

## The Structure and Regulation of Mutual Funds

**M**utual funds are highly regulated financial entities that must comply with federal laws and regulations. In particular, the U.S. Securities and Exchange Commission (SEC) regulates mutual funds under the Investment Company Act of 1940. The 1940 Act imposes restrictions not only on mutual funds but also on their investment advisers, principal underwriters, directors, officers and employees. The 1940 Act also regulates the two other types

of investment companies—closed-end funds and unit investment trusts.

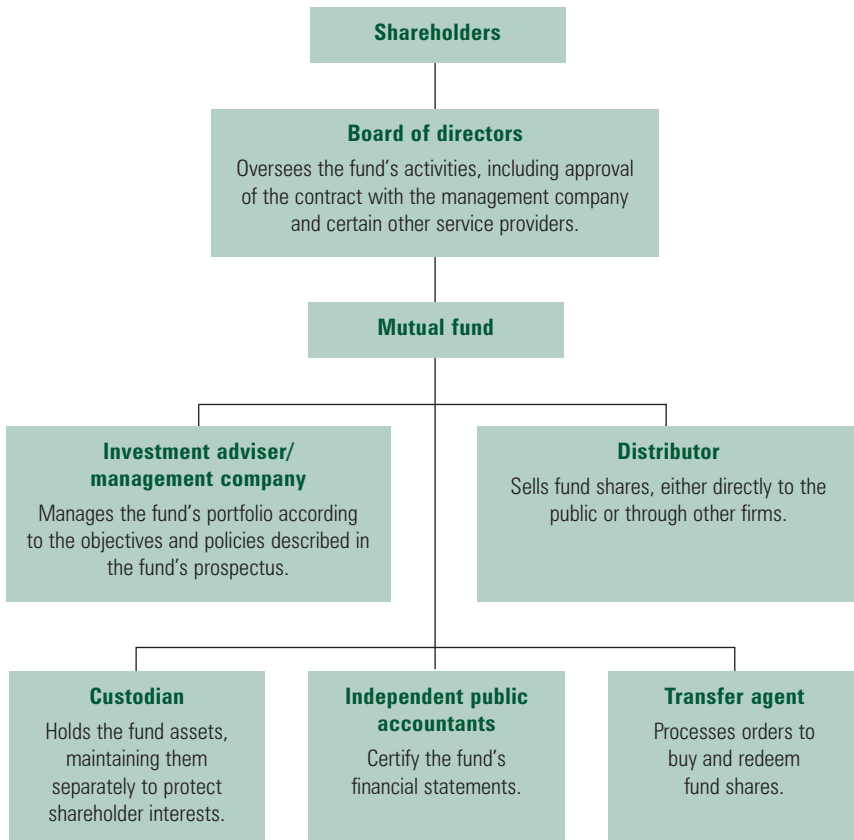
Virtually all mutual funds are externally managed. They do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors. The diagram on page 30 depicts a typical mutual fund complex, including its principal service providers.

### Four Principal Securities Laws Govern Mutual Funds

- ▶ **The Investment Company Act of 1940** regulates the structure and operations of mutual funds. Among other things, the 1940 Act requires mutual funds to maintain detailed books and records, safeguard their portfolio securities, and file semiannual reports with the U.S. Securities and Exchange Commission (SEC).
- ▶ **The Securities Act of 1933** requires the federal registration of all public offerings of securities, including mutual fund shares. The 1933 Act also requires that all prospective investors receive a current prospectus describing the fund.
- ▶ **The Securities Exchange Act of 1934** regulates broker-dealers, including mutual fund principal underwriters and others who sell mutual fund shares, and requires them to register with the SEC. Among other things, the 1934 Act requires registered broker-dealers to maintain extensive books and records, segregate customer securities in adequate custodial accounts, and file detailed, annual financial reports with the SEC.
- ▶ **The Investment Advisers Act of 1940** requires federal registration of all investment advisers to mutual funds. The Advisers Act contains various antifraud provisions and requires fund advisers to meet recordkeeping, reporting and other requirements.

