

# APPENDIX

## A

# How US-Registered Investment Companies Operate and the Core Principles Underlying Their Regulation

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## The Origins of Pooled Investing

The investment company concept dates to the late 1700s in Europe, according to K. Geert Rouwenhorst in *The Origins of Mutual Funds*, when “a Dutch merchant and broker...invited subscriptions from investors to form a trust...to provide an opportunity to diversify for small investors with limited means.”

The emergence of “investment pooling” in England in the 1800s brought the concept closer to US shores. In 1868, the Foreign and Colonial Government Trust formed in London. This trust resembled the US fund model in basic structure, providing “the investor of moderate means the same advantages as the large capitalists...by spreading the investment over a number of different stocks.”

Perhaps more importantly, the British fund model established a direct link with US securities markets, helping to finance the development of the post–Civil War US economy. The Scottish American Investment Trust, formed on February 1, 1873, by fund pioneer Robert Fleming, invested in the economic potential of the United States, chiefly through American railroad bonds. Many other trusts followed that not only targeted investment in America, but also led to the introduction of the fund investing concept on US shores in the late 1800s and early 1900s.

The first mutual, or open-end, fund was introduced in Boston in March 1924. The Massachusetts Investors Trust introduced important innovations to the investment company concept by establishing a simplified capital structure, continuous offering of shares, the ability to redeem shares rather than hold them until dissolution of the fund, and a set of clear investment restrictions and policies.

The stock market crash of 1929 and the Great Depression that followed hampered the growth of pooled investments until a succession of landmark securities laws—beginning with the Securities Act of 1933 and concluding with the Investment Company Act of 1940—reinvigorated investor confidence. Renewed investor confidence and many innovations led to relatively steady growth in industry assets and the number of accounts.

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## Four Principal Securities Laws Govern Investment Companies

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### **The Investment Company Act of 1940**

Regulates the structure and operations of investment companies through a combination of registration and disclosure requirements and restrictions on day-to-day operations. The Investment Company Act generally requires the registration of all investment companies with more than 100 investors. Among other things, the act addresses investment company capital structures, custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interest), and the duties of fund boards.

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### **The Investment Advisers Act of 1940**

Regulates investment advisers. The Advisers Act requires all advisers to registered investment companies and other large advisers to register with the Securities and Exchange Commission (SEC). The act also contains provisions requiring fund advisers to meet recordkeeping, custodial, reporting, and other regulatory responsibilities.

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### **The Securities Exchange Act of 1934**

Regulates the trading, purchase, and sale of securities, including investment company shares. The 1934 Act also regulates broker-dealers, including investment company principal underwriters and others that sell investment company shares, and requires them to register with the SEC. In 1938, the act was revised to add Section 15A, which authorized the SEC to create self-regulatory organizations. Pursuant to this authority, in 1939 a self-regulatory organization for broker-dealers—which is now known as the Financial Industry Regulatory Authority (FINRA)—was created. Through its rules, inspections, and enforcement activities, FINRA, with oversight by the SEC, continues to regulate the conduct of broker-dealers, thereby adding another layer of protection for investors.

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### **The Securities Act of 1933**

Requires the registration of public offerings of securities—including investment company shares—and regulates such offerings. The 1933 Act also requires that all investors receive a current prospectus describing the fund.

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## The Types of US Investment Companies

Fund sponsors in the United States offer four main types of registered investment companies: mutual funds, closed-end funds (CEFs), exchange-traded funds (ETFs), and unit investment trusts (UITs).

The majority of investment company assets are held in **mutual funds**. Mutual funds can have actively managed portfolios, in which a professional investment adviser creates a unique mix of investments to meet a particular investment objective, or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index. One hallmark of mutual funds is that they issue redeemable securities, meaning that the fund stands ready to buy back its shares at their next computed net asset value (NAV). The NAV is calculated by dividing the total market value of the fund's assets, minus its liabilities, by the number of mutual fund shares outstanding.

Money market funds are one type of mutual fund. They offer investors a variety of features, including liquidity, a market-based rate of return, and the goal of returning principal, all at a reasonable cost. These funds, which are typically publicly offered to all types of investors, are registered investment companies that are regulated by the Securities and Exchange Commission (SEC) under US federal securities laws, including Rule 2a-7 under the Investment Company Act. That rule contains numerous risk-limiting conditions concerning portfolio maturity, quality, diversification, and liquidity.\* Since October 2016, institutional prime money market funds (funds that primarily invest in corporate debt securities) and institutional municipal money market funds maintain a floating NAV for transactions based on the current market value of the securities in their portfolios. Government money market funds and retail money market funds (funds designed to limit all beneficial owners of the funds to natural persons) are allowed to use the amortized cost method of pricing or penny rounding—or both—to seek to maintain a stable share price. Money market funds' boards of directors also have the ability to impose liquidity fees in certain circumstances.

Unlike mutual funds, **CEFs** do not issue redeemable shares. Historically, the vast majority of CEFs have been “listed” CEFs—investment companies that issue a fixed number of common shares in an initial public offering (IPO) that are publicly traded on an exchange or in the over-the-counter market, like traditional stocks. Once issued, shareholders may not redeem those shares directly to the fund (though some CEFs may repurchase shares through stock repurchase programs or through a tender for shares). Investors in listed CEFs buy or sell shares through a broker, just as they would trade the shares of any publicly traded company. Subsequent issuance of common shares generally only occurs through secondary or follow-on offerings, at-the-market offerings, rights offerings, or dividend reinvestments.

There are also “unlisted” CEFs, which have recently seen steady asset growth. Unlisted CEFs are not listed on an exchange but are sold publicly to retail investors, mainly through intermediaries, or to certain qualified investors through private placement offerings. Unlike listed CEFs, unlisted CEFs do not issue a fixed number of shares but are permitted to continuously offer their shares at net asset value (NAV) following their IPO. As they are not traded on an exchange, unlisted CEFs engage in scheduled repurchases or tender offers for a certain percentage of the CEF's shares to allow shareholders to exit the fund. The ability of a shareholder to exit the CEF is dependent on the timing of the scheduled repurchase or tender offer and whether the repurchase or tender is “over-subscribed.” For more information on CEFs, see chapter 5.

