CHAPTER ONE

UNDERSTANDING MUTUAL FUNDS

> [M]utual funds embody the American Ideal . . . whereby the individual is treated to the privileges of the elite.
>
> (*Don Phillips, in* **Morningstar Mutual Funds**, *April 3, 1992*)
>
> [T]he Investment Company Act of 1940 [is] one of the world's most perfect legal documents.
>
> (*Jason Zweig, Money, in* **Morningstar Mutual Funds**, *August 18, 1995*)
>
> The art of investing in mutual funds . . . rests on simplicity and common sense.
>
> (*John C. Bogle, Vanguard Group, in* **Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor**, *1999*)

When the financial history of the twentieth century is ultimately written, one chapter will be dedicated to mutual funds. This industry has been and continues to be one of the extraordinary growth stories in the history of US financial markets. The Investment Company Institute (ICI) (1997c), the industry trade association, reported industry assets were $35.8 billion in 1974, and by 1996 they had escalated to $3.5 trillion – an annual growth rate of nearly 24 percent! And, by the end of the century, ICI (2000c) reported mutual funds assets were off the chart at over $6.8 trillion – almost doubling assets in three years! Over 8,000 named mutual funds are offered by over 400 different sponsors. Mutual funds are not only the most rapidly growing financial institutions, they are second in size only to commercial banks, and closing rapidly. In fact, mutual fund assets are equal to some 70 percent of the country's annual gross domestic product.

Several major forces explain most of this industry growth. But the first and essential force has been the demonstrated effectiveness of mutual funds as vehicles for providing individual investors with market rates of return, along with investment alternatives and services traditionally available only to institutional and other large investors. This is seen in the immense wealth generated by the historically unsurpassed duration and performance of equity securities since 1982. This performance has contributed enormously to the total of assets managed by mutual funds.

Mutual funds have thus effectively brought Wall Street to Main Street by providing single packages of securities that provide portfolio diversification, professional portfolio management,

shareholder services, and a variety of investment objectives, among others. But mutual funds have also attracted huge investments from institutional investors, business organizations, and nonprofit organizations.

This first chapter has several goals. The first goal is to describe the role of mutual funds as financial institutions in the financial services industry that engage in financial intermediation. Investors utilize mutual funds to acquire financial market assets. This intermediation process helps channel savings to productive uses.

The second goal is to describe mutual funds and related investment vehicles within their regulatory and historical contexts. Mutual funds are a type of investment company primarily regulated under the Investment Company Act of 1940. The two major types of investment companies are unit investment trusts (UITs) and management investment companies. Management investment companies are further subclassified as open-end funds or closed-end funds. Open-end funds are called mutual funds. The 1940 Act mandates a critical role for mutual fund independent directors as shareholder watchdogs.

The third goal is to describe mutual funds as entities with regulatory and director oversight and external service providers, including investment advisors. Mutual funds are shell entities with portfolios and management functions performed by external service providers: (1) investment advisors, (2) administrators, (3) custodians, (4) transfer agents, (5) principal underwriters, and (6) auditors and legal counsel. Mutual funds are sponsored, staffed, and managed by management companies that in their roles as investment advisors manage fund portfolios for asset-based fees.

MUTUAL FUNDS AS FINANCIAL INTERMEDIARIES

Mutual funds are part of what is known as the *financial services industry*. This industry includes two basic types of *financial institutions*: depository and non-depository. Depository institutions include commercial banks, savings and loans, mutual savings banks, and credit unions. Non-depository institutions include mutual funds, as well as insurance companies, pension funds, finance companies, investment banks, and venture capital firms. Financial institutions are also called *financial intermediaries* because they channel surplus cash assets from economic units to economic units with deficit savings and productive needs for cash. This *intermediation* process thus channels savings to productive uses.

Financial intermediaries have evolved by providing customers with financial assets more efficiently and conveniently than they can obtain them directly in financial markets. For example, a common approach to intermediation has savers acquiring financial assets by opening bank savings accounts. The savers receive assets (savings accounts) and banks simultaneously acquire deposit liabilities. Banks then use these funds to create assets by loaning funds to firms, such as for seasonal inventory buildup. In these cases, intermediation channels savings in the form of saver assets and creates deposit liabilities used to acquire financial assets.

There are several versions of the intermediation process. First, there is classic intermediation, which has savers acquire financial assets directly from financial institutions. For example, a Redwood City, CA, executive buys a CD from his local bank. A second version has savers utilizing intermediaries to acquire assets in financial markets. This is the form of intermediation provided by mutual funds, among others. Purchases of mutual fund shares represent proportional

ownership of portfolios acquired by these same mutual funds. Third is an alternative to intermediation in the direct acquisition of financial assets in financial markets. For example, a Santa Barbara, CA, lawyer buys shares direct from a closely held technology company.

Purchase of mutual fund shares is thus an alternative to direct purchase of securities from issuers. It is a simple alternative to implement. Opening an account involves completing a mutual fund account application and mailing it along with a purchase check, or calling a broker or financial advisor to open an account. Many funds provide applications on their Web sites. Mutual funds pool these checks to buy portfolio securities managed for shareholders. This book provides a guide to the selection of the right funds, one fund at a time.

INVESTMENT COMPANIES AND UNIT INVESTMENT TRUSTS

Regulatory framework and classification

The term *mutual fund* is well known, as is its shorter version, *fund*. Mutual funds are a type of investment company primarily regulated under the Investment Company Act of 1940 (the 1940 Act), which assigns primary regulatory oversight to the Securities and Exchange Commission (SEC). The 1940 Act and laws governing investment advisors to mutual funds are summarized in table 1. The Act defines an investment company as primarily engaged in the business of investing, reinvesting, owning, holding, or trading in securities, with at least 40 percent of assets so invested, exclusive of subsidiaries and US Treasury securities. Chapter 4 notes concerns associated with SEC oversight.

The 1940 Act includes two major types of *investment companies: unit investment trusts* and *management* (“*managed*”) *investment companies*. A third type, “face amount certificates,” is of minor importance and not discussed. Unit investment trusts (discussed in detail below) are investment companies with generally fixed portfolios (not actively managed) and finite lives. Management investment companies are further subclassified as *open-end funds* (*open-end management companies*) or *closed-end funds* (*closed-end management companies*). Open-end and closed-end funds are further classified as *diversified* or *non-diversified* (legally defined below).

The legal notion of diversification as a good thing is validated by finance theory, which shows the portfolio risk reduction properties of effective diversification. Management investment companies are organized and managed by investment advisors, usually with assistance of other service providers. The portfolios are managed to meet stated investment objectives and are either passively managed or actively managed portfolios (discussed below).

Each type of management investment company has unique characteristics, as well. In summary, open-end funds are called mutual funds, but the latter term is not defined in the 1940 Act. However, when people say mutual funds or funds, this is interpreted to mean open-end management investment companies, diversified or non-diversified, which offer continuously redeemable securities. Mutual funds shares are both sold and redeemed continuously at portfolio *net asset value* (NAV) per share – total assets less liabilities, divided by number of shares outstanding at close of trading.

On the other hand, closed-end funds have initial, and perhaps intermittent, share offerings, just as regular companies do. The shares are not redeemable and are traded like companies’ shares at prices determined by supply and demand. Their lives are perpetual.

