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INVESTMENT ADVISERS

Private Fund Advisers Considering Mutual Funds

BY PAUL MILLER

The Dodd-Frank Wall Street Reform and Consumer Protection Act required many private fund advisers to register with the Securities and Exchange Commission (SEC) in 2012. This registration requirement for advisers not previously required to be registered advisers eliminated one of the barriers that many private fund advisers confronted when considering whether to manage a registered fund, which must be advised by a registered adviser. Since then, many private fund advisers have considered taking that step - managing a mutual fund. This article discusses key issues that a private fund adviser may want to consider when determining whether to manage a mutual fund, the options available for managing a mutual fund, and the relative advantages and disadvantages of each option.

Introduction

There are various types of registered investment companies, the most common of which is an open-end management investment company (commonly referred to as a ''mutual fund''). Mutual funds register under the 1940 Investment Company Act (ICA), and generally register their shares under the 1933 Securities Act (Securities Act) for the purposes of making a public offering of the shares. Shares of mutual funds are continuously offered, priced daily at their net asset value (NAV) per share and redeemable at the option of the shareholder at the current NAV per share.

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Mutual funds represent an important investment option for individual and institutional investors, including retirement plan investors. According to recently released statistics from the Investment Company Institute (ICI), mutual funds had approximately $13.0 trillion in total net assets at year-end 2012, which reflected an increase of $1.4 trillion from total net assets at year-end 2011.[1] Mutual funds held in defined contribution plans (which includes 401(k) plans, 403(b) plans, Keoghs and other similar plans) and individual retirement accounts (IRAs) accounted for $5.3 trillion, or 27 percent, of the $19.5 trillion U.S. retirement market.[2]

Although mutual fund requirements may impose limitations on a private fund adviser's business and present investment strategy and subject a private fund adviser to broader compliance requirements, there are a number of advantages to managing a mutual fund. The investor limitations imposed on private funds by Sections 3(c)(1) and 3(c)(7) of the ICA do not apply to mutual funds, as their shares are registered with the SEC under the Securities Act. Accordingly, shares of mutual funds can be offered to any investor, subject to the terms of a fund's prospectus, and mutual funds can market and advertise to a larger, retail audience. Unlike private funds, a mutual fund can invest in new issues without restriction and can accept investors subject to the Employee Retirement Income Security Act without limitation. Finally, as indicated by the total net asset figures discussed above, mutual funds are widely accepted

[1] INV. CO. INST., 2013 INVESTMENT COMPANY FACT BOOK 23 (2013), *available at* http://www.ici.org/pdf/2013_factbook.pdf.
[2] *Id.* at p.132.

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Mutual Fund Requirements Affecting a Private Fund Adviser and Implementation of its Investment Strategy

When considering whether to manage a mutual fund, a private fund adviser should consider the impact of the various statutory and regulatory requirements applicable to mutual funds on its business, enhanced compliance requirements, and the implementation of its intended investment strategy for the mutual fund. Those requirements fall generally into three general categories: (i) requirements affecting the adviser's intended investment strategy and its implementation; (ii) requirements governing transparency and publicly available information; and (iii) requirements affecting the adviser's compensation arrangements and other business matters.

Requirements Affecting Investment Strategies. The mutual fund requirements that are most likely to impact the investment strategy of the private fund adviser are those limitations relating to liquidity, restrictions on leverage, required disclosures of the investment strategy and permitted investments of the mutual fund, and diversification. A private fund adviser should consider the impact of these limitations on its intended investment strategy for the mutual fund.

Because mutual funds continuously offer their shares and such shares are redeemable at a price based on the current NAV per share, the SEC limits a mutual fund's investments in illiquid securities to 15 percent of the fund's net assets. For this purpose, an illiquid asset is any asset that may not be sold or disposed of in the ordinary course business within seven days at approximately the value at which the fund has valued the investment.

