UNCONSTRAINED MUTUAL FUNDS AND RETAIL INVESTOR PROTECTION

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Abstract

The proliferation of unconstrained mutual funds calls into question the effectiveness of retail investor protections under the Investment Company Act of 1940. Analyzing trading data and prospectuses of a hand-selected sample of all unconstrained mutual funds launched from 2010 through 2015 (N=449), the authors provide an overview of the evolution of unconstrained mutual funds, contrasting core characteristics with publicly available data pertaining to benchmarked mutual fund investment indices. This article demonstrates that unconstrained mutual funds share multiple investment strategy and risk attributes with fixed income hedge funds. The authors evaluate associated investor protection concerns.

Keywords: *Unconstrained Mutual Funds, Private Fund, Mutual Fund, Hedge Funds, Hybrid Funds, Liquid Alternative Assets, Retail Alternative Funds, Asset Classes, Proliferation, Confluence, Investment Styles, Securities Regulation, Retail Investors, Investor Protection, Risk Attributes, Investment Strategy*

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I. Introduction

The emergence and proliferation of unconstrained mutual funds (UMFs)[1] raise important retail investor[2] protection questions

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[1] UMFs are registered open-end investment management companies that implement, through their investment managers, a credit-focused investment strategy that generally is not tethered to any benchmark. Instead, the strategy provides the manager with the operational freedom to pursue risk-adjusted returns using any debt instruments or securities, regardless of issuer, sector, jurisdiction, liquidity or quality. *See* Conrad de Aenlle, *When Bond Funds Think Outside the Box*, N.Y. TIMES (Apr. 4, 2014), https://www.nytimes.com/2014/04/06/business/mutfund/when-bond-funds-think-outside-the-box.html?_r=0 [https://perma.cc/2BVZ-M45P]; Jeffrey R. Kosnett, *A Timely Look at Unconstrained Bond Funds*, KIPLINGER (Sept. 30, 2014), http://www.kiplinger.com/article/investing/T041-C003-S013-a-timely-look-at-unconstrained-bond-funds.html [https://perma.cc/YDW4-YFD9]. Credit mutual funds can be (i) registered open-end investment management companies, (ii) closed-end funds, (iii) exchange-traded funds (ETFs), and/or (iv) Unit Investment Trusts (UITs). The authors recognize that while the mutual fund industry itself may use all of these offering-types as synonyms, each in fact has substantively different legal and regulatory characteristics. *See* Actively Managed Exchange Traded Funds, 66 Fed. Reg. 57,614 (Nov. 15, 2001).

[2] As used in this article, "retail investor" means an investor who has limited investment experience and a lower net worth than an "accredited investor." *See* 15 U.S.C. § 80b-11(g)(2) (2012) ("'retail customer' means a natural person, or the legal representative of such natural person, who receives personalized investment advice about securities from a broker, dealer, or

under the Investment Company Act of 1940 (Company Act).[3] While mutual funds and private funds[4] occupy distinct segments of the

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investment adviser; and uses such advice primarily for personal, family, or household purposes."); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 405 (Jan. 4, 2007) (the difference between retail and accredited investors rests on a "measure whether that person is likely to have sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment"); *see* Brian G. Cartwright, Gen. Counsel, U.S. Sec. & Exch. Comm'n, The Future of Securities Regulation (Oct. 24, 2007), https://www.sec.gov/news/speech/2007/spch102407bgc.htm [https://perma.cc/7TWH-78MK] ("By 'retail investor' I just mean those investors who lack the sophistication or net worth to gain access to institutional markets."). The number of retail investors is relatively large (mostly due to retirement accounts), but the actual amount invested is relatively small per investor. *See* Press Release, Wells Fargo, Wells Fargo Survey Find Saving for Retirement Not Happening for a Third of Middle Class (Oct. 22, 2014), https://www.wellsfargo.com/about/press/2014/middle-class-retirement-saving_1022/ [https://perma.cc/PG69-YRLF] ("According to the survey, middle-class Americans have saved a median of $20,000, which is down from $25,000 in 2013. . . . Seventy percent of respondents have a 401(k) or equivalent plan available to them through their employer, and a majority of them (93%) are currently contributing to their plans."); INV. CO. INST., 2015 INVESTMENT COMPANY FACT BOOK 29, 124 (2015), https://www.ici.org/pdf/2015_factbook.pdf [https://perma.cc/BW8X-P8Z5] (stating that retail investors held 89 percent of the nearly $16 trillion in mutual fund assets, and that approximately 55 percent of all households' assets held in 401(k) accounts as of December 2014 were invested in mutual funds).