Management investment companies are legal entities, usually corporations, but they may be organized as business trusts or partnerships. They pool investor dollars with the same investment objectives and create, organize, and manage securities portfolios. These pooled dollars are obtained from the public sale of shares through which investors receive proportional ownership in portfolios, typically diversified, that are actively or passively managed by investment professionals.

Investment management companies

In addition to management investment companies, including mutual funds, there are *investment management companies*, also known as management companies, investment advisors, investment managers, fund managers, fund advisory firms, and fund advisors. These companies are easily confused with the legal term "management investment companies" discussed above – note the word reversal. Management companies sponsor (create), organize, staff, and directly/indirectly manage mutual funds. Most important, they are responsible for managing fund portfolios for fund shareholders on a fee basis. In a few words, mutual funds are shell entities with real portfolios that contract with management companies to provide investment advisory and usually other services. Technically, mutual fund entities hire management companies as investment advisors to provide professional portfolio management and usually other services.

THE 1940 ACT AND REGULATION OF INVESTMENT COMPANIES

The 1940 Act is generally considered model federal legislation and is summarized in table 1. The 1940 Act was enacted at the end of the Great Depression that followed the 1929 stock market crash. Congress determined that the disclosure and anti-fraud provisions of the landmark 1933 and 1934 securities laws (discussed below) were inadequate to protect investment company investors. The 1940 Act's mandate is wide and includes investment companies but also investment advisors, distributors of fund shares, directors, officers, and fund employees.

The 1940 Act requires investment companies to register with and report to the SEC, which has regulatory oversight. The Act's major objectives are to (1) ensure investors receive adequate and accurate information, (2) protect fund assets, (3) prevent abusive fund self-dealing, (4) prevent issuance of shares with unfair or discriminatory provisions, and (5) ensure securities bought and sold are fairly priced.

Investment company activities

Ratner (1998) summarized 1940 Act provisions concerning regulation of investment company activities. First, investment companies must register with the SEC by filing notifications that include investment policies and other required information. Registered investment companies must file annual reports with the SEC. Second, to protect investment company

assets, all securities must be held secure with bank custodians, stock exchange member firms or under procedures established by the SEC. All persons with access to the securities must be bonded.

Third, there are capital structure limitations. Investment companies may not issue senior securities (debt or preferred stock) other than notes payable – banks. Closed-end funds may not issue more than one class of debt securities or preferred stock and are restricted in amount. Registered management companies may not issue rights or warrants to purchase securities. And investment companies may not issue securities unless their net worth is at least $100,000.

Fourth, investment companies may not pay dividends from sources other than accumulated undistributed net income, or net income for the current or preceding years, unless accompanied with written disclosure of sources of payments. The Internal Revenue Service (IRS) requires that investment companies must distribute shareholder dividends equal to at least 90 percent of taxable ordinary income, to avoid taxation.

Fifth, the investment activities of investment companies are regulated along several dimensions. Investment companies may not purchase securities on margin, sell securities short, or participate in joint trading accounts. Underwriting commitments totaling more than 25 percent of total assets are prohibited.

There are also numerous activities that require approval of a majority of shares voting: (1) borrowing money, (2) issuing senior securities (prohibited for mutual funds), (3) underwriting securities, (4) engaging in real estate or commodities transactions, (5) making loans, (6) changing investment policy concerning concentration or diversification of assets, (7) changing investment company subclassification, and (8) ceasing to be an investment company.

Investment companies are not limited to "legal lists" in making investments and are not subject to "prudent man" rules. Managers may not be held liable for losses from bad investments or even those deemed imprudent by conservative investors. Managers are subject to SEC sanction for failure to provide the kind of investment management and supervision stated in advertisements or statements of policy. In such cases, courts have held directors civilly liable under state laws for losses due to mismanagement.

Sixth, investments in other investment companies are limited. No investment company may own more than 3 percent of stock in other investment companies, invest more than 5 percent of assets in any one investment company, or invest more than 10 percent of assets in other investment companies generally.

Company management and control

Ratner (1998) next summarized 1940 Act provisions concerning investment company management and control. First, regulations include investment company shareholders, directors, and officers. Shares issued must have equal voting rights and voting trusts are prohibited. Solicitation of proxies is subject to approximately the same rules applying to listed companies generally. In addition to voting rights under state law, shareholders are entitled to vote on several important changes: (1) investment policy or status, (2) approval or assignment of investment advisory contracts, (4) filling more than specified minimum numbers of director vacancies, (5) sale of stock in closed-end funds at prices below net asset value, and (6) appointment of independent public accountants.

There are also provisions designed to ensure integrity of investment company directors and officers, as well as independence of directors. No persons convicted within ten years of securities-related felonies or enjoined from securities-related activities may serve as directors or officers or in other specified capacities. Directors or officers may not be indemnified against liabilities arising from willful misfeasance, bad faith, gross negligence, or reckless disregard of duty.

To assure director independence, no more than 60 percent of board members may be "interested persons" of investment companies. However, "no load" (no up-front sales charges) funds managed by registered investment advisors are required to have only one "non-interested" director. Interested persons include broker-dealers, persons who served as legal counsel within the past two years, immediate family members of affiliated persons, and any persons determined by the SEC to have "a material business or professional relationship" with investment companies or principal executive officers within the past two years.

Second, management compensation is regulated. Acting under board of director supervision, investment company officers normally contract with separate entities called investment advisors to provide all management and advisory services for fees. Investment advisors may be partnerships or private/public corporations. Investment advisors normally create one or more mutual funds as corporate shells to provide vehicles for pooling investor monies. Investment advisors must serve under written contracts approved initially by vote of shareholders and subsequently approved annually by directors. Investment advisory contracts typically call for compensation based as percentages of net portfolio assets.

The SEC has criticized advisory fees as bearing no relation to value of services provided and grossly higher than fees charged by pension fund managers and others for portfolios of comparable size and investment objectives. Shareholder suits on behalf of a number of mutual funds have alleged "waste" of corporate assets and "breach of fiduciary duty" under state and federal laws. In fully litigated cases, courts have found advisory fees high, but not so much as to be considered waste. Some cases have been settled with reduction of advisory fees as portfolios reached specified sizes, and other adjustments.

A 1970 amendment to the 1940 Act provides that investment advisors are deemed to have a "fiduciary duty" with respect to reasonableness of fees. Fiduciary duty is interpreted to prevent investment advisors from increasing fees, even with shareholder approval, if increases provide no benefit. This duty may be enforced in court, by the SEC, and by shareholder suits, without prior demand of directors. In addition, the provision provides that any amendment in renewal of investment advisory contracts must be approved by majority of *disinterested* (*independent*) *directors*, who are "under duty" to request information reasonably necessary to evaluate contracts.

Third, to prevent "trafficking" in investment advisory contracts, transfer of management is regulated. To prevent investment advisors from assigning advisory contracts to other entities, all contracts automatically terminate upon assignment. Assignment includes transfers of controlling interest in investment advisory firms, which also require shareholder approval. The court has held payments of fees to former advisors in connection with changes in advisors to be breach of implied advisor fiduciary duty. A 1975 addition to the 1940 Act provides that sale proceeds of investment advisory firms are protected if for periods of three years at least 75 percent of affected investment company directors are disinterested, and as long as no unfair compensation burdens are placed on investment companies resulting from sales.

