

Mutual Fund Structures and Risks

A talk with Professor John Morley

I. Mutual Funds Overview

A. Mutual Funds

- Make up the largest category of funds.
- Pools of stocks, bonds and other investment securities. Shares in pools are issued to purchasers.
- Because shares are sold widely to the general public, mutual funds must be registered with the SEC and comport with the requirements of the Investment Company Act (ICA).
- Redemption rights in mutual funds
 - The ability to exchange shares for cash value.
 - Typically, shareholders in a mutual fund can redeem their shares every day.

B. Investment Company Act (ICA) and Investment Advisers Act (IAA) of 1940

- ICA¹
 - Regulates organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.
 - Designed to minimize conflicts of interest that arise in these complex operations. Focuses on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.
- IAA²
 - Regulates investment advisers. Registration requirements for advisers generally who have at least \$100 million of assets under management.

C. Structure of mutual funds

- Investment fund formation
 - Advisory or management companies, composed of general partners or advisors, establish funds as distinct legal entities from the company. Places their portfolio of securities, currency, and other investments and liabilities in a separate entity. Contracts with the funds to supply the operational and administrative services of the funds.
 - The funds have no employees or operational assets of their own. The agreement between the entities can stipulate other restrictions such as

¹ Investment Company Act of 1940: <http://legcounsel.house.gov/Comps/Investment Company Act Of 1940.pdf>

² Investment Advisers Act of 1940: <http://legcounsel.house.gov/Comps/Investment Advisers Act Of 1940.pdf>

- authorizing only the advisory company to direct operations and strategies or limiting the funds' ability to remove the management company or its employees.
 - Advisory company typically organized the funds and solicits outside investments. All of the funds managed by the advisory company are marketed under the advisory company's brand, e.g. Fidelity or Vanguard.
 - Funds pay fee to management. The fees are the basis of the advisory company's business and are not performance based.
- Ownership
 - Advisory company owns the physical assets like office space, the office equipment, IP, and the contracts of its employees. Its liabilities include outstanding loan and unperformed derivative obligations.
 - Funds' assets include the securities, currency, real estate, and assorted financial instruments. Its liabilities include outstanding loans and unperformed derivative obligations.
- Structure facilitates simultaneous management of multiple funds.

II. Unique Structure—Challenges and Opportunities

A. Challenges in structure

- Conflict of interest among funds
 - Adviser has separate fiduciary duty to each client/fund. Favoring one over another in allocation of resources can be a breach.
- Investors have little control over funds. Trade-off is ability to redeem every day.
- Possibility that fund manager may mix clients assets with its own.
- Risks magnified for unsophisticated investors.

B. Limits exposure to risks but also claims to profitability or control

- Fund's exposure to management companies' liabilities is limited. E.g. shielded from creditors of management because of separate legal structure.
- Fund investors have no claims to management's residual earnings/profits.
- Fund investors have no residual control over management companies and their assets.

C. Control rights

- The ICA requires mutual funds to give shareholders some minimum control rights, including a shareholder elected board of directors and a right to terminate and replace the advisory company.
- In practice, votes can be avoided for initial directors when a fund first forms. They can then serve indefinitely without reelection and appoint their own replacements.
- Voting rights has less value because of exit rights.

D. Asset-based fee structure

- Mutual fund fees vs PE or hedge funds are asset-based, not performance-based.
- Advisers have a strong incentive to attract new investors and keep existing investors from redeeming.

E. Exit rights

- Investors can redeem their shares for the cash value equal to a pro rata share of the funds' assets after debts and liabilities. Called the net asset value (NAV) per share. Typically, can redeem every day and usually on less than 24 hours notice.
- NAV is tied to the value of the fund's holdings; does not reflect value of the fees and portfolio changes expected.
- Exit rights results in low activism among shareholders. Investors would only choose to i.e. exercise voting rights if net benefit of activism exceeded the net benefit of exit. Redemption is cheaper than activism in mutual funds.

F. Exchange-traded funds (ETFs)

- ETF are a type of mutual fund.
- Shares may be bought and sold on securities exchanges. Shares can also be redeemed and purchased with the funds themselves, in large blocks and only through in-kind trades of securities.

Resources

- John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 Yale L.J. 1228 (2014): http://digitalcommons.law.yale.edu/fss_papers/4918/
- John Morley and Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 Yale L.J. 84. (2010): http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=5520&context=fss_papers