Mutual funds are subject to restrictions on incurring leverage, which limit the extent to which they can engage in borrowings and in derivative transactions, such as futures, forwards and swaps, and other practices, such as short selling. Specifically, Section 18 of the ICA prohibits a mutual fund from issuing senior securities, and the SEC has interpreted the term ''senior security'' broadly to include any transaction exposing a mutual fund to leverage, including derivative transactions.[3] To avoid application of the Section 18 leveraging prohibition when engaging in a derivative transaction or other practice under SEC interpretive guidance, a mutual fund must either segregate assets equal to the amount of its leverage exposure or cover such exposure by holding an offsetting position equal to the amount of its exposure. These asset segregation and coverage requirements effectively limit to no more than 50 percent the amount of assets a mutual fund can commit to such investment or practices.

Mutual funds must disclose in their prospectuses and statements of additional information their policies concerning borrowing money, issuing senior securities, underwriting securities, concentrating in a particular industry or group of industries, purchasing real estate and commodities and making loans to others. Once disclosed, these policies become fundamental policies, which can be changed only upon shareholder vote. For example, if a fund discloses that it will not concentrate in any industry, the fund may not invest more than 25 percent of its assets in any one industry without first obtaining shareholder approval of a change to that policy. Further, Rule 35d-1 requires mutual funds with certain names that suggest a type of investment (e.g., small capitalization companies) to invest at least 80 percent of their net assets in that type of investment.

The ICA and Internal Revenue Code (Code) impose certain limitations on mutual funds that could affect the implementation of a private fund adviser's investment strategy within a mutual fund. The ICA diversification requirements provide that a diversified fund must have at least 75 percent of the value of its total assets in cash and cash items, government securities, securities of other investment companies and other securities. For purposes of this calculation, a fund may not include in the 75 percent basket of assets securities of any single issuer accounting for more than 5 percent of the fund's total assets or constituting more than 10 percent of the issuer's outstanding voting securities.[4]

Sub-Chapter M of the Code governs the taxation of mutual funds and contains certain diversification requirements with which a mutual fund must comply to avoid taxation at the mutual fund level. Under the Sub-Chapter M diversification requirement, a mutual fund must maintain at least 50 percent of the value of its total assets in cash, cash items, government securities, securities of other registered investment companies and investments in other securities. To qualify for the last category (investments in other securities), the securities of any one issuer may not represent more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer. The diversification requirement also provides that no more than 25 percent of a mutual fund's total assets may be invested in the securities of any one issuer (other than government securities or securities of other regulated investment companies).

Various provisions of Section 12 of the ICA limit a mutual fund's investments in other investment companies (including most exchange-traded funds), insurance companies, and securities of issuers engaged in securities-related activities (e.g., broker-dealers and investment advisers). Section 12(d)(1) restricts a mutual fund from acquiring securities of another registered investment company if, after such acquisition, the mutual fund owns: (i) more than 3 percent of the company's voting securities; (ii) securities of the company with a value in excess of 5 percent of the value of the mutual fund's total assets; or (iii) securities of the company and all other investment companies having a value in excess of 10 percent of the mutual fund. Section 12(d)(2) generally limits a mutual fund's investments in securities of an insurance company to no more than 10 percent of the outstanding voting securities of the company. Section 12(d)(3) and Rule 12d3-1 limit investments in securities of issuers engaged in securities-related activities.

Section 17 of the ICA and related rules restrict transactions between a mutual fund and its affiliated per-

[3] Investments by a mutual fund in certain derivative instruments, such as futures and swaps, may subject the private fund adviser to regulation by the CFTC.

[4] A mutual fund may choose to be non-diversified for ICA purposes.

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sons. An affiliated person of a mutual fund includes any company in which the fund owns 5 percent or more of its outstanding voting securities, any person directly or indirectly controlling, controlled by, or under common control with the mutual fund, and the fund's officers, directors, and investment adviser. These limitations can affect or otherwise limit investments in affiliated companies, co-investments in an issuer by the mutual fund and other clients of the adviser (including its private funds) and a mutual fund's use of affiliated persons to execute its securities transactions.

