

SECTION
One

An Investor's Guide to Mutual Funds

Mutual funds are designed to make life easier for investors. Funds give savers of even modest means access to top-quality investment management combined with a high level of convenience and service, all at a reasonable price.

Since the mission of funds is to serve investors, we start this book by taking a look at mutual funds from an investor's perspective. We give an overview of mutual funds by focusing on four critical questions:

1. Why invest through mutual funds?
2. How do mutual funds work?
3. How do investors research a potential mutual fund purchase?
4. How do investors choose a mutual fund that's right for them?

This section has four chapters:

Chapter 1 provides an introduction to investing through mutual funds. It reviews their advantages and disadvantages, summarizes their history, and discusses how they are used by investors today. It concludes by providing an overview of the entities that work to ensure that funds meet their obligations to investors: the government regulators and the industry associations.

Chapter 2 describes the basic structure and operations of a mutual fund. It begins with a discussion of two key fund features: daily liquidity at

net asset value and pass-through tax status. It explains how funds operate through contracts with service providers supervised by a board of directors, and it discusses the ethical standards that apply to fund managers. Finally, it compares mutual funds to alternative methods of investing, either directly in securities or through other commingled investment vehicles.

Chapter 3 explains how investors can learn about potential mutual fund investments through information provided by the funds themselves. It begins with a review of the principle of disclosure. It then focuses on the summary prospectus of a mutual fund and then continues with an overview of the other parts of the prospectus and of the shareholder reports. It ends with a discussion of how investors can use this information to select mutual funds.

Chapter 4 discusses how investors might go about choosing a mutual fund. It places funds in the context of a personal financial plan, and then explains the various approaches to evaluating fund performance results. It next reviews each type of mutual fund and ends with a discussion of the factors investors should consider when choosing a funds in that category.

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CHAPTER 1

Investing through Mutual Funds

The odds are high that you already own a mutual fund. You're in good company: at the end of 2009, some 87 million people in the United States had invested at least a portion 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, anyone with some 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 at no cost
- Access to the expertise of a professional money manager
- 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
- Full reporting that allows easy comparisons among funds

These benefits have proven to be very popular with investors around the world; they held a total of \$23 *trillion* in fund assets at the end of 2009. American households now put more of their money in mutual funds than

they do in banks, making mutual funds an integral part of financial planning for many people.² We describe a few typical fund buyers in “Mutual Fund Investors.”

MUTUAL FUND INVESTORS

Are you—or is someone you know—in a similar position to 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 baby granddaughters. She opens college savings plan accounts for both, with the intent to make annual contributions to them. 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.
- The executive director of a small nonprofit looking to earn a return on her organization's modest surplus. An institutional money market fund managed by a national bank provides both a competitive yield and easy access to the funds if they're needed to meet any unanticipated expenses.

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 the United States alone, there were more than 7,600 funds to choose from in 2009 with many different investment profiles—from bond funds to emerging market funds. (See “The ABCs of Risk” to understand how diversification helps investors.)

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 β) is the risk of the market overall. Alpha (Greek 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, the 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 apportion your account into stocks around the world to increase the chance that you have at least some money invested in the country that's gaining market share.

While the principle of diversification is simple, implementation can be more complex. For example, it's not entirely clear how many securities are needed to eliminate alpha risk. In the U.S. stock market, for example, many professional investors will tell you that holding 20 to 30 securities is sufficient. The scholarly research, on the other hand, suggests that the number of stocks you need to completely eliminate idiosyncratic risk is both much higher than the practitioners' rule of thumb and rising over time. Although one study from the early 1990s calculates that 50 stocks will do the trick, the subtitle of a 2007 article asserts that "100 Stocks Are Not Enough"—while another study published that same year concludes that for certain types of stocks, such as smaller companies, maybe even 170 holdings won't provide complete diversification.³

- *Daily liquidity.* Investors in mutual funds 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. 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 this easier to do through a mutual fund. Also, some securities are available only to investors with significant assets. For example, some stocks and bonds can be purchased only by qualified institutional buyers responsible for at least \$100 million in assets. While most mutual funds meet this test, very few individuals do. 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 offer their shareholders an easy way to invest, either 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 tax 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 their money through a mutual fund. Just as importantly, funds provide all of this information in a standardized format, which makes it easy to compare offerings.