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\* On July 15, 2023, the SEC adopted a number of amendments to Rule 2a-7.

**ETFs** are a hybrid of investment companies. They are structured and legally classified as open-end management investment companies or UITs (discussed below) but trade intraday on stock exchanges like listed CEFs. ETFs only buy and sell fund shares directly with authorized participants in large blocks, often 50,000 shares or more. For more information on ETFs, see chapter 4.

**UITs** are also a hybrid, with some characteristics of mutual funds and some of CEFs. Like listed CEFs, UITs historically issued only a specific, fixed number of shares, called units. Like mutual funds, the units are redeemable; but unlike mutual funds, generally the UIT sponsor will maintain a secondary market in the units so that redemptions do not deplete the UIT's assets. A UIT does not actively trade its investment portfolio—instead it buys and holds a set of particular investments until a set termination date, at which time the trust is dissolved and proceeds are paid to shareholders. For more information, see chapter 2.

## The Organization of a Mutual Fund

A mutual fund typically is organized under state law either as a corporation or a business trust (sometimes called a statutory trust). The three most popular forms of organization are Massachusetts business trusts, Maryland corporations, and Delaware statutory trusts (Figure A.1).\*

Historically, Massachusetts business trusts were the most popular—in part because the very first mutual fund was formed as a Massachusetts business trust. This was a common form of organization at the time for pools that invested in real estate or public utilities, and it provided a model for others to follow. Developments in the late 1980s gave asset management companies other attractive choices, and since then, the percentage of funds organized as Massachusetts business trusts has declined as more and more funds have formed as Maryland corporations and Delaware statutory trusts. For example, in 1987, Maryland revised its law to align it with interpretations of the Investment Company Act concerning when funds are required to hold annual meetings. As a result, Maryland corporations became more competitive with the Massachusetts business trust as a form of organization for mutual funds. In 1988, Delaware—already a popular domicile for US corporations—adopted new statutory provisions devoted specifically to business trusts (since renamed statutory trusts). Benefits, such as management of the trust and limited liability afforded to the trust's beneficial owners, have led to Delaware statutory trusts being the most favored form of mutual fund organization.

Mutual funds have officers and directors (if the fund is a corporation) or trustees (if the fund is a business trust).† The fund's board plays an important role in overseeing fund operations, described in more detail on page 137.

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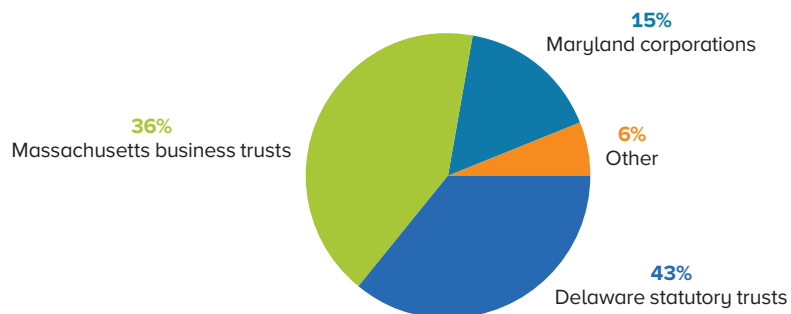
\* At year-end 2023, 6 percent of mutual funds chose other forms of organization, such as limited liability partnerships, or other domiciles, such as Ohio or Wisconsin.

† For ease of reference, this appendix refers to all directors and trustees as *directors* and all boards as *boards of directors*.

FIGURE  
A.1

## The Most Popular Forms of Mutual Fund Organization

Percentage of funds, year-end 2023



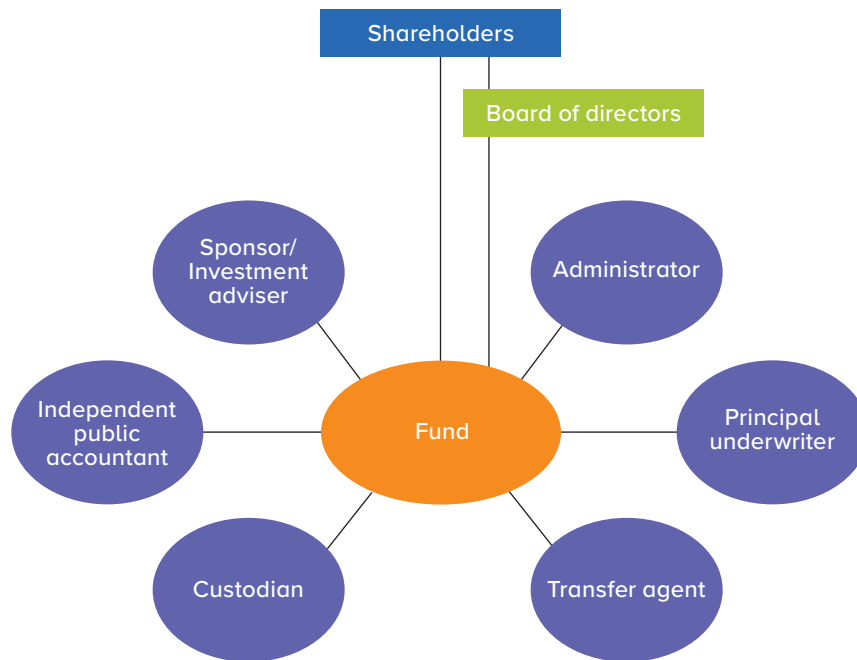
**Number of funds: 8,992**

Note: Data include mutual funds that do not report statistical information to the Investment Company Institute and mutual funds that invest primarily in other mutual funds.

Unlike other companies, a mutual fund is typically externally managed; it is not an operating company and has no employees in the traditional sense. Instead, a fund relies upon third parties or service providers—either affiliated organizations or independent contractors—to invest fund assets and carry out other business activities. Figure A.2 shows the primary types of service providers funds usually rely upon.

