Abstinence in the Face of the Mutual Fund Debt Elixir: In Response to Professor John Morley

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In recent years, a combination of bruising market losses, increased correlation among asset classes, unexpected illiquidity and high-profile scandals has left the investment management industry reeling.[1] In the wake of the Great Recession,[2] asset managers find themselves scrambling to respond to significant shifts in investor behavior and an evolving regulatory landscape.[3] Two of the most observable trends have been (i) the investing class's increasing appetite for alternative streams of return and (ii) a noticeable desire for more regulated investment vehicles.[4]

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[1] *See generally Exotic to Mainstream: Growth of Alternative Mutual Funds in the U.S. and Europe* 2, SEI INVESTMENTS CO. (May 4, 2010), http://www.seic.com/docs/IMS/SEI-ExoticMaintsteam-US.pdf.

[2] For a discussion of the Great Recession and its causes, *see* STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW at xi-xvii (2012); and Michael C. Macchiarola, *Beware of Risk Everywhere: An Important Lesson From the Current Credit Crisis*, 5 HASTINGS BUS. L.J. 267, 269-273 (2009).

[3] *See, e.g.* Exploring Strategies in Response to a Shifting Landscape, J.P. MORGAN INVESTOR SERVICES (2013), available at https://www.jpmorgan.com/cm/-BlobServer/is_exploring_strategies_in_response.pdf?blobkey=id&blobwhere-=1320605420833&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs (noting that today's asset managers are confronting "numerous challenges, including capturing new capital from investors, escalating competition, increased regulatory requirements, operational complexity and profit margins that are still below pre-crisis levels.").

[4] *See generally The Rise of Liquid Alternatives & The Changing Dynamics of Alternative Product Manufacturing and Distribution*, CITI PRIME SERVICES (May 2013) at 4 (observing a "growing need for alternative strategies" and a "flattening of the differences between publicly offered and privately offered funds.").

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As an investment professional involved in today's "liquid alternatives" mutual fund movement,[5] I was quite pleased to come across Professor John Morley's "The Regulation of Mutual Fund Debt" in the *Yale Journal on Regulation*.[6] The article grapples—albeit from an academic point of view—with many of the issues that fund structurers encounter, on a more practical level, as we imagine, structure and develop innovative products for investors. Morley's article represents a significant contribution to the discussion of mutual fund regulation, providing—in the professor's own words—"the first general examination of mutual fund capital structure regulation under the Investment Company Act of 1940."[7] More basically, Morley's article succeeds in establishing a firm foundation for additional examination and discovery and highlights the importance of imagining what might be instead of settling for what already is.

This short Response (the "Response") attempts to buttress the still nascent discussion surrounding mutual fund capital structure. Moreover, the Response encourages Professor Morley and the broader academic community to advance the examination of investment vehicles and their limitations in light of the evolving needs of today's investing public. The seriousness and complexity of the subject matter, and its tangible ramifications for investors, necessitate a more thorough examination. And it is hoped that this Response plays some role in promoting that discussion.

This Response proceeds in three parts. Part I represents the heart of the Response, reintroducing the basic framework through which the article's author analyzes the features unique to the mutual fund capital structure. This Part suggests that the strictures imposed

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[5] According to one study, "[a]ssets in U.S. alternative mutual funds and Exchange Traded Funds (ETFs) have more than doubled since 2008, and now represent 883 portfolios with more than $550 billion in assets." *The Retail Alternatives Phenomenon: What Enterprising Private Fund Managers Need To Know* 2, SEI INVESTMENTS CO. (June 12, 2013), http://www.seic.com/docs/IMS/SEI-IMS-RetailAlternatives-US-2013.pdf.

[6] John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343 (2013).

[7] *Id.* at Abstract. All statutory references to the Investment Company Act of 1940 (ICA) are to 15 U.S.C. § 80(a) (2006), and, unless otherwise stated, all references to the rules under the Investment Company Act of 1940 are to 17 C.F.R. 270 (2013).

on mutual fund capital structure represent a small part of the patchwork that forms the Investment Company Act of 1940 ("the Act"). The individual sections of the Act are not easily decoupled. Instead, the overall application of the entire Act exceeds the sum of its parts. As importantly, structuring choices and regulatory limitations have tangible effects on investors. Part II challenges the regime proposed by the article, arguing briefly that a regulatory accommodation allowing mutual funds to issue debt would not fulfill enough of an investor need to justify the change and, at the same time, might not be as harmless as the Article suggests. Finally, Part III concludes the Response by cautioning that any change to the regulation of mutual funds requires further consideration and deliberation.

