



**Risk Management Update
August 2014**

COMPLIANCE CONSIDERATIONS FOR ADVISERS AND SUB-ADVISERS OF MUTUAL FUNDS

According to the Investment Company Institute (“ICI”)¹, at the end of 2013 approximately 79% of U.S. mutual fund complexes were independent fund advisers. They surmise that this is largely due to the “series trust” structure, which is an arrangement that provides multiple unaffiliated SEC registered investment advisers with the ability to have their own mutual fund(s) within the same registered investment company (“RIC”). A series trust is generally offered by third party vendors, such as banks and trust companies, and gives investment advisers a turnkey solution to offering proprietary mutual funds to investors.

One of the main attractions to turnkey solutions is cost efficiency, and for series trusts the outsourced services that are packaged in the arrangement generally include accounting, administration, compliance, distribution, fund governance and legal. This allows an investment advisory firm to focus the majority of its time and energy on marketing and managing the mutual fund. However, even in these types of arrangements advisers are still responsible for ensuring that their proprietary mutual fund(s) comply with all the regulations under the Investment Company Act of 1940, as amended (the “1940 Act”), along with any other applicable federal and state laws. Importantly, there are a number of 1940 Act rules that mandate adherence by investment advisers and sub-advisers to mutual funds, regardless of whether or not the mutual fund they manage is affiliated. For example, investment advisers and sub-advisers (hereafter referred to as “mutual fund managers”) to mutual funds are required to have a written Code of Ethics that adheres to Rule 17j-1 of the 1940 Act, in addition to Rule 204A-1 of the Investment Advisers Act of 1940, as amended (the “Advisers Act”).

Some of these requirements may not be readily apparent to advisory firms when entering into a series trust arrangement, particularly if they are managing a mutual fund for the first time. This Risk Management Update outlines some important regulatory obligations applicable to mutual fund managers and provides useful guidance and compliance steps for consideration.

Rule 38(a)-1 of the 1940 Act – Mutual Fund Compliance Program Rule

Registered mutual funds are required under Rule 38(a)-1 to have compliance programs that include, among other things, written policies and procedures addressing 1940 Act requirements, including internal controls designed to prevent violations of applicable federal securities laws. Some of the 1940 Act rules that directly impact mutual fund managers include:

- Rule 10f-3: Requirements when purchasing securities in an affiliated underwriting
- Rule 12d-1: Exemptions pertaining to purchasing other mutual funds

¹ 2014 *Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*. 54th edition: ICI Investment Company Institute.

- Rule 12d-2: Exemptions pertaining to insurance companies and securities related businesses
- Rule 17a-1: Exemption of certain underwriting transactions
- Rule 17a-2: Exemption of certain purchase, sale, or borrowing transactions
- Rule 17a-3: Exemption of transactions with fully owned subsidiaries
- Rule 17a-4: Exemptions of transactions pursuant to certain contracts
- Rule 17a-6: Exemption for transactions with portfolio affiliates
- Rule 17a-7: Exemption of certain transactions with affiliated persons
- Rule 17e-1: Exemptions for payments of commissions to affiliated brokers.
- Rule 17j-1: Personal investment activities of mutual fund personnel
- Rule 30b1-4: Reporting of proxy voting
- Rule 31a-1: Books and records maintenance requirements
- Rule 31a-2: Books and records preservation requirements
- Rule 34b-1: Sales literature deemed to be misleading

Compliance Steps: At the beginning of the engagement with the mutual fund, mutual fund managers should obtain and review a copy of the mutual fund's Rule 38a-1 policies and procedures to determine what procedures are applicable and what actions are necessary. It also is important to work with the fund's CCO to clarify their expectations and reporting requirements. Notably, some of the above rules require reporting to the mutual fund's Board of Trustees, and in some cases the mutual fund manager will need to provide appropriate and periodic information and certifications to the mutual fund's CCO in order to accomplish such reporting.

The next step for mutual fund managers is to implement written policies and procedures as appropriate that address the applicable rules and reporting requirements. The Form ADV will need to be updated to reflect the new mutual fund management arrangement, which should include disclosures related to compensation arrangements, services, and any conflicts that may exist (*e.g.*, side by side trading). Finally, internal controls and forensic tests should be utilized to test the effectiveness of the mutual fund manager's compliance program.

