IM Guidance Update

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SERIES INVESTMENT COMPANIES: AFFILIATED TRANSACTIONS

A typical mutual fund today operates as a "series company," or a single corporation or state business trust established under one set of organizational documents and a board of directors or trustees, but offering investors several investment portfolios (series). Organization as a "series company" affords the mutual fund various operational cost savings. Each series, however, has its own investment objectives and policies, and its own set of shareholders separate from those of any other series. Each series also is a separate investment company for purposes of the investor protections afforded by the Investment Company Act of 1940 (1940 Act).

Protections for Each Series' Shareholders

The 1940 Act generally provides for the use of series, but does not specifically address all of the different aspects of applying its requirements to series as such. In administering the 1940 Act, the Commission and the staff have applied its requirements to a series as a separate investment company in virtually all circumstances.[1] By doing so, the Commission and the staff seek to ensure that investors receive the same protections under the 1940 Act regardless of whether they invest in a mutual fund organized as a series company or a mutual fund that has a single investment portfolio.

Some of the key provisions of the 1940 Act govern transactions involving a mutual fund and its "affiliated persons." The staff is issuing this guidance to remind mutual funds that are series companies about the importance of ensuring that their compliance policies and procedures are reasonably designed to prevent violations of the federal securities laws as they apply to each series.[2] In particular, a mutual fund should review its compliance policies and procedures for the appropriate identification of "affiliated persons" with respect to each series of the mutual fund for purposes of transactions that may be prohibited under the 1940 Act.[3]

An Example

For example, section 17(a) of the 1940 Act generally prohibits an "affiliated person" of a mutual fund or an affiliated person of such person from selling any security or other property to the mutual fund. This prohibition applies to transactions with each series of the mutual fund,[4] so that not only does the prohibition in section 17(a) apply when a series is a party to the purchase or sale transaction, but the series also is a relevant person for purposes of determining whether the counterparty to a mutual fund's transaction is an "affiliated person." Specifically, under the 1940 Act, an "affiliated person" of another person includes, among others, a person who owns 5% or more of the outstanding voting securities of such other person.[5] When a person owns 5% or more of the outstanding voting securities of a series, that person is an affiliated person of that series and thus subject to the prohibitions in section 17(a) of the 1940 Act. Thus, to prevent violations of section 17(a) of the 1940 Act, a mutual fund's compliance policies and procedures should provide for the identification of, among others, persons owning 5% or more of the outstanding voting securities of a series, in a manner that is appropriate to the circumstances of the particular mutual fund.[6]

Endnotes

1 *See, e.g.*, *Fair and Equitable Treatment of Series Type Investment Company Shareholders*, Rel. No. IC-7276 (Aug. 8, 1972). *See also* J.R. Fleming, *Regulation of Series Investment Companies under the Investment Company Act of 1940*, 44 Bus. Law. 1179 (Aug. 1989). In registering under section 8 of the 1940 Act, however, the multiple series of a series company may use a single registration statement. *See* Form N-1A, *available at* www.sec.gov/about/forms/formn-1a.pdf.

2 Rule 38a-1 under the 1940 Act, in relevant part, requires a mutual fund to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the mutual fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the mutual fund.

3 The Commission's Release adopting rule 38a-1 under the 1940 Act states that "[t]o prevent self-dealing and overreaching by persons in a position to take advantage of the fund, the [1940 Act] prohibits funds from entering into certain transactions with affiliated persons. Funds should have policies and procedures in place to identify these persons and to prevent unlawful transactions with them." *Compliance Programs of Investment Companies and Investment Advisers*, Rel. IC-26299 (Dec. 17, 2003) at text accompanying note 53. Section 17(a) is one of the 1940 Act's provisions setting forth these prohibitions. *Id.* at note 53.

4 *See*, *e.g.*, rule 17a-7 under the 1940 Act (exempting from the prohibition in section 17(a), among other things, certain transactions between an affiliated person and a series).

5 *See* section 2(a)(3) of the 1940 Act.

6 Each share of stock issued by a series of a mutual fund is a voting security, as required under section 18(i) of the 1940 Act. The term "voting security" is defined in section 2(a)(42) of the 1940 Act to mean any security presently entitling the owner or holder thereof to vote for the election of directors of a company. Also under section 2(a)(42) of the 1940 Act, "[a] specified percentage of the outstanding voting securities of a company means such amount of its outstanding voting securities as entitles the holder . . . thereof to cast said specific percentage of aggregate votes which the holders of all the outstanding voting securities of such company are entitled to cast." Section 2(a)(8) of the 1940 Act defines "company," in relevant part, to mean "any organized group of persons whether incorporated or not," so that a series is a "company" for purposes of section 2(a)(42) of the 1940 Act. *See* rules 17a-8(a)(3) and 18f-2(h) under the 1940 Act. *See also Exemption of Certain Purchase or Sale Transactions Between a Registered investment Company and Certain Affiliated Persons Thereof*, Rel. IC-11676 (Mar. 10, 1981) at note 1. Therefore, the calculation of the percentage ownership of the outstanding voting securities of a series is based on the total outstanding voting securities of that series. A mutual fund's compliance policies and procedures also should provide for the identification of entities owning 5% or more of the outstanding voting securities of the series company to which the series belongs for purposes of monitoring transactions with affiliated persons of the series company and preventing violations of, among others, section 17(a) of the 1940 Act. In that respect, the calculation is based on the total outstanding voting securities of the series company.

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- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

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