Mutual funds have disadvantages as well. These include:

- *Fees.* Investors pay for all these benefits. In 2009, stock fund investors on average paid a little under 1 percent—0.86 percent to be precise—of the value of their fund assets for a year's worth of basic management services, including investment management and administration, together with annual marketing charges known as 12b-1 fees. Excluded from the 0.86 percent figure are the trading commissions that funds paid as they bought and sold 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 a shareholder will pay to own a fund 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 0.28 percent or 28 basis points. (See "Basis Points" for a definition of that term.) The fees may be 63 basis points per year on a bond fund bought directly from a fund company. But a small investment in a fund that buys high-growth start-up companies purchased through a financial adviser could cost 1.65 percent in annual fees plus

a one-time sales load of 5.3 percent. (For a full explanation of mutual fund fees, see Chapter 15.)

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.”

Offsetting some of this cost, annual fees are subtracted from a fund's taxable income, making them effectively tax-deductible. In 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. We talk more about fund taxation in the next chapter.
- *Less predictable income.* Dividend and interest income are 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 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. An investor who objects to owning a particular stock can't insist that it be sold out of just his account. A large investor can't get a break on annual fees, which isn't available to other large investors. In fact, whenever one fund investor has been given special treatment, it often leads to scandal in the industry.

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

The mutual fund is a fairly recent invention, dating back only to the beginning of the twentieth century.⁴ That's when Boston law firms began to form trust divisions to manage the assets of wealthy local families. When their wealth became dispersed as it was passed down through the generations, the mutual fund came into existence as a way to jointly manage multiple family accounts. The year 1924 saw the introduction of a new type of fund, the *open-end* fund that was to become the standard for the industry, innovative at the time because it stood ready to accept new money and honor redemption requests from investors on a daily basis. "Funds from the 1920s" provides background on the two oldest funds.

Though the growth of the mutual fund industry was soon stymied by the stock market crash of 1929 and the Great Depression, legislation enacted in the 1930s and 1940s, as part of Franklin Roosevelt's New Deal, created a more regulated, less freewheeling financial industry—an environment that played to funds' strengths. In particular, the Investment Company Act of 1940 established strict operating standards for mutual funds and other types of investment companies, combining limits on fund promotion and portfolio investing with minimum requirements for reporting and pricing. The Act didn't mean much change for open-end funds, which had already adopted most of its provisions, but it did level the playing field by eliminating competition from less scrupulous investment managers.

Nevertheless, the growth rate of mutual funds was modest from the 1940s through the 1970s. Funds invested largely in stocks over this period,

FUNDS FROM THE 1920s

The recent explosive growth of the industry means that the vast majority of mutual funds today are veritable infants. Of the 7,600-plus funds registered at the end of 2009, fewer than one in five are more than 25 years old. Yet a few funds have very long histories. The two oldest U.S. funds are:

Massachusetts Investors Trust. This is the fund that started it all, the first open-end mutual fund, established in 1924. From its very beginning, Massachusetts Investors Trust adopted the shareholder protections that would only later become standard in the industry, including a willingness to redeem investments every day and to disclose its holdings regularly. MIT opened its own offices and hired its first full-time employee during the Great Depression, and by 1959, when *Time* magazine featured it in a cover story on mutual funds, it was the biggest fund in the industry, with assets of \$1.5 billion. Today, MIT is part of the MFS family of funds. It invests in high quality companies with superior growth characteristics, whose stocks are selling at reasonable prices.