FIGURE  
A.2

## Organization of a Mutual Fund



Although it typically has no employees, a fund is required by law to have written compliance policies and procedures that govern the operations of the fund and the fund's administrator, investment adviser, transfer agent, and principal underwriter, and that are reasonably designed to ensure the fund's compliance with the federal securities laws. All funds must also have a chief compliance officer (CCO), whose appointment must be approved by the fund's board (or principal underwriter or depositor, if a UIT) and who must annually produce a report for the board (or principal underwriter or depositor) regarding the adequacy of the fund's compliance policies and procedures, the effectiveness of their implementation, and any material compliance matters that have arisen.

### Fund Boards

A fund board represents the interests of the fund's shareholders by overseeing the management and operations of the fund, including the fund's contractual arrangements with its service providers. For more information on fund boards, see page 137.

### Shareholders

Like shareholders of other companies, mutual fund shareholders have specific voting rights. These include the right to elect directors at meetings called for that purpose and the right to approve material changes in the terms of a fund's contract with its investment adviser, the entity that manages the fund's assets. For example, a fund's management fee cannot be increased unless a majority of shareholders vote to approve the increase.

## Sponsors

Setting up a mutual fund is a complicated process performed by the fund's sponsor, which is typically the fund's investment adviser. The fund sponsor has a variety of responsibilities. For example, it must assemble the group of third parties needed to launch the fund, including the persons or entities charged with managing and operating the fund. The sponsor provides officers and affiliated directors to oversee the fund and recruits unaffiliated persons to serve as independent directors.

Some of the major steps in the process of starting a mutual fund include organizing the fund under state law, registering the fund with the SEC as an investment company pursuant to the Investment Company Act, and registering the offering of fund shares for sale to the public pursuant to the Securities Act of 1933.\* Unless the sales of shares in a particular state qualify for an exemption, the fund also must make filings and pay fees to those states in which the fund's shares will be offered to the public. The Investment Company Act also requires that each new fund have at least \$100,000 of seed capital before distributing its shares to the public; this capital is usually contributed by the sponsor or adviser in the form of an initial investment.

## Advisers

Investment advisers have overall responsibility for directing the fund's investments and handling its business affairs. The investment advisers have their own employees, including investment professionals who work on behalf of the fund's shareholders and determine which securities to buy and sell in the fund's portfolio, consistent with the fund's investment objectives and policies. In addition to managing the fund's portfolio, the adviser often serves as administrator to the fund, providing various "back-office" services. As noted earlier, a fund's investment adviser is often the fund's initial sponsor and its initial shareholder through the seed money invested to create the fund.

To protect investors, a fund's investment adviser and the adviser's employees are subject to numerous standards and legal restrictions, including restrictions on transactions that may pose conflicts of interest. Like a mutual fund, investment advisers are required to have their own written compliance programs that are overseen by CCOs and establish detailed procedures and internal controls designed to ensure compliance with all relevant laws and regulations.

## Administrators

A fund's administrator handles the many back-office functions for a fund. For example, administrators often provide office space, clerical and fund accounting services, data processing, bookkeeping, and internal auditing; they also may prepare and file SEC, tax, shareholder, and other reports. Fund administrators also help maintain compliance procedures and internal controls, subject to oversight by the fund's board and CCO.

## Principal Underwriters

Investors buy and redeem fund shares either directly through a fund's transfer agent or indirectly through a broker-dealer that is authorized to sell fund shares. In order to offer a particular fund's shares, however, a broker-dealer must have a sales agreement with the fund. The role of a fund's principal

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\* For more information on the requirements for the initial registration of a mutual fund, see the SEC's Investment Company Registration and Regulation Package, available at [www.sec.gov/divisions/investment/invcoreg121504.htm](http://www.sec.gov/divisions/investment/invcoreg121504.htm).



underwriter is to act as the agent for the fund in executing sales agreements that authorize broker-dealers to offer for sale and sell fund shares. Though principal underwriters must register under the Securities Exchange Act of 1934 as broker-dealers, they (1) do not operate as full-service broker-dealers, (2) typically are not involved in offering or selling fund shares to retail investors, and (3) do not establish or maintain accounts for retail investors.

## Transfer Agents

Mutual funds and their shareholders rely on the services of transfer agents to maintain records of shareholder accounts; calculate and distribute dividends and capital gains; and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Some transfer agents also prepare and mail statements confirming shareholder transactions and account balances. Additionally, they may maintain customer service departments, including call centers, to respond to shareholder inquiries.

## Auditors

Auditors certify the fund's financial statements. The auditors' oversight role is described more fully on page 138.

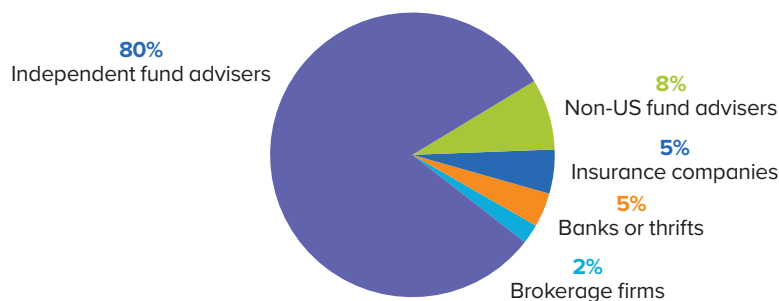
## Types of Mutual Fund Complexes

A variety of financial services companies offer registered funds in the United States. At year-end 2023, 80 percent of investment company complexes were independent fund advisers (Figure A.3), managing 70 percent of investment company assets. Other types of investment company complexes in the US market include non-US fund advisers, insurance companies, banks, thrifts, and brokerage firms.

FIGURE  
A.3

### 80 Percent of Fund Complexes Were Independent Fund Advisers

Percentage of investment company complexes by type of intermediary, year-end 2023



## Tax Features of Mutual Funds

Mutual funds are subject to special tax rules set forth in subchapter M of the Internal Revenue Code. Unlike most corporations, mutual funds are not subject to taxation on their income or capital gains at the entity level, provided that they meet certain gross income and asset requirements and distribute their income annually.

