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Still Spry at 75: Reflections on the Investment Company Act and the Investment Advisers Act

By Jay G. Baris and Andrew J. Donohue

This year we celebrate the 75th anniversary of the enactment of two of the crowning legislative achievements of the last century: the Investment Company Act of 1940 (Investment Company Act)[1] and the Investment Advisers Act of 1940 (Investment Advisers Act).[2]

Towards the end of the Great Depression, Congress enacted these two monumental laws to address the perceived abuses of investment trusts and investment advisers. After 75 years, we can now look back and conclude that these two laws have done much to protect investors and set a regulatory framework for "the flow of such savings into the capital markets."[3] More importantly, the flexibility and adaptability of the Investment Company Act and the Investment Advisers Act ensure that they will continue to serve investors and the national economy for the next 75 years.

In order to understand why these two laws have endured and flourished, we must first understand the environment that led to their enactment. In this article, we explore the origins of these two laws, what they were designed to do, how they achieved their legislative goals, and why they continue to play a critical role in capital formation and protection for investors.

Background

The Investment Company Act and the Investment Advisers Act were the last in a series of laws "designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's."[4] They were preceded by the Securities Act of 1933,[5] the Securities Exchange Act of 1934,[6] the Public Utilities Holding Act of 1935,[7] and the Trust Indenture Act of 1939.[8]

Although the earliest investment companies can be traced to investment trusts created under English common law, the modern day story of investment companies and investment advisers begins during the Roaring '20s:

> State law restrictions on companies owning shares of other companies had fallen, thus opening the door to a boom in the investment company industry. World War I was over; business was booming; and Wall Street was thriving. There was an increasing interest in securities, generally ascribed by some to the Liberty Bond and Victory Loan drives during World War I. Investors of modest means were looking to cash in on a roaring stock market and investment

> companies were offering a means of pooling funds to provide for diversification, economies of scale and professional management. Most investment companies were closed-end funds.[9]

During the heyday of the stock market, 1927-1929, the stock market rose quickly, thereby increasing the popularity of investment companies that provided leverage, which most funds did at that time.[10] Fund assets rose from $550 million in 1927 to almost $2.6 billion in 1929.[11]

The growing popularity of investment funds, coupled with a largely unregulated industry, created ripe opportunities for fund sponsors to abuse the investing public. Through small holdings of share classes that retained all of the voting power, these sponsors were able to take control of large investment funds with what was, essentially, other people's money; little of their own money was at risk. With this degree of control, the sponsors essentially operated large funds as their personal piggy banks. The torrent of investments, according to one observer, placed "control of billions into the hands of the lucky but too often unscrupulous insiders."[12]

In March 1929, Paul Cabot, a prominent investment executive, recognized the potential for abuse posed by sponsors of unregulated investment pools. Cabot predicted that unless fund promoters in the United States avoided the "'errors of false principles'" committed in the early history of investment trusts in England, the United States "'shall inevitably go through a similar period of disaster and disgrace.'"[13]

Cabot said that the two major abuses presented by the investment company industry were that:

1) The companies were being operated primarily to serve the self-interest of the sponsors rather than the best interests of shareholders; and
2) The companies were being used as receptacles for otherwise unmarketable securities.[14]

These abuses, Cabot said, were traced to dishonesty, inattention, inability, and greed.

Several months later, investors suffered the shock of the infamous stock market crash. The losses that investors suffered at the hands of unscrupulous promoters were compounded by the losses suffered through leveraged investments.[15] By way of example, share prices of the United Founders Corporation, a popular closed-end fund, plummeted from a high of 75 in 1929 to 1⅜ in 1931.[16]

These abuses by fund sponsors and the losses created by the stock market crash caught the attention of Congress.

In 1935, Congress enacted the Public Utilities Holding Company Act (PUHCA). Section 30 of the PUHCA directed the newly created Securities and Exchange Commission (SEC) to make a study of investment trusts and investment companies and to report its findings and recommendations to Congress. At the direction of Congress, the SEC conducted an exhaustive study of investment funds, including investment advisory services, supervised by Commissioner Robert E. Healy.[17] The birth of the two Acts can be traced directly to the study required by Section 30.