The Pioneer Fund. In 1928 Philip Carret, then a journalist working for *Barron's*, started a small, family-funded investment trust, originally called the Fidelity Investment Trust. Carret managed the portfolio himself for 23 years with a goal to “buy values—not fancy names.”⁵ Today's Pioneer Fund pursues reasonable income and capital growth by investing in stocks as part of the Pioneer fund family.

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 under the Federal Reserve Act—capped the rates that a bank could pay on

savings and checking accounts to less than 5 percent. Fat rates of interest were available only on \$10,000 Treasury bills and \$100,000 certificates of deposits, 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 those 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 in the 1980s and 1990s

Once investors had been introduced to the advantages of money market funds, they were quick to turn to mutual funds for other investment needs. From 1984 to 2009, U.S. mutual fund assets increased 30-fold, from \$370.7 billion to \$11.1 *trillion*, a compound annual growth rate of 15.0 percent. Adjusted for inflation, that's an annual growth rate of 11.3 percent, significantly higher than the 2.8 percent per year gain in real gross domestic product over that same period.⁶ Perhaps even more remarkably, total fund assets declined in only two of those 25 years, as a result of post-bubble declines in the stock market in 2002 and 2008. (The growth trajectory is shown in Figure 1.1.)

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 the savings already invested in mutual funds. At the same time, the very

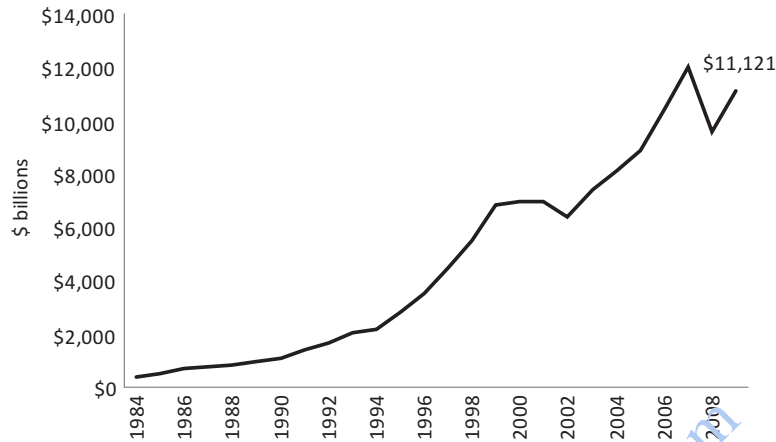


FIGURE 1.1 Growth in U.S. Mutual Fund Assets
Source: Investment Company Institute.

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 credit crisis. (See “The Crashes” for an introduction to both.)

THE CRASHES

There have been two times in the past 15 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 *credit 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.

- *Tax-exempt funds.* Tax-exempt funds were developed in the late 1970s, after legislation was enacted that eliminated a tax penalty on municipal bonds owned through a mutual fund.⁷ 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 following decade brought consumers to a field of investing formerly available only to large institutions.
- *Target-date funds.* More recently, the development of target date funds, a type of hybrid fund investing in varying amounts of both stocks and bonds, has created a new alternative for individuals saving for retirement.

This broad range of offerings has ensured that the fund industry can provide options for all economic environments. Figure 1.2 shows how, from

