CHAPTER 1

Investing through Mutual Funds

COPYRIGHTED MATERIAL

The odds are high that you already own a mutual fund. You're in good company: at the end of 2013, an estimated 96 million people in the United States had, on average, invested 22 percent of their money through a fund.[1] Notice that we say that you invest *through* a mutual fund rather than *in* a fund. That's because a mutual fund isn't really an investment itself; it's just an intermediary—a financial intermediary.

Mutual funds have made it easy for individuals (you, me, and anyone with money to invest) and institutions (corporations, foundations, pension funds) to pool their money to buy stocks, bonds, and other investments. A fund is *mutual* because all of its returns—from interest, dividends, and capital gains—and all of its expenses are shared by the fund's investors.

Funds offer investors advantages over buying and selling securities directly, including:

- Reduction of risk by investment diversification.
- Ability to sell your investment daily.
- Access to the expertise of professional money managers.
- Ability to participate in investment strategies that might not otherwise be available to smaller investors.
- Administrative convenience and shareholder services.
- A high level of investor safeguards.
- Comprehensive reporting that enables easy comparisons among funds.

These benefits have proven to be very popular with investors around the world; they held a total of $30 trillion in fund assets at the end of 2013. U.S. households now put more of their money into mutual funds than they do directly into stocks, making mutual funds an integral part of financial planning for many people.[2] We describe a few typical fund buyers in "Mutual Fund Investors."

Trim Size: 6in x 9in

Pozen c01.tex V3 - 12/18/2014 10:47am Page 4

MUTUAL FUND INVESTORS

Are you—or is someone you know—like one of these typical mutual fund investors?

- A middle-aged couple looking to retire sometime in the next 10 to 15 years. He works for a technology company, while she runs her own consulting business. They're building a retirement nest egg by investing in stock mutual funds through his company's 401(k) plan and her individual retirement account.
- A grandmother who wants to help finance the college tuition of her two infant granddaughters. She opens college savings accounts for both, planning to make annual contributions. She puts the assets in each account into a balanced mutual fund that holds a mix of stocks and bonds.
- A young professional tired of paying rent for his small apartment in the city. He has a goal of moving into his own condo in a few years and has started setting money aside for the down payment through automatic deductions from his paycheck. His savings go into a bond mutual fund recommended by a financial adviser.

This chapter provides an introduction to investing through mutual funds. It reviews:

- The advantages and disadvantages of investing through mutual funds.
- Their history and their use by investors today.
- The regulators and industry associations that play a key role in the fund industry.

ADVANTAGES AND DISADVANTAGES OF MUTUAL FUNDS

Mutual funds have gained such acceptance in household finances because they offer many advantages that include:

- *Greater diversification*. Through a mutual fund, investors may be able to own more securities than they could if they were acting just for themselves. Plus, investors can diversify even further by buying

more than one fund. In 2013, in the United States alone, there were around 10,000 funds to choose from with many different investment profiles—from bond funds to emerging market funds.[3] (See "The ABCs of Risk" to understand how diversification helps investors.)

- *Daily liquidity*. Investors in the most common type of mutual fund have the right to sell their position back to the fund at the end of every business day at a price equal to the value of their share of the fund's holdings. It's fast and easy, because there's no need to find another buyer or negotiate a sale price.
- *Professional management*. Funds hire professional investors with a high level of expertise to buy and sell securities on their behalf. Because these managers are working on behalf of a large number of investors, they can afford the top-notch analysts and sophisticated technology that can help them identify investments with higher returns.
- *Access to investment opportunities*. Individuals who want to invest overseas often find it easier to go through a mutual fund. Also, some securities are available only to investors with significant assets. For example, only qualified institutional buyers responsible for at least $100 million in assets can purchase certain restricted stocks and bonds—a test that most mutual funds meet but that very few individuals do.[4] But by investing through mutual funds, which usually have minimum investments in the range of only $5,000 to $10,000, individuals are able to participate in these opportunities.
- *Administrative convenience and shareholder services*. Funds make buying and selling simple, offering shareholders the ability to make transactions over the phone or through the Internet, often 24 hours a day. Fund owners can also take advantage of a host of other services, such as performance reporting, check writing, automatic purchase programs, or access to retirement planning and other educational materials.
- *Investor protections*. A system of government regulation ensures that mutual fund assets are legitimately invested. In the United States, this includes oversight by an independent board of directors. As a result, investors in funds have less to fear from Ponzi schemes and other forms of theft.
- *Transparency and comparability*. Mutual funds are required to report to their investors regularly on their holdings and investment strategy, so that investors have a very good idea of what they're getting into when they invest through a mutual fund. Just as important, funds provide all of this information in a standardized format, which makes it easy to compare offerings.

THE ABCs OF RISK

Reducing your investment risk is simple—all you have to do is buy more than one investment. This strategy of not putting all your eggs in one basket is technically known as *diversification*.

To understand why it works, it's useful to think of securities as having two kinds of risk: beta risk and alpha risk. Beta (often referred to by the Greek letter b or β) is the risk of the market overall. Alpha (Greek a or α), or *idiosyncratic risk*, is the ups and downs related to a specific investment. Looking at how they work together in a single stock, the price of that stock will tend to rise and fall with the stock market (beta). At the same time, the fortunes of the particular company issuing the stock will also have a big impact (alpha). As a general rule, a company's stock will do better than the market when the company news is good and worse when it is not.

Diversification reduces overall risk by reducing alpha risk. That's because when you hold a diversified portfolio, good news on one security might offset bad news on another. Diversified investors don't have to worry as much about being wiped out when one investment goes sour—when, for example, the buggy whip manufacturer they've sunk their money into goes bankrupt after years of declining sales.

