

**Meeting Between Federal Reserve Board Staff
and Representatives of the Investment Company Institute
January 4, 2011**

Participants: Scott Alvarez, Kieran Fallon, Paige Pidano, Mark Van Der Weide, Michael Gibson, Diana Hancock (Federal Reserve Board)

Paul Schott Stevens, Karen Hess McMillan, Brian Reid (Investment Company Institute); James Virgil Mattingly, Jr., Samuel Woodall III (Sullivan & Cromwell LLP)

Summary: Federal Reserve Board staff met with representatives of the Investment Company Institute (ICI) to discuss the structure, operation, and regulation of registered investment companies. ICI requested the meeting in light of the new authority provided to the Financial Stability Oversight Council and the Federal Reserve Board under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act. ICI's representatives presented an overview of registered investment companies (other than money market mutual funds), including the types, number, and assets of such companies, the typical structure of a mutual fund, and the major provisions of the Investment Company Act of 1940 and SEC regulations governing the operation of mutual funds. The ICI representatives provided the attached presentation, which guided the discussion.

Principal Risk Limiting Provisions in the Structure, Operation and Regulation of Registered Investment Companies

Investment Company Institute

January 2011

Overview of Presentation

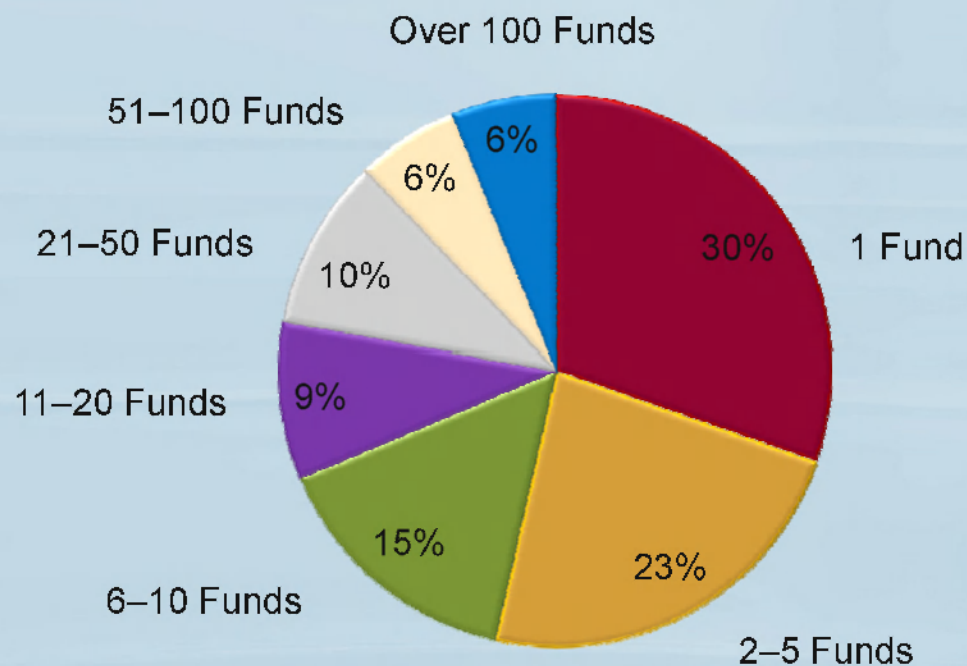
- I. The types, number, and assets of registered investment companies
- II. The typical structure of a mutual fund
- III. Major provisions of the Investment Company Act

Types of Registered Investment Companies

- There are four types of registered investment companies:
 - Open-end investment companies, commonly called “mutual funds”
 - Exchange traded funds, commonly called “ETFs”
 - Closed-end investment companies
 - Unit investment trusts, commonly called “UITs”
- Mutual funds are the most common

Type	Number	Assets
Mutual funds	7,570	\$11.3 trillion
ETFs	863	\$794 billion
Closed-end funds	620	\$244 billion
UITs	6,049	\$38 billion