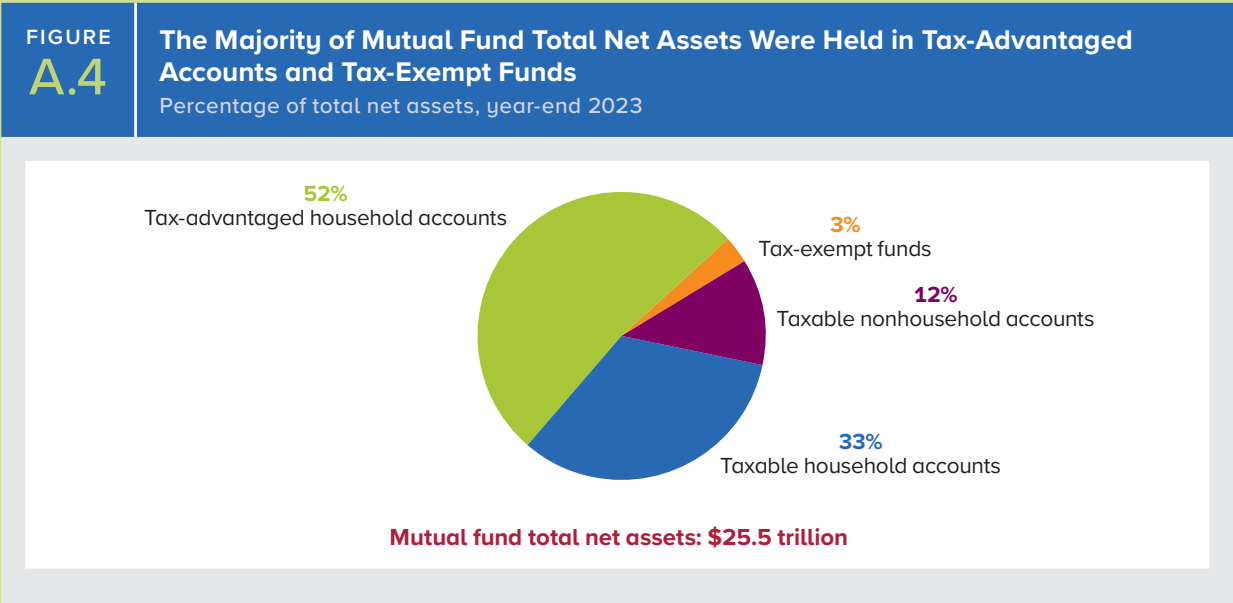
To qualify as a regulated investment company (RIC) under subchapter M, at least 90 percent of a mutual fund's gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock, securities, or foreign currencies. In addition, at the close of each quarter of the fund's taxable year, at least 50 percent of the value of the fund's total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities that, with respect to any one issuer, represent neither more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the fund's assets may be invested in the securities of any one issuer (other than government securities or the securities of other funds), the securities (other than the securities of other funds) of two or more issuers that the fund controls and that are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.

If a mutual fund satisfies the gross income and asset tests and thus qualifies as a RIC, the fund is eligible for the tax treatment provided by subchapter M, including the ability to deduct from its taxable income the dividends it pays to shareholders, provided that the RIC distributes at least 90 percent of its income (other than net capital gains) each year. A RIC may retain up to 10 percent of its income and all capital gains, but the retained income and capital gains are taxed at regular corporate tax rates. Therefore, mutual funds generally distribute all, or nearly all, of their income and capital gains each year.

The Internal Revenue Code also imposes an excise tax on RICs, unless a RIC distributes by December 31 at least 98 percent of its ordinary income earned during the calendar year, 98.2 percent of its net capital gains earned during the 12-month period ending on October 31 of the calendar year, and 100 percent of any previously undistributed amounts. Mutual funds typically seek to avoid this charge—imposed at a 4 percent rate on the under-distributed amount—by making the required minimum distribution each year.

# Mutual Fund Assets by Tax Status

Fund investors are responsible for paying tax on the amount of a fund’s earnings and gains distributed to them, whether they receive the distributions in cash or reinvest them in additional fund shares. Investors often attempt to lessen the impact of taxes on their investments by investing in tax-exempt funds and tax-advantaged retirement accounts and variable annuities. As of year-end 2023, 3 percent of all mutual fund assets were held in tax-exempt funds and 52 percent were invested in tax-advantaged accounts held by households (Figure A.4).



## Types of Distributions

Mutual funds make two types of taxable distributions to shareholders: ordinary dividends and capital gains.

Ordinary dividend distributions come primarily from the interest and dividends earned by the securities in a fund’s portfolio and net short-term gains, if any, after expenses are paid by the fund. These distributions must be reported as dividends on a US investor’s tax return and are taxed at the investor’s ordinary income tax rate, unless they are qualified dividends. Qualified dividend income is taxed at a maximum rate of 20 percent. Some dividends paid by mutual funds may qualify for these lower top tax rates.

Long-term capital gains distributions represent a fund’s net gains, if any, from the sale of securities held in its portfolio for more than one year. Long-term capital gains are taxed at a maximum rate of 20 percent.

Certain high-income individuals also are subject to a 3.8 percent tax on net investment income (NII). The tax on NII applies to interest, dividends, and net capital gains, including those received from a mutual fund.

Non-US investors may be subject to US withholding and estate taxes and certain US tax reporting requirements on investments in US funds. Amounts distributed to non-US investors that are designated as interest-related dividends or dividends deriving from capital gains will generally be eligible for exemption from US withholding tax. Other distributions that are treated as ordinary dividends will generally be subject to US withholding tax (at a 30 percent rate or lower treaty rate).

To help mutual fund shareholders understand the impact of taxes on the returns generated by their investments, the SEC requires mutual funds to disclose standardized after-tax returns for one-, five-, and 10-year periods. After-tax returns, which accompany before-tax returns in fund prospectuses, are presented in two ways:

- After taxes on fund distributions only (preliquidation)
- After taxes on fund distributions and an assumed redemption of fund shares (postliquidation)

## Types of Taxable Shareholder Transactions

An investor who sells mutual fund shares usually incurs a capital gain or loss in the year the shares are sold; an exchange of shares between funds in the same fund family also usually results in either a capital gain or loss.

