

The Investment Company Act of 1940

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SUMMARY

The growth of the mutual fund industry is one of the most striking developments in U.S. investing over the past sixty-five years. In 1940, total industry assets stood at a mere \$448 million; by 1970, that figure had grown to \$48 billion. Today, more than ninety-two million Americans own mutual funds, nearly half of all households, and industry assets are almost \$8 trillion.

Mutual funds, or open-end investment companies, are the most prevalent of the three types of investment companies, and far outnumber closed-end funds and unit investment trusts. This presentation will use the terms mutual fund or fund interchangeably with investment company.

The Investment Company Act of 1940 (the “Act”)

- The mutual fund industry – and its shareholders -- have generally thrived under the Act.
- The genius of the Act is that it tempers pervasive regulation with a flexibility that allows for innovation and change in products, services and investor protections.
- The Act remains a vital and positive force in the US financial markets.

The History leading up to the Act

- Reeling from the economic collapse that followed the stock market crash of 1929, Congress enacted a series of statutes to restore order to the nation's financial markets and public confidence in the integrity of those markets.
- The Act was the last of the major federal securities laws to be enacted, following on the heels of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act").
- The Investment Advisers Act of 1940 ("Advisers Act") was signed into law at the same time as the Act, adding yet another layer of regulation.
- It is no exaggeration to state that the net cast by these four statutes subjects mutual funds to level of regulation experienced by no other issuer of securities.

Why was the Act deemed necessary?

- As public companies, Funds already were subject to the disclosure and antifraud provisions of the Securities Act, and mutual fund distributors already were regulated as broker-dealers under the Exchange Act.
- However, unlike other types of corporations, a mutual fund is nothing more or less than a large pool of liquid assets.
- Moreover, virtually all mutual funds are managed externally and have no employees of their own.
- Thus, unlike other corporations, mutual funds are managed by outside entities and individuals that may have conflicting loyalties and obligations.
- The other federal securities laws rely heavily on disclosure and antifraud provisions to address potential abuses. The Act was a recognition by Congress that in the case of the unique conflicts presented by mutual funds, disclosure and antifraud protection aren't enough.

Definition of “Investment Company”

- The Act is comprehensive in the types of entities that must register as an “investment company.”
 - *The Act forces every company that falls within the Act’s definition of “investment company” to register, absent a statutory exclusion or SEC exemptive relief.*
 - *The definition, set forth in Section 3 of the Act, includes not only traditional mutual funds, but also reaches companies not commonly thought of as investment companies and that had no intention of doing business as an investment company.*
 - *The scope of the Act ensure that shareholders in any entity that devotes significant assets to investing in securities will receive the Act’s protections.*

The definition includes:

- *any company that holds itself out as being engaged primarily, or proposes to be engaged primarily, in the business of investing, reinvesting, or trading in securities (the traditional mutual fund);*
- *any company that is engaged or proposes to be engaged in the business of issuing face amount securities of the installment type, or has any such certificates outstanding (this provision has little relevance today); and*
- *any company that is engaged or proposes to engage in the business of investing, reinvesting or trading in securities, and owns or proposes to acquire investment securities having a value in excess of forty percent of the company's total assets (exclusive of government securities and cash items) on an unconsolidated basis (this provisions covers so-called inadvertent investment companies, issuers that had no intention of becoming investment companies but nonetheless find themselves subject to its provisions).*
- *Section 7 of the Act restricts the activities of unregistered investments companies, and prohibits, among other things, the public offering of securities and engaging in interstate commerce.*

Fund Operations

- The Act affects virtually every aspect of investment company operations. The objectives of the Act generally are to:
 - *Ensure that potential investors and fund shareholders receive timely and accurate information that promotes informed decision-making.*
 - *Prohibit self-dealing, in which people or entities related to a fund use the fund to their own advantage. So-called “affiliated transactions” are prohibited unless specifically approved by the SEC.*
 - » *the sale or purchase of property to or from the fund;*
 - » *borrowing by the fund from an affiliate or vice versa;*
 - » *joint transactions in which the fund and fund affiliate(s) are parties;*
 - » *transactions in which a fund affiliate receives other than ordinary broker’s compensation for acting as agent for the fund in connection with the purchase or sale of property by the fund; and*
 - » *purchases by a fund of securities during an underwriting in which a fund affiliate is one of the underwriters.*