[3] *See* 15 U.S.C. §§ 80a-1–64 (2012).

[4] As used in this article, the term "private fund" refers to a pooled investment vehicle, the interests of which are privately offered and placed, and which pursues an actively-traded credit strategy run by natural person portfolio management staff (i.e., investment recommendations are not based on an algorithm). *See* U.S. Sec. & Exch. Comm'n, *Private Equity Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/investment-products/private-equity-funds [https://perma.cc/4T29-ZFRD]. Unlike mutual funds, in most private funds (including those considered for purposes of the study in this article), there is no substantive limitation on, for example, (i) the types of securities which the fund may trade, (ii) the jurisdictions of the markets where those

investment market, traditionally employ different investment strategies, and serve largely different classes of investors, UMFs display characteristics of both mutual funds and private funds, and occupy a unique market niche.[5] UMFs appear to transcend many traditional investment and legal distinctions that have characterized mutual funds and private funds, by combining the regulatory structure of a mutual fund with the investment strategy of a private fund implementing a credit strategy and principally trading fixed income instruments.[6] The Securities and Exchange Commission (SEC) perceives most retail investors as lacking the investment experience needed to understand the risks associated with investing in private funds.[7] As such, interests in private funds may only be

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securities may be traded, or (iii) the degree of concentrated ownership of a security (or securities), or the degree of exposure to an industry or market, that the fund may take on. *See* FRANCOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 46–47 (Wiley, 2006).

[5] As mentioned, the focus of this article is on registered open-end investment management companies, usually referred to as mutual funds. Closed-end funds, which are beyond the scope of this article, are generally subject to the same regulatory regime as mutual funds, but are structurally and operationally distinct from mutual funds in several important respects. *See Closed-End Fund Information*, U.S. SEC. & EXCHANGE COMMISSION (Jan. 16, 2013), https://www.sec.gov/answers/mfclose.htm [https://perma.cc/5QND-W9F9].

[6] *See generally,* Frank J. Fabozzi et al., *Overview of the Types and Features of Fixed Income Securities* in THE HANDBOOK OF FIXED INCOME SECURITIES 3 (Frank J. Fabozzi ed., 7th ed. 2005), http://financebooks.org/media/pdfs/the_handbook_of_fixed_income_securities.pdf [https://perma.cc/V5W6-DSF6]. "Fixed income" includes a broad range of instruments. *See* MORNINGSTAR, MORNINGSTAR GLOBAL FIXED INCOME CLASSIFICATION 4 (2012), http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/MorningstarGlobalFixedIncomeClass.pdf [https://perma.cc/P6HL-6Q7X] (listing the following categories of fixed income instruments: Government, Municipal, Corporate, Securitized, Cash & Equivalents and Derivatives).

[7] *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Protecting the Retail Investor (Mar. 21, 2014), https://www.sec.gov/News/Speech/Detail/Speech/1370541226174 [https://perma.cc/Y2T7-44TY] ("The retail investor must be a constant focus of the SEC—if we fail to serve and safeguard the retail investor, we have not fulfilled our mission."); Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Keeping a Retail Investor Focus in Overseeing the Fixed

purchased by high net worth and sophisticated investors through private placements, although the private funds implement substantially the same investment strategy as a fixed income-focused UMF, and are subject to substantially the same types of strategic and other investment risks as a UMF.[8] In contrast, UMFs are subject to the same regulatory framework as traditional mutual funds and, accordingly, are widely offered and available to retail investors, including those with minimal or no investment experience.[9]