Transactions with affiliates

Ratner (1998) next summarized 1940 Act provisions for investment company transactions with affiliates. Such transactions are obvious potential sources of conflicts of interest. The primary concern is to prevent investment companies from buying/selling securities at prices that favor affiliates. Affiliated persons, promoters, or principal underwriters of investment companies may not buy or sell investment company property without specific SEC approval. Approval requires transactions to be fair and reasonable without "overreaching" by any parties, consistent with investment company investment policies, and within the general purposes of the 1940 Act.

First, investment company joint transactions are regulated. Investment companies are prohibited from "joint participation" with affiliates in which arrangements are less than advantageous. These transactions require prior SEC approval. Patterns in which investment company officers or directors repeatedly make the same investments as investment companies are considered joint participations.

The definition of "affiliated person" includes not only those who control investment companies or own more than 5 percent of their shares, but also any entities in which investment companies owns more that 5 percent of shares. Any understandings between investment companies and "portfolio affiliates," such as stock acquisitions in connection with takeover bids, constitute joint arrangements.

Second, investment company brokerage transactions are regulated. Affiliated persons are barred from receiving any compensation for acting as agent or broker in investment company transactions, except where commission are "usual and customary." This latter exception permits brokerage firms that are investment advisors to also act as investment company brokers. The SEC has standards for satisfying this requirement. The larger problem had been routing of commission to brokerage firms that provide other services to investment companies and their advisors. These so called "give ups" were traditional prior to prohibition of fixed commission rates. Investment companies would direct trades to brokerage firms skilled in trade execution with instructions to give up part of the commission to other brokerage firms that provided services.

Following prohibition of fixed commission rates in 1975, new legislation provided investment advisors have not breached fiduciary duty by causing investment companies to pay higher than competitive commission. But only if the commission is "reasonable" in relation to the value of brokerage and research services provided to all accounts under management. The purpose was to allow investment advisors to use the commission they pay to acquire research as well as trade execution services. These *soft dollar payments* are discussed in a later chapter. The SEC ruled such payments could *not* be made for readily available products and services. Ten years later, this rule was terminated as too difficult to apply or unduly restrictive. The SEC decided soft dollar payments are permissible as long as services/products provided are lawful and appropriate to portfolio manager performance.

Sale of fund shares

And, finally, Ratner (1998) summarized 1940 Act provisions concerning investment company sale of fund shares. Closed-end funds are like regular corporations and issue fixed numbers of shares at one time or more. Open-end funds make continuous offerings (sales) and redemption

(sale) of shares at prices equal to fund net asset value. Open-end funds include both *load funds* and *no-load funds*. Traditional load funds imposed upfront sales fees to compensate brokers and financial advisors for selling shares received through captive distributors. Traditional no-load funds did not impose sales fees, but sold shares direct to shareholders through distributors. Principal underwriters of fund shares operate under written contracts renewed at least annually by shareholders or directors. The various sales fee arrangements are updated and discussed in chapter 3.

First, the disclosure requirements of the 1933 Act were modified under the 1940 Act as they apply to investment company registration statements. Further, any sales literature that supplements the required *prospectus* must be filed with the SEC. The required content of the prospectus is in table 2. Also, because mutual funds make continuous offerings of shares, dates of amendments to registration statements are considered the effective dates of registration statements and original dates of fund public offerings.

In 1979, the SEC took steps under the Securities Act of 1933 (the 1933 Act) and the 1940 Act to reduce restrictions on what mutual funds may say in advertisements. Those that include only information that *could* be included in the prospectus satisfy "prospectus delivery [to shareholder] requirements." Also, requirements governing what makes investment company sales literature "false or misleading" were reduced. The SEC was also authorized to permit investment companies to use a prospectus that includes information not in the prospectus filed with the registration statement. In 1988, the SEC required mutual funds to provide a standardized "fee table" in the prospectus.

The 1933 Act is the original "truth in securities" legislation for sales of new securities, including mutual fund shares. Mutual funds are required to register their continuous public offering of shares, and are prohibited from fraudulent and misleading advertising. Investors must be provided with a prospectus of "material facts," including investment objective and policies, investment strategies, performance, expenses, and fees.

Upon request, investors must also be provided *statements of additional information* (SAI). The prescribed content of the SAI is in table 2. This much more detailed document has been required since 1983 for the purpose of reducing information overload in the prospectus. In 1998, additional information was moved to the SAI, including disclosure of shareholder voting rights.

Funds must also distribute *annual* and *semi-annual reports* of financial condition and performance, including portfolios. These documents are oriented towards fund performance, current and historical.

Second, the 1940 Act imposed controls on prices at which investment companies may sell shares. The purpose is to prevent dilution of shareholder share values or unfair discrimination between shareholders. Closed-end funds may not issue shares at prices below net asset value without consent of a majority of shareholders. This control effectively prevents new offerings because closed-end funds normally trade at a *discount* to net asset value.

For open-end funds, the National Association of Securities Dealers (NASD) is authorized to adopt rules that prescribe prices at which security dealers may buy mutual funds shares and resell them to the public. The NASD is the industry's legally defined self-regulatory authority. It also performs on-site examinations and investigates investor complaints. It administers and interprets the SEC's legal framework for fund advertising and sale literature. And it regulates the required certification of broker/dealers as "registered representatives" and enforces rules of conduct.

Mutual fund shares may be sold only at current offering prices described in prospectuses, including any sales *loads*. In 1966, fixed brokerage commission on sales of stock was prohibited to ensure competition. However, the 1940 Act was amended to prevent abolition of fixed mutual fund sales fees. The NASD was given responsibility to ensure maximum loads are not "grossly excessive." excessive, but provide reasonable compensation for sales agents and underwriters. The maximum sales load is 8.50 percent.

The 1940 Act prohibits mutual funds from distributing their own shares, except in compliance with SEC rules. Prior to 1980, mutual funds were effectively prohibited from paying distribution costs from fund assets. Sales expenses were paid from sales loads received by distributors or, in the case of no-load funds, by the management companies.

This prohibition was removed in 1980 when the SEC adopted rule 12b-1 (12b-1 fees), which is discussed and assessed in chapters 2 and 3. If approved by shareholders and directors, mutual funds may act as distributors of their own shares and pay all or part of the costs from fund assets. The SEC has moved against some mutual funds for charging fund assets for costs unrelated to sales, and for charging 12b-1 fees and advertising as no-load funds. The definition of "no load" was later changed so funds with small 12b-1 fees can advertise as no-load funds (discussed in chapter 3).

The sanctions that may be applied to mutual funds for violations of securities laws and regulations are also discussed in Ratner (1998).

Other regulatory acts

Investment advisors, including those for mutual funds, must register under the Investment Advisors Act of 1940. This Act, summarized in table 1, imposes general fiduciary responsibilities and antifraud provisions. It also imposes record-keeping requirements and provides for reports and disclosure to shareholders and the SEC.

The SEC was created by the Securities Exchange Act of 1934 (the 1934 Act), which also extended the 1933 Act to outstanding securities. This Act regulates broker-dealers, including distributors of mutual fund shares. They must meet financial responsibility requirements, maintain financial and customer records, provide custodial accounts for customer securities, and file annual reports with the SEC.