How did unscrupulous promoters subordinate the interests of security holders to their own? The abuses were not merely instances of outright embezzlement. Testimony of SEC and industry officials painted a grim picture and described a parade of horrors that crooked sponsors inflicted on unsuspecting investors. The public record of the study consisted of 33,000 pages of transcript and 4,800 exhibits.

In his testimony, SEC Commissioner Healy said the study found that insiders, who controlled large investment companies with little direct investment of their own, forced those funds to:

- Purchase worthless securities and other investments of doubtful value from or at the behest of fund insiders;
- Loan money to insiders;

- Bail-out insiders from dubious and illiquid investments, from onerous commitments, and from trading accounts;
- Finance banking clients of insiders and companies in which insiders had personal interests; and
- Operate as discretionary brokerage accounts, with funds paying insiders high brokerage commissions.[18]

Commissioner Healy described the "flagrant abuse" of fund sponsors to organize investment funds to generate large profits without any risk to the promotors. To achieve large personal gains and to ensure their control of the funds without substantial investment of their own, they drew up fund charters to allow insiders to deal as principal with those funds, and to provide for the broadest exculpatory clauses. The insiders gave themselves long-term management contracts, overseen by boards of directors that were solely or predominantly insiders. Moreover, these insiders "frequently transferred control of the remainder of the public's funds to other persons, without the prior knowledge or consent of these security holders."[19] This "trafficking in control of investment trusts reached surprising proportions," Commissioner Healey said, and frequently investors were kept in the dark because of inadequate or deceptive reports to shareholders.[20]

This laundry list of abuses (abuse of control, conflicts of interest, lack of disclosure, excessive management charges and hidden fees, to name but a few), compounded by the stock market crash of 1929 that wiped out the fund-savings of millions of investors, inspired Congress to adopt the Investment Company Act and the Investment Advisers Act.

The Investment Company Act

Congress designed the Investment Company Act to address the evils and abuses catalogued by the Investment Trust Study prepared for Congress. Following on the heels of its earlier cousins, the Securities Act of 1933 and the Securities Exchange Act of 1934, the Investment Company Act is based on the same principles of full and fair disclosure to investors. But the Investment Company Act recognizes the belief of Congress that disclosure alone will not cure the potential evils and abuses that Congress found. For this reason, the Investment Company Act "imposes an extensive and comprehensive system of regulation for funds."[21]

The Investment Company Act, as enacted in 1940, empowered the SEC to bring an action against an investment adviser or certain other insiders who have been guilty "of gross misconduct or gross abuse of trust."[22] In 1970, that provision was redesignated as Section 36(a), and changed the standard to authorize the SEC to bring an action against any person who "has engaged within five years of the … action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct … ."[23] Section 36 is a centerpiece of investor protection against abuses by insiders.

Requirements and restrictions. To address the evils and abuses cited in the Investment Trust Study, the Investment Company Act prescribes many requirements and includes many prohibitions. It would be difficult, if not impossible, for true operating companies to comply with all of these requirements.

<u>Transactions with affiliated persons.</u> Perhaps the centerpiece of the Investment Company Act is Section 17. Among other purposes, this section was designed to prevent insiders from dumping worthless securities on investment companies.

Section 17 prohibits many principal transactions with an "affiliated person" of investment companies and restricts transactions in which an affiliated person is a "joint or joint and several participant" with the investment company.[24] These restrictions also apply to affiliated persons of affiliated persons (more popularly known as second-tier affiliates). As any Investment Company Act law practitioner will tell you, the analysis of whether a particular transaction is prohibited by this section can become rather complicated. A failure to recognize and prevent a prohibited transaction can result in dire consequences to the affiliated person.

Fund governance. If Section 17 is the heart of the Investment Company Act, then the governance requirements are its soul. The governance provisions were designed to prevent insiders from controlling investment companies to the detriment of public shareholders.

Section 10 requires that at least 40 percent of an investment company's directors must not be "interested persons" of the fund (the independent directors). An interested person includes any affiliated person of the fund and others, including any affiliated person of a fund's investment adviser or principal underwriter, any family member of an affiliated person, or anyone who served as legal counsel to the fund over the past two years.

The SEC expanded on this principle by adopting rules requiring funds that rely on any one of several common exemptive rules to have a board of directors consisting of a least a majority of independent directors,[25] among other requirements.