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## The Structure of a Mutual Fund



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### DIRECTORS

A mutual fund is governed by a board of directors. The directors of a mutual fund have oversight responsibility for the management of the fund's business affairs. They must exercise the care that a reasonably prudent person would take with his or her own business. They are expected to exercise sound business judgment, establish

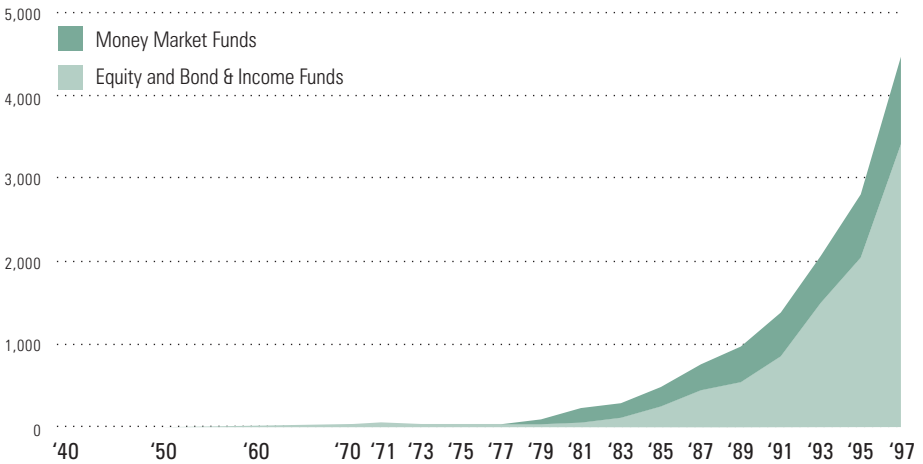
procedures and undertake oversight and review of the performance of the investment adviser, principal underwriter and others that perform services for the fund.

A provision of the 1940 Act states that at least 40 percent of a fund's board of directors must be independent of the fund's investment adviser or principal

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## Assets of Mutual Funds

(billions of dollars)



Note: See page 116 for data points on this chart.

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underwriter. Independent fund directors serve as watchdogs for shareholder interests and oversee a fund's investment adviser and others closely affiliated with the fund.

### SHAREHOLDERS

Like shareholders of other companies, mutual fund shareholders have specific voting rights. These include the right to elect directors at a meeting called for that purpose (subject to a limited exception for filling vacancies). Material changes in the terms of a fund's investment advisory contract must be approved by a shareholder vote, and funds seeking to change investment objectives or policies

deemed fundamental must also seek shareholder approval.