Requirements Governing Transparency. A private fund adviser should be aware of a number of regulatory disclosure and reporting requirements applicable to mutual funds. The registration statement disclosure requirements require, among other things, that a mutual fund present performance information in the fund's prospectus using a standardized methodology and compare that performance to the performance of an appropriate broad-based index. The registration statement disclosure requirements also require that a fund disclose in its prospectus and statement of additional information, which are publicly available, detailed information about the fund's portfolio managers. The disclosure must include information about the number of private funds, registered investment companies and managed accounts managed by the portfolio managers, their compensation arrangements relating to management of those products and any conflicts associated with managing the products. The disclosure requirements also require disclosure of the proxy voting policies of the fund's adviser when the fund has delegated proxy voting authority to the adviser. In addition, the registration statement requirements require that the adviser of a mutual fund file a copy of its code of ethics as an exhibit to the fund's registration statement.

Mutual funds are required to publicly disclose, within 60 days of the end of each fiscal quarter, their portfolio holdings through annual and semi-annual reports and Form N-Q filings. Public disclosure of portfolio holdings can reveal implementation of the investment strategy and often leads to questions from shareholders, clients and others about the strategy, specific investments and fund performance.

Requirements Affecting Compensation Arrangements and Other Business Matters. Unlike private funds, mutual funds are limited in paying performance-based compensation to an adviser. Performance-based compensation arrangements tied to capital appreciation of the fund are limited to a fulcrum fee arrangement unless all shareholders of the mutual fund meet the definition of "qualified client" under Rule 205-3 of the 1940 Investment Advisers Act. A qualified client includes (i) a natural person who, or a company that, immediately after entering into an advisory contract has at least $1 million under the management of the adviser; or (ii) a natural person who, or a company that, the adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million or (B) is a qualified purchaser as defined in section 2(a)(51)(A) of the ICA at the time the contract is entered into. Investors in mutual funds typically do not meet this requirement due to the retail nature of mutual fund offerings.

Relative to private funds, mutual funds are subject to stringent requirements governing their advisory compensation arrangements. Sections 15 and 36 of the ICA and factors developed in various court decisions govern the advisory fee and advisory agreement approval process for mutual funds, which entails the presentation of information to the board of directors/trustees of the mutual fund, including the independent directors/trustees. The board is responsible for approving the advisory agreement and fee after considering information provided to it. Mutual funds typically pay lower advisory fees than private funds.

Side-by-side management of a private fund and a mutual fund with substantially similar investment objectives and strategies can create most-favored-nation issues for a private fund adviser that has fee side letters with investors in the private fund. Side-by-side management also raises conflict of interest and investment opportunity and trade allocation issues for the adviser, and those issues can be more difficult when the private fund adviser and its personnel are entitled to receive performance-based compensation from the private fund or have substantial personal investments in the private fund.[5] Because of Section 18 of the ICA, side letter arrangements with individual shareholders of a mutual fund are not possible because all mutual fund shareholders must be treated equally.

Options for Managing a Mutual Fund

When considering whether to manage a mutual fund, there are several options that a private fund adviser can pursue, including sponsoring a proprietary fund, establishing a series of an existing series trust mutual fund, or sub-advising an allocated portion of a new or existing mutual fund (or series thereof). These options and their potential advantages and disadvantages are discussed below.

Proprietary Mutual Fund Option. A private fund adviser can establish and sponsor one or more proprietary mutual funds. Under this option, the private fund adviser typically engages a third party administrator or law firm to establish a fund under state law (e.g., as a Maryland corporation, Delaware business trust or Massachusetts business trust), draft its governing documents, prepare and file with the SEC the fund's registration statement and source potential director/trustee candidates. The fund conducts an organizational board meeting at which the board ratifies previous actions taken by an initial director to establish the fund, approves agreements between the fund and the private fund adviser and other service providers (e.g., distributor, custodian, transfer agent, fund accountant and administrator and independent registered accounting firm), and approves the fund's compliance policies and procedures. After the mutual fund is launched, the private fund adviser is responsible for complying with the statutory and regulatory requirements applicable to mutual funds discussed above in implementing its strategy for the proprietary fund and in managing the operations of the proprietary fund.