The SEC also adopted rules that would require funds relying on these ten common exemptive rules, to have a board of directors consisting of at least 75 percent of independent directors, and to require an independent board chair.[26] The court subsequently invalidated these provisions.

Oversight by the Board of Directors. Section 15(a) of the Investment Company Act requires a fund's board of directors to approve any contract to provide investment advisory services, including the amount of the advisory fees. This section was designed to prevent insiders from entering one-sided and often long-term management contracts, and to prevent "trafficking" of advisory contracts.

Section 15(c), added in 1970, provides that fund directors have a duty to request and evaluate, and the investment adviser a duty to furnish, the information reasonably necessary to evaluate the terms of an advisory contract. The independent directors must approve this agreement at an in-person meeting called for that purpose.

To prevent trafficking of investment advisory agreements, Section 15(a) requires that every investment advisory agreement must provide for its automatic termination in the event of its "assignment," which includes a change of control of the adviser.

Limits on leverage. To address Congressional concerns that fund investment companies took on excessive leverage, the Investment Company Act limits the amount of "senior securities" that funds may issue. Senior securities include bonds, preferred shares, or any arrangement that would provide a preference to the instrument's holder in bankruptcy. Generally, mutual funds cannot borrow money except from a bank and then only if they have 300 percent asset coverage to limit leverage. Mutual funds, however, may borrow up to five percent of their assets on a temporary basis from banks; such loans are not considered senior securities.

Many types of derivative instruments involve a degree of leverage. Interpretations by the SEC and its staff provide some flexibility. For example, the SEC has stated that certain types of leveraged investments will not involve issuances of "senior securities" if the fund segregates liquid assets on the books of its custodian bank that are sufficient to cover the amount of potential losses due to leverage.[27]

Daily valuation. To address Congressional concerns that valuation of investment companies was opaque, the Investment Company Act requires daily valuation of portfolio securities. Each business day, a mutual fund must calculate its net asset value (NAV). The NAV is the price used to settle all trades in mutual fund shares. Each business day, a mutual fund must redeem or buy back shares from investors at the NAV per share next determined after the fund receives the sell order. This pricing scheme is referred to as "forward pricing." Generally, funds use market values to determine a fund's NAV. When a market value for particular securities is not readily available, the fair value must be determined in good faith by the fund's directors. Fair valuation is a challenge for regulators and boards of directors alike.

Disclosure and reporting. To address Congressional concerns that fund sponsors often did not adequately disclose the risks of investing, the Investment Company Act required investment companies to register their shares and disclose specific information. It authorized the SEC to impose additional disclosure requirements.

Generally, investment companies that: are organized or created under the laws of the US or of a state; meet the definition of an "investment company;" and otherwise cannot rely on an exception or an exemption from registration, must register with the SEC under the Investment Company Act. Moreover, if they are making a public offering, they must register their securities under the Securities Act.

To register with the SEC, the issuer must first file its notification of registration (Form N-8A). Within three months after the filing of its notification, the investment company must file the appropriate form with the SEC to both register as an investment company, and register its securities under the Securities Act. By way of example, for a mutual fund, this would be accomplished by filing Form N-1A. After registration, investment companies are required to periodically file certain reports with the SEC, and, in addition, must deliver certain other reports to their shareholders.

At the heart of an investment company's disclosure is its prospectus. An open-end investment company's prospectus is "evergreen," and must be kept current and up to date by subsequent amendment or supplement. In it, the investment company discloses to its shareholders (and potential shareholders) information about itself that an ordinary shareholder would want to know. For example, the investment company discloses to its shareholders the type of investment strategy that its funds will undertake, and the corresponding risks that may or may not arise. In addition, to name but a few items, the investment company discloses to its shareholders the fees its shareholders will be charged, the composition of its board of directors, and its investment adviser.

What is an investment company? Recognizing that the definition of an investment company would be very broad and would include not only operating companies, but companies that really are not in the business of investing in securities as well, the law excluded many types of issuers from the definition of an investment company.

Section 3(a) of the Investment Company Act contains two basic definitions of an investment company: a subjective test and an objective test.