On the other hand, diversification doesn't help at all with beta risk. A diversified portfolio of U.S. stocks, for example, will still be likely to go down in price when the U.S. stock market is doing poorly.

Truly diversified investors spread their savings not just among individual investments but also among markets. Not sure whether the economy is getting stronger or weaker? You could decide to buy both stocks and bonds, since stocks tend to do well in a strong economy, while bonds tend to do well in a weak one. Believe there's a chance that the United States is losing its competitive edge? You might spread your account among stock markets around the world to increase the chance that you have at least some money invested in the country that's doing well.

While the principle of diversification is simple, implementation can be more complex. For example, the number of securities needed to eliminate alpha risk can vary. One recent study concludes that, in the U.S. stock market under normal economic and market conditions, holding 40 to 70 stocks is sufficient for diversification. However, fewer holdings are needed when investing in markets outside the United States, and more are required to eliminate alpha risk in times of market distress.[5]

Trim Size: 6in x 9in

Pozen c01.tex V3 - 12/18/2014 10:47am Page 7

Mutual funds have disadvantages as well. These include:

- *Fees*. Investors pay for all these benefits. In 2013, the average investor paid 0.71 percent of the value of their fund assets for a year's worth of basic management services, including investment management and administration, combined with annual marketing charges known as 12b-1 fees.[6] Excluded from the 0.71 percent figure are the trading commissions that funds are charged when they buy and sell stocks. Also excluded: sales loads—paid by some investors when they purchase shares of a fund—and program fees for using mutual funds as part of certain investment plans, such as wrap programs provided by brokerage firms or variable annuities offered by insurance companies.

  How much shareholders pay to own funds varies widely, depending on the type of fund and the way the fund's shares are distributed to investors. Annual expenses on a money market fund in a 401(k) plan at work may be only 0.20 percent or 20 basis points. (See "Basis Points" for a definition of that term.) The fees on a high-quality bond fund bought directly from a fund company may be 55 basis points per year. But a small investment in an alternatives fund purchased through a financial adviser could cost 2.25 percent in annual fees plus a one-time sales load of 1.0 percent.[7] (For a full explanation of mutual fund fees, see Chapter 5.)

  Offsetting some of this cost, annual fees are subtracted from a fund's taxable income, making them effectively tax-deductible. By contrast, an investor who owns individual securities can't deduct investment-related expenses unless they add up to more than 2 percent of the investor's adjusted gross income for that year, a floor that few investors exceed.
- *No control on timing of gains*. Mutual funds don't allow investors to control the timing of capital gains. Investors who own individual stocks or bonds can choose when to sell a security to recognize a tax gain or loss. If they're not quite ready to pay taxes on the gain from a stock that has gone up, they can simply decide to wait—maybe until they can sell another stock at a loss to offset the gain. Shareholders in U.S. mutual funds, in contrast, don't have that option. The manager of the mutual fund decides when to sell the securities the fund holds, and the investors in the fund are required to pay taxes on the net capital gain that same year, even if they haven't reduced their investment in the fund.
- *Less predictable income*. Dividend and interest income are normally less predictable in mutual funds, which means that investors who place a priority on steady income might be better off owning individual securities. They can buy bonds and hold them until maturity, knowing that they will receive the same interest payment regularly until the bonds are

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 8

redeemed. In contrast, because a mutual fund buys and sells bonds often, the income it generates will vary, depending on the specific combination of securities owned on any given date.

- *No customization*. One final drawback to mutual funds: they don't allow for any customization. Instead, everyone in a fund gets exactly the same deal. Investors who object to owning a particular stock can't insist that it be sold out of just their accounts. Large investors can't get breaks on fees that aren't available to all large investors. In fact, whenever any fund investors are given special treatment, it often leads to scandal in the industry.

BASIS POINTS

Mutual fund expenses are often expressed as a percentage of fund assets. Two decimal places are typically required for sufficient precision—for example, 1.07 percent.

Another way to express expenses is in *basis points,* often referred to casually as *bips* or *beeps*. A basis point is one-hundredth of a percent, so that "107 basis points" is the same as "1.07 percent."

HISTORY AND GROWTH

The growing recognition of the advantages of mutual funds has led to a significant change in the way that Americans invest. U.S. households have been steadily increasing their positions in mutual funds while reducing their direct holdings of individual stocks. Let's take a look at how mutual funds evolved to become such a key element in individuals' financial plans.

Early History

Mutual funds as we know them today are a relatively recent innovation, dating back only to 1924.[8] That's when Boston families first set up *open-end* mutual funds to manage wealth that had become dispersed as it was passed down through the generations. These open-end funds were innovative because they stood ready to accept new money and honor redemption requests from investors on a daily basis.

They were not immediately popular. In fact, during much of the roaring 1920s, *closed-end* funds—which sold a fixed number of shares

and didn't allow investors to redeem daily—were much more successful, in part because they could use borrowed money to boost returns. But while this *leverage* worked to increase returns in the boom years, it generated large losses in the stock market crash of 1929—along with calls for more regulation of what had been a very freewheeling industry.

The Roosevelt administration responded to those calls by driving the passage of a series of laws, most notably the Investment Company Act of 1940, which established strict standards for the investment industry. Less-scrupulous fund managers had to adapt to the new rules or go out of business. But open-end funds had already largely adopted these standards—which put them in a very strong competitive position. As evidence of the value of the approach, the very first open-end mutual fund, the Massachusetts Investors Trust, is still around today, as part of the MFS family of funds.