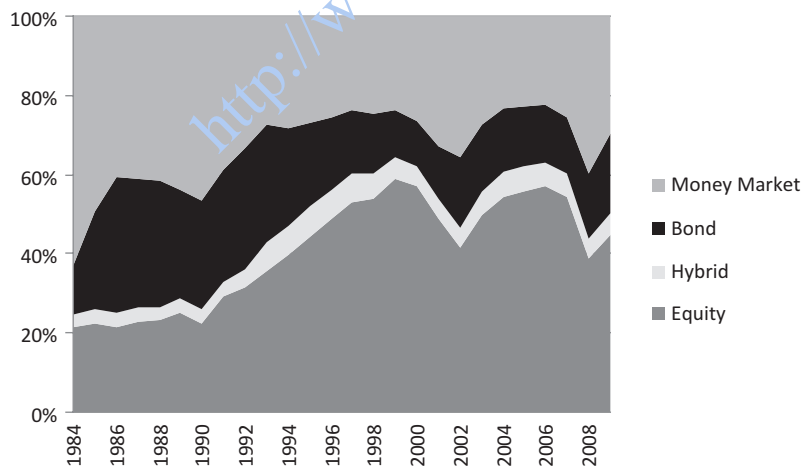


FIGURE 1.2 Share of Assets by Fund Type
Source: Investment Company Institute.

1984 through 2009, assets have shifted among the four main types of mutual funds: stock funds, bond funds, money market funds, and hybrid 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 and hybrid funds moved to center stage at the start of the 1990s, so that by the end of the decade, they were almost two-thirds of the fund industry. Since then, their popularity has tracked the rise and fall of the stock market. Money market and bond funds have generally provided a haven for investors in those periods when stock funds are out of favor. At the end of 2009, equity and hybrid funds together accounted for 50 percent of the mutual fund industry, and money market funds 30 percent, with bond funds making up the balance.

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 8.5 percent of the amount invested.

DEALING WITH BROKERS

A *broker-dealer* is firm that buys or sells securities, either for clients or for its own account. Broker-dealers are sometimes called *brokerage firms*. Merrill Lynch, Morgan Stanley Smith Barney, and Edward Jones are all examples of broker-dealers.

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. That’s why one publication targeted at brokers is titled *Registered Rep*.

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, directly to the public, avoiding intermediaries altogether. Because they did not involve a sales load, direct sales 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, and perhaps the most significant, 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 services provided have been so popular that retirement accounts now make up more than one-third of industry assets. At the same time, mutual funds have become a critical component of the nation's retirement system, accounting for 25 percent of retirement plan assets at the end of 2009.

Distribution through intermediaries has evolved. Today, both banks and insurance companies sell funds to the public, the latter often through variable annuity contracts or life insurance policies. 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, into a complete financial solution which charges an additional and 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, as we see in Chapter 17. At the end of 2009, investor ownership of mutual funds outside the United States exceeded a total of \$11 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

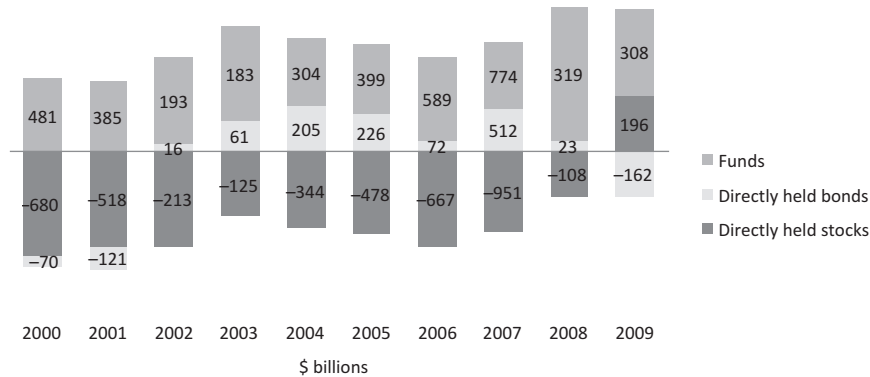


FIGURE 1.3 Household Net Investments in Funds, Bonds, and Stocks⁸
 Source: Investment Company Institute.

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

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. In 1989, only 39 percent of U.S. households owned bonds and stocks. That figure soared to 57 percent in 2001, before tailing off to 49 percent. Many of the investors buying stocks and bonds for the first time made their purchases through mutual funds.

By the end of 2009, some 43 percent of all U.S. households—50.4 million in total—had invested at least some of their assets through 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 40 percent to 45 percent in the past decade.