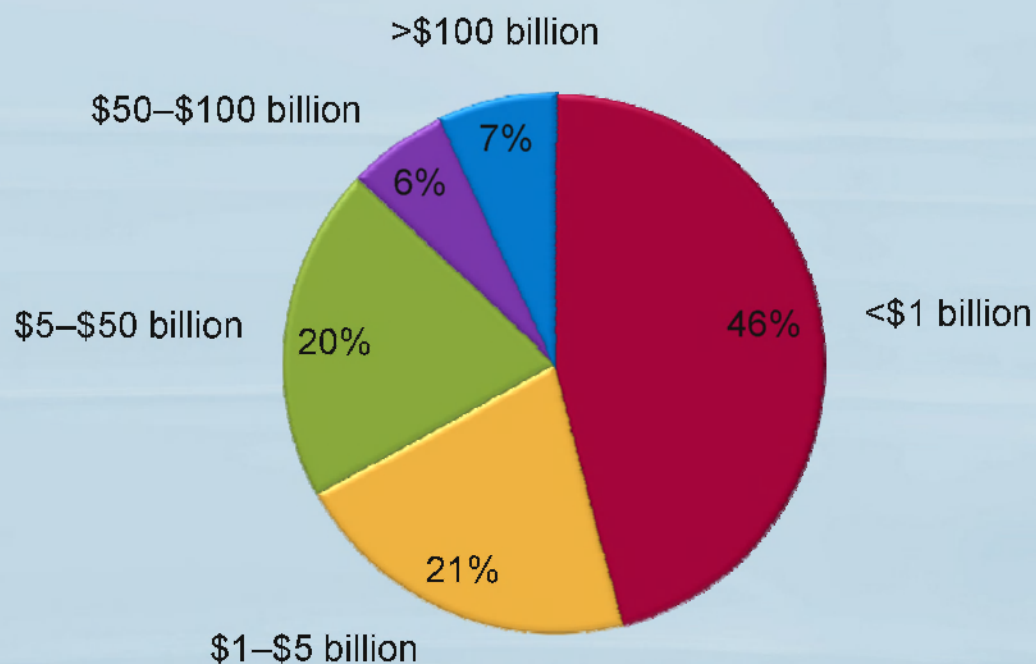
Share of Fund Complexes by Number of Funds Managed



Total Number of Complexes 510

Source: Investment Company Institute

Share of Fund Complexes by Asset Size



Total Number of Complexes 510

Source: Investment Company Institute

Number of Fund Sponsors

2000–2009

- Fund sponsors leaving
- Fund sponsors entering
- Total number of fund sponsors at year-end



Source: Investment Company Institute

Share of Assets at Largest Mutual Fund Complexes

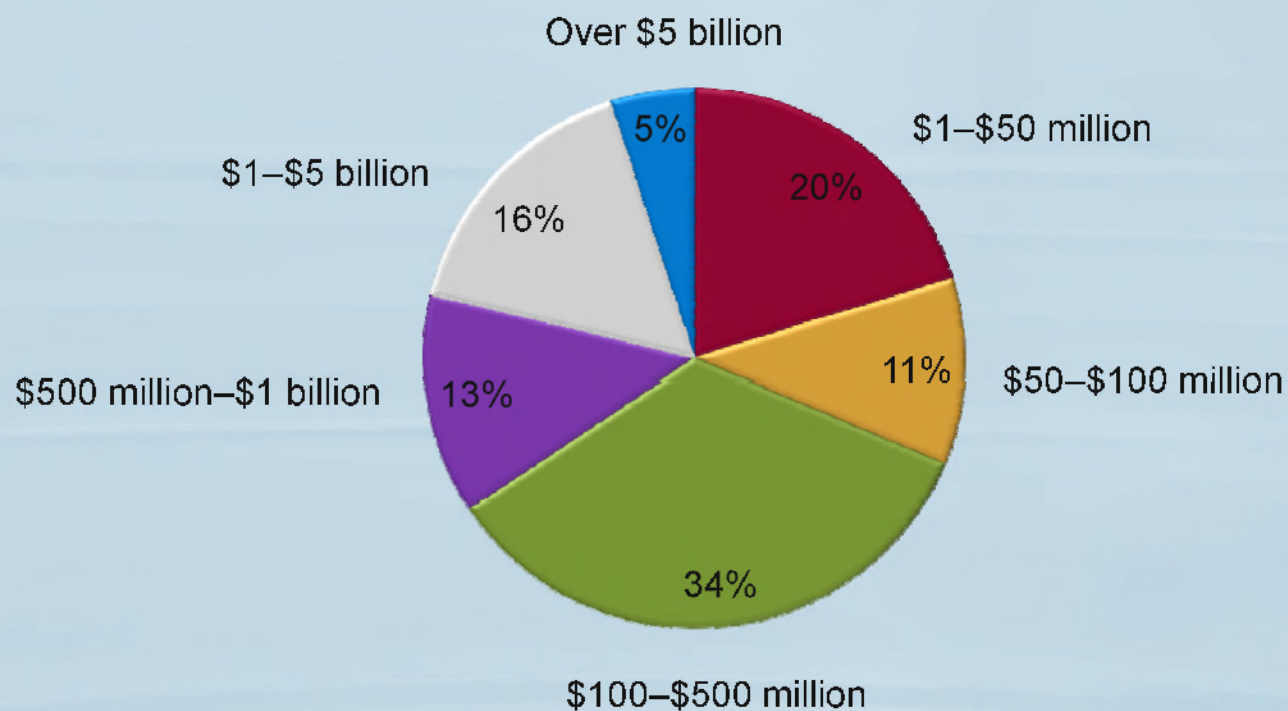
Percentage of industry total net assets, year-end, selected years