The National Securities Market Act of 1996 (the 1996 Act) extended the 1940 Act and provides for more efficient management of investment companies with more effective, but less burdensome, regulation. The federal government is given sole authority to regulate investment company disclosure and advertising. States may still require investment companies to register and submit their SEC documents, and they do retain jurisdiction for fraud, deceit and unlawful broker-dealer conduct. They also maintain jurisdiction under laws regulating registered corporations generally.

Diversification requirements

As noted above, the 1940 Act also classified investment companies as diversified or non-diversified. This is a different brand of diversification than assumed when discussing portfolio

diversification (chapter 2). Legal diversification requires that, as to 75 percent of assets, diversified investment companies may *not* (1) acquire more than 10 percent of voting shares of any single security issuer, or (2) invest more than 5 percent of fund total assets in any one security issuer. No limits exist on the remaining 25 percent of fund assets, but, in practice, funds rarely invest more than 10 percent of assets in a single security.

Subchapter M of the Internal Revenue Code also imposes diversification requirements on investment companies. However, these requirements are less restrictive than those required under the 1940 Act. They state that no single security may exceed 25 percent of assets, and, as to 50 percent of total assets, no one security may exceed 5 percent of assets. Cash, cash items, US Treasury securities, and securities of other regulated investment companies are excluded.

Distribution requirements

Investment company distributions are further regulated under subchapter M of the Internal Revenue Code. This Act also requires registration under the 1940 Act. Importantly, investment companies must meet exacting income distribution requirements to qualify as *regulated investment companies* and receive *pass-through tax treatment* (*tax conduits*). This is crucial because eligible investment companies are exempt from federal income and excise taxes. This exemption requires investment companies to receive at least 90 percent of gross income from security holdings, and they must distribute annually at least 90 percent of ordinary income and realized long-term capital gains to shareholders. Exemption from excise taxes requires them to distribute annually at least 98 percent of annual ordinary income and realized net long-term capital gains (the latter for the year ending October 31), as well as any previous year income not distributed.

Mutual fund dividend and interest income, less management fees and other operating expenses, plus net realized short-term capital gains, is paid to shareholders as *dividend* (*income*) *distributions*. These distributions are reported for tax purposes as ordinary dividends. Mutual funds pay realized long-term capital gains to shareholders as *capital gains distributions*. These distributions are reported for tax purposes as long-term capital gains. Although qualifying investment companies receive pass-through tax treatment, distributions are taxable income to shareholders, whether reinvested in additional shares or paid by check. Capital gain distributions are taxed preferentially as long-term gains. But the key is no federal income taxation of mutual fund income.

State regulation of directors

States impose two types of responsibilities and specific duties on directors in general. The first is a "duty of care," which requires diligence, care, and skill that persons of "ordinary prudence" exercise in serving corporate interests. Directors must obtain adequate information and exercise "business judgment" in decision making. The second is "loyalty," which requires "good faith" dealings favoring corporate interests in resolving conflicts of interest. Specific corporate director duties include selection of principal officers, declaration of dividends, setting shareholder meetings, and determining shareholder dates of record for dividends.

INVESTMENT COMPANIES AND UNIT INVESTMENT TRUSTS: CHARACTERISTICS

Open-end investment companies (mutual funds)

Historically, mutual funds have been what are called *actively managed funds*. They seek to earn superior returns by actively managing their portfolios. But, increasingly, funds are becoming what are called *index* (*passively managed*) *funds*. Index funds manage their portfolios to mimic performance of particular benchmark market indices, such as the S&P 500 Index. In any case, the defining characteristic of mutual funds as open-end funds is continuous offering of new shares to investors and, under normal market conditions, continuous readiness to redeem (buy back) outstanding shares upon request. Numbers of outstanding shares fluctuate as they are bought and redeemed. If fund share purchases exceed redemptions and *exchanges*, the result is *net cash inflows* and more dollars to invest. Conversely, if redemptions and exchanges exceed purchases, the result is *net cash outflows* and fewer dollars invested. Net cash outflows are covered from *cash assets* (*reserves*), sales of securities, and/or pre-established bank lines of credit.

Mutual fund shares are priced daily at net asset value, which, as noted, is computed by taking total market value of the portfolio, less fund liabilities, and dividing the remainder by number of outstanding shares. Shares are sold at net asset value (plus any sales charges) and redeemed at net asset value (less any fees). Fund shares are sold to investors in two basic ways: direct to investors or indirectly through sales agents, such as financial planners.

Closed-end investment companies

As noted above, closed-end funds are similar to regular corporations – their shares outstanding are fixed following public offerings. Thus they stand ready neither to sell nor to redeem shares on an ongoing basis. As a result, closed-end funds are not concerned with potential investor redemptions, which allows them to buy less liquid securities. Share prices vary and are determined by market supply and demand. Their portfolios are actively managed, typically diversified, and managed in accordance with fund objectives and policies. Any ordinary income and realized long-term capital gains are distributed to shareholders. Closed-end funds normally have perpetual lives.

In 1999, ICI (1999c) reported 476 closed-end funds with total assets of $151.6 billion. Domestic closed-end funds represent 77 percent of total closed-end fund assets. These funds include equity funds, specialty stock funds (*sector funds*), US Treasury bond funds, and municipal bond funds. Foreign closed-end funds include equity funds, government bond funds, and corporate bond funds, some of which are defined by country or region.

Initial public offerings of closed-end funds generally sell at a premium to net asset value of approximately 10 percent, which reflects investment banking fees. Subsequently, outstanding shares trade in secondary markets, including exchanges and over the counter, in exactly the same way as common stock. Prices reflect supply and demand, and investors pay transaction costs in both initial public offerings and secondary market transactions executed through broker-dealers.

In the secondary market, closed-end fund shares tend to trade at discount to net asset value of about 10 percent. Occasionally, they may trade at premium to net asset value. Thus unlike mutual fund shares, closed-end fund shares do not normally trade at net asset value. Shares selling at discount may provide above-average returns if discounts narrow or disappear. Jones (1998) and Malkiel (1995) provided a brief discussion and analysis, respectively, of closed-end fund discounts/premiums.

Because closed-end funds normally do not sell at net asset value, Zweig (1996) offered the following guidelines: (1) do not buy bad funds at discount to net asset value, (2) do not buy funds at initial public offerings to avoid underwriting fees – wait for prices to settle, (3) never pay premiums to net asset value and buy only at discount, (4) reinvest dividends to buy additional shares selling at discount, (5) invest long-term to minimize commission, and (6) buy funds with low expense ratios. Rekenthaler (1994a) also recommended buying closed-end funds at discount, but added that this does not make them preferable to mutual funds. Also, with the subsequent introduction of *exchange-traded funds* (ETFs), closed-end single *country funds* do not have exclusive offerings in these markets.

Unit investment trusts

Unit investment trusts differ from open-end and closed-end funds in three major ways. First, UITs are organized by sponsors under trust indentures with trustees that represent investors, rather than directors and shareholders. Portfolio assets are placed with trustees, normally banks or trust companies, for safe keeping and administration. Second, portfolios are fixed at inception, but they are monitored and may be changed if issues of creditworthiness arise. The portfolios are preselected to meet investment objectives, not actively managed, and require few service providers. Third, unlike mutual funds, they do not have perpetual lives but instead terminate at predetermined dates, which vary widely with the nature of the securities held.