The subjective test, contained in Section 3(a)(1)(A), defines an investment company as any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . ." This broad language is meant to capture a large range of issuers and may include issuers that do not consider themselves to be investment companies. Whether a company is, or holds itself out as being, "engaged primarily" in this business depends on the particular facts and circumstances.[28]

The objective test, contained in Section 3(a)(1)(C), defines an investment company as any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." The term investment securities includes all securities except (A) government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies and (ii) are not relying on the exception from the definition of investment company available to small investment companies (fewer than 100 shareholders)[29] and investment companies the shares of which are held exclusively by "qualified purchasers,"[30] described below.

How the subjective test and the objective test operate in the real world is a complicated matter and fills many pages of textbooks, SEC guidance, and law firm memoranda. It is beyond the scope of this article.[31]

The Investment Company Act provides a number of exceptions from the definition of an "investment company." Section 3(c)(1) generally excludes small investment companies that have not more than 100 beneficial owners and that do not publicly offer their shares.[32] Section 3(c)(7), added in 1996, excludes investment companies that are owned exclusively by "qualified purchasers" and that do not publicly offer their shares. Hedge funds and private equity funds typically rely on one of these two exclusions from the definition of an "investment company."

Section 3(c)(1) and Section 3(c)(7) recently became the subject of a controversy when Congress enacted the Dodd-Frank Act in 2010.[33] The Dodd-Frank Act included the so-called Volcker Rule, which generally prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining an ownership interest in or sponsoring a "covered fund."[34] In relevant part, a covered fund includes any issuer that would be an investment company, but for Section 3(c)(1) or 3(c)(7). The Volcker Rule has broad implications for capital structures and transactions in the US and outside of the US, and requires a detailed understanding of this corner of the Investment Company Act.[35]

The Investment Company Act excludes other issuers from the definition of an investment company, including, among others types of issuers: banks,[36] insurance companies,[37] and issuers "primarily engaged" in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.[38] The SEC, by exemptive rule, has adopted other exclusions over the years.

The Investment Company Act also provides an escape valve for issuers that fail the "objective" test. Section 3(b)(1) excludes from the definition of an investment company: (1) any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. This exclusion is self-executing but, in reality, may be of limited use. Law firms typically would provide a reasoned legal opinion to issuers that seek legal comfort; however, the capital markets often require a "clean" or conclusory opinion that many law firms may be reluctant to provide.

Section 3(b)(2) authorizes the SEC, upon application by an issuer, to declare that an issuer is primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or through: (A) majority-owned subsidiaries or (B) controlled companies conducting similar types of businesses.

Consequences of investment company status. If an issuer is an investment company, then it must register with the SEC and comply with the requirements and restrictions described above. Issuers that fall within the definition of an investment company, but that fail to register, are subject to Draconian consequences. For example, US issuers that fall within the definition of an investment company, but that fail to register, may not make use of interstate commerce to conduct business,[39] and all of its contracts may be voidable.[40] These restrictions effectively require operating companies to avoid falling within the definition of an investment company or else they cannot conduct business in the US. Non-US companies that fall within the definition of an investment company generally cannot publicly issue securities in the US without an order from the SEC, which is rarely given.[41]

What kinds of investment companies are there? Other than face-amount certificate companies and unit investment trusts, investment companies generally fall into two variations of management companies: open-end investment companies and closed-end investment companies.

Open-end investment companies. Open-end investment companies, also known as mutual funds, provide daily liquidity and typically continuously offer their shares. They value their portfolios generally once a day and they must redeem investors' shares at the net asset value (NAV) next determined after receipt of a request to sell.

Closed-end investment companies. Closed-end investment companies typically raise a fixed amount of capital through a public offering and their shares are often listed on a stock exchange. They do not provide daily liquidity, and shares trade at market prices, which means that the shares may trade at a premium or a discount to their true NAV.

Business development companies. Business development companies are closed-end investment companies designed to provide funding to smaller companies in the capital markets. Funds that elect business development company status must limit most of their investments to "eligible portfolio companies."[42] In exchange, they are exempt from many, but not all, of the restrictions that apply to investment companies.

Others. Other innovative kinds of investment companies include money market funds and exchange-traded funds, which require either an exemptive rule or an order from the SEC exempting them from rules that would otherwise make it impossible for them to operate.

The Investment Advisers Act

The Investment Advisers Act was the last in the series of securities legislation that Congress enacted in 1940. Unlike the Investment Company Act, which contains specific requirements and limitations under which investment companies must operate, the Investment Advisers Act is a relatively short, principles-based statute that has been interpreted to impose a fiduciary standard on money managers. The centerpiece of this law is a broad anti-fraud provision that prohibits certain types of transactions that involve self-dealing or other real or potential conflicts of interest.