UMFs have become an increasingly important "alternative" mutual fund investment product.[10] Mutual funds comprise the largest set of pooled investment vehicles in the United States. As of December 31, 2014, there were almost 16,000 U.S. registered open-end investment companies, collectively holding over $18 trillion in assets under management.[11] By contrast, in 2015 the global market for hedge funds comprised only 10,149 pooled vehicles,[12] managing a total of $3.197 trillion in assets.[13] UMFs are a growing component of the mutual fund market.[14] In 2016, Morningstar categorized 448 mutual funds as involving some element of unconstrained or non-traditional characteristics.[15]

Income Market (Apr. 16, 2013), https://www.sec.gov/News/Speech/Detail/Speech/1365171515252 [https://perma.cc/L7WN-QFN5] ("I consider the protection of investors, particularly retail investors, to be my primary obligation.").

8 *See* 15 U.S.C. § 77b (2012); 17 C.F.R. § 230.215 (2016).

9 *See* 15 U.S.C. §§ 80a-1–80a-64 (2012) (subjecting both UMFs and traditional mutual funds to the Company Act).

10 Kosnett, *supra* note 1.

11 INV. CO. INST., *supra* note 2, at 6.

12 Svea Herbst-Bayliss, *Record Number of Hedge Funds Now Operating Around World: HFR*, REUTERS (June 19, 2015), http://www.reuters.com/article/us-hedgefunds-launches idUSKBN0OZ1KF20150619 [https://perma.cc/JDC2-BHDB].

13 PREQIN, 2016 PREQIN GLOBAL HEDGE FUND REPORT 7 (2016), https://www.preqin.com/docs/samples/2016-Preqin-Global-Hedge-Fund-Report-Sample-Pages.pdf [https://perma.cc/CV9S-VE5U].

14 *See* Sean Clark, *Unconstrained Versus Nontraditional Bond Funds*, CLARK CAPITAL MGMT. GRP. (May 5, 2016), https://www.ccmg.com/unconstrained-versus-nontraditional-bond-funds/ [https://perma.cc/S329-9EH5] (stating Morningstar started with approximately 100 funds in the category and now has 300).

15 *See generally* MORNINGSTAR, THE MORNINGSTAR CATEGORY CLASSIFICATIONS (2014), http://corporate.morningstar.com/us/documents/MethodologyDocuments/M

Market forces have been a significant factor in the emergence of UMFs.[16] Structural and regulatory changes to the capital markets precipitated by the financial crisis of 2007–2008 and a low interest-rate environment, in combination with the enormous growth of private funds, created, and over time increased, the demand[17] for retail "alternative" mutual funds.[18] The net assets of mutual funds employing alternative investment strategies increased by almost 200 percent from 2009 to 2014.[19] During this period, the growing number of side-by-side management structures, in which an

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ethodologyPapers/MorningstarCategory_Classifications.pdf [https://perma.cc/9KM3-LYLP]; *Nontraditional Bonds: Total Returns*, MORNINGSTAR (Mar. 2, 2017), http://news.morningstar.com/fund-category-returns/nontraditional-bond/$FOCA$NT.aspx [https://perma.cc/26G7-WS4S] (listing 448 funds categorized by Morningstar as "non-traditional").

[16] *See* OFFICE OF FIN. RESEARCH, U.S. DEP'T OF THE TREASURY, ASSET MANAGEMENT AND FINANCIAL STABILITY 9 (2013), https://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf [https://perma.cc/UR2W-GH4R] ("An extended low interest rate investment climate, low market volatility, or competitive factors may lead some portfolio managers to `reach for yield,' that is, seek higher returns by purchasing relatively riskier assets than they would otherwise for a particular investment strategy."); Renee Haltom, *Reaching for Yield: Are the Fed's low interest rate policies pushing investors toward risk*?, ECON FOCUS 5 (2013), https://www.richmondfed.org/~/media/richmondfedorg/publications/research/econ_focus/2013/q3/pdf/federal_reserve.pdf [https://perma.cc/LCA2-HKZA] ("[A]fter a recession, the central bank may cut interest rates to boost the economy. For a while, risk premia remain elevated, pushing overall market interest rates higher, so investors have little need to search for yield. As risk premia recede, however, investors may become desperate for higher returns and shift toward riskier investments.").