Fund Operations (continued)

- *Ensure that fund assets are valued fairly.*
 - » Market value
 - » Fair value
- *Protect the physical custody of fund assets.*
 - » assets be held with a qualified U.S. bank or, in accordance with SEC rules, with a U.S. broker-dealer, a U. S. central depository, or in highly-regulated self custody.
 - » Officers and employees with access to assets must be bonded.
- *Inhibit unsound or unduly complex capital structures.*
 - » “senior securities” (securities that receive any sort of preferential treatment over other securities issued by the fund)
 - » severely limiting borrowings by the fund.

A wide variety of other measures advance the goals of the Act.

- The Act calls for extensive recordkeeping by each fund, and gives the SEC the authority at any time to inspect these books and records at the fund's place of business.
- Any individual who has been convicted of a wide variety of securities or commodities-related offenses may not be associated with a fund for ten years following the determination of culpability. Any individual who has been permanently enjoined for a securities-related or commodities-related offense also is barred.
- The financial reports that accompany reports to shareholders must be certified by an independent public accountant that has been approved by fund shareholders.

Mutual Fund Governance

- The Act relies on an unusually rigorous corporate governance system to further advance the objectives of the Act.
 - *Every mutual fund is organized as a corporation or business trust under state law.*
 - *As such, each fund director (or trustee in the case of a business trust) is charged with all of the responsibilities of directors or trustees under state law.*
- The Act goes beyond state law and imposes a number of additional conditions and requirements on fund boards.
 - *While the Act requires that at least forty percent of each board be composed of directors who are “independent” of the fund’s investment adviser and that a majority must be independent of the fund’s principal underwriter, in practice a majority generally must be independent of the fund’s adviser.*

In 2004, the SEC amended several exemptive rules widely used in the industry to require specific fund governance standards:

- *must have a board 75% of which is independent of the funds adviser;*
- *the independent directors must select and nominate other independent directors;*
- *any legal counsel retained by the independent directors must be independent legal counsel;*
- *an independent director must serve as chairman of the board;*
- *the board must annually evaluate its performance;*
- *the independent directors must meet in executive session at least quarterly; and*
- *the independent directors must be authorized to retain experts and hire employees as necessary.*

The Fund board is responsible for:

- the consideration and approval of the fund's contracts with its investment adviser, principal underwriter and other major service providers.
- the pricing of fund assets.
- approving any changes of investment policies.

Shareholder Voting Rights

- Under the Act, all shares issued by a mutual fund must be voting stock and each share must have equal voting power.
- Like shareholders of other public companies, mutual fund shareholders have voting rights established by the law of the state in which the fund is established.
- The Act reserves a number of additional matters for shareholder approval:
 - *changes in the terms of the fund's contract with its investment adviser*
 - *changes in the fund's fundamental investment objective and policies.*

The Act has proven remarkably adaptive to changing circumstances.

- The Act grants the SEC authority to enhance investor protection for mutual fund investors where needed. As in the case with new products and services, Congress recognized that the Act needed the flexibility to adapt to changes in the industry that might suggest a need for additional investor protections. Under this authority, the SEC has added a requirement that funds have a code of ethics for personal trading by certain employees, and adopted a comprehensive package of fund governance reforms.
- Congress reflected this approach in the Act by generally prohibiting funds from engaging in certain practices that were subject to abuses except as permitted by SEC rules. Congress ensured that investor protection would be furthered by requiring, explicitly or implicitly, that any such rules be “in the public interest and for the protection of investors.”
- Recognizing that markets and circumstances change and that the fund industry can and should evolve for the betterment of investors, the Act grants the SEC broad authority to grant exemptions from the Act in situations that were not foreseeable in 1940. Again, the SEC’s use of this authority must be based on a finding that the exemption is consistent with the protection of investors. As a result, in the 65 years since passage of the Act, the industry has been able to develop a variety of products and services not contemplated in 1940.