The Investment Advisers Act reflects the concern that whenever advice to a client might result in financial benefit to the adviser, other than the fee for providing advice, "'that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated . . . .'"[43]

The Investment Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser— consciously or unconsciously— to render advice which was not disinterested."[44] For this reason, the US Supreme Court held in 1963 that to prove that an investment adviser engaged in fraud, a plaintiff is not required to prove the adviser's intent to injure and actual injury to clients through its actions.[45] Moreover, the courts have determined that there is no implied private right of action under the Investment Advisers Act, so much of the development of the law has been through SEC pronouncements and enforcement cases.[46]

Built-in Flexibility – the Exemptive Orders

Congress built into the Investment Company Act a framework for flexibility and adaptability. Even if by "patchwork"[47] and "piecemeal by orders,"[48] the SEC has the power to exempt compliance with certain provisions of the Investment Company Act, without the immediate need for more formal, legislative rulemaking through Congress.

Generally, Section 6(c) authorizes the SEC, by rules and regulations, to exempt any "person, security, or transaction" from any provision of the Investment Company Act "to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investor and the purposes fairly intended by the policy and provisions of [it]."[49] Despite its broad language, the SEC, however, uses the "the wisdom" of its powers with "circumspection."[50]

Challenges for the Future

The world of investment funds and investment advisers today is very different from the world as it existed in the Roaring '20s.

At the time of the 1929 stock market crash, total investment company assets peaked at approximately \$8 billion, up from approximately \$700 million in 1926. By 1932, total assets managed by funds dropped to below \$2 billion.[51]

Investors, regulators, and fund sponsors in 1940 could not fathom that nearly 75 years later, mutual fund assets alone would exceed \$15 trillion.[52]

While the Investment Company Act and the Investment Advisers Act have survived the test of time and continue to provide a sound regulatory scheme, the elderly statutes face some pressures brought on by changing times.

The Investment Company Act and the Investment Advisers Act were enacted at a time when the principal means of communication were newspapers and the telephone; securities were traded only on physical exchanges, they were settled in-person with paper certificates, and funds invested in simple stocks and bonds.

The authors of the two Acts did not contemplate how changes in technology would revolutionize the fund industry. They could not contemplate flash trading, electronic settlement, or global investing, or that investors could trade mutual fund shares on an iPhone. Nowhere in the two Acts is there any reference to derivatives. No one in 1940 ever heard of inverse floaters, collateralized mortgage obligations, sub-prime loans, or other investing techniques that are commonplace today.

To be sure, changes in technology and changes in the market have created new challenges involving liquidity, valuation, and disclosure, among other issues.

Yet, with some notable exceptions, the basic structure of the Investment Company Act, and the basic principles behind it, remain unchanged, and it has grown and adapted to meet changing times.

Perhaps the greatest challenge facing the Investment Company Act is the dichotomy, or gap, between technical compliance with 75-year-old rules and concepts, when compared to actual investment techniques and performance that we witness today. For example, through the use of derivatives, a fund investing primarily in fixed income securities can achieve a return equal to the economic exposure to a basket of equity securities.

Investment companies' use of derivatives and leverage provides a graphic example of the challenges that the SEC, fund managers, and investors face today.

In 2009, Andrew J. Donohue summarized three concerns regarding investment companies' use of derivatives:

1) Funds should have a means to deal effectively with derivatives outside of disclosure;
2) A fund's approach to leverage should address both implicit and explicit leverage; and
3) A fund should address diversification from investment exposures taken on versus the amount of money invested.[53]

These challenges provide a framework of how the SEC, building on the foundation of the Investment Company Act and its inherent flexibility, can address seismic changes in technology and the marketplace:

> Like layers of an onion, underlying these three concerns are a gamut of issues. For example, should the application of '40 Act leverage restrictions to derivatives held by investment companies be re-examined? Is the thirty year patchwork of stated Commission policy and staff positions regarding investment companies' use of derivatives sufficient or is regulatory and/or legislative action necessary to address the leverage created by investment companies' use of derivatives? If you believe action is necessary, what do you recommend? Do existing rules sufficiently

address matters such as the proper procedure for investment company pricing and liquidity determinations of derivatives holdings? Are investment company boards exercising meaningful oversight of funds' use of derivatives, including risk management, proper accounting and internal controls?[54]

Conclusion

The last 75 years have been an interesting journey, to say the least. The Investment Advisers Act and the Investment Company Act have had a profound impact on the capital markets and on investors. The carefully tailored provisions of the Investment Company Act have provided a sound basis for the regulation of the industry, while the exemptive flexibility built into that act has allowed it to adapt to changing markets and conditions. The Advisers Act, with its principles-based approach, has also permitted the growth of that important industry while holding firm the desire to protect investors.

