain instruments that can create future indebtedness including short sales, reverse repurchase agreements and derivative transactions, such as swaps, futures, and written options. When a registered fund uses these instruments, it is required to "cover" its future obligations by either entering into an economically offsetting position or by segregating sufficient liquid assets sufficient to meet its future obligations.[6]

Names Rule

Section 35(d) provides that an investment company may not adopt a misleading name. Pursuant to Rule 35d-1, a fund that suggests a particular type of investment (*e.g.,* equities or bonds) or investment in a particular industry must invest at least 80% of their assets (net assets plus borrowings) in that type of investment or industry. These requirements apply to terms such as "equity," "fixed income," "international," and "large-cap." However, certain investment terms used in fund names such as "focused," "super concentrated," "growth," "income," and "managed futures" are viewed as suggesting an investment strategy rather than type of investment and are not subject to the "80% test."

Investment Company Act Diversification

Section 5 provides that a fund may elect to be diversified or non-diversified. A diversified fund is one which, with respect to 75% of its assets, the fund is invested in cash and cash items (including receivables), U.S. Government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer. Any fund not meeting this test is deemed non-diversified; however, even non-diversified funds must generally still meet certain Internal Revenue Code diversification requirements. A fund cannot change from diversified to non-diversified without a shareholder vote; however, with certain limitations, a non-diversified fund may change its policy without a shareholder vote.

Whether to elect to be a diversified fund under the Investment Company Act is primarily a marketing decision. To the extent that electing to be a diversified fund would likely interfere with an intended investment strategy, funds generally elect to be non-diversified.

Concentration Policy

Concentration refers to a fund investing more than 25% of its total assets in a particular industry or group of industries. A fund must disclose its policy regarding concentration and may not change this policy without a shareholder vote. With limited exceptions, a fund may not reserve freedom of action to adjust from concentrating to not concentrating in a particular industry. In addition, while a fund is generally free to provide its own reasonable definitions of industries, the SEC staff has taken certain positions regarding particular industry classifications, such as with privately issued mortgage-backed securities.

Investments in Other Investment Companies

Section 12(d)(1)(A) limits a fund's ability to invest in other registered investment companies such that a fund may not hold more than 3% of another registered investment company's voting securities, invest more than 5% of its assets in another registered investment company or 10% of its assets in the securities of other registered investment companies. There are several exclusions to these requirements such as Rule 12d1-1 which essentially excludes money market funds from these restrictions and Rule 12d1-2 which permits funds to invest in affiliated investment companies beyond these limitations with certain restrictions. In addition, a number of funds have received exemptive relief from the SEC to exceed these limitations or to invest in both affiliated funds and derivatives.

Securities Related Issuer Requirements

Section 12(d)(3) limits a fund's ability to invest in a security or other interest in a broker-dealer, underwriter or investment adviser (*i.e.,* a securities related issuer). Pursuant to Rule 12d3-1, a fund may purchase a security from an unaffiliated securities related issuer without limitation where the securities related issuer received less than 15% of its gross revenues in its most recent fiscal year from securities related activities. For securities related issuers that do not meet this 15% test, a fund may invest in securities issued by such firms (if they are not affiliated with the fund's adviser or distributor) pursuant to the following limitations: the fund cannot have more than 5% of its total assets in securities issued by the securities related issuer and the fund (i) cannot own more than 5% of any class of the securities related issuer's equity securities and (ii) cannot own more than 10% of the principal amount

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of the securities related issuer's debt securities. These limitations often come into play with swaps and structured notes.

As a practical matter, the investment restrictions above allow a broad spectrum of strategies to be translated into registered funds. However, some strategies, in particular those that necessarily involve high amounts of leverage or illiquid instruments, may be better suited to private funds or closed-end funds.

Conclusion

Since 2003, all registered advisers have been required to adopt compliance policies and procedures and designate a CCO to oversee their compliance programs. While this is also the starting point for meeting the compliance requirements relating to registered funds, an adviser that is new to this space will likely need to expand and reorient its policies to address the numerous specific requirements of the Investment Company Act.

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[1]17 C.F.R. 203A-1 (advisers to registered investment companies must be registered with the SEC; however, under the same rule, if an adviser is not already registered with the SEC, advising a registered investment company is alone a sufficient basis to register with the SEC).

[2]The business issues related to managing an investment company are numerous and beyond the scope of this article (including, for example, key issues such as sponsoring new funds, serving as sub-adviser, or other arrangements). After evaluating this question, firms would face additional questions, such as distribution options and the selection of service providers.

[3]See, e.g., Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (Court reiterates view that Congress' intent in enacting the Advisers Act was to protect investors by ensuring adequate disclosure by investment advisers).

[4]See, B. Barbash and J. Massari, The Investment Advisers Act of 1940: Regulation by Accretion, 39 Rutgers Law Journal 627 (2008) for a discussion of how the SEC has used its enforcement authority to impose more substantive requirements on advisers, particularly in the area of trading practices.

[5]Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA–2204; IC–26299 (Dec. 17, 2003) (the "Compliance Rule Release").

[6]In a recent concept release, Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776 (Aug. 31, 2011), the SEC discussed the asset coverage obligation under Section 18 and noted that many funds meet this obligation with respect to derivative instruments that are contractually required to cash settle by segregating the daily "mark to market" amount as opposed to segregating the notional amount of the contract. The Commission sought comment on these practices.