Nevertheless, the growth rate of mutual funds was modest from the 1940s through the 1970s. Funds invested mainly in stocks over this period, meaning that their fortunes were tied to the ups and downs of the market. As a result, the industry experienced a small growth spurt during the late 1950s and 1960s, when the economy was strong and stock prices were rising. But the mini-boom turned to prolonged bust when stocks plummeted in 1973. In the ensuing recession, it became very difficult, if not impossible, to sell stock mutual funds.

By the end of the decade, with the stock market still moribund, the action was in interest rates. From 1979 through 1982, interest rates soared into double digits, seldom dropping below 10 percent, and at one point rising to almost 20 percent. But most individual investors couldn't earn these high returns at the bank, because banking regulations—specifically Regulation Q—capped the rates that a bank could pay on savings and checking accounts to less than 5 percent.[9] Fat rates of interest were available only on $10,000 Treasury bills and $100,000 certificates of deposit, investments beyond the reach of the average American.

Enter the money market fund. By pooling together money from many investors, money market funds could afford to buy these high-yielding securities, making the attractive returns available to individuals of moderate means. The introduction of check-writing privileges made these funds even more competitive with bank deposits. The public was happy to move money out of their low-yield bank savings accounts into the new alternative: between 1977 and 1982, total assets held in money market funds grew from less than $4 billion to more than $200 billion. By the end of that period, three-quarters of the mutual fund industry's assets were in money market funds.

The dominance of money funds was short-lived, lasting only until the early 1980s. That's when Regulation Q was phased out, allowing banks to start paying competitive rates of interest again, and when the nascent bull market in stocks and bonds brought other types of mutual funds into the public eye. But money market funds remained a key financial tool for both businesses and individuals. And they played a critical role in positioning fund managers for the future. They did this by enabling funds to expand their reach among individual investors, who could exchange easily from money market funds into other types of funds when market conditions were right.

The Surge in Growth

Once investors had been introduced to the advantages of money market funds, they were quick to turn to mutual funds for other investment needs. Over a 30-year period ending in 2013, U.S. mutual fund assets increased, from $293 billion to $17.1 *trillion*. Adjusted for inflation, that's an annual growth rate of 15 percent, significantly higher than the 3 percent per year gain in real gross domestic product over that same period. (The growth trajectory is shown in Figure 1.1.)[10]

The steady expansion in fund assets was primarily the result of three factors: the bull market in stocks and bonds, new product introductions, and expanded distribution. We take a look here at each.

Growth factor 1: The bull market for both stocks and bonds. Rising prices for stocks and bonds from 1984 to 1999 increased the value of

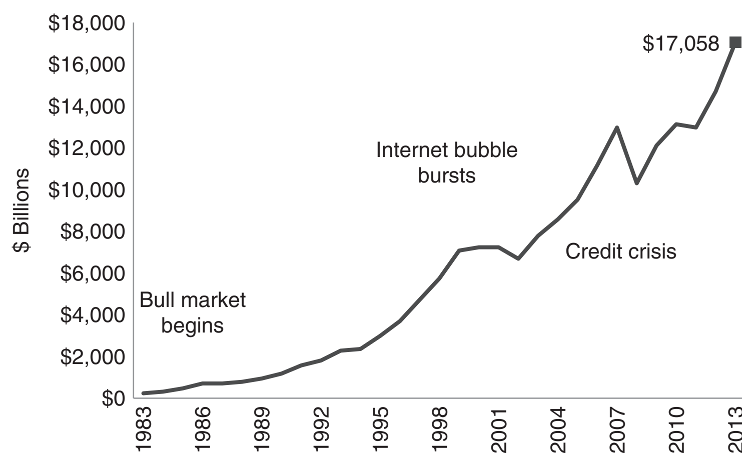

FIGURE 1.1 Growth in U.S. Mutual Fund Assets
Source: Investment Company Institute, *2014 Investment Company Fact Book*.

savings already invested in mutual funds. At the same time, the very favorable market environment in the 1990s encouraged more individuals to take their money out of savings accounts and begin investing in bonds and stocks. The boom times ended with two market crashes, the collapse of the Internet bubble, and the financial crisis of 2008. (See "The Crashes" for an introduction to both.)

THE CRASHES

There have been two times in the past 20 years when stock prices rose dramatically—and eventually fell even more dramatically. The first was the Internet bubble, which developed in the late 1990s in lockstep with the public's growing awareness of the potential of the World Wide Web. This bubble popped in March 2000 when it became clear that going virtual was not a guarantee of real profits.

Much of the hot air released from Internet stocks was to find its way into real estate. House prices around much of the world ballooned through most of the first decade of the new century, inflated by the easy-to-obtain mortgages that banks offered to even the most unsuitable buyers. When overextended property owners defaulted on their loans in startlingly high numbers, real estate prices fell with a thud—seriously wounding many financial institutions in the process. The shakeout in 2008 has come to be known as the *financial crisis*.

Growth factor 2: New product introductions. Encouraged by the success of the money market fund, management companies created new types of funds to meet investor needs and win market share from other financial institutions.

- *Index funds*. The first index fund, the Vanguard First Index Investment Fund (now the Vanguard 500 Index Fund) was launched in 1976. Though it took some time for index funds to catch on with the public, they are now the preferred vehicle for many savers.
- *Tax-exempt funds*. Tax-exempt funds were developed in the late 1970s, after legislation eliminated a tax penalty on municipal bonds owned through a mutual fund.[11] Tax-exempt funds were to become popular in the 1980s, after Congress curtailed many of the other strategies that individuals had used to reduce their tax bills.