[17] *See generally* SEI, THE RETAIL ALTERNATIVES PHENOMENON: WHAT ENTERPRISING PRIVATE FUND MANAGERS NEED TO KNOW (2013), https://www.seic.com/IMS/SEI-IMS-RetailAlternatives-US-2013.pdf [https://perma.cc/3FS2-HWNY] (detailing low interest-rate markets, the financial crisis, and other factors leading to the development and adoption of alternate mutual funds).

[18] As used in this article, the term "'alternative' mutual fund" refers to a registered open-end investment management company that offers the attractive features of a mutual fund structure, such as daily pricing and liquidity and position transparency, with the relatively more aggressive investment strategies and trading tactics of a private fund, and the corresponding prospect of a private fund's absolute returns.

[19] INV. CO. INST., *supra* note 2, at 214.

investment adviser manages both mutual funds and hedge funds,[20] further suggests that investment advisers are adjusting their operations to satisfy retail investor demand for alternative investments.[21] UMFs are a direct product of this trend.[22]

The emergence of UMFs is a natural extension of the confluence of mutual funds and private funds.[23] Because UMFs employ investment strategies and trading tactics typical of private funds following a fixed income strategy, but are subject to regulation under the Company Act, UMFs exemplify the continuing convergence of mutual fund and private fund product offerings.[24] The Dodd-Frank Act and the Jumpstart our Businesses Act (JOBS Act) imposed additional, substantive reporting and other obligations

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[20] *See generally* Tom Nohel et al., *Side-by-Side Management of Hedge Funds and Mutual Funds*, 23 REV. FIN. STUD. 2342 (2010) (documenting 344 cases of this "side-by-side management").

[21] SEI, *supra* note 17, at 4 (citing Financial Advisor, Private Wealth & SkyBridge Capital, *Alternative Investment Survey 2012*, FINANCIAL ADVISOR (Aug. 23, 2012), http://www.fa-mag.com/news/alternative-investments-survey-2012-11725.html [https://perma.cc/CY8R-EQ3X]) (noting for the year 2012 that 53 percent of retail investors stated that they would consider using alternative investments, 74 percent of advisers used alternative strategies, and 75 percent of advisers in the preceding year increased their allocation to alternative assets).

[22] *See* Wulf A. Kaal, *Confluence of Mutual and Private Funds*, in ELGAR HANDBOOK ON MUTUAL FUNDS (forthcoming 2016) (U. of St. Thomas Legal Studies Research Paper No. 16-06, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715083 [https://perma.cc/6RD6-RCJF].

[23] *Id.*

[24] *See id.* at 11 ("Despite different legal obligations and opposing incentives for private and mutual fund managers who operate alternative mutual funds, 29 alternative mutual funds offer the attractive features of mutual funds, such as significant diversification, daily pricing and liquidity, relative stability, and transparency. By offering investors exposure to hedge fund strategies (including going short, investing in illiquid securities, currencies, long-short equity, private equity, real estate, commodities, and global macro) and certain asset classes, complex trading techniques, and leverage, retail alternative funds combine mutual fund characteristics with the more aggressive strategies and the corresponding prospect of absolute returns of hedge funds.").

on private funds and private fund managers.[25] This resulted in the "industry as a whole . . . experiencing dynamic change—moving from what some would say was a secretive industry, to a widely-recognized and influential group of investment managers."[26] The registration and increased disclosure requirements for certain private fund advisers under the Dodd-Frank Act subject those managers to substantively the same registration and reporting obligations as those that apply to advisers to mutual funds.[27] Other factors driving this confluence include the softening of the "general solicitation" requirements under the JOBS Act relating to private placements,[28] and the equal treatment accorded to mutual funds and private funds for purposes of the Financial Stability Oversight Council's Systemically Important Financial Institution designation.[29]