Unit investment trusts (*fixed trusts*) are organized by single or "syndicates" of broker-dealers that purchase the portfolios and sell the trusts. Trusts distribute dividend and interest income plus any cash proceeds from maturing bonds, bonds redeemed by issuers, and disposition of bonds with deteriorating creditworthiness. Investors are charged modest annual fees, reflecting unmanaged portfolios, to cover trust and administrative expenses.

There are approximately twelve broker-dealers that sponsor UITs. As noted in ICI (1997b), there are 12,386 trusts with assets of $78 billion. Broker-dealers initially sell the redeemable *trust certificates* (*units*) at net asset value plus sales fees of some 3–4 percent. Fees may be delayed to allow purchasers to first earn some income. Normally, units trade at offering prices for about one month following initial offerings. Performance information is usually provided to investors monthly.

After initial sale, units normally trade in secondary markets, where they are priced by supply and demand. Typically, investors may sell units to the broker-dealers who organized the trusts or other dealers that make markets in the units. These broker-dealers resell the units at ask prices that approximate net asset value plus fees at initial offering. The markets are usually relatively illiquid, with large trading costs. Thus there are significant investor transaction costs at initial offerings and secondary market trades.

In the absence of secondary markets, investors may redeem units (limitations may apply) with the trustees prior to termination, which may range from six months for trusts holding money market securities to twenty or more years for bond trusts. Trustees may sell securities as needed to meet unit redemptions. Trust assets are liquidated at termination, with investors receiving return of bond principal and equity capital.

Historically, unit trusts predominantly held fixed-income securities, especially tax-exempt bonds. Times have changed and equities now represent over 50 percent of unit trust assets. These equity trusts hold stocks and generally have shorter lives than bond trusts, such as five years. The trusts are designed for particular: (1) investment strategies, (2) indexed portfolios, including broad and narrowly defined market indices, (3) demographic markets, such as retirees, and (4) types of investors, such as individual investors.

Fixed-income trusts were traditionally primarily designed for high tax bracket investors desiring tax-exempt securities. Other widely used trusts also invest in money market instruments, corporate bonds, international bonds, mortgage-backed securities, and US Treasury obligations.

INVESTMENT COMPANIES: A HISTORICAL NOTE

Investment companies have a longer history than suggested by their great visibility and growth since the 1980s. They originated in London in 1868 with the first of what are now called closed-end funds. By the 1880s, closed-end funds were operating in the United State, where they became the dominant class of investment company. But this ended with poor performance after the 1929 market crash and subsequent depression. These events obviously greatly reduced public confidence and ability to invest, as well as securities and financial institutions generally. Worse, however, numerous closed-end funds were excessively leveraged and often engaged in speculative and fraudulent practices. As a result, closed-end funds were largely discredited and, to this day, they have never regained their once dominant position. There are now about 500 closed-end funds, many of which focus on single country markets, such as the Germany Fund.

Mutual funds are now the dominant class of investment company. The highlights of this growth are outlined and discussed in Zweig (1999a, b). The year 1924 marked organization of the first modern mutual fund, the Massachusetts Investment Trust (MIT). The second fund, State Street Investment Trust, followed just four months later. In 1925, MIT organized Investment Trust Fund A on the then wild premise that common stocks outperform bonds and cash over the long term. In 1928, First Investment Counsel Trust, now Scudder Income Fund, was organized as the first no-load fund. And, in 1932, MIT employed the first industry research director, who initiated the industry practice of preparing stock research reports. MIT continues to be located in Boston, MA, a city with a long tradition of trust management.

As the first mutual fund MIT was the model for what was to become the mutual fund industry. First, from its beginning in 1924, MIT's portfolio was 100 percent common stock. This was at a time when bonds were considered the only prudent investment. Stocks were speculative! Second, MIT used only conservative investment principles, none of the speculative

antics of numerous closed-end funds. And, third, MIT's portfolio was publicly disclosed, which was a real shock to Wall Street. Disclosure was the exception to accepted practice at that time. In this regard, MIT's first portfolio is reprinted in table 3. Other than the predominance of railroad, railroad-related and utility shares, industrial holdings include a fair number of household names that today look like anything but speculative common stocks: Standard Oil, Texaco, United Fruit, US Steel, General Motors, General Electric and Eastman Kodak. Fourth, and most important, MIT introduced the mutual fund's defining attribute – the continuous offering and redemption of shares at net asset value.

As, if this were not enough, MIT also contributed importantly to writing mutual fund legislation and to subsequent industry growth. MIT officials actually assisted in drafting the 1940 Act, which was patterned after MIT's own bylaws. Further, MIT worked hard to win congressional approval of mutual fund pass-through tax treatment for mutual funds. This tax conduit for qualifying funds greatly enhanced investor interest in mutual funds. Without this tax break, it is unlikely the fund industry would have anything approaching its current amount of assets under management.

Nonetheless, the 1929 market crash and subsequent depression had tremendously adverse effects on the mutual fund industry. The crash and depression, along with wide use of speculative investment practices, led to the landmark 1933 and 1934 Acts, which were designed to protect investors and regulate securities markets. The 1940 Act extended this legislation and subjected mutual funds to very extensive regulation. This has also been very important to investor confidence and eventual success of the mutual fund industry.

When, years later, *Time* ("The Prudent Man," 1959) featured the then still very modest-sized mutual fund industry, it was MIT's chief investment officer who was the cover story. This success story continues today in Boston. The MIT is now the MFS Massachusetts Investors A fund, and the investment advisor is Massachusetts Financial Services, a subsidiary of Sun Life Assurance of Canada.

In subsequent years, mutual funds continued to experience both good times and bad. Funds were not especially popular during the 1950s, but they became quite the thing during the short-lived growth stock mania of the 1960s. A few *portfolio managers*, such as Gerry Tsai, even acquired celebrity status. His fifteen minutes of fame lasted about as long as his fund's superior performance did, which was not very long at all. Numerous other star portfolio managers also came and went, and the star icon soon generally disappeared until reborn again in the 1980s. These early *star* (*portfolio*) *managers* (*stars*) had quite consistent patterns – short-lived hot streaks followed by often disastrous flame-outs.

However, introduction of *money market funds* in 1971 did much to spur investment in mutual funds. These funds invest in short-term securities, such as Treasury bills, bank certificates of deposit and commercial paper. Money market funds are competitive alternatives to bank interest-paying deposits. They are normally managed to maintain a $1 net asset value. The first money market fund, the Reserve Fund, opened when inflation was over 10 percent. The fund offered individual investors something they were not accustomed to – money market rates of interest on small accounts, which were over 20 percent when inflation was at its highest. Mutual funds also offered an increasingly diverse menu of shareholder services. In 1974, Fidelity Daily Income Trust became first to offer the most important service – check writing on fund accounts.

Developments following the severe bear market of 1973–4 also encouraged investor interest in mutual funds. Investors were provided with increasing numbers of mutual funds and expanding variety of investment objectives to meet their needs. This spectrum increased some threefold from the mid-1970s to the present. Increased choice was seen in expanded offerings of bond funds, such as tax-exempt municipal bonds, as well as international funds that facilitated increased global investing. And, in what has become a huge success, 1976 marked the shaky introduction of the first retail index mutual fund, the First Index Investment Trust. This fund is now the Vanguard 500 Index Fund, by far the largest retail index mutual fund, with assets over $70 billion (one fund!). For a while, when its assets exceeded $100 billion, the fund was the largest mutual fund.