- *Sector funds*. The 1980s also saw the introduction of sector funds focused on particular industries, appealing to investors who might otherwise purchase individual stocks.
- *International funds*. The launches of new types of international funds in the 1990s brought consumers to a field of investing formerly available only to large institutions.
- *Target-date funds*. The development of target-date funds roughly 15 years ago created a new option for individuals saving for retirement. Target-date funds are a type of *hybrid fund*, investing in both stocks and bonds.
- *Alternatives funds*. Funds that use alternative investment techniques to control risk have been growing in popularity in the last few years.

This broad range of offerings has ensured that the fund industry can provide options for all economic environments. Figure 1.2 shows how, from 1984 through 2013, assets have shifted among stock funds, bond funds, money market funds, and hybrid and alternative funds. While money market funds were still predominant in 1984, the interest rates paid on these funds were already beginning to decline, and assets subsequently shifted toward bond funds. Stock funds moved to center stage in the 1990s, so that by the end of the decade, they were over half of the fund industry. More recently, bond funds again became popular as a haven during the financial crisis of 2008, while hybrid funds and alternative funds have been gaining momentum. At the end of 2013, stock funds accounted for 55 percent of the mutual

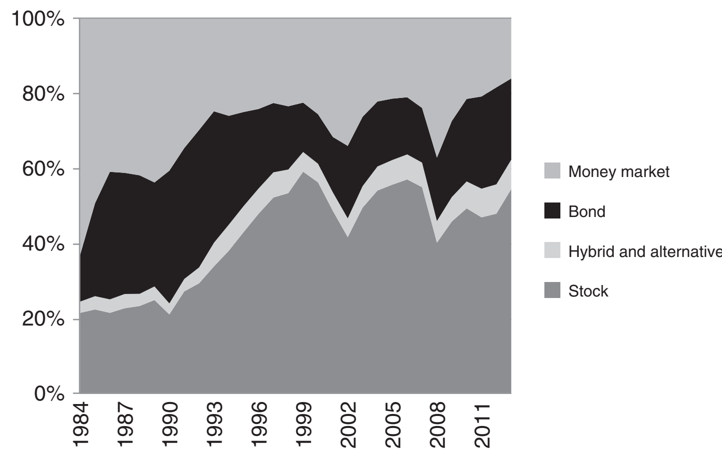

FIGURE 1.2 Share of Assets by Fund Type
Source: Investment Company Institute, *2014 Investment Company Fact Book*.

fund industry, while bond funds were 22 percent and money market funds 16 percent. Target-date and alternative funds made up the balance.[12]

Growth factor 3: Expanded distribution. Over the past 30 years, fund management companies have reached out to new groups of investors through new distribution channels. Until the 1970s, almost all mutual funds were sold to the public through intermediaries; in other words, they were managed by one company, but sold to the public by another, usually a *broker-dealer*. ("Dealing with Brokers" provides key definitions.) Brokers at these firms would make personalized investment recommendations to their clients, who were generally quite wealthy. At that time, brokers were normally compensated for giving this advice through commissions, which were fees charged to the investor on a purchase or sale transaction. In the case of mutual funds, the commission is called a *front-end sales load* or *front-end sales charge* and is deducted from the investment before it goes into the fund. In the 1960s, sales loads were a hefty 8.5 percent of the amount invested.

DEALING WITH BROKERS

A *broker-dealer* is a firm that buys or sells securities, either for clients or for its own account.[13] Broker-dealers are sometimes called *brokerage firms*. Merrill Lynch, Morgan Stanley, and Edward Jones are all examples of broker-dealers. The largest broker-dealers are often called *wirehouses*, a term that recalls the days when these firms were technology leaders because of their private telecommunications networks.

In the past, the salespeople employed by broker-dealers were referred to as *brokers*. Today, however, they are usually called *financial advisers* or *account executives*. In legal parlance, they are *registered representatives,* because they are licensed with the appropriate regulatory agencies.

This traditional method of distribution through intermediaries began to change with the advent of money market funds. These funds were sold without a front-end load directly to the public, who became aware of them through advertisements and mailings. Eventually, some mutual fund management companies began to sell all of their funds, including stock and bond funds, in the same way, avoiding intermediaries altogether. Because they did not involve a sales load, direct sales of these *no-load funds* became very popular with cost-conscious investors who were comfortable making their own investment decisions without the help of a broker.

The introduction of 401(k) plans in the 1980s—combined with the tremendous growth in individual retirement accounts or IRAs—created another way to distribute funds: through retirement accounts. Mutual funds became the preferred investment option in these accounts, while fund management companies became leading providers of the detailed recordkeeping and customer service capabilities retirement plans require. The retirement channel has become extremely important; by 2013, over one-third of industry assets were held in retirement accounts.[14] At the same time, mutual funds have become a critical component of the nation's retirement system, accounting for more than one-quarter of retirement plan assets.

Distribution through intermediaries has evolved. Today, both banks and insurance companies sell funds to the public. Registered investment advisers, unaffiliated with a broker-dealer, have also become a major factor in fund distribution. Their entry into mutual fund distribution sparked a new trend: charging clients an annual fee based on assets rather than a front-end load triggered by a purchase. Broker-dealers have responded with similar programs that incorporate mutual funds, purchased without a sales load, which charge a separate fee for participation.

Mutual fund distribution has gone global, too. Fund management companies have set up shop around the world, opening funds for local investors. And with the growing acceptance by many governments of the European Union's harmonized fund format, funds can now be distributed across borders. At the end of 2013, investor ownership of mutual funds outside the United States exceeded $15 trillion in more than 40 countries.