Part I

As we approach the three-quarter century mark since the adoption of the Investment Company Act and the accompanying Investment Advisers Act of 1940, it is important to remember that, whatever its shortcomings, the regulation of mutual funds has served investors quite well.[8] As Professor Morley acknowledges, the current regulatory regime deserves credit for an "almost complete absence of bankruptcies among mutual funds in the last 70 years."[9] Against such a backdrop, any changes similar to those suggested in the article face an uphill battle.

Nonetheless, the article makes a significant contribution by (i) examining the possible explanations for the blanket prohibition on the issuance of mutual fund debt securities and (ii) daring to ask whether mutual funds should be freed from the restriction, to "be allowed to issue debt securities to the public."[10]

There are, however, shortcomings in the approach offered by Professor Morley. First, by focusing almost exclusively on the provi-

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[8] *See, e.g.*, Paul Roye, Division Director of Div. of Inv. Mgmt., U.S., Sec. & Exch. Comm'n, Keynote Address at the EEESI General Membership Meeting 2000: Regulation of Mutual Funds in the United States: A Successful Regulatory Regime (Sept. 22, 2000) (transcript available at http://www.sec.gov/news/speech/spch402.htm) (noting that the Investment Company Act "has proved to be remarkably resilient").

[9] Morley, *supra* note 6, at 346.

[10] *Id.* at 347.

sions of the Investment Company Act that directly address capital structure, the article glosses over some of the other protections mutual fund regulations typically afford investors.[11] Second, the article's proposal—allowing mutual fund debt issuance regulated as to form and amount—is likely to be met with all of the subjectivity of the current "senior security" regime without the benefit of seventy years of industry practice and regulatory interpretation.[12]

The provisions of the Act directly addressing capital structure cannot be understood in isolation. To the contrary, they represent a single part of a more robust regime. In describing the scope of the Act, a former SEC Commissioner once observed:

> It places substantive restrictions on virtually every aspect of the operations of investment companies; their governance and structure, their issuance of debt and other senior securities, their investments, sales and redemptions of their shares, and, perhaps most importantly, their dealings with service providers and other affiliates.[13]

In addition to the provisions directly addressing capital structure,[14] specific portions of the Act protect investors in terms of diversification,[15] disclosure,[16] liquidity[17] and price transparency.[18]

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[11] For a summary of some of those protections, see Dianne M. Sulzbach & Philip T. Masterson, *Offering Alternative Investment Strategies in a Mutual Fund Structure: Practical Considerations*, THE INVESTMENT LAWYER (Oct. 2008).

[12] For a summary of some of the SEC's interpretations of the "senior security" provisions of Section 18 of the Investment Company Act, see *Registered Investment Company Use of Senior Securities——Select Bibliography*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm (last visited Feb. 1, 2014).

[13] Roye, *supra* note 8.

[14] For example, Section 18(f)(1) prohibits a mutual fund from issuing any class of senior security, or selling any class of senior security of which it is the issuer. Funds are generally permitted to borrow from a bank provided that immediately after any such borrowing there is asset coverage, as defined in section 18(h), of at least 300%. The Commission and the staff have indicated, however, that they will not object to funds engaging in certain types of transactions without complying with the asset coverage and other requirements of section 18(f)(1), provided that the funds segregate assets, or otherwise "cover" their obligations under the instruments, consistent with Commission and staff guidance. *See* 15 U.S.C. § 80a-18 (2012).

Also, the unique tax status of mutual funds adds an additional layer of protection by requiring a reasonable amount of diversification. The taxation of mutual funds is governed by subchapter M of the Internal Revenue Code.[19] Unlike most corporations, mutual funds are not subject to entity-level taxation on their income or capital gains, provided that they meet certain gross income, asset, and distribution requirements.[20] In addition, at the close of each quarter, a fund

[15] Section 5(b) of the Investment Company Act categorizes a fund as a "diversified company" or "non-diversified company" based on the quality and diversity of its total assets. Absent a shareholder vote, Section 13(a) prohibits a funds from (i) changing from diversified to non-diversified and (ii) deviating from the investment policy or concentration policy stated in its registration statement. *See id.* §§ 5(b) & 13(a).

[16] In pertinent part, Section 30(b)(1) of the Investment Company Act requires that every registered investment company file with the Commission "such information documents and reports (other than financial statements) as the Commission may require to keep reasonably current the information and documents contained in the registration statement of such company." ICA § 30(b)(1). A Fund's quarterly filing of portfolio holdings is accomplished on Form N-CSR or Form N-Q and, depending on circumstances and timing, need not be audited. *See generally*, Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies Securities and Exchange Commission 17 CFR Parts 210, 239, 249, 270, and 274 [Release Nos. 33-8393; 34-49333; IC-26372; File No. S7-51-02], available at https://www.sec.gov/rules/final/33-8393.htm.