	1985	1990	1995	2000	2005	2008	2009	2010*
Top 5 complexes	37	34	34	32	37	38	39	40
Top 10 complexes	54	53	47	44	48	53	53	54
Top 25 complexes	78	75	70	68	70	75	74	74

** Data as of October 2010.*

Source: Investment Company Institute

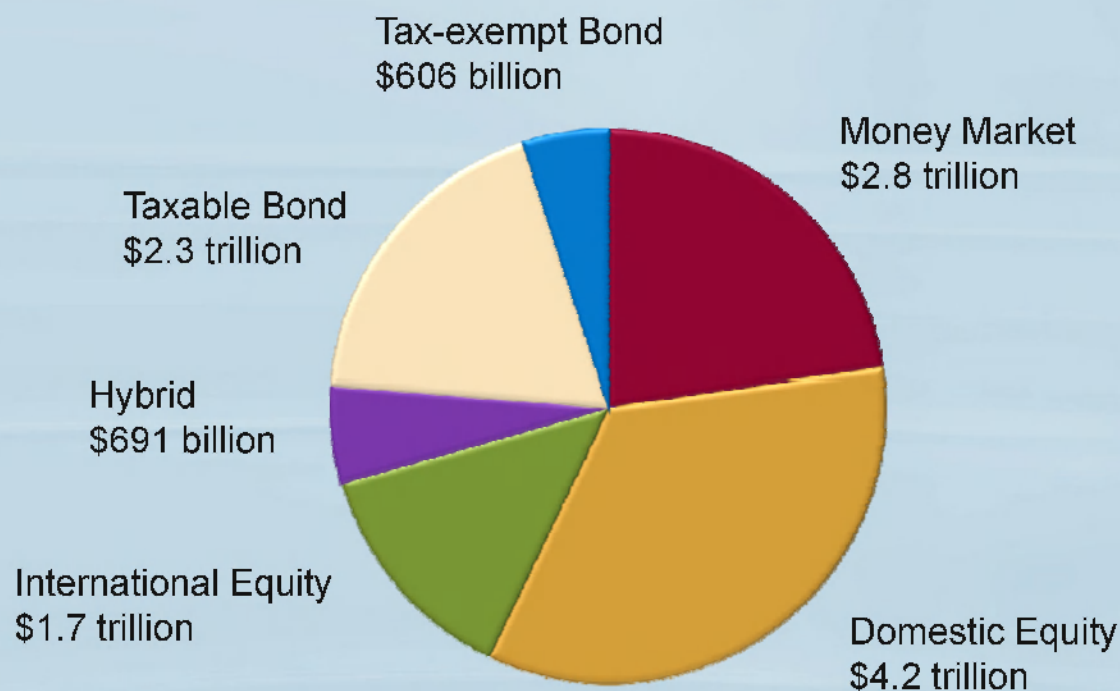
Share of RICs* by Asset Size



Total Number of RICs 9,053

* Includes Mutual Funds, ETFs and Closed-end funds. Excludes funds that invest exclusively in other funds.
Source: Investment Company Institute