There is little doubt that the Investment Company Act and the Investment Advisers Act have been successful in achieving the goals established by Congress. The challenge for the next 75 years will be how the industry and the regulators continue to adapt to an ever-changing world.

Jay G. Baris is the chair of the Investment Management practice at Morrison & Foerster LLP. **Andrew J. Donohue** was Managing Director and Investment Company General Counsel of Goldman Sachs Asset Management, and served as the Director of Investment Management of the Securities and Exchange Commission from 2006-2010. The authors gratefully acknowledge the assistance of Matthew J. Kutner, an associate of Morrison & Foerster LLP, in preparing this article.

NOTES

1 U.S.C. §§ 80a-1-80a-64 (2012).

2 §§ 80b-1-80b-21.

3 Investment Company Act § 1(a)(4).

4 Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

5 §§ 77a-77aa.

6 §§ 78a-77pp.

7 §§ 79-79z-6.

8 §§ 77aaa-77bbbb.

9 Paul F. Roye, Dir., SEC Div. of Inv. Mgmt, remarks to the 2014 Investment Company Regulation and Compliance Conference, "The Exciting World of Investment Company Regulation" (June 14, 2001), available at *http://www.sec.gov/news/speech/spch500.htm*.

10 Timothy Peter Ansberry, "Federal Legislation, Investment Company Act of 1940," 29 *Geo. L.J.* 614, 614 (1940-1941) (*Ansberry*).

11 John H. Holland, Acting Director, Investment Company Division, Securities and Exchange Commission, address before the Annual Convention of the National Association of Securities Commissioners (Oct. 8, 1941) at 2, *http://www.sec.gov/news/speech/1941/100841hollands.pdf* (*Holland Speech*).

12 *Ansberry*, *supra* n.10, at 614.

13 Commissioner Robert E. Healy, Statement before the subcommittee of Committee on Banking and Currency on Wagner-Lea Act, S. 3580, to regulate investment trusts and investment companies (Apr. 2, 1940) at 2, available at *http://www.sec.gov/news/speech/1940/040240healy.pdf* (*Healy Testimony*).

14 *Id*.

15 *Ansberry*, *supra* n.10, at 614.

16 *Holland Speech*, *supra* n.11, at 2.

17 Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 76-477, at 1, available at *http://archive.org/stream/investmenttrusts312unit/investmenttrusts312unit_djvu.txt* (*Investment Trust Study*).

18 *Healy Testimony*, *supra* n.13, at 4.

19 *Id*. at 5.

20 *Id*.

21 Andrew J. Donohue, Dir., Div of Inv. Mgmt, Luncheon Address Before a Meeting of the Business Law Section of the American Bar Association Committee on Federal Regulation of Securities (Apr. 24, 2010), available at *http://www.sec.gov/news/speech/2010/spch042410ajd.htm*.

22 We are not aware of any legislative history on the origin of the term "gross abuse of trust," as it originally appeared in the Investment Company Act. Anecdotal evidence provided by Meyer Eisenberg, who served as Deputy General Counsel of the SEC, suggests the term was a divine inspiration, negotiated by David Schenker, who was the Chief Counsel for the SEC's Investment Trust Study. According to Eisenberg, "David Schenker got it out of the Yom Kippur prayer for forgiving sins, 'God forgive me for the sin I have committed before time in the abuse of trust.'" Interview by Richard Phillips, Securities and Exchange Commission Historical Society, with Meyer Eisenberg, Deputy General Counsel of the Securities and Exchange Commission, in Washington, D.C. (Sept. 7, 2003), available at *http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/oral-histories/eisenberg090703Transcript.pdf*.

23 Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1428-29 (1970).