Mutual Fund Ownership in the United States Today

The combination of attractive features and broad distribution has made mutual funds a compelling alternative to direct investing in securities. In 9 of the past 10 years, U.S. households have increased their positions in mutual funds while reducing their direct holdings of individual stocks. Figure 1.3

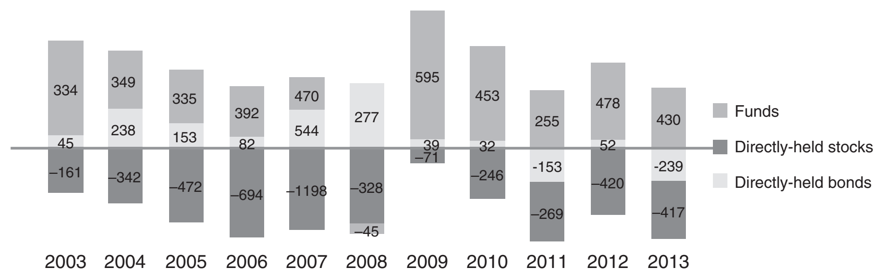

FIGURE 1.3 Household Net Investments in Funds, Bonds, and Stocks ($ billions)
Source: Investment Company Institute, *2014 Investment Company Fact Book*.

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 15

shows the recent data on household investment in funds, bonds, and stocks.[15]

This shift toward mutual funds has occurred in the context of increasing household interest in investing savings, as opposed to leaving them in the bank. For example, household investment in stocks has increased significantly. In 1981, less than one-third of U.S. households owned stocks, either directly or indirectly through a fund, and stocks accounted for just over a quarter of their financial assets. By 2007, half of U.S. households had invested, on average, half of their assets in stocks.

Households are very likely to make stock investments through mutual funds. In 2013, over 46 percent of U.S. households—56.7 million in total—had invested at least some of their assets through mutual funds. As Figure 1.4 illustrates, the proportion of households owning mutual funds zipped upward in the 1980s and 1990s and has remained steady at around 45 percent for the past 15 years.

So who are these mutual fund owners? In 2013, they were likely to be employed, married, and middle-aged; half were college graduates. Their median household income was $100,000 per year, with median financial assets (excluding their home) of $200,000. Mutual fund owners did not generally fall into the ranks of the very wealthy; only 8 percent earned more than $200,000 annually. Table 1.1 summarizes the data.

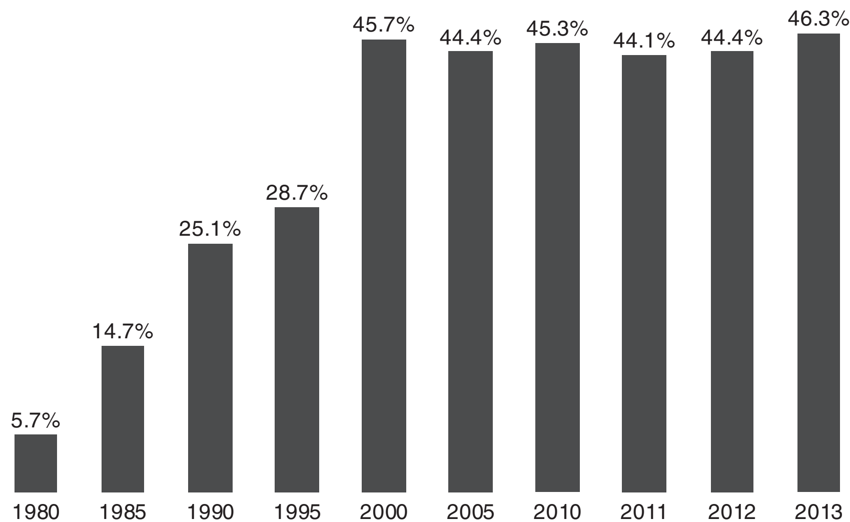

FIGURE 1.4 Percentage of U.S. Households Owning Mutual Funds
Source: Investment Company Institute, *2014 Investment Company Fact Book*.

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 16

TABLE 1.1 Profile of Mutual Fund Investors (2013)

Demographic Characteristics	
Median age	52
Married or living with a partner	76%
Employed, full-time or part-time	69%
College graduates	47%
Financial Characteristics	
Median household income	$80,000
Less than $50,000	24%
Between $50,000 and $200,000	68%
More than $200,000	8%
Median household financial assets (excludes primary residence)	$200,000

Source: Investment Company Institute, *2014 Investment Company Fact Book*.

A few more facts: The average fund-owning household had invested $100,000 in three different funds. Funds represented the majority of financial assets for 66 percent of these households. Virtually all were investing to prepare for retirement, although they were also concerned about saving for emergencies, reducing taxable income and financing education. Four of five owned mutual funds in a 401(k)-type retirement plan at work, with roughly a third owning funds only as a part of that plan.

REGULATORS AND INDUSTRY ASSOCIATIONS

With such widespread household interest in mutual funds, it's critical that they fulfill their commitments to their investors. As a result, mutual funds have become the most strictly regulated segment of the U.S. securities industry. The entity with primary oversight responsibility for funds' compliance with all of the relevant laws and related regulations is the Securities and Exchange Commission; it works closely with FINRA, the Financial Industry Regulatory Authority. Many other Federal regulators also play a key role in the regulation of the industry. Finally, the states are often involved in investigating and prosecuting violations of the rules.

The fund industry associations help the industry handle the high level of regulatory oversight. They include the Investment Company Institute and NICSA.