The data analysis in this paper shows that the growth in the number of UMFs raises important questions regarding the retail investor protection principles embodied in the current mutual fund regulatory scheme.[30] This analysis reveals, among other things, that UMFs share several important investment strategy and risk attributes with private funds, including broad authority to: (i) trade almost any type of security, including illiquid securities; (ii) take concentrated investment risks in individual securities, sectors, or markets; (iii) make extensive use of derivatives; (iv) engage in short selling; and (v) change the duration of the portfolio without any effective limit. However, unlike private funds, which are generally limited to investors who satisfy particular investment sophistication and net worth requirements, shares of UMFs may be purchased by retail investors, including those with quite limited or even no investment experience.[31]

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[25] *See generally* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Jumpstart our Business (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).
[26] Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Hedge Funds—A New Era of Transparency and Openness (Oct. 18, 2013), https://www.sec.gov/News/Speech/Detail/Speech/1370539892574 [https://perma.cc/79WE-E8U2].
[27] *See infra* Part III (contrasting the legal framework for UMFs and Private Funds).
[28] *See* the JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d; Kaal, *supra* note 22, at 4.
[29] Kaal, *supra* note 22, at 5.
[30] *See generally infra* Part V.
[31] *See* Kosnett, *supra* note 1.

This article has six parts. After a short introduction in Part I, Part II introduces the basic characteristics and evolution of UMFs. Part III contrasts the legal frameworks applicable to mutual funds, including UMFs, and private funds. Part IV discusses UMF data included and analyzed in the authors' study, and demonstrates that UMFs share numerous and important investment risk and other characteristics with private funds following similar credit strategies. Part V then examines several important policy questions regarding the effectiveness of the disclosure regime under the Company Act to alert retail investors to the risks of investing in UMFs. Part VI details conclusions from this research.

II. Unconstrained Mutual Funds

In the recent past, UMFs have proliferated an otherwise challenging investment environment because of their attractive characteristics.[32] While academics have investigated the role of UMFs since the early 2000s,[33] it was only recently that the market for UMFs has taken off.[34] Record-low interest rates, significant market dislocations, and retail investors' persistent efforts to boost income and protect capital, have all significantly increased the demand for UMFs in the last few years.[35] The popularity of UMFs can partially

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[32] *See* Joshua Brown, *The Biggest Mistake Investors Are Making Right Now*, FORTUNE (Mar. 25, 2015), http://fortune.com/2015/03/25/unconstrained-bond-funds-risk/ [https://perma.cc/2P7J-5AKL] ("But of course, we tend to be willing to ignore historical facts when a more convenient promise comes along. And in this care [sic], that promise is the rise of the unconstrained bond fund.").

[33] *See generally* Andres Almazan et al., *Why Constrain Your Mutual Fund Manager*?, 73 J. FIN. ECON. 289 (2004) (examining the form, adoption rates, and economic rationale for various mutual fund investment restrictions among a sample of U.S. domestic equity funds from 1994 to 2000, and identifying systematic patterns in investment constraints within the set).

[34] *See* OFFICE OF FIN. RESEARCH, *supra* note 6; Brown, *supra* note 32 ("Between the beginning of 2010 and the end of 2014, the assets under management in the top 10 "nontraditional bond funds" have quintupled from $16 billion to over $80 billion. In fact, these 10 funds have seen their assets double over just the last two years.").

[35] BRANDES INST., UNCONSTRAINED BOND INVESTING: TOO GOOD TO BE TRUE? 1 (2015), https://www.brandes.com/docs/default-source/brandes-institute/unconstrained-bond-investing.pdf [https://perma.cc/RR7J-Z33X]; Brown, *supra* note 30 ("The popularity of this type of fixed income fund has

be traced back to their ability to pursue absolute returns in the fixed-income market without being affected by the constraints of conventional credit mutual fund benchmarks.[36]

Managing UMFs provides investment managers with many benefits. The investment manager of a UMF typically has broad authority regarding the trading and investment of fund capital.[37] For example, the manager may have broad authority to take significant investment risks using derivatives, both as part of the investment adviser's directional investment strategy, and for hedging. Investment managers of UMFs may also be permitted to: (i) commit a significant percentage of the fund's total capital to concentrated positions in one or more U.S. or non-U.S. issuers, or in particular U.S. or non-U.S. industrial sectors or markets; (ii) direct the fund to invest heavily in illiquid securities, non-investment grade securities, and potentially non-securities (e.g., bank loans); and (iii) shorten and lengthen the duration of the portfolio.[38] Additionally, the manager may not be required to cause the fund to adhere to a performance benchmark or index.[39] Many of these UMF benefits and characteristics are shared with private funds.