Investors are liable for tax on any capital gain arising from the sale of fund shares, just as they would be if they sold a stock, bond, or other security. Capital losses from mutual fund share sales and exchanges, like capital losses from other investments, may be used to offset other capital gains in the current year and thereafter. In addition, up to \$3,000 of capital losses in excess of capital gains (\$1,500 for a married individual filing a separate return) may be used to offset ordinary income.

The amount of a shareholder's gain or loss on fund shares is determined by the difference between the cost basis of the shares (generally, the purchase price—including sales loads—of the shares, whether acquired with cash or reinvested dividends) and the sale price. Tax rules enacted in 2012 require all brokers and funds to provide cost basis information to shareholders, as well as to indicate whether any gains or losses are long-term or short-term, for fund shares acquired beginning in 2012. For shares acquired before 2012, many funds have voluntarily been providing cost basis information to shareholders or computing gains and losses for shares sold.

## Tax-Exempt Funds

Tax-exempt bond funds distribute amounts attributable to municipal bond interest. These “exempt-interest dividends” are exempt from federal income tax and, in some cases, state and local taxes. Tax-exempt money market funds invest in short-term municipal securities or equivalent instruments and also pay exempt-interest dividends. Even though income from these funds generally is tax-exempt, investors must report it on their income tax returns. Tax-exempt funds provide investors with this information and typically explain how to handle exempt-interest dividends on a state-by-state basis. For some taxpayers, portions of income earned by tax-exempt funds also may be subject to the federal alternative minimum tax.

## Mutual Fund Ordinary Dividend Distributions

Ordinary dividend distributions represent income—primarily from interest and dividends earned by securities in a fund’s portfolio—after expenses are paid by the fund. Mutual funds distributed \$644 billion in dividends to fund shareholders in 2023 (Figure A.5). Bond and money market funds accounted for 66 percent of all dividend distributions in 2023. Overall, 38 percent of dividend distributions were paid to tax-advantaged household accounts and tax-exempt fund shareholders. Another 47 percent were paid to taxable household accounts.

FIGURE  
A.5

### Dividend Distributions

Billions of dollars

Year	Tax-advantaged household accounts and tax-exempt funds	Taxable household accounts	Taxable nonhousehold accounts	Total
2000	\$75	\$87	\$25	\$186
2005	84	61	21	166
2010	112	64	12	188
2015	140	93	17	250
2020	158	125	22	305
2021	163	135	19	317
2022	186	163	30	379
2023	244	300	100	644

## Mutual Fund Capital Gains Distributions

Capital gains distributions represent a fund's net gains, if any, from the sale of securities held in its portfolio. When gains from these sales exceed losses, they are distributed to fund shareholders. Mutual funds distributed \$245 billion in capital gains to shareholders in 2023—67 percent of these distributions were paid to tax-advantaged household accounts, and 30 percent were paid to taxable household accounts and tax-exempt fund shareholders (Figure A.6).<sup>\*</sup> Equity mutual funds typically represent the bulk of capital gains distributions. In 2023, 45 percent of equity mutual fund share classes made a capital gains distribution, and 69 percent of these share classes distributed more than 2.0 percent of their assets as capital gains.

FIGURE  
A.6

### Capital Gains Distributions

Billions of dollars

Year	Tax-advantaged household accounts	Taxable household accounts and tax-exempt funds	Taxable nonhousehold accounts	Total
2000	\$194	\$119	\$13	\$326
2005	78	44	8	129
2010	22	18	3	43
2015	250	114	15	379
2020	224	125	17	367
2021	502	280	39	822
2022	268	111	15	394
2023*	164	74	8	245

\* In 2023, tax-exempt funds distributed less than \$10 million in capital gains.

Note: Capital gains distributions include long-term and short-term capital gains.

\* Only the net gains from the sale of a fund's assets held for more than one year (long-term capital gain distributions) are taxed as capital gains. Net short-term gains are taxed as ordinary dividend distributions. Data presented here on capital gains distributions include both long-term and short-term capital gains.

## Core Principles Underlying the Regulation of US Investment Companies

Embedded in the structure and regulation of mutual funds and other registered investment companies are several core principles that provide important protections for shareholders.

### Transparency

Funds are subject to more extensive disclosure requirements than any other comparable financial product, such as hedge funds and other private pools. The cornerstone of the disclosure regime for mutual funds and ETFs is the prospectus.\* Mutual funds and ETFs are required to maintain a current prospectus, which provides investors with information about the fund, including its investment objectives, investment strategies, risks, fees and expenses, and performance, as well as how to purchase, redeem, and exchange fund shares. Importantly, the key parts of this disclosure, with respect to performance information and fees and expenses, are standardized to facilitate comparisons by investors. Mutual funds and ETFs may provide investors with a summary prospectus containing key information about the fund while making more information available online and by mail upon request.

Mutual funds and ETFs are also required to make statements of additional information (SAIs) available to investors upon request and without charge. The SAI conveys information about the fund that, though useful to some investors, is not necessarily needed to make an informed investment decision. For example, the SAI generally includes information about the history of the fund, offers detailed disclosures on certain investment policies (such as borrowing and concentration policies), and lists officers, directors, and other persons who control the fund.

The prospectus, SAI, and certain other required information are contained in the fund's registration statement, which is filed electronically with the SEC and is publicly available via the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. Mutual fund and ETF registration statements are amended at least once a year to ensure that financial statements and other information do not become stale.† These funds also amend registration statements throughout the year as necessary to reflect material changes to their disclosures.

In addition to the registration statement disclosure, funds provide shareholders with several other disclosure documents. Funds must transmit annual and semiannual shareholder reports within 60 days after the end and the midpoint of the fund's fiscal year, respectively.‡ These reports contain performance

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\* CEFs and UITs also provide investors with extensive disclosures, but under a slightly different regime that reflects the way shares of these funds trade. Both CEFs and UITs file an initial registration statement with the SEC containing a prospectus and other information related to the initial offering of their shares to the public.