Securities and Exchange Commission

The Securities and Exchange Commission, or SEC, was created by Congress in 1934 as the agency primarily responsible for administering Federal

Trim Size: 6in x 9in

Pozen c01.tex V3 - 12/18/2014 10:47am Page 17

securities laws.[16] Its mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[17] Five commissioners are responsible for overseeing its operations. They are appointed by the president of the United States to five-year terms; these terms are staggered so that one commissioner is appointed each year. To ensure bipartisanship, no more than three serving commissioners may be of the same political party.

The SEC has five divisions:

1. The *Investment Management Division* has the greatest impact on the mutual fund industry. It oversees investment companies and the investment advisers that manage them.
2. The *Division of Trading and Markets* monitors the buying and selling of securities through regulation of broker-dealers and exchanges. Of particular relevance to mutual funds, this division oversees the shareholder service division of fund managers, known as the *transfer agent*.[18]
3. The *Division of Enforcement* investigates potential violations of the law, recommends action when it believes there has been a violation, and negotiates settlements with offenders. It often acts on the basis of referrals from the Office of Compliance Inspections and Examinations, as described in "SEC Inspections."
4. The *Division of Corporation Finance* ensures that publicly traded corporations provide investors with the information needed to make informed decisions. As significant holders of corporate securities, mutual funds are beneficiaries of this division's work.
5. The *Division of Economic and Risk Analysis* was created in 2009, as the SEC's think tank. It provides rigorous research that helps the SEC identify trends and make decisions.

SEC INSPECTIONS

To make sure that firms are complying with regulations, the SEC's Office of Compliance Inspections and Examinations conducts reviews of securities firms. Problems detected by OCIE (often spoken of as "*Oh*-see") may be referred to the Division of Enforcement for follow-up action. OCIE examiners may appear in offices at any time, sometimes as the result of a tip, if there's cause to believe that a firm is violating a significant rule.

(*continued*)

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 18

(*Continued*)

OCIE can also ask for information from many firms at one time as part of a *risk-focused,* or *sweep,* exam, looking at a new issue in the industry. For example, in February 2011, OCIE asked a number of investment advisers how they were using social media. The findings from the risk exam were published early the following year in a "Risk Alert."[19]

By law, the SEC must follow a lengthy procedure whenever it considers new regulations.[20] Key components of this process are:

- First, the SEC staff issues a proposed rule, which explains the need for the regulation and its specific terms.
- In most cases, the SEC will then request comments on the proposed regulation, during a specified comment period. Although anyone can comment on an SEC proposal, firms in the industry typically provide most of the input, both on the advisability of a new regulation and on the feasibility of its technical provisions. Occasionally—usually when a new regulation represents a significant break with the past—the SEC will actively solicit comments before issuing a proposed regulation. In such cases, it issues a *concept release*, giving a broad overview of the potential change and requesting input.
- The SEC staff reviews the comments received and makes any appropriate changes to the proposed rule. As part of this process, the staff will assess whether the benefits of the new rule outweigh its costs. The rule becomes a final rule after it has been voted on by the SEC commissioners and approved by at least a majority.

This lengthy rule-making process is designed not just to ensure that all technical issues have been addressed—which facilitates implementation—but also to build consensus around the new regulation. However, while most of their decisions are made unanimously, the commissioners may divide when voting on more contentious issues.

After a final rule is issued, management companies and other industry firms can seek informal interpretive advice from the SEC in the form of *no-action* letters. The requesting organization writes a letter to the SEC, essentially asking, "Will the SEC take any enforcement action if we do such-and-such?" and describing some activity it would like to undertake but isn't sure is permitted. The SEC staff studies the proposed action, and,

if it feels that it doesn't violate a statute or rule, the Office of the Chief Counsel of the appropriate division issues a no-action letter. The letter generally says that the staff "will not recommend to the Commission that it take enforcement action" related to the proposed activity.

These letters—while not technically binding on the Commission—serve to alleviate concerns on the part of requesting organizations that their proposed activity might lead to enforcement action. For example, in a recent no-action letter to the Managed Funds Association, the SEC staff clarified whether certain staff members of an investment adviser should be treated as "employees" or "investors" when applying certain rules.[21]

Most no-action letters address subtle or arcane issues in the interpretation of the regulations (as in the Managed Funds Association case) or unique situations that defy easy categorization. They provide the industry and the SEC with a valuable tool for resolving the inevitable ambiguity associated with complex securities laws.

Funds can also ask to be exempt from certain regulations. This *exemptive relief* is essential for exchange-traded funds, as we'll discuss in Chapter 15.[22] Before granting an exemption, the SEC must issue a public notice of the proposed exemption and allow for comments—as it would for a new regulation—in a process that is much more formal than the one for no-action letters.

More information about the SEC is available on its website: www.sec.gov. All of the SEC's recent proposed rules, final rules, concept releases, and no-action letters are posted there.

FINRA

The mission of FINRA (*Fin*-rah), the Financial Industry Regulatory Authority, is to both protect investors and ensure that the securities markets operate fairly and honestly. FINRA took on its current name when its predecessor, the NASD (National Association of Securities Dealers, which was once part of the NASDAQ stock exchange) merged with the enforcement division of the New York Stock Exchange in July 2007. It oversees the activities of broker-dealers and their registered representatives, specifically with regard to their sale of securities to the public. Its website is www.finra.org.

Of most importance to mutual funds, FINRA regulates much of their distribution activity.