[17] SEC guidelines require a mutual fund to have at least eighty-five percent of its assets in liquid securities. A security is generally deemed to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the mutual fund has valued it. *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992) (noting that the eighty-five percent standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies"). Although the Commission has rescinded the Guidelines to Form N-1A, most of the positions taken in the Guidance, including those relating to liquidity, continue to represent the SEC staff's position.

[18] Nearly all funds offer shareholders liquidity and market-based valuation of their investments at least daily. Mutual fund shares are redeemable on a daily basis at a price reflecting the current market value of the fund's portfolio, calculated according to pricing methodologies established by the fund's board of directors. *See generally* ICA § 2(a)(41); 17 C.F.R. 270.22c-1.

[19] *See* I.R.C. § 851-855.

[20] The "Qualifying Income" test provides that to qualify as a regulated investment company at least ninety percent of a mutual fund's gross income must be derived from certain sources, including dividends, interest, payments with respect to securi-

must hold a mix of assets that qualify it as a "regulated investment company" and provide a reasonable level of diversification.[21]

After summarizing the capital structures available to mutual funds and examining several possible legislative motives informing the decision to prohibit mutual funds from issuing debt securities, Professor Morley concludes that the regulation of mutual funds' capital structure is "incoherent."[22] Any such incoherence, however, might be in the eye of the beholder. And, while no structure can insulate an investor from market losses, the mutual fund regulatory framework has been remarkable for the breadth and depth of its regulation and the lack of mutual fund bankruptcies or scandals that have occurred during its time in place.[23]

Morley's main proposal is to lift the ban on debt issuance in favor of a regime that manages some allowable level of debt.[24] In many ways, this proposal sets out to solve a problem that does not exist. There seems scant evidence of an investing public clamoring for something that the mutual fund debt elixir will cure. In fact, investors have been inundated with innovative new products in recent years.[25] Perhaps the current prohibition on senior securities would be more palatable to Professor Morley if it was recharacterized as a very con-

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ties loans, and gains from the sale or other disposition of stock, securities, or foreign currencies. I.R.C. § 851(b)(2).

[21] The "Diversification" test provides that at least fifty percent of the value of the fund's total assets must consist of cash, cash items, government securities, securities of other regulated investment companies, and investments in other securities which, with respect to any one issuer, represent neither more than five percent of the assets of the fund nor more than ten percent of the voting securities of the issuer. In addition, no more than twenty-five 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). I.R.C. § 851(b)(3).

[22] Morley, *supra* note 6, at 347.

[23] *See, e.g.*, INV. CO. INST., INVESTMENT COMPANY FACT BOOK at App. A (53d ed. 2013) (noting that "[f]unds are subject to more extensive disclosure requirements than any other comparable financial product, such as separately managed accounts, collective investment trusts, and private pools").

[24] Morley, *supra* note 6, at 348.

[25] *See generally Retail Liquid Alternatives: The Next Frontier* 3, GOLDMAN SACHS GLOBAL INVESTMENT RESEARCH (Dec. 6, 2013), http://www.alphacapitalmgmt.com/media/pdfs/120613_Retail_Liquid_Alternatives.pdf (describing the retail liquid alternative market as having nearly 400 products, with 1/3 of those products launched over the past two years).

servative (and easier to administer) version of the regime he desires—with fund borrowings highly regulated as to form, amount and counterparty.[26] Besides, in many contexts, abstinence often proves as easy as temperance might be difficult.[27]

Part II

Professor Morley cites the lack of available fixed rate products in support of allowing mutual funds to issue debt securities.[28] Such a justification seems both curious and inexact. The article asserts that the lack of debt issuance by mutual funds has "profound consequences for the retirement portfolios of household investors" because it means that "most Americans' retirement portfolios consist almost entirely of common stock, rather than debt."[29] The fact that the mutual fund investment itself represents an equity position in an investment company should be of little concern. More importantly, the mutual fund's underlying portfolio might be comprised of all types of securities, fixed income and otherwise.[30] A mutual fund

[26] It should be noted that investors in funds with embedded derivatives facing certain counterparties are also provided an additional protection beyond the scope of this Response. In general, Section 12(d)(3) of the Investment Company Act of 1940 prohibits registered investment companies from purchasing or otherwise acquiring any security issued by a broker, dealer or underwriter. In effect, this prohibition significantly curtails the counterparty risk a mutual fund might incur contra a so-called "securities related issuer." *See* 15 U.S.C. § 80a-12(d)(3) (2012). For a general discussion of Section 12(d)(3) and the accompanying Rule 12d3-1, see Lawrence P. Stadulis & Timothy W. Levin, *SEC Regulation of Investment Company Investments in Securities Related Business Under the Investment Company Act of 1940*, 2 VILLANOVA J. L. & INV. MGMT. 9 (2000). For a general discussion of the ramifications of mutual funds employing derivatives, see SEC Concept Release, Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776; File No. S7-33-11 (Aug. 31, 2011).