24 Investment Company Act § 2(a)(3) defines an "affiliated person" of another person to mean:

> (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding Voting securities of such other person; (B) any person 5 per centum or more of whose outstanding Voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

25 *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 2, 2001), available at *http://www.sec.gov/rules/final/34-43786.htm*.

26 *Investment Company Governance*, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Jul. 27, 2004), available at *http://www.sec.gov/rules/final/ic-26520.htm*. The Court of Appeals for the D.C. Circuit overturned this requirement. *See* Chamber of Commerce of U.S. v. Sec. & Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005).

27 *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25,128 (Apr. 27, 1979).

28 Generally, when evaluating whether a company is an investment company, the five-factor test that was developed in In the Matter of Tonopah Mining Company Co. of Nevada, 26 S.E.C. 426 (July 21, 1947) is applied. These factors include: an evaluation of the company's assets; the nature of the company's income; the company's historical development; the company's public representations of policy; and the activities of the company's officers and directors.

29 Investment Company Act § 3(c)(1).

30 Investment Company Act § 3(c)(7), which was added in 1996 by the National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

31 For a comprehensive explanation of investment company status, *see* Robert H. Rosenblum, Investment Company Determination under the 1940 Act: Exemptions and Exceptions (A.B.A., 2003).

32 Section 3(c)(1)(A) requires issuers to look to the beneficial owners of certain issuers that own more than 10 percent of the outstanding voting securities of the issuer, and count them for determining compliance with 100 investor rule. This requirement was added to discourage issuers from structuring companies to avoid the 100 investor limitation.

33 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (*Dodd-Frank Act*).

34 *See generally Prohibition and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536-01 (Jan. 31, 2014) (codified at 12 C.F.R § 44 (OCC); 12 C.F.R. § 248 (Federal Reserve), 12 C.F.R. § 351 (FDIC), 17 C.F.R. § 255 (SEC)). The CFTC simultaneously issued an identical rule. *See generally* Prohibition and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (Jan. 31, 2014) (codified at 17 C.F.R. § 75), available at *http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf*.

35 For a summary of the Volcker Rule and its application, *see* Morrison & Foerster LLP*:* "A User's Guide to The Volcker Rule" (Feb. 2014), *http://media.mofo.com/files/Uploads/Images/131223-A-Users-Guide-to-The-Volcker-Rule.pdf*

36 Investment Company Act § 3(c)(3).

37 Investment Company Act § 3(c)(3).

38 Investment Company Act § 3(c)(5).

39 Investment Company Act § 7(a).

40 Investment Company Act § 47.

41 Investment Company Act § 7(d).

42 Investment Company Act § 55.

43 *Capital Gains Research Bureau, Inc.*, 375 U.S. at 188.

44 *Id*. at 192-93.

45 *Id*. at 192.

46 Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). Thus, the SEC, not an investment adviser's clients, can sue an investment adviser for fraud under the Investment Advisers Act.

47 Remarks by Andrew J. Donohue, "Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality?" (Apr. 17, 2009), available at *http://www.sec.gov/news/speec h/2009/spch041709ajd.htm* (*Donohue Paradigm Speech*).

48 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 1.02[B][2] (2d ed. 2007 Supp.).

49 Investment Company Act §6(c).

50 In the Matter of the Nat'l Ass'n of Small Bus. Inv. Co., Admin. Proceeding No. 3-1825 (Sec. & Exch. Comm'n Nov. 28, 1969), available at *https://www.sec.gov/alj/aljdec/aljdecarchive/aljdecarc1969.shtml*.

51 *Investment Trust Study*, *supra* n.17, at pt. III, ch. 1, 3-4 ("From total assets not exceeding $700,000,000 at the end of 1926, the industry expanded to the extent that its total assets had a market value of about $7,000,000,000 at the end of 1929, and reached a peak of probably over $8,000,000,000 before the break in the market in that year. These figures for total assets of the industry in 1929 compare with total assets of below $2,000,000,000 by the middle of 1932, and not more than $2,800,000,000 at the end of 1937.").

52 Investment Company Institute, "Trends in Mutual Fund Investing," January 2015, available at *http://www.ici.org/research/stats/trends/trends_01_15*. This figure does not include assets held in exchange traded funds or closed-end funds.

53 *Donohue Paradigm Speech*, *supra* n.47.

54 *Id*.