- It licenses those individuals who participate in the selling of mutual funds and securities. FINRA requires the licensing of individuals who sell only mutual funds (through the Series 6 exam and registration), those who sell mutual funds and other securities (Series 7),

the supervisors of the selling brokers (Series 24), and certain operations staff (Series 99).[23]

- It reviews almost all fund sales and advertising materials and may bring disciplinary proceedings against firms or individuals for violations of fund advertising or sales rules.[24]
- It has authority to limit the sales loads that funds charge. This maximum is currently 8.5 percent of the amount invested, though, as we'll see, most sales of funds today involve a much smaller sales load.[25]

Unlike the SEC, FINRA is not a governmental agency but a self-regulatory organization. SROs typically come about when industry members join together to police themselves, in an attempt to throw out bad apples in advance, rather than have the government come along and root through the entire barrel. An SRO can acquire and exercise quasi-governmental authority, subject to SEC oversight, and this is what has happened with FINRA. The SEC, through the Division of Trading and Markets, has delegated a portion of its responsibilities to FINRA, those having to do with the regulation of broker-dealers doing business with the public. Another example of an SRO in the investment industry is the Municipal Securities Rulemaking Board, which monitors the market for municipal bonds.[26]

Other Federal Regulators

Many other federal regulators may take actions that affect the fund industry. Key regulators include:

- *Commodity Futures Trading Commission*. The CFTC oversees mutual funds' use of many derivative securities. Its website is www.cftc.gov.
- *Department of Labor*. Acting through its division of Employee Benefits Security Administration, or EBSA, the DOL sets rules for employer-provided retirement plans; as we've discussed, these plans represent a significant proportion of mutual fund assets. EBSA regulations govern plan terms and reporting to participants, which include both current and retired employees. For more on the DOL's role in retirement plans, go to www.dol.gov/ebsa.[27]
- *Financial Crimes Enforcement Network*. FinCEN, a bureau of the U.S. Treasury, fights money laundering, and its rules play an important role in mutual fund operations, particularly the handling of shareholder accounts. Learn more at www.fincen.gov.
- *Financial Stability Oversight Council*. Charged with maintaining the stability of the financial system as a whole, the FSOC has authority over

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 21

systemically important financial institutions, or SIFIs. Mutual funds designated as SIFIs are subject to FSOC oversight. The FSOC, which is chaired by the Secretary of the Treasury, is composed of the chairs of key federal agencies, including the Federal Reserve Board of Governors, the SEC, and the Federal Deposit Insurance Corporation. Its website at www.treasury.gov/initiatives/fsoc has more information about the FSOC's membership and goals.

- *Internal Revenue Service*. The IRS determines the tax status of fund-related transactions, whether trading within the portfolio or the purchase and sale of fund shares.

State Regulators

State regulation plays an important role in the fund industry, though the nature of the states' impact has changed significantly over the past 15 years. Until 1996, most states maintained their own regulatory agencies with their own rules—which were often inconsistent with those established by the SEC. To bring some order to the chaos, Congress enacted the National Securities Markets Improvement Act.[28] NSMIA preempted state authority in most areas, giving the SEC the sole regulatory authority on most substantive issues. In doing so, it relieved funds of a considerable burden in responding to fragmented and conflicting state regulatory requirements.

Yet NSMIA explicitly preserved local authority to investigate and prosecute fraud involving mutual funds, and the states have often flexed their muscles in this regard. Most notably, in 2003, the New York State Attorney General's office was instrumental in uncovering and pursuing abuses regarding trading in mutual fund shares, as we discuss in Chapter 14. Also, under NSMIA, funds interested in selling shares in a state must usually register with and pay a fee to that state's regulators.

Investment Company Institute

The Investment Company Institute is the industry's primary trade association. Founded shortly after the passage of the Investment Company Act of 1940, the ICI's membership today includes almost all of the fund complexes in the United States. This broad base of support has allowed the fund industry to speak with one voice before Congress, the SEC, and other regulators, making the ICI an effective advocate for industry interests.

The ICI has a critical educational mission as well. Its research department is a primary source of information on investment industry trends, covering topics as diverse as the retirement plan market, investor demographics, and fund fees.

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 22

TABLE 1.2 Other Fund Industry Associations

Short Name	Full Name	Focus	Website
CFA Institute	CFA Institute	Investment management	www.cfainstitute.org
IRI	Insured Retirement Institute	Annuities	www.irionline.org
IAA	Investment Adviser Association	Registered investment advisers	www.investmentadviser.org
MFA	Managed Funds Association	Hedge funds, managed futures funds	www.managedfunds.org
MMI	Money Management Institute	Managed accounts and other packaged investment solutions	www.moneyinstitute.com
MFDF	Mutual Fund Directors Forum	Independent mutual fund directors	www.mfdf.org

NICSA

NICSA (*Nick*-sa) helps fund management companies and service providers respond to new regulations. Established in 1962 as an informal forum for operations and shareholder service professionals, NICSA works with the industry to develop and implement best practices for complying with regulations and operating more effectively. NICSA's website at www.nicsa.org has information on its programs.

Other Fund Industry Associations

Several other associations serve the fund industry, by providing members with essential information or advocating for changes in laws or regulations. Table 1.2 lists other industry associations with their areas of focus.

CHAPTER SUMMARY

Mutual funds enable investors to pool their funds together to buy stocks, bonds, and other investments. All of the fund's returns and all of its expenses are shared by the fund's investors.

Mutual funds have gained considerable acceptance in household finances because they enable investors to diversify more—both in numbers and types of securities—than they would if they were investing on their own. Funds are also a convenient way to invest: They allow investors to

sell their holdings daily, provide professional investment management, and offer a range of other investor services. Mutual funds are subject to extensive government regulations that provide a high level of protection for investors. On the negative side, mutual funds charge fees for these services, and there is little opportunity for investors to customize a fund to fit their situation.