† Section 10(a)(3) of the Securities Act of 1933 prohibits investment companies that make a continuous offering of shares from using a registration statement with financial information that is more than 16 months old. This gives mutual funds and ETFs four months after the end of their fiscal year to amend their registration statements.

‡ Until July 2024, open-end funds may transmit a notice to shareholders indicating that a new shareholder report is available online and in print by request in lieu of transmitting a shareholder report. The notice must include a website address where the shareholder report can be accessed and a toll-free telephone number the shareholder can use to request a paper copy of the report at no charge.

and expense information, financial statements, and a list of the fund's portfolio securities.\* An independent accountant must audit the financial statements included in the annual shareholder report. The annual shareholder report for non–money market mutual funds and most ETFs must also provide management's discussion of fund performance (MDFP), describing the factors that affected the fund's performance, including relevant market conditions and investment strategies and techniques used by the fund's investment adviser.†

Funds are also required to file Form N-PORT with the SEC. Form N-PORT must include a complete list of the fund's portfolio securities in a structured data format along with other information, including flows, returns, securities lending information, and—for funds investing more than a specified amount in fixed-income securities—portfolio-level risk metrics. Funds must file Form N-PORT for each month during the year; however, only the filing relating to the third month of each fiscal quarter is made publicly available. These requirements cause funds to publicly disclose their portfolio holdings at least four times each fiscal year.‡

Funds must also file census-type information annually on Form N-CEN and must annually disclose how they voted on specific proxy issues at portfolio companies on Form N-PX. Funds are the only shareholders required to publicly disclose each and every proxy vote they cast. They are not required to mail Form N-PORT, Form N-CEN, or Form N-PX to shareholders, but the forms are publicly available via the SEC's EDGAR database.§

The combination of prospectuses, SAs, annual and semiannual shareholder reports, Form N-PORT, Form N-CEN, and Form N-PX provides the investing public, regulators, media, and other interested parties with far more information on funds than is available for other types of investments. This information is easily and readily available from most funds and the SEC. It is also available from private-sector vendors, such as Morningstar, that compile publicly available information on funds in ways that might benefit investors.

## Daily Valuation and Liquidity

Nearly all funds offer shareholders liquidity and market-based valuation of their investments at least daily. ETFs and listed CEF shares are traded intraday on stock exchanges at market-determined prices, giving shareholders real-time liquidity and pricing. Unlisted CEFs engage in scheduled repurchases or tender offers for a certain percentage of the CEF's shares to allow shareholders to exit the fund and are required to price the current market value of the fund's portfolio investments in connection with the repurchase or tender or when offering its shares. Mutual fund shares are redeemable on a daily basis at a price that reflects the current market value of the fund's portfolio investments. The value of each portfolio investment

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\* Beginning in July 2024, open-end funds must transmit to shareholders a condensed annual and semiannual shareholder report that highlights key information, including cost and performance information, key fund statistics, and a graphical presentation of holdings. The full financial statements and a list of the fund's full portfolio securities will move to an easily accessible online site that the fund operates and must be delivered to shareholders upon request. Until July 2024, a fund is permitted to include a summary portfolio schedule in its shareholder reports in lieu of the complete schedule, provided that the complete portfolio schedule is filed with the SEC and provided to shareholders upon request, free of charge. The summary portfolio schedule includes each of the fund's 50 largest holdings in unaffiliated issuers and each investment that exceeds 1 percent of the fund's NAV.

† CEFs must also include an MDFP section in their annual shareholder reports.

‡ Money market funds, which already must file portfolio holdings with the SEC monthly on Form N-MFP and disclose those holdings on their websites, are not required to file Form N-PORT.

§ Again, only the Form N-PORT filing relating to the third month of the fiscal quarter is made publicly available.



is determined either by a market quotation, if one is readily available, or at fair value (i.e., an estimate of the amount for which the investment could be sold in a current transaction). Under the SEC's fair value rule, fair value for applicable portfolio investments may be determined by the fund's board or its investment adviser (subject to continued oversight by the fund's board).

The daily pricing process is a critically important core function that involves numerous staff of the investment adviser and pricing vendors. The fair valuation process, a part of the overall pricing process, receives particular scrutiny from funds, their advisers, and their boards of directors, as well as regulators and independent auditors. Under SEC rules, all funds must adopt written fair valuation policies and procedures and establish and apply methodologies for determining fair values in particular instances.\* Those methodologies must be consistent with US generally accepted accounting principles (GAAP).

This daily valuation process results in a NAV for the fund. The NAV is the price used for all mutual fund share transactions occurring that day—new purchases, sales (redemptions), and exchanges from one fund to another within the same fund family.† It represents the current mark-to-market value of all the fund's assets, minus liabilities (e.g., accrued fund expenses payable), divided by the total number of outstanding shares. Mutual funds release their daily NAVs to investors and others after they complete the pricing process, generally around 6:00 p.m. eastern time. Daily fund prices are available through fund toll-free telephone services, websites, and other means.

The Investment Company Act requires mutual funds to process transactions based upon “forward pricing,” meaning that shareholders receive the next computed NAV following the fund's (or an intermediary's) receipt of their transaction orders. For example, for a fund that prices its shares as of 4:00 p.m.,‡ orders received before 4:00 p.m. receive the NAV determined that same day as of 4:00 p.m. Orders received after 4:00 p.m. receive the NAV determined as of 4:00 p.m. on the next business day. Forward pricing is an important protection for mutual fund shareholders. It is designed to minimize the ability of shareholders to take advantage of fluctuations in the prices of a fund's portfolio investments that occur after the fund has last calculated its NAV.

When a shareholder redeems shares in a mutual fund, he or she can expect to be paid promptly. Mutual funds may not suspend redemptions of their shares (subject to certain narrow exceptions)§ or delay payments of redemption proceeds for more than seven days.

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\* For more information on the valuation process, see ICI's *Fund Valuation Under the SEC's New Fair Value Rule* (December 2021), available at [www.ici.org/files/2021/21-ppr-fund-valuation-primer.pdf](http://www.ici.org/files/2021/21-ppr-fund-valuation-primer.pdf).