So who are these individuals? In 2009, they were likely to be employed college graduates of middle age; most had a spouse or a partner sharing responsibility for financial decision making. Their median household income was \$80,000, with median financial assets (excluding their home) of \$150,000. Mutual fund owners did not generally fall into the ranks of the very wealthy: only 22 percent had financial assets exceeding \$500,000 and just 16 percent earned more than \$150,000 annually.

A few more facts: The average fund-owning household had invested \$80,000 in four different funds.⁹ Funds represented the majority of financial assets for 66 percent of these households. Their most important reason by

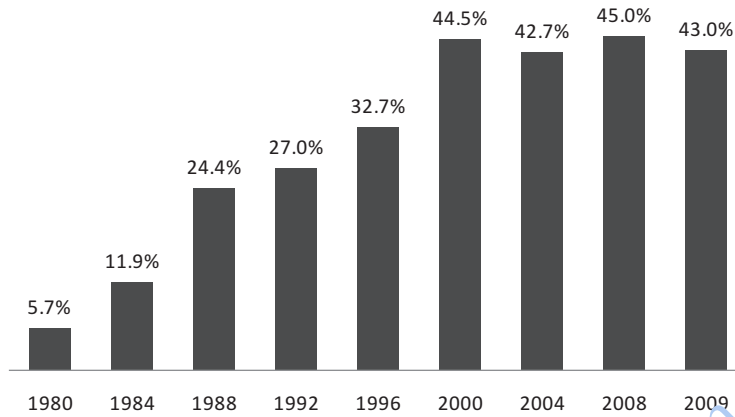


FIGURE 1.4 Percentage of U.S. Households Owning Mutual Funds
 Source: Investment Company Institute.

far for investing in funds was to prepare for retirement, although they were also concerned about reducing taxable income, meeting emergency needs, financing education, providing income, and saving for a house or other large purchase. More than 80 percent participated in a retirement plan sponsored by their employer, with more than a quarter owning funds only as a part of that plan. Table 1.1 provides the data.

TABLE 1.1 Profile of Mutual Fund Investors (2009)

Demographic Characteristics	
Median age	50
Married or living with a partner	76%
Employed, whether full-time or part-time	73%
College graduates	47%
Partners share financial decision making	61%
Financial Characteristics	
Median household income	\$80,000
Less than \$50,000	23%
Between \$50,000 and \$150,000	61%
More than \$150,000	16%
Median household financial assets (excludes primary residence, but includes employer-sponsored retirement plan)	\$150,000
Less than \$500,000	78%
Participate in employer-sponsored retirement plan	82%

Source: Investment Company Institute.

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 subsequent regulations is the Securities and Exchange Commission; it works closely with FINRA, the Financial Industry Regulatory Authority. The Department of Labor also plays a role through its regulation of employer-sponsored retirement plans. Finally, the states are often involved in investigating and prosecuting violations of the rules.

The fund industry associations play a key role in helping the industry handle the high level of regulatory oversight. The Investment Company Institute is the principal advocate for the industry with legislators and regulators, while NICSAs, the National Investment Company Service Association, provides educational programs on the implementation of new regulations.

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 securities laws. Its mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."¹⁰ 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*.
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.”

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 is cause to believe that a firm is violating a significant rule. 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.

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 Risk, Strategy, and Financial Innovation* was created in 2009. It studies longer-term trends in the financial markets and makes recommendations on how the SEC might adapt its regulatory approach in light of them.

By law, the SEC must follow a lengthy procedure whenever it considers new regulations. This process works as follows:

- 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, it’s typically firms in the industry that provide 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. 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. As a result, while new regulations can be approved by a simple majority of the SEC commissioners, they almost always receive their unanimous support. The few instances when a decision has been made over the dissent of one or two commissioners have been newsworthy. A split decision did occur in 2010 when the commissioners divided over whether to pursue an enforcement action against Goldman Sachs. (They voted three to two to proceed.) But the last time it happened before that was in 2004.¹¹

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 they would like to undertake but aren’t sure is permitted. The SEC staff studies the proposed action, and, if they feel that it does not 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 action might lead to enforcement action.