While the first mutual funds were established in Boston in the 1920s, most of their growth has occurred within the past three decades. The bull market for both stocks and bonds in the 1980s and 1990s boosted the value of fund assets and encouraged more individuals to invest, often through mutual funds. Fund management companies expanded the market for mutual funds by introducing new types of funds and opening up other channels for distribution—through direct sales and through retirement plans as well as through financial intermediaries. In 2013, mutual funds were held by over 46 percent of U.S. households.

Mutual funds are subject to strict government oversight. The Securities and Exchange Commission, or SEC, is the primary regulator of the fund industry, though other federal regulators and the states also play a role. The industry associations help the industry handle this high level of regulation. The Investment Company Institute is the principal advocate for the industry with legislators and regulators, while NICSA helps the industry develop and implement best practices.

NOTES

1. Except as noted, all statistics in Chapter 1 in text, figures, and tables are from the Investment Company Institute, *2014 Investment Company Fact Book*.
2. Jesse Bricker, Arthur B. Kennickell, et al., "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 98, no. 2 (June 2012), Table 5.
3. Includes open-end, closed-end, and exchange-traded funds; excludes unit investment trusts.
4. 17 CFR 230.144A, "Private resales of securities to institutions."
5. Vitali Alexeev and Francis Tapon, "Equity Portfolio Diversification: How Many Stocks Are Enough? Evidence from Five Developed Markets," SSRN (November 28, 2012).
6. Asset-weighted average for open-end stock, bond, and hybrid funds, excluding fund of funds. Also excludes money market funds.
7. Average or median based on Morningstar data or on Investment Company Institute, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2012," *ICI Research Perspective* 19, no. 4 (June 2013) and *2014 Investment Company Fact Book*.

Trim Size: 6in x 9in Pozen c01.tex V3 - 12/18/2014 10:47am Page 24

8. There were older mutual funds, but these were of the closed-end variety. For more on the history of mutual funds, see Matthew P. Fink, *The Rise of Mutual Funds* (New York: Oxford University Press, 2008).
9. Formerly 12 USC 371a, "Payment of interest on demand deposits" (section 19(i) of the Federal Reserve Act) and 17 CFR 217, "Prohibition against the payment of interest on demand deposits (Regulation Q)." All references to Regulation Q were eliminated as the result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 627, "Interest-bearing transaction accounts authorized."
10. Assets for 1983 through 1989 for open-end funds only; assets from 1990 on for open-end funds, closed-end funds and unit investment trusts (including exchange-traded funds). Inflation adjustment based on the Consumer Price Index from the U.S. Bureau of Labor Statistics; real gross domestic product from the U.S. Bureau of Economic Analysis.
11. 26 USC 852(b)(5), "Taxation of registered investment companies and their shareholders." Section 2137 of the Tax Reform Act of 1976, "Exempt-interest dividends of registered investment companies." Before the legislation was passed, the interest income from municipal bonds held in a mutual fund was subject to tax.
12. Assets for 1984 through 1989 for open-end funds only; other asset figures for open-end funds, closed-end funds, and unit investment trusts (including exchange-traded funds).
13. Technically, a *broker* arranges trades for its clients, charging a commission for its services. It does not take ownership of the securities as part of the transaction. A *dealer,* in contrast, buys and sells securities for its own account; it expects to earn a spread when it trades. Many firms are both brokers and dealers and therefore can engage in both activities.
14. Assets in individual retirement accounts and defined contribution plans.
15. Net investments include net new cash and reinvested interest and dividends. Funds are long-term funds only (excluding money market funds) and include mutual funds, variable annuities, exchange-traded funds, and closed-end funds.
16. 15 USC 78d, "Securities and Exchange Commission."
17. Securities and Exchange Commission, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," www.sec.gov/about/whatwedo.shtml (accessed February 8, 2014).
18. 15 USC 78q-1(c), "National System for Clearance and Settlement of Securities Transactions." 17 CFR 240.17ad-1 – 240.17ad-21T.
19. Office of Compliance Inspections and Examinations, "National Examination Program Risk Alert: Investment Adviser Use of Social Media." (January 4, 2012).
20. 5 USC Subchapter 11, "Administrative Procedures." For more detail on the Federal rulemaking process, see *The Reg Map: Informal Rulemaking* at www.reginfo.gov/public/reginfo/Regmap/index.jsp.
21. Letter from the Investment Adviser Regulation Office and Chief Counsel's Office, Division of Investment Management, to the Managed Funds Association (February 6, 2014).

22. Exemptive relief is available only for regulations under the Securities Exchange Act of 1934. 17 USC 78mm, "General exemptive authority."
23. FINRA Manual, FINRA Rule 1230, "Registration Categories," and NASD Rules 1020, "Registration of Principals," and 1030, "Registration of Representatives."
24. FINRA Manual, NASD Rule 2210, "Communications with the Public."
25. FINRA Manual, NASD Rule 2830, "Investment Company Securities," under authority established by the Investment Company Act of 1940 (15 USC 80a-22(a), "Distribution, redemption, and repurchase of securities; regulations by securities associations."
26. For more on self-regulatory organizations, see CFA Institute, "Self-Regulation in the Securities Markets: Transitions and New Possibilities" (2013) and John Carson, "Self-Regulation in Securities Markets," *Policy Research Working Paper* 5542 (World Bank, January 2011).
27. The Employee Retirement Income Security Act (ERISA) specifically excludes from Department of Labor oversight the assets within mutual funds used in a retirement plan. See 29 USC 1002(21)(B), "Definitions;" 29 USC 1101(b)(1), "Coverage;" and 29 CFR 2509.75-3, "Interpretive bulletin relating to investments by employee benefit plans in securities of registered investment companies."
28. Pub. L. 104-290, October 11, 1996, 110 Stat. 3416.