† The pricing process is also critical for ETFs, although for slightly different reasons. ETFs operate like mutual funds with respect to transactions with authorized participants that trade with the ETF in large blocks, often of 50,000 shares or more. The NAV is the price used for these large transactions. Listed CEFs are not required to strike a daily NAV, but most do so to provide the market with the ability to calculate the difference between the fund's market price and its NAV. That difference is called the fund's *premium* (if the market price is greater than the NAV) or *discount* (if the market price is less than the NAV). Although an unlisted CEF is only required to price when offering shares or engaging in a repurchase or tender, many price daily (and are required to if continuously offered).

‡ Mutual funds and ETFs must price their shares at least once every business day as of a time determined by the fund's board. Many of these funds price as of 4:00 p.m. eastern time or when the New York Stock Exchange closes.

§ Section 22(e) of the Investment Company Act prohibits mutual funds and ETFs from suspending redemptions unless the SEC permits them to do so or declares an emergency, or the New York Stock Exchange closes or restricts trading. These occurrences are relatively rare, although funds have suspended redemptions on several occasions, such as during Hurricane Sandy in 2012. See also page 123.

Under the SEC’s liquidity rule, no more than 15 percent of a mutual fund’s or ETF’s portfolio may be invested in illiquid assets,\* in part to ensure that the fund can meet redemption requests. This liquidity rule and its related reporting framework also impose other liquidity-related regulatory obligations on these funds.

## Oversight and Accountability

All funds are subject to a strong system of oversight from both internal and external sources. Boards of directors, which include independent directors, and written compliance programs overseen by CCOs (see Compliance and Risk Management Programs on page 138) are examples of internal oversight mechanisms. External oversight is provided by the SEC, FINRA, and external service providers such as certified public accounting firms.

### FUND BOARDS

Mutual funds, CEFs, and ETFs structured as open-end funds have boards. The role of a fund’s board of directors is primarily one of oversight. The board of directors typically is not involved in the day-to-day management of the fund company. Instead, day-to-day management is handled by the fund’s investment adviser or administrator pursuant to a contract with the fund.

Investment company directors review and approve major contracts with service providers (including, notably, the fund’s investment adviser), approve policies and procedures to ensure the fund’s compliance with federal securities laws, and undertake oversight and review of the performance of the fund’s operations. Directors devote substantial time and consider large amounts of information in fulfilling these duties, in part because they must perform all their duties in “an informed and deliberate manner.”

Fund boards must maintain a particular level of independence. The Investment Company Act requires at least 40 percent of the members of a fund board to be independent from fund management. An independent director is a fund director who does not have any significant business relationship with a mutual fund’s adviser or underwriter. In practice, most fund boards have far higher percentages of independent directors. As of year-end 2022, independent directors made up at least three-quarters of boards in 89 percent of fund complexes.†

Independent fund directors play a critical role in overseeing fund operations and are entrusted with the primary responsibility for safeguarding the interests of the fund’s shareholders. They serve as watchdogs, furnishing an independent check on the management of funds. Like directors of operating companies, they have a fiduciary duty to represent the interests of shareholders. But independent fund directors also have specific statutory and regulatory responsibilities under the Investment Company Act beyond the duties required of other types of directors. Among other things, they oversee the performance of the fund, approve the fees paid to the investment adviser for its services, and oversee the fund’s compliance program.

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\* Money market funds are held to different liquidity standards. For more information on this topic, see The Types of US Investment Companies on page 123 and [www.ici.org/mmfs/current/16\\_mmf\\_reg\\_summ](http://www.ici.org/mmfs/current/16_mmf_reg_summ).

† See *Overview of Fund Governance Practices, 1994–2022* for a description of the study that collects data on this and other governance practices. Available at [www.ici.org/files/2023/23-fund-governance-practices.pdf](http://www.ici.org/files/2023/23-fund-governance-practices.pdf).

## COMPLIANCE AND RISK MANAGEMENT PROGRAMS

The board's oversight function was greatly enhanced by rules adopted in 2003 that require every fund and adviser to have a CCO who administers a written compliance program reasonably designed to prevent, detect, and correct violations of the federal securities laws. Compliance programs must be reviewed at least annually for their adequacy and effectiveness, and fund CCOs are required to report directly to the independent directors.

## REGULATORY OVERSIGHT

Internal oversight is accompanied by a number of forms of external oversight and accountability. Funds are subject to inspections, examinations, and enforcement by their primary regulator, the SEC. Fund underwriters and distributors also are overseen by FINRA, a self-regulatory organization. Funds affiliated with a bank may also be overseen by banking regulators. All funds are subject to the antifraud jurisdiction of each state in which the fund's shares are offered for sale or sold.

## AUDITORS

A fund's financial statement disclosure is also subject to several internal and external checks. For example, annual reports include audited financial statements certified by an independent public accounting firm subject to oversight by the Public Company Accounting Oversight Board (PCAOB). This practice ensures that the financial statements are prepared in conformity with GAAP and fairly present the fund's financial position and results of operations.

## SARBANES-OXLEY ACT

Like officers of public companies, fund officers must make certifications and disclosures required by the Sarbanes-Oxley Act. For example, they have to certify the accuracy of the fund's financial statements.

## ADDITIONAL REGULATION OF ADVISERS

In addition to the system of oversight applicable directly to funds, investors enjoy protections through SEC regulation of the investment advisers that manage fund portfolios. All advisers to registered funds are required to register with the SEC and are subject to SEC oversight and disclosure requirements. Advisers also owe a fiduciary duty to each fund they advise, meaning that they have a fundamental legal obligation to act in the best interests of the fund pursuant to a duty of undivided loyalty and utmost good faith.

## Limits on Leverage

The inherent nature of a fund—a professionally managed pool of assets owned pro rata by its investors—is straightforward and easily understood by investors. The Investment Company Act fosters simplicity by prohibiting complex capital structures and limiting funds' use of leverage.