For example, in a recent no-action letter it issued, the SEC staff said that it would not recommend enforcement action if Bear Stearns Asset Management, after its emergency acquisition by J.P. Morgan during the credit crisis, continued to act as the investment adviser to the mutual funds it managed before the acquisition. The no-action letter was needed because Bear Stearns’s contract to manage the fund was legally terminated upon the change in ownership, and the takeover happened so swiftly that there wasn’t time to prepare a new contract and seek approval from fund investors in advance.

Most no-action letters address subtle or arcane issues in the interpretation of the regulations—or unique situations (as in the Bear Stearns case)—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.

More information on the SEC is available on its web site: 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 protect America's investors by making sure the securities industry operates fairly and honestly."¹² FINRA took on its current name when its predecessor, the NASD (National Association of Securities Dealers, once part of the NASDAQ stock market) 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 web site 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), and the supervisors of the selling brokers (Series 24). It has also proposed that many operations professionals, especially those dealing with customer accounts, be licensed as well.
- It reviews almost all sales and advertising materials produced by the funds and may bring disciplinary proceedings against firms or individuals for violations of fund advertising or sales rules.
- It limits the sales loads on securities that broker-dealers sell, which effectively enables it to set maximum limits on the sales loads the funds charge. This maximum is currently 8.5 percent of the amount invested.

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 SRO in the investment industry is the Municipal Securities Rulemaking Board, which monitors the market for municipal bonds.

Department of Labor

Why would the Department of Labor be involved with the regulation of mutual funds? Because the DOL is responsible for overseeing employer-provided retirement plans. As we've seen, retirement plans have come to represent a significant proportion of mutual fund assets. Acting through its division of Employee Benefits Security Administration or EBSA, the DOL sets rules regarding plan terms and reporting to participants, which include both current and retired employees. Mutual funds offering retirement plans must be cognizant of DOL regulations. For more on the DOL's role in retirement plans, go to www.dol.gov/ebsa.

State Regulators

State regulation of mutual funds has changed significantly over the past 15 years. Until 1996, most states maintained their own regulatory agencies with their own rules—often inconsistent with those established by the SEC. To bring some order to the chaos, Congress enacted the National Securities Markets Improvement Act. 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 recently been flexing their muscles in this regard. For example, in 2003, the New York State Attorney General's office was instrumental in uncovering and pursuing abuses regarding trading in mutual fund shares, as is discussed 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. At the end of 2009, ICI member firms managed funds with assets representing over 93 percent of the industry total. Its web site is www.ici.org.

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 devotes considerable resources to advocacy. According to the Center for Responsive Politics, in

2009 it spent \$5.5 million on lobbying and employed nine in-house staff in lobbying activities. Its political action committee made \$695,000 in contributions to federal candidates in the 2008 election cycle.¹³

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. In 2009, it produced close to 150 reports with statistics on the mutual fund business (many of them cited in this chapter). The ICI also holds well-attended conferences for industry participants and generates materials for investor education.

NICSA

NICSA (*Nick-sa*), the National Investment Company Service Association, 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's mission is solely educational. Like the ICI, it is a membership organization; unlike the ICI, it does not engage in any lobbying. Instead, it organizes both live conferences and webinars that brief managers on the latest business developments. It also sponsors discussion groups that develop and codify best practices for complying with regulations.

NICSA's web site at www.nicsa.org has information on its programs.

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 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. Today, mutual funds are held by 43 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 FINRA, the Department of Labor, 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 NICSAs, the National Investment Company Service Association, provides educational programs on the implementation of new regulations.

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