Assets of RICs* by Investment Style

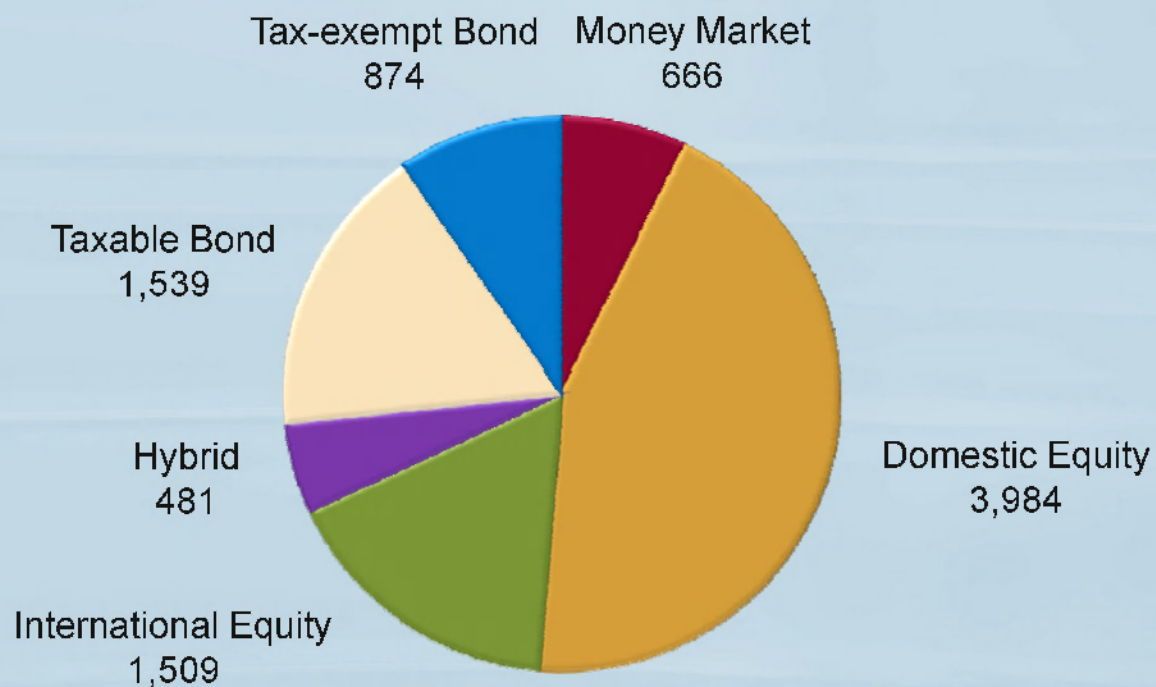


Total Assets of RICs \$12.3 Trillion

* Includes Mutual Funds, ETFs and Closed-end funds. Excludes funds that invest exclusively in other funds.