[27] *See, e.g.* GRETCHEN RUBIN, HAPPIER AT HOME (2012) at 122 (discussing this philosophy, albeit in a far different context, and attributing it to Samuel Johnson).

[28] Morley, *supra* note 6, at 354.

[29] *Id*.

[30] The PIMCO Total Return Fund, for example, with over $230 billion in assets, seeks to achieve its investment objective by investing primarily in a diversified portfolio of fixed income instruments. *See Prospectus for PIMCO Total Return Fund*, PIMCO (July 31, 2013), http://pe.newriver.com/summary.asp?cid=PIMCOLL&cusip=693390700&doctype

holding a bond portfolio, for example, undoubtedly offers investors a return stream best characterized as fixed-income-like. Moreover, the risk of holding the equity of a mutual fund is mitigated by the fact that the fund's capital structure is barred from including any debt or additional class of equity. As the residual claimholder, the mutual fund shareholder is only advantaged versus a typical equity investor in a corporation. Accordingly, she should find comfort from the embargo of any claimant who could assert priority in the capital structure.

In fact, the certainty that inures to the shareholder, free from any claim with priority in the capital structure, is at the heart of the current senior securities regulatory regime. Mutual fund investors enjoy the position as owners of a pro rata share of an underlying pool of investments. Such an understanding would be strained if the mutual fund were permitted to issue debt. The introduction of the accompanying leverage would require investors to perform an additional layer of analysis to understand the distortion to their pro rata status resulting from such debt.

The Investment Company Act of 1940 was, in large measure, a response to hearings that "revealed that the capital structures of many investment companies were highly complex, often consisting of many classes of securities with different dividend, liquidation, and voting rights."[31] Read in conjunction with other sections of the Act prohibiting transactions with fund affiliates, the limitations on capital structure were aimed at mollifying investor confusion and minimizing the risky leverage that characterized investment funds prior to the Act's adoption.[32]

As one commentator observed shortly after the passage of the Investment Company Act,

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=pros&oldurl=%2FRegulatory%2FExternal%20Documents%2FPIMCO_Bond_Funds_Statutory.pdf.

[31] Roye, *supra* note 8. *See also* Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. QRTLY. 303, 307 (1941) (asserting that open-end mutual funds first came to prominence after abuses were uncovered in the structure of investment companies, their affiliations and their high pressure sales practices).

[32] *See generally* Roye, *supra* note 8 (noting that "[t]he U.S. Congress enacted the Investment Company Act to address these abuses in the investment company industry, assure investor protection, and preserve the important role investment companies' play in capital formation").

> Almost all agreed that it was unsound to have outstanding an issue of bonds or preferred stock, where the common stock was subject to redemption at the will of the stockholder, for the equity could thus be taken away completely from behind the senior security.[33]

Such words still ring true today. And, the legislative intent of the prohibition on debt coupled with (i) an absence of mutual fund failures, (ii) the wide and increasing variety of available investment products and (iii) the tremendous amount invested in today's existing mutual funds counteract the notion that a pivot to a debt issuance regime is either necessary or worth the risks.

Part III

Professor Morley has done a real service in providing the opening framework for academicians, practitioners, investors, and firms to explore further the capital structure of mutual funds. While somewhat sympathetic to the incoherent nature of the capital structure regulations, I must confess skepticism toward the view that attributes significant investor benefits to any regulatory change allowing mutual funds to issue debt. Instead, it appears that the article largely aims to solve a problem that does not exist. In the process, it might reveal too trusting a view that any such change might be managed smartly and without unintended consequences. At the very least, a more thorough and holistic examination of the likely effects on the mutual fund's overall regulatory framework is required before such an alteration can be responsibly suggested. Cognizant too that recent innovations in the alternative investment landscape have significantly expanded the products available to investors—perhaps beyond what Professor Morley and his colleagues in the academy might yet fully appreciate—one cannot help but recall Victor Hugo's observation that sometimes "caution is the eldest child of wisdom."

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[33] Jaretzki, *supra* note 31, at 335.