Innovations in retirement and savings vehicles have also increased demand for mutual funds. These innovations included 401(k), 403(b) and 457 salary reduction pension plans, Keogh plans and SEP IRA self-employed retirement plans, SIMPLE 401(k) small company pension plans, SIMPLE IRA and ROTH IRA individual retirement plans, and EDUCATION IRAs. These various savings vehicles provided new investment incentives for American workers and savers.

Moreover, much growth in mutual fund assets has been caused by major shifts in company pension plans from defined benefit to self-directed 401(k) defined contribution plans. This shift has "required" individuals to become more involved in retirement planning, and it has also increased awareness that bank Certificates of deposit are not the route to long-term retirement security.

Retirement assets represent an increasing share of mutual funds assets, and mutual funds represent an increasing share of retirement assets. ICI (2000e) reported mutual fund retirement assets as proportions of total mutual fund assets increased from 19 percent in 1990 to 35 percent in 1999. And, mutual fund proportions of total US retirement assets increased from 5 percent in 1990 to 19 percent in 1999. Even more impressive, mutual fund proportions of total 401(k) assets increased from 9 percent in 1990 to 45 percent in 1999.

Further, much growth in mutual fund assets is due to increased proportions of households that invest in funds. ICI (2000f) reported the percentage of households investing in mutual funds increased from 5.7 percent in 1980 to 49 percent in 2000. The percentage reached 72 percent for households with incomes of at least $50,000. ICI (2000c) found this growth very much reflected in increasing numbers of mutual funds – from 857 in 1982 to 7,791 in 1999.

Much of the growth in mutual fund assets since 1982 may be seen in the turnaround and increase in net cash inflows to funds. By 1981, mutual funds had endured ten consecutive years of net cash *out*flows, but since then net cash flows have been positive in each and every year, except 1988. The 1988 outflow was a major mistake that followed the October 1987 market collapse. Reid and Millar (2000) reported that, in 1989, $73 billion in net new cash was invested in mutual funds, but by 1999 it was $364 billion! Reid (2000) provided a review of fund industry developments during the 1990s.

But the largest incentive to mutual fund investing has been the unprecedented size and duration of stock market returns since 1982, early in the Reagan administration. The origins of this performance may be traced to the large reductions in income tax rates. While several downdrafts have lowered returns from time to time in subsequent years, the only years with negative returns have been 1990, a very small loss, and 2000. For example, annualized returns

on the S&P 500 Index from August 1982 to 1996 exceeded 17 percent, compared to its historical 9–11 percent.

This unprecedented bull market is seen in table 4, which reproduces the extraordinary performance of the top fifty stock funds. The top-ranked fund had annualized returns of an amazing 23.8 percent, and the lowest of the ranked funds earned 18.6 percent. Thus it is no surprise that individuals and others invested heavily in mutual funds, especially equity funds, and these cash inflows mostly continue.

MUTUAL FUNDS AS ORGANIZATIONS

Mutual funds organized as corporations are like other corporations with shareholder-elected directors. Funds organized as business trusts are governed by shareholder-elected trustees. Use of the business trust organization is normally motivated by more favorable tax treatment. For example, the Vanguard group of funds reorganized as Pennsylvania business trusts owing to higher taxes they would have had to pay by remaining registered Maryland corporations.

As noted above, mutual funds may issue only common stock, with shareholders having "mutuality of interest" in fund assets and income. But, with rare exceptions, funds have been permitted to issue senior securities, including preferred stock. Funds may also borrow from banks to meet cash withdrawals from share redemptions. But, more recently, funds prefer to use less costly interfund loans under the same management. These "in the family" loans require SEC authorization, which limits loan size, terms and interest rates.

The most important change in mutual fund capital structure has been the issuance of *multiple share classes* (discussed later). Each class has a different menu of sales charges and fees (including none) attached to the same or equivalent portfolios. Multiple share classes enable funds to appeal to diverse types of investors through increased share distribution channels.

Service providers

Mutual funds differ from typical corporations in a very significant way – they are *not* managed internally. Mutual funds are basically shell entities holding securities, for which administrative, investment, and legally required functions are provided by external *service providers* (subcontractors). Investment management companies sponsor, organize, and arrange for provision of services required by funds. They act as fund investment advisors and provide the essential research and portfolio management services consistent with fund investment objectives, policies, and limitations. Summaries of fund service providers are in ICI (1996b) and Kunert (1993).

The specifics of services provided by mutual fund service providers vary, but a general description follows:

1 *Investment advisor:* provides research and portfolio management services consistent with fund investment objectives, policies, and limitations as stated in the prospectus; functions include formulation and implementation of investment style and strategies, security analysis, market and economic analysis, portfolio allocation, security buy/sell decisions, and performance evaluation.

2 *Administrator:* provides management and regulatory oversight; reviews and reports performance of other administrative service providers and ensures fund regulatory compliance; may pay office, equipment, and personnel expenses; may provide general accounting services and prepare/file SEC, tax, shareholder, and other reports.
3 *Custodian:* holds portfolio cash and securities in safe keeping; settles portfolio transactions – receives cash and securities and makes authorized cash payments and security deliveries; collects portfolio interest and dividends; pays authorized expenses, shareholder redemptions, and disbursements; and maintains related records.
4 *Transfer agent:* fulfills shareholder transaction requests and receives and authorizes disbursement of monies from shareholder transactions; maintains and provides shareholder account and transaction records; provides a wide range of shareholder services; provides shareholder communications, including account and transaction statements, annual and semi-annual reports, prospectus, proxy statements, and informational material; often serves as disbursing agent for shareholder distributions.
5 *Distributor (principal underwriter):* as broker-dealer provides direct and/or indirect distribution of shares to investors; distributes fund publications; and provides fund marketing and advertising.

Auditors and legal counsel provide compliance services. Auditors determine whether fund financial reports and records are in compliance and report to directors. Counsel ensures fund regulatory compliance and advises disinterested directors concerning contracts with investment advisors and other providers. Fund legal counsel is normally separate from that to investment advisors. Figure 1.1 summarizes these relationships along with overviews of service providers.

Non-advisory service functions may be contracted directly by mutual funds and/or by fund investment advisors, which in turn provide them directly and/or indirectly through one or more affiliates and/or non-affiliates. Non-advisory contractual service relationships vary considerably among funds. At one extreme, funds contract independently with each service provider, which may directly and/or indirectly provide the particular service. Most funds contract with investment advisors to provide inclusive "service packages," especially in the case of money market funds. In any case, investment advisors normally provide administrator services, as well. These various contracts, including transfer agents, require board approval, including a majority of disinterested directors when providers are affiliates of advisors.

As noted above, the 1940 Act requires mutual funds to contract with custodians to ensure safe keeping of cash and securities. These "shareholder trustees" hold fund assets to protect them from fraud and negligence. Custody includes use of central securities depositories and the US Treasury's book entry system to minimize the physical movement of traded securities. Banks and trust companies normally act as custodians, but stock exchange member firms and others may serve, if approved. However, custodians must be otherwise independent. Custodial fees are normally based on fund asset size and volume of securities transactions. They also reflect the complexity and scope of services provided. Custodial contracts require the approval of fund directors, including a majority of disinterested directors, as well as shareholders of a majority of shares voting. Normally, less than 10 percent of outstanding shares are voted.