Source: Investment Company Institute

Number of RICs* by Investment Style



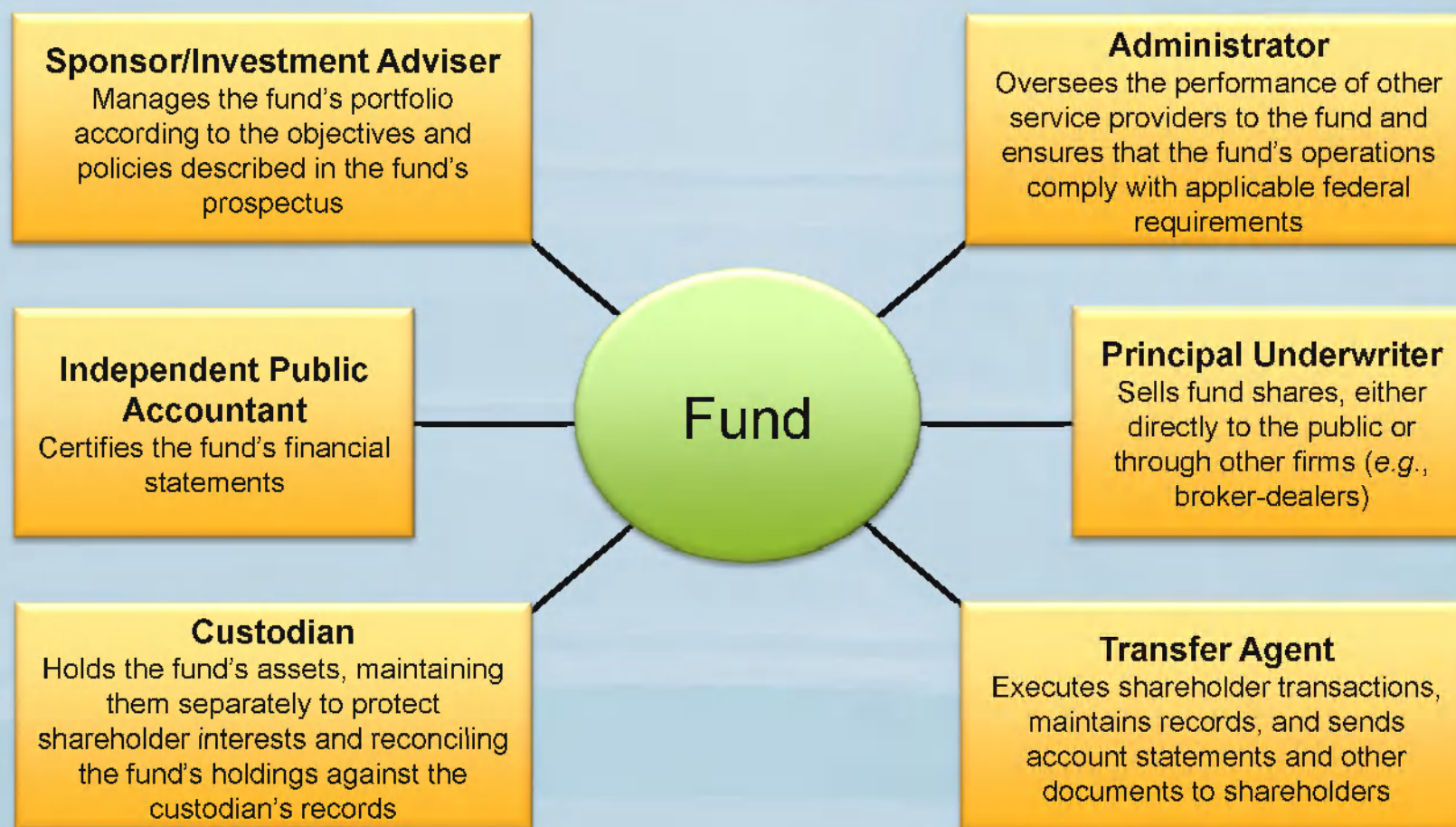
Total Number of RICs 9,053

* Includes Mutual Funds, ETFs and Closed-end funds. Excludes funds that invest exclusively in other funds.
Source: Investment Company Institute

Focus on Mutual Funds: Organization

- Each fund is a separate legal entity, distinct from its sponsor and all other funds
- Funds often are formed as Massachusetts or Delaware business trusts or Maryland corporations
 - Each fund has its own board of directors or trustees
- Virtually all funds are managed externally; they are not operating companies and generally have no employees in the traditional sense
 - Instead, funds rely upon their sponsor/adviser and third-party service providers to manage fund assets and conduct other business, under the oversight of fund boards

Major Service Providers



The Sponsor/Investment Adviser

Sponsor/Investment Adviser

Manages the fund's portfolio according to the objectives and policies described in the fund's prospectus



Fund

- The sponsor/investment adviser is the key service provider
 - Responsible for the concept, design, and launch of the fund
 - Must register with the SEC
 - Subject to the full panoply of regulation under the Investment Advisers Act
 - Must act in the best interest of the fund, as the adviser is subject to a strict fiduciary duty

Regulation of Registered Investment Companies

- Registered investment companies are subject to regulation under each of the four major federal securities laws
 - Securities Act of 1933
 - Securities Exchange Act of 1934
 - Investment Company Act of 1940
 - Investment Advisers Act of 1940
- Registered investment companies also are subject to regulation by state securities commissions and self-regulatory organizations, such as FINRA