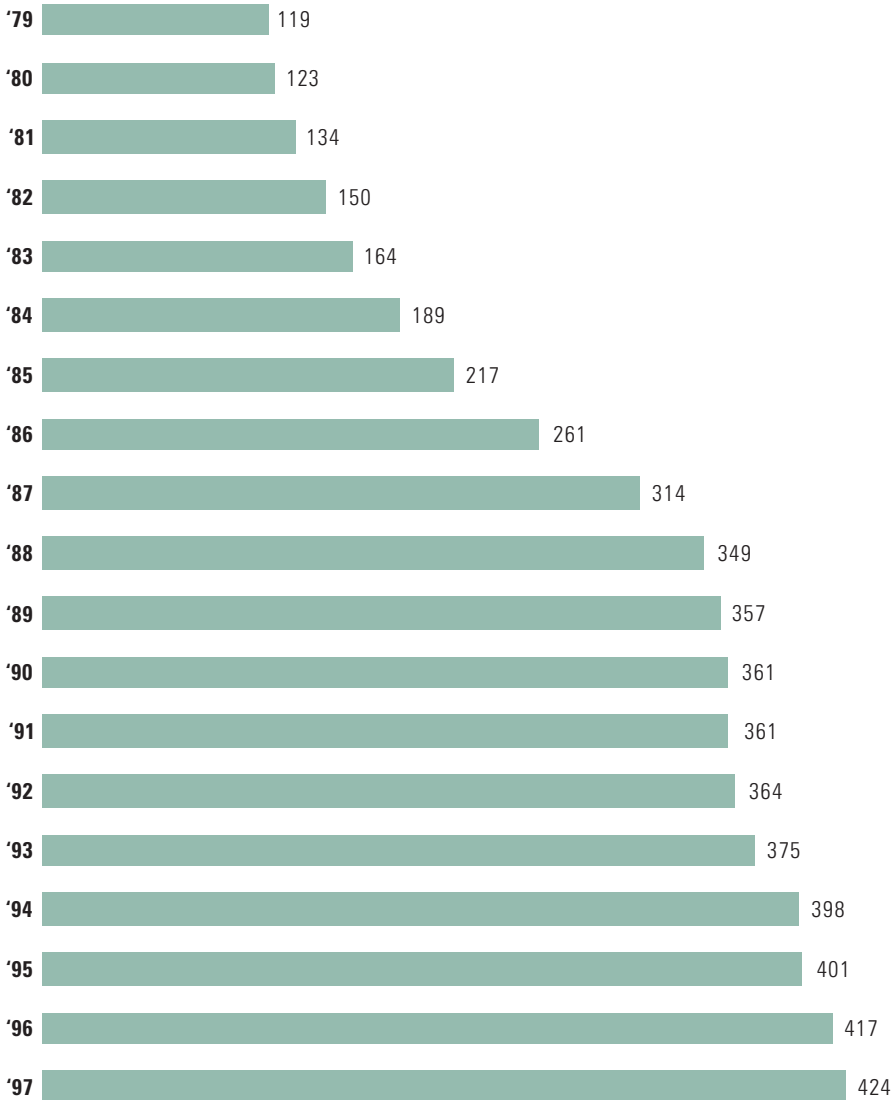
### INVESTMENT ADVISER

An investment adviser is responsible for selecting portfolio investments consistent with objectives and policies stated in the mutual fund's prospectus. The investment adviser places portfolio orders with broker-dealers and is responsible for obtaining the best overall execution of those orders.

A written contract between a mutual fund and its investment adviser specifies the services the adviser performs. Most advisory contracts provide for the adviser to

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## Number of Mutual Fund Complexes\*



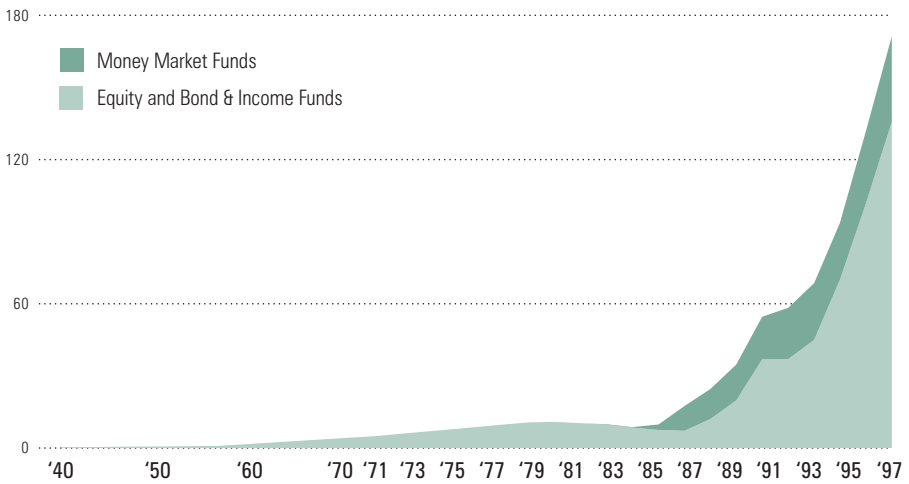
\*Investment Company Institute member firms (accounting for 95% of mutual fund industry assets)

Note: A fund complex is a group of funds under substantially common management (or distributorship), composed of one or more families of funds.

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## Mutual Fund Shareholder Accounts

(millions)



Note: See page 116 for data points on this chart.

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receive an annual fee based on a percentage of the fund's average net assets.

The adviser is subject to numerous legal restrictions, especially regarding transactions between itself and the fund it advises.