Custodians may also be contracted to provide other services. For example, the Dodge & Cox Fund contracts with Firststar Trust Company as custodian, transfer agent, and dividend disbursing agent. On the other hand, Fidelity Low-priced Stock Fund has only a custodial

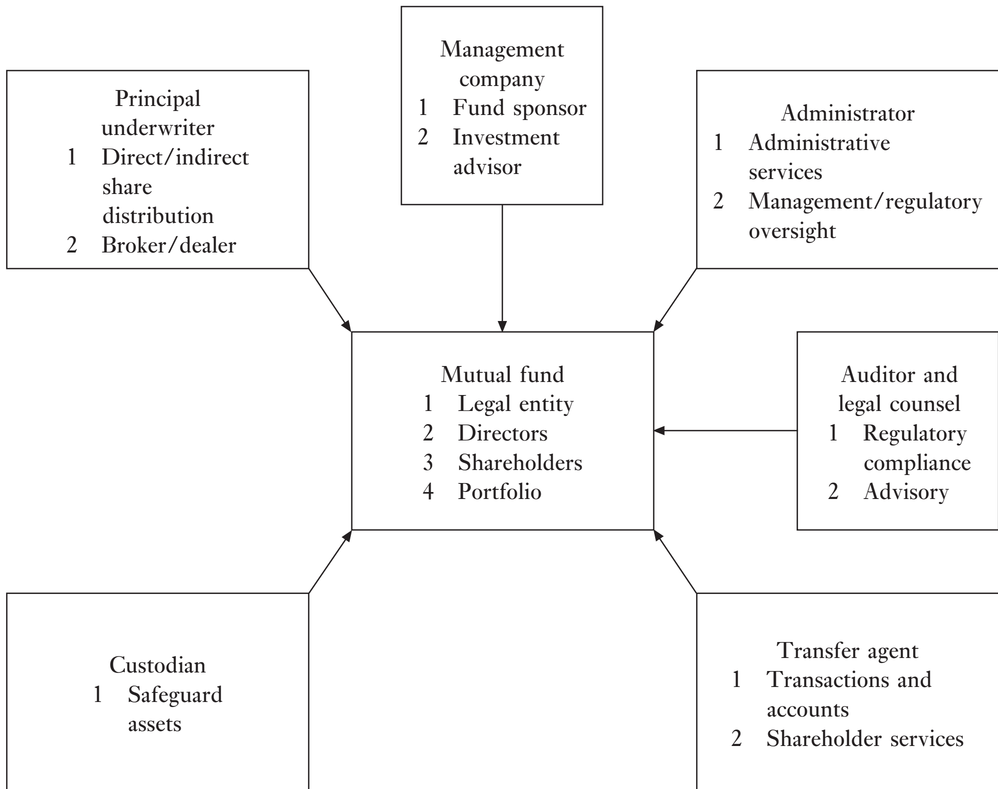

Figure 1.1 Mutual fund service providers. Management company: portfolio management. Administrator: administration and management/regulatory oversight. Auditor: accounting compliance. Legal counsel: legal compliance. Transfer agent: transactions, accounts, and services. Custodian: safeguard assets. Principal underwriter: distribute shares.

contract with Brown Brothers Harriman. Transfer agency, dividend disbursement, shareholder, and accounting services are provided by Fidelity Services Company, an affiliated company.

Mutual funds may not act as distributors (principal underwriters) of their shares, except in compliance with SEC rules. Prior to 1980, the distribution costs of shares sold without sales charges were borne by management companies. Mutual fund assets could not be used for this purpose. Distribution costs of shares with sales charges were paid from these fees.

The payment of distribution costs of mutual fund shares changed dramatically in 1980. As noted, rule 12b-1 allows funds to charge share distribution costs against fund assets. These fees are primarily used to pay sales commission, but also for other distribution expenses, such as advertising, marketing materials, and payments to sales agents and others for "continuing shareholder services." Use of 12b-1 fees must be pursuant to plans approved annually by fund directors, including a majority of disinterested directors. Directors must also determine that imposition of 12b-1 fees will "reasonably benefit" funds and shareholders. For example, Vanguard Windsor II imposes no 12b-1 fees, while the Robertson Stephens Contrarian fund

charges a 0.75 percent annual fee. Distributors are generally broker-dealer affiliates of investment advisors. In these cases, disinterested directors must comprise a majority of board members.

The SEC regulates principal underwriters in their role as *registered broker-dealers*, and, under its legal framework, the NASD regulates mutual funds' advertising and sales practices. Fund shares are sold using either one or two distribution channels. *Direct-market funds* use direct sales methods such as newspaper and mail advertising to offer shares to investors. Sales force (*indirect-market*) *funds* solicit and distribute shares through full-service brokers, discount brokers, online discount brokers, *mutual fund supermarkets* (fund supermarkets), insurance agents, banks, and financial planners and advisors. Direct market fund shares are usually, but not exclusively, sold at net asset value without sales charges (loads). On the other hand, sales force fund shares are sold at net asset value plus loads, which are primarily used to compensate commission sales agents, such as brokers. For example, Fidelity Investments employs both direct and indirect sales methods, and some of their direct sale funds have sales charges.

Transfer agents must register with the SEC to provide mutual fund services. Contracts with transfer agents are negotiated and approved by fund boards, including a majority of disinterested directors. Approval is required because transfer costs are fund expenses. Average account size is the most important determinant of transfer agent fees. Other arrangements include asset-based fees and transaction-based fees. Out-of-pocket expenses may be reimbursed separately. Large management companies usually provide these services through affiliates to ensure quality and reduce expenses. Managers of small funds usually find it more economical to rely on external providers.

Investment advisors

Mutual fund investment advisors provide portfolio management services, and they normally also provide administrator services. In the latter case, advisors and administrators are often the same entities. If not the same, administrators may be affiliates of advisors or independent entities. Smaller fund operations usually contract with independent administrators.

In addition to contractual roles as mutual fund investment advisors, investment management companies normally also advise/manage other types of portfolios as well. This is normally the case because advisors normally began by managing money for private clients, such as large individual accounts, partnership accounts, trusts, pension plans, and foundations. For example, Harris Associates advised this range of private clients prior to sponsoring mutual funds.

Some management companies are stand-alone entities, such as Barr Rosenberg's Rosenberg Institutional Equity Management. Others are components or affiliates of brokerage firms, such as Legg Mason Fund Advisor, or insurance companies, such as Nationwide Advisory Services, or banking institutions, such as Wachovia Asset Management.

In the simplest case, management companies advise a single mutual fund entity. For example, Westchester Capital Management advises one open-end investment company, the Merger Fund. But as the market for mutual funds has expanded, management companies have generally added, incrementally, to the number of funds they advise. This has been done in different ways. In one, a single open-end investment company operates a series of distinct portfolios managed as separate mutual funds, For example, Fidelity Growth and Income Portfolio is a

diversified portfolio of Fidelity Securities Fund, an open-end investment company organized as a Massachusetts business trust.

In other cases, multiple open-end investment companies are organized, each with a diversified series of distinct portfolios. Until recent changes, the Vanguard Index Trust was one of over thirty investment companies totaling more than ninety-five distinct portfolios. Sets of mutual funds and/or series of funds under the management of one investment advisor are called (*mutual*) *fund families* or (*mutual*) *fund complexes*. For example, Harris Associates advises the Oakmark Family of Funds and its six funds. One the other extreme, giant Fidelity Investments is the largest fund family, with over 150 funds/portfolios.