Mutual Fund Investment Restrictions

The 1940 Act mandates a number of fundamental investment restrictions that must be adhered to by certain types of mutual funds, which cannot be changed without shareholder vote. Some of the more common restrictions² include:

- **Diversification Test:** If a mutual fund is classified as a "diversified" fund, then 75% of the fund's assets must be limited in respect of any one holding to an amount not greater

² The information outlining these restrictions is provided in summary form and does not include all the requirements pertaining to each listed restriction. For a complete description of each restriction, see <http://www.sec.gov/about/laws/ica40.pdf>, and http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&tpl=/ecfrbrowse/Title17/17cfr270_main_02.tpl.

than 5% of the fund's total assets and not more than 10% of the outstanding voting securities of such issuer.

- Concentration Limit: Unless a mutual fund declares itself as a “concentrated” fund, it cannot invest more than 25% of its total assets in any one industry or group of industries.
- Investments in Other Registered Investment Companies, Insurance Companies, and Securities Related Businesses: Section 12 of the 1940 Act limits the amount a mutual fund portfolio can invest in broker-dealers, underwriters, investment advisers, insurance companies and other mutual funds.

The IRS also imposes diversification restrictions on mutual funds in order to maintain their status as a RIC for tax purposes.

Compliance Steps: Prior to trading for the mutual fund portfolio, mutual fund managers should perform an in-depth review of the mutual fund's Prospectus and Statement of Additional Information (“SAI”) to have a clear understanding of all applicable investment restrictions. The firm placing trades for the mutual fund should implement, to the extent possible, an electronic pre-trade and post trade compliance system to track adherence with investment restrictions. It also is important to discuss with the mutual fund's CCO the protocols for reporting any trade errors and restriction violations, as such may cause a re-pricing of the mutual fund's daily net asset value (“NAV”).

Marketing of Mutual Funds

There are three main regulations pertaining to marketing and advertising of mutual funds.³ These are:

- Rule 482 of the Securities Act of 1933: Permits advertising without delivering a prospectus, so long as prospectus is offered in the advertisement. Rule 482 contains specific standards for the presentation of mutual fund and variable annuity performance data; including required disclosures and information on the prominence, proximity, type size and style requirements for certain information.
- Rule 34b-1 of the Investment Company Act of 1940: Requires that the performance data comply with the specific standards set forth in Rule 482.
- Rule 135a of the Securities Act of 1933: Permits a generic advertisement by mutual funds that are general in nature and do not make specific reference to any particular mutual fund or include performance information. These advertisements are not required to be preceded or accompanied by a statutory prospectus.

The Financial Industry Regulatory Authority (“FINRA”) also has rules pertaining to mutual fund marketing and advertising. For example, Rule 2210 – Communications with the Public, mandates that member firms ensure that communications with the public are not misleading.

³ The following information is provided as information only for the Mutual Fund Managers, which should be considered if/when the Manager creates marketing collateral on behalf of the series trust or fund.

Mutual fund distributors are broker-dealers that are members of FINRA and are required to file mutual fund marketing and advertising materials with FINRA for review and comment. FINRA also requires certain persons that market/solicit for the mutual fund to have a Series 6 license or equivalent and be registered with FINRA.

Compliance Steps: Prior to marketing or soliciting for a mutual fund, the mutual fund manager should ensure that any of their personnel performing such activity are properly licensed and registered. Such personnel also may need to be registered as an investment adviser representative in any State where they are located and marketing. The mutual fund manager's CCO should ensure their firm has implemented procedures and internal controls requiring all market and advertising materials pertaining to and/or mentioning the mutual fund, which has been created by their firm to be provided to either the CCO of the mutual fund or the CCO of the distributor for filing with FINRA prior to use.

Conclusion

While series trusts provide investment advisory firms with a way to lessen the administrative costs associated with running a mutual fund, such arrangements do not alleviate the additional compliance responsibilities that come with managing a mutual fund. It is extremely important for all mutual fund managers to review their adherence to 1940 Act requirements and interface with fund CCOs on a continuous basis.

For more information on this topic, please do not hesitate to contact us at (619) 278-0020.

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