### ADMINISTRATOR

Administrative services may be provided to a fund by an affiliate of the fund, such as the investment adviser, or by an unaffiliated third party. Administrative services include overseeing the performance of other companies that provide services to the fund and ensuring

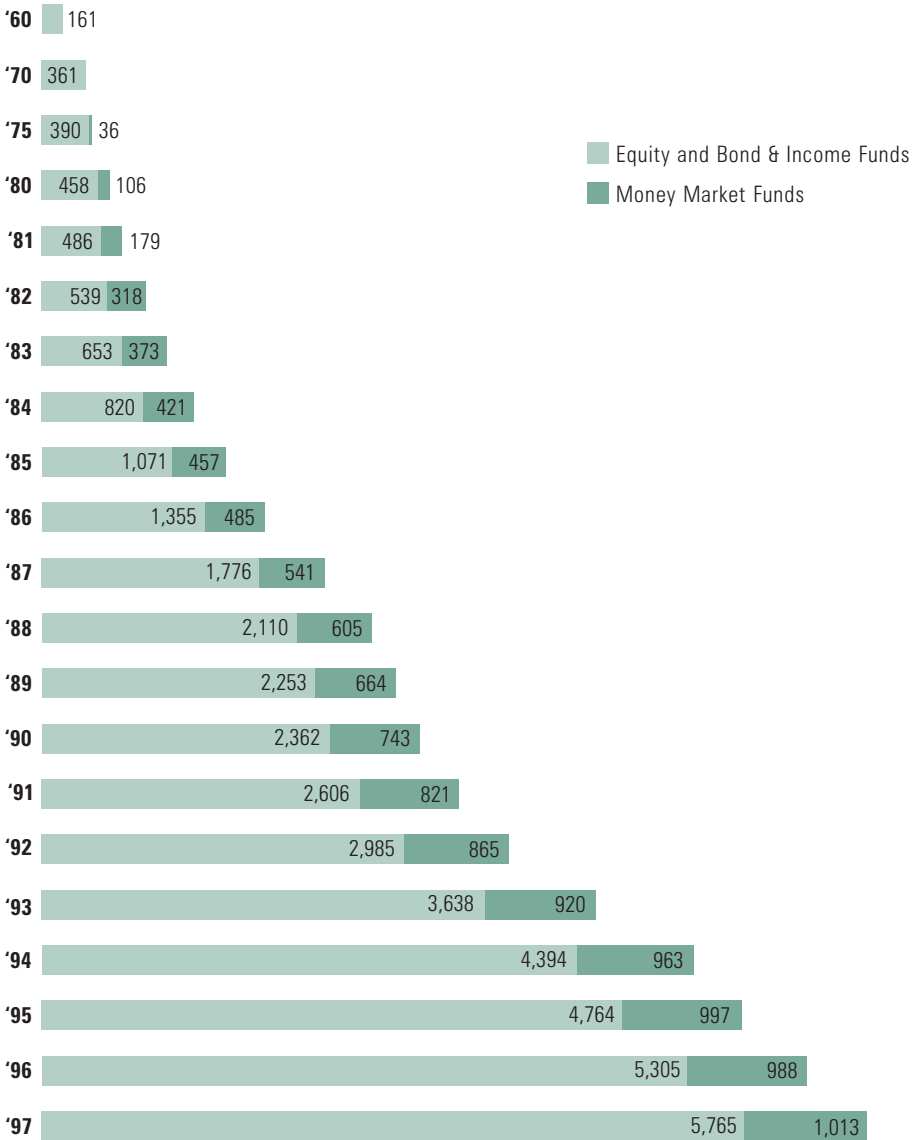
that the fund's operations comply with federal requirements. Typically, a fund administrator pays for office costs and personnel, provides general accounting services and may also prepare and file SEC, tax, shareholder and other reports.

### PRINCIPAL UNDERWRITER

Most mutual funds continuously offer new shares to the public at a price based on the current value of fund assets plus any sales charges. Mutual funds usually distribute their shares through principal underwriters. Principal underwriters are regulated as broker-dealers and

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## Number of Mutual Funds



are subject to National Association of Securities Dealers, Inc. (NASD) rules governing mutual fund sales practices.

## CUSTODIAN

Mutual funds are required by law to protect their portfolio securities by placing them with a custodian. Nearly all mutual funds use qualified bank custodians. The SEC requires mutual fund custodians to segregate mutual fund portfolio securities from other bank assets.

## TRANSFER AGENT

A transfer agent is employed by a mutual fund to conduct record-keeping and related functions. Transfer agents maintain records of shareholder accounts, calculate and disburse dividends, and prepare and mail shareholder account statements, federal income tax information and other shareholder notices. Some transfer agents prepare and mail statements confirming shareholder transactions and account balances and maintain customer service departments to respond to shareholder inquiries.