As mentioned, mutual funds are typically corporations (or business trusts) with boards of directors (or trustees) elected by shareholders. As such, they are technically shareholder-owned. But they are not shareholder-controlled through elected directors. Actual control of mutual funds normally lies with investment advisors – the management companies that sponsored them, obtained regulatory approval, organized them, nominated directors and staffed principal officers, among other functions.

Nonetheless, mutual fund shareholders must approve (affirm, actually) certain board decisions, including changes in investment objectives, policies, investment advisory contracts, and fee schedules, selection of directors to fill a specified number of vacancies, appointment of independent public accountants, and "fundamental" limitations on portfolio securities.

The 1940 Act requires mutual fund investment advisory contracts be approved by a majority of disinterested directors and owners of a majority of shares voting. This process initiates with appointing principal fund officers, who normally also serve on boards of directors – the same boards that officially named them officers. Further, principal fund officers/directors normally hold similar positions in the sponsoring management companies acting as fund investment advisors.

Investment advisory contracts should include advisor responsibilities and fees, expenses paid by the parties, any other service functions to be provided and fees, and portfolio investment objectives, policies, strategies, and limitations. Contracts could well include specific investment services, such as economic and market forecasts, portfolio manager and analyst services, and methods of security analysis, portfolio allocation, investment style, trade execution, and performance evaluation, among others.

Further, if investment advisors also provide some or all non-investment services, these and their fees should be specified. As noted above, non-investment services could include administration, managerial oversight, asset safe keeping, customer service, shareholder records and share distribution. These service suppliers and their responsibilities should also be specified, including those provided directly and/or indirectly through affiliated and/or unaffiliated firms.

It is not by some Evil Empire conspiracy that management companies control mutual funds in their roles as investment advisors, but because a business purpose is served. The motivation to sponsor, organize, and manage funds is for the purpose of attracting, pooling, and investing shareholder dollars for asset-based fees. One implication of this control has been that fund boards routinely renew investment advisory contracts. Exceptions occur more frequently if advisors subcontract one or more *subadvisors* to manage some portion or all of fund portfolios. Manager tenure in these cases is determined more by investment performance than by control.

The "lock" investment advisors have on mutual funds is not necessarily bad for shareholders. Shareholders usually focus on performance, not control issues. The best shareholder remedy when funds underperform is to cash-out and move to more user-friendly funds or fund families. Exceptions could occur if for some reason large individual or institutional shareholders found it advantageous to leverage their positions seeking improved fund performance and/or portfolio management.

Boards of directors

As suggested above, mutual funds have two general types of board directors: *interested* (*inside*) *directors* and disinterested (independent) directors. Interested directors are those affiliated with fund investment advisory firms and the funds themselves. The 1940 Act mandates critical roles for independent directors as shareholder watchdogs. These outside directors carry primary responsibility for ensuring the primacy of shareholder interests in mutual fund management. Their single most important function is approval of contracts between funds and investment advisors. Independent directors may not be affiliated with investment advisors and must satisfy various tests of independence. The other board members, the inside directors, normally have dual affiliations as fund officers/directors and investment advisory officers/principals.

To foster board independence, no more than 60 percent of directors may be interested and, conversely, at least 40 percent must be disinterested. Interested persons include: (1) affiliated persons, or immediate families, with direct control relationships with mutual funds or investment advisors; (2) fund investment advisors, principal underwriters, broker-dealers or affiliates, and legal counsel within the last two years; and (3) persons determined to have "material business relationships" with funds. Moreover, specified persons are prohibited from serving as mutual fund directors. These include persons convicted of specified felonies or misdemeanors, and those enjoined from acting as broker-dealers, investment advisors, or participating in specified investment and financial activities.

Independent directors generally comprise nominating committees for new mutual fund directors, but they are required to do so if 12b-1 fees have been adopted. Independent directors are provided legal counsel and consultants for assistance in negotiating and approving service provider contracts, of which investment advisor contracts are most important. They must also approve transfer agent, custodian, and principal underwriter contracts. They may vote to remove investment advisors, but this is done only infrequently and requires shareholder approval, which is given even less frequently. Director responsibilities are summarized in ICI (1995), and their responsibilities under federal law are summarized in table 5.

To summarize, mutual fund directors are responsible for: (1) evaluation of portfolio performance; (2) renewal of investment advisory and subadvisory contracts; (3) pricing of fund shares; (4) securities valuation and maintenance of required portfolio liquidity; (5) regulatory compliance oversight; (6) oversight of compliance with investment objectives, policies, and restrictions; (7) rules governing transactions with investment advisor affiliates, and (8) approval of contracts with other service providers.

Moreover, investment advisory contracts are "fundamental" to mutual fund operations and must: (1) be approved initially by owners of a majority of shares voting; (2) specify advisor

compensation schedules; (3) terminate, with notice, if ordered by the board or owners of a majority of shares voting; and (4) terminate if assigned to other parties. As stated, renewal of advisory contracts and approval of non-advisory service contracts require majority vote of independent directors, who have fiduciary responsibility for their terms and costs. Both independent directors and owners of a majority of shares voting must approve adoption of 12b-1 fees.

Mutual fund organization: an example

The varying aspects of mutual fund organizational and service provider relationships make an example useful. Tweedy Browne Fund (the corporation) serves well for this purpose. Tweedy Browne's prospectus (1998) clearly presented its relationships with service providers.

The corporation is a registered open-end investment company incorporated in the state of Maryland that offers a series of two diversified portfolios: Global Value Fund and American Value Fund. Each fund is a regulated investment company under subchapter M of the Internal Revenue Code, and are therefore exempt from federal income/excise taxes.

The corporation's directors supervise the funds, and shareholders have one vote for each share owned. No annual shareholder meetings are required or held, but special meetings may be called to elect/remove directors and to change fundamental investment policies.

The corporation contracts with Tweedy Browne, a registered investment advisor, to provide each fund's advisory services. Each fund's daily business and investment affairs are managed subject to board policies, legal requirements, and its investment objective, policies, and restrictions. Tweedy Browne's general partners manage each fund's portfolio and make the investment decisions. Their investment approach, decisions, and performance are discussed thoroughly in each fund's annual report to shareholders. Tweedy Browne receives an annual advisory fee of 1.25 percent of each fund's daily net assets.

Each fund is also responsible for directly paying the following other expenses: (1) legal, accounting and auditing fees; (2) custodian, transfer agent and dividend disbursing agent fees; (3) independent director fees and expenses; (4) fidelity bond and liability insurance premiums; (5) interest expenses, brokerage fees, and other trading costs; (6) taxes; (7) shareholder printing and servicing expenses; (8) litigation expenses; and (9) extraordinary or non-recurring expenses, etc.

First Data Shareholder Services Group is each fund's administrator. It provides management services for an annual fee of 0.09 percent of average daily net assets, subject to specified minimums and limitations. It also acts as each fund's agent for transfer, shareholder servicing, and dividend disbursement.

Boston Safe Deposit & Trust Company is custodian of each fund's cash and securities. Tweedy Browne, in its role as registered broker-dealer, acts as each fund's principal underwriter for share distribution.