The Investment Company Act imposes various requirements on the capital structure of mutual funds, CEFs, and ETFs, including limitations on the issuance of "senior securities" and borrowing. These limitations greatly minimize the possibility that a fund's liabilities will exceed the value of its assets.

Generally speaking, a senior security is any debt that takes priority over the fund's shares, such as a loan or preferred stock. The SEC historically has interpreted the definition of senior security broadly, finding that selling securities short, purchasing securities on margin, and investing in many types of derivative instruments, among other practices, may create senior securities.

The SEC recently modernized its framework governing funds' use of derivatives, permitting mutual funds, CEFs, and ETFs to invest in derivatives if they adopt a derivatives risk management program that a fund's board oversees and comply with an outer-bound limit on fund leverage risk. Funds that limit their derivatives exposure to less than 10 percent of their net assets will not need to comply with the new requirements but will need to adopt and implement written policies and procedures reasonably designed to manage the fund's derivatives risks. The Investment Company Act also limits borrowing. With the exception of certain privately arranged loans and temporary loans, any promissory note or other indebtedness would generally be considered a prohibited senior security.\* Mutual funds and ETFs are permitted to borrow from a bank if, immediately after borrowing, the fund's total net assets are at least three times total aggregate borrowings. In other words, the fund must have at least 300 percent asset coverage.

CEFs have a slightly different set of limitations. They are permitted to issue debt and preferred stock, subject to certain conditions, including asset coverage requirements of 300 percent for debt and 200 percent for preferred stock.

In addition, funds may invest in reverse repurchase agreements and other similar financing transactions if they treat those investments as borrowings subject to the relevant asset coverage requirements applicable to open-end funds (mutual funds or ETFs) or CEFs or if they treat such transactions as derivatives investments.

Many funds voluntarily impose stricter limitations on their ability to issue senior securities or borrow than set forth under the Investment Company Act. Funds often, for example, adopt a policy stating that they will borrow only as a temporary measure for extraordinary or emergency purposes and not to finance investment in securities. In addition, they may disclose that, in any event, borrowings will be limited to a small percentage of fund assets (such as 5 percent). These are meaningful voluntary measures, because under the Investment Company Act, a fund's policies on borrowing money and issuing senior securities cannot be changed without the approval of fund shareholders.

## Custody

To protect fund assets, the Investment Company Act requires all funds to maintain strict custody of fund assets, separate from the assets of the adviser. Although the act permits other arrangements,† nearly all funds use a bank custodian for domestic securities. Foreign securities are required to be held in the custody of an international foreign bank or securities depository.

A fund's custody agreement with a bank is typically far more elaborate than the arrangements used for other bank clients. The custodian's services generally include safekeeping and accounting for the fund's assets, settling securities transactions, receiving dividends and interest, providing foreign exchange services, paying fund expenses, reporting failed trades, reporting cash transactions, monitoring corporate actions at portfolio companies, and tracing loaned securities.

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\* Temporary loans cannot exceed 5 percent of the fund's total net assets and must be repaid within 60 days.

† The Investment Company Act contains six separate custody rules for the possible types of custody arrangements for mutual funds, CEFs, and ETFs. UITs are subject to a separate rule that requires the use of a bank to maintain custody. See Section 17(f) of the Investment Company Act and SEC Rules 17f-1 through 17f-7.

The strict rules on the custody and reconciliation of fund assets are designed to prevent theft and other fraud-based losses. Shareholders are further insulated from these types of losses by a provision in the Investment Company Act that requires all mutual funds to have fidelity bonds designed to protect them against possible instances of employee larceny or embezzlement.

## Prohibitions on Transactions with Affiliates

The Investment Company Act contains a number of strong and detailed prohibitions on transactions between the fund and fund insiders or affiliated organizations (such as the corporate parent of the fund's adviser). Many of these prohibitions were part of the original statutory text of the act, enacted in response to instances of overreaching and self-dealing by fund insiders during the 1920s in the purchase and sale of portfolio securities, loans by funds, and investments in related funds. The SEC's Division of Investment Management has said that "for more than 50 years, [the affiliated transaction prohibitions] have played a vital role in protecting the interests of shareholders and in preserving the industry's reputation for integrity; they continue to be among the most important of the act's many protections."<sup>\*</sup>

Although a number of prohibitions in the Investment Company Act relate to affiliated transactions, three are particularly noteworthy:

- General prohibition on direct transactions between a fund and an affiliate
- General prohibition on "joint transactions," where the fund and affiliate are acting together vis-à-vis a third party
- Restrictions preventing investment banks from placing or "dumping" unmarketable securities with an affiliated fund by generally prohibiting the fund from buying securities in an offering syndicated by an affiliated investment bank

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<sup>\*</sup> See *Protecting Investors: A Half Century of Investment Company Regulation, Report of the Division of Investment Management, Securities and Exchange Commission (May 1992)*, available at [www.sec.gov/divisions/investment/guidance/icreg50-92.pdf](http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf). The Division of Investment Management is the division within the SEC responsible for the regulation of funds.

## Diversification

Both tax and securities laws provide diversification standards for funds registered under the Investment Company Act. To qualify as RICs under the tax laws, all mutual funds, CEFs, and ETFs, as well as most UITs, must meet a tax diversification test every quarter. The effect of this test is that a fund with a modest cash position and no government securities would hold securities from at least 12 different issuers. Another tax diversification restriction limits the amount of an issuer's outstanding voting securities that a fund may own.

The securities laws set higher standards for funds that elect to be diversified. If a fund elects to be diversified, the Investment Company Act requires that, with respect to at least 75 percent of the portfolio, no more than 5 percent may be invested in the securities of any one issuer and no investment may represent more than 10 percent of the outstanding voting securities of any issuer. Diversification is not mandatory, but all mutual funds, CEFs, and ETFs must disclose whether or not they are diversified under the act's standards.

In practice, most funds that elect to be diversified are much more highly diversified than they need to be to meet these two tests. As of December 2023, for example, the median number of stocks held by US equity mutual funds was 77.\*

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\* This number—calculated using Morningstar data—is the median among domestic equity mutual funds, excluding sector funds and funds of funds.