[5] Advisers to mutual funds are limited in using mutual fund brokerage commissions to acquire only eligible brokerage and research services under Section 28(e) of the Securities Exchange Act of 1934.

Advantages of this option when compared to the series trust mutual fund and sub-adviser options discussed below include control of matters affecting the start-up and ongoing operation of the proprietary fund (e.g., through selection of service providers, matters presented to the board of directors/trustees at its meetings, etc.) and branding and marketing of the proprietary fund. Most often, employees of the adviser-sponsor serve as officers and directors of the proprietary fund and, therefore, are in positions to affect daily determinations affecting the fund. In addition, the proprietary fund is branded to include the name of the sponsor.

Disadvantages of this option when compared to the other options include the potential higher upfront costs in establishing and registering the proprietary fund (which are borne typically by the adviser-sponsor) and ongoing operation and compliance responsibilities attributable to managing the day-to-day operations of the proprietary fund. The advantages of control and branding can also bring liabilities and reputational risks.

Series Trust Mutual Fund Option. Another option for managing a mutual fund is to establish a series of an existing series trust mutual fund sponsored by a third party. Series trust mutual funds are typically sponsored and administered by a bank or third-party administrator and offer multiple ''series,'' or funds, which incorporate the investment strategies of different investment advisers. The series trust mutual fund has an existing board of directors/trustees, service providers, chief compliance officer and compliance program. The costs of operating the series trust mutual fund are shared among the various series of the fund. Under this option, a private fund adviser establishes a series of the series mutual fund, employing its intended investment strategy. The private fund adviser is responsible for complying with the statutory and regulatory requirements applicable to mutual funds discussed above in implementing its strategy for its series.

Advantages of this option when compared to the proprietary fund option include potentially lower start-up and on-going costs for the private fund adviser and less burdensome administrative and compliance responsibilities because many of these responsibilities are performed by the sponsor or administrator of the series trust mutual fund (not the adviser). Disadvantages include less control by the private fund adviser of the day-to-day operation of the series and interaction with the board (and corresponding reliance on the sponsor or administrator), potential investment and other limitations imposed by the series trust mutual fund due to the collective administration of the series funds, and potential limitations on the size of the series managed by the private fund adviser relative to size of the overall series trust mutual fund.

Sub-Adviser Option. Yet another option for managing a mutual fund is to sub-advise an allocated portion (or ''sleeve'') of assets of a mutual fund or the entire assets of a mutual fund. Under this option, the private fund adviser is engaged as a sub-adviser to the mutual fund, which can be either a proprietary mutual fund or a series of a series trust mutual fund, and is responsible for managing only the allocated portion of the assets or the entire fund in accordance with the intended investment strategy of the private fund adviser. In most cases, the private fund adviser (as sub-adviser) is responsible for complying with the statutory and regulatory requirements applicable to mutual funds discussed above in implementing its strategy for the sleeve or fund, although, in some instances, the primary adviser may assume this responsibility.

Advantages of this option when compared to the proprietary fund option and series trust mutual fund option include lower start-up costs as the adviser or fund sponsor typically incurs these costs and the private fund adviser generally has to invest in less infrastructure and personnel because the administrative burdens are less for a sub-adviser as compared to the primary fund adviser. Disadvantages include less control and lower advisory or management fees for implementing the investment strategy, as the primary adviser typically shares a portion of its overall advisory fee from the mutual fund with each sub-adviser to the fund.

Conclusion

Managing a mutual fund is often the next logical step in the evolution of any private fund adviser's business, and mutual funds continue to serve as valuable options for attracting investment (particularly retirement) assets. Understanding the requirements applicable to mutual funds and how those requirements can impact the private fund adviser and its intended investment strategy is critical to making a sound decision to enter the mutual fund business. Once that decision is made, the next step is to understand the options available for managing a mutual fund and the advantages and disadvantages of those options.

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