Regulation of Registered Investment Companies

- Not all competing investment products are registered with the SEC and regulated the same way as registered investment companies

ICA Registered Funds

Mutual funds, ETFs,
CEFs, UITs

Alternative Products

Hedge funds, private equity funds, venture capital pools, separate accounts, collective investment trusts, commodity pools

Regulation of Registered Investment Companies

- Common exceptions from the definition of “investment company” under the ICA relied upon by alternative products include:
 - Section 3(c)(1): excludes privately offered investment pools with fewer than 100 beneficial owners
 - Section 3(c)(7): excludes privately offered investment pools owned exclusively by “qualified purchasers” such as institutional investors and high net worth clients
 - Section 3(c)(11): excludes bank collective trust funds
 - Rule 3a-4: allows advisers to manage separate accounts for clients

Major Provisions of the Investment Company Act

- Core objectives of the ICA:
 - Protect fund assets
 - Prohibit or restrict affiliated transactions
 - Limit leverage
 - Ensure simple capital structures and balance sheet transparency
 - Ensure liquidity of fund shares by, among other things, daily marked-to-market valuation of the fund's portfolio
 - Provide for strong independent governance and oversight
 - Require full and accurate disclosure and operational transparency

Protecting Fund Assets – Custody

- Fund portfolio assets must be held in a custody arrangement meeting the strict requirements of Section 17(f) of the ICA
- Assets are held by eligible custodian banks
 - The custodial agreement is typically far more elaborate due to ICA requirements than those used for other bank clients
- No party other than the fund has claim to the assets
 - Assets belong to the fund; the adviser and custodian have no right to access, use or rehypothecate fund assets
 - Creditors of the adviser, custodian, and other service providers have no claim against fund assets
 - As a result, the failure of an adviser or custodian would have little impact on the fund

Restrictions on Affiliated Transactions

- The ICA contains a number of strong and detailed prohibitions on transactions between a fund and fund insiders or affiliated organizations (such as the corporate parent of the fund’s adviser)
- Three rules in particular:
 - Provisions generally prohibiting direct transactions between a fund and an affiliate (Section 17(a) and related rules)
 - Provisions generally prohibiting joint transactions, where the fund and affiliate are acting together vis-à-vis a third party (Section 17(d) and related rules)
 - Provisions preventing investment banks from placing or “dumping” unmarketable securities with an affiliated fund (Section 10(f) and Rule 10f-3)
- In addition, board and shareholder approval are required for certain transactions, such as fund mergers and liquidations, that may entail a change in control

Limits on Leverage

- Section 18 of the ICA prohibits the issuance of “senior securities” and strictly limits borrowing and leverage
 - Generally speaking, a senior security is any debt that takes priority over the fund’s shares, such as a loan or preferred stock
 - Any future obligation of the fund must be “covered” by segregating unencumbered, liquid assets at least equal in value to the potential obligation
 - Funds may not borrow, except from banks and subject to 300% asset coverage (total net assets at least three times greater than total aggregate borrowings)

Restrictions on Capital Structure

- The ICA ensures that funds have a simple capital structure
 - Section 18 of the ICA, described on the previous slide, prohibits mutual funds from issuing debt or preferred stock
 - Closed-end funds have somewhat more flexibility in this regard
 - Section 12 of the ICA restricts the amount that funds may invest in securities issued by other investment companies, insurance companies, investment advisers, broker-dealers and underwriters
 - This prevents funds from controlling other investment companies and creating complicated pyramid structures
 - This simple capital structure promotes balance sheet transparency: little/no structural leverage, no joint ventures, no off-balance sheet financing

Ensuring Liquidity of Fund Shares – Restrictions on Portfolio Management

- Provisions for diversification, liquidity, daily valuation, and the payment of redemption proceeds are designed to ensure that mutual funds do not present the risks that might come from concentrated or illiquid portfolios
- Diversification
 - Tax and securities law diversification tests (Subchapter M of the Internal Revenue Code and Section 5 of the ICA)
 - Diversification is not mandatory, but all mutual funds must disclose whether they are diversified under the ICA's standards
- Portfolio liquidity
 - General rule: no more than 15% of fund assets in illiquid securities

Ensuring Liquidity of Fund Shares – Restrictions on Portfolio Management (cont.)

- Daily valuation
 - All fund share transactions are conducted on a “forward priced” basis, at the next computed NAV for the fund (Section 22(c) of the ICA and related rules)
 - The NAV reflects the current market value of the fund’s portfolio securities, calculated according to pricing methodologies established and overseen by each fund’s board
- Prompt payment of redemption proceeds
 - Mutual funds may not suspend redemptions of their shares (subject to certain extremely limited exceptions) or delay payments of redemption proceeds for more than seven days (Section 22(e) of the ICA)

Providing Strong Governance and Oversight (cont.)

- Oversight by the fund board
 - Fund board has primary responsibility for looking after the interests of fund shareholders
 - Must maintain a specified level of independence on the fund board
 - In nearly 90% of fund complexes, 75 percent or more of fund directors are independent of management
 - Although not required, almost two-thirds of fund complexes have an independent director serving as the board's chair and one-fourth of fund complexes have a lead independent director on the board
 - Virtually all independent directors have their own independent counsel (generally with a law firm that does little or no work for the adviser and certain of its affiliates)

Providing Strong Governance and Oversight (cont.)

- Fund board oversight (cont.)
 - Like directors of operating companies, fund directors have duties of loyalty and care under state law
 - Independent fund directors also have specific statutory and regulatory responsibilities under the ICA
 - Oversee the fund's investment program and performance, compliance program and risk management, and use of service providers
 - Approve advisory and underwriting agreements, including specific approval of the fees paid to those service providers for their services

Providing Strong Governance and Oversight (cont.)

- Compliance programs and CCOs
 - All funds and all advisers must have compliance programs and chief compliance officers (CCOs) (Rule 38a-1 under the ICA)
 - Compliance programs must be:
 - In writing
 - Reasonably designed to prevent, detect, and correct violations of the federal securities laws
 - Reviewed at least annually for their adequacy and effectiveness

Providing Strong Governance and Oversight (cont.)

- Compliance program and CCOs (cont.)
 - The CCO is responsible for administering the compliance program
 - At least annually must meet separately with, and provide a written report directly to, the fund's independent directors
 - Report provides overview of the operation of the compliance program at the fund, each adviser, and each principal service provider
 - Report details any material compliance matter that occurred since the last report
 - The fund board oversees the compliance program and is vested with the authority to take corrective action, up to and including discharging service providers

Providing Strong Governance and Oversight (cont.)

- Auditors
 - Fund financial statements are prepared in accordance with GAAP, and must be certified by a public accounting firm subject to oversight by the PCAOB
 - Auditors, among other things, verify the prices for all portfolio securities held by the fund at the report date
- Sarbanes-Oxley certifications
 - Fund officers are required to make certifications and disclosures required by the Sarbanes-Oxley Act

Requiring Disclosure and Transparency

- Funds are subject to more extensive disclosure requirements than any other comparable financial product
- Cornerstone of the disclosure regime is the prospectus
 - Mutual funds must maintain a current (“evergreen”) prospectus, with supplementary amendments (“stickers”) for material changes and annual updates to incorporate current financial statements
 - Prospectus provides investors with information about the fund, including its investment objectives and strategies, risks, fees and expenses, and performance, as well as how to purchase, redeem, and exchange fund shares
 - Performance information and fees and expenses are standardized to facilitate comparisons by investors

Requiring Disclosure and Transparency (cont.)

- Funds also make “statements of additional information” (SAIs) available upon request
 - SAIs include information about the fund that may not be needed to make an investment decision, such as lists of officers, directors, and control persons
- In addition to prospectuses and SAIs, funds provide investors with several other disclosure documents:
 - Annual (audited) and semi-annual reports
 - Form N-Q, with portfolio holding disclosure (together with above reports, funds report all holdings on quarterly basis)
 - Form N-PX, with proxy vote disclosure

Regulatory Oversight

- Funds, their advisers and service providers are subject to strong regulatory oversight
 - Funds are subject to inspections, examinations, and enforcement by their primary regulator, the SEC
 - Fund advertising is overseen by FINRA, a self-regulatory organization
 - State securities regulators have jurisdiction to monitor fraud
 - Increasingly, other regulators are involved as well