Nevertheless, UMFs face several challenges. Morningstar, for example, the largest database of mutual fund information in the United States, considers UMFs to be an unproven asset sub-class.[40]

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exploded, and it is entirely a creature of the zero interest rate percentage environment."). *See generally* Claude B. Erb, The Superinvestors of Unconstrained Bondsville (Jan. 15, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2550528 [https://perma.cc/H5L9-WXYS] (discussing unconstrained bonds and whether or not they are successful due to skill or luck).

[36] *See* Deborah Kidd, *Shedding Light on Unconstrained Bond Funds*, 2014 INVEST. RISK & PERFORMANCE 1 (2014) ("Common to funds in the category is the lack of a conventional benchmark, a reflection of the funds' unbounded opportunity sets and potential for alpha.").

[37] *Id*.

[38] *Id*.; *see* Almazan et al., *supra* note 33 at 294–95.

[39] Kidd, *supra* note 36, at 1.

[40] *See* Eric Jacobson, *The New Non-Traditional-Bond Category*, MORNINGSTAR (Jan. 19, 2012), http://www.morningstar.com/advisor/t/51166436/the-new-non-traditional-bond-category.htm [https://perma.cc/FX7X-9RFB] ("Still in their early years, non-traditional-bond funds haven't impressed . . . . Morningstar launched the non-traditional-bond category in November 2011, partly in response to an explosion of new bond funds over the past few years.").

Morningstar uses a holdings-based analysis, along with input from its fund analysts, to determine the proper category of a mutual fund.[41] The Morningstar data available for UMFs with three years of investing history offer no evidence that UMFs have a superior performance to mutual funds in comparable asset classifications.[42] On average, UMF performance has disappointed over the last three years, with returns lower than the return on the ten-year Treasury.[43] Often, poor UMF performance has been accompanied by high fees and increased credit risk.[44]

UMFs can also exacerbate investment risks. For instance, some of the most popular UMF strategies could significantly increase a portfolio's exposure to risk, especially during a downturn.[45] UMFs

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[41] *Morningstar Fiduciary Services Program Documents and Sample Reports*, MORNINGSTAR, http://corporate.morningstar.com/US/documents/investmentfactsheets/PSA_Sample%20Reports.pdf [https://perma.cc/3C94-TFC5].

[42] *See* Jacobson, *supra* note 40 ("Not a single fund in the category managed to beat the Barclays Aggregate [Bond Index] last year, which ended on a 7.8% gain. A couple came close, while a small handful otherwise managed to eke out positive returns. On average, the distinct portfolios in this group lost around 1% for the year."); *Crow Point Alternative Income Investor, Growth of 10k*, MORNINGSTAR, http://www.morningstar.com/funds/XNAS/AAIFX/quote.html [https://perma.cc/5QPV-SE3R].

[43] *See* Robert Huebscher, *The Verdict on Unconstrained Bond Funds*, ADVISOR PERSPECTIVES (Jan. 14, 2014), http://www.advisorperspectives.com/newsletters14/pdfs/The_Verdict_on_Unconstrained_Bond_Funds.pdf [https://perma.cc/MB8M-GX7E]; Trevor Hunnicutt, *Jeffery Gundlach Warns Advisers on 'Unconstrained' Bond Funds*, INV. NEWS (May 20, 2015), http://www.investmentnews.com/article/20150520/FREE/150529994/exclusive-jeffrey-gundlach-warns-advisers-on-unconstrained-bond-funds [https://perma.cc/U9M4-ZJVC].

[44] BRANDES INST., *supra* note 35 (listing new risks that may accompany unconstrained bond funds.). While the volatility of UMFs (3.83) was higher than that of intermediate funds (2.95), it was lower than that of long-term funds (5.98). *Id.*

[45] *See* Carl O'Donnell, *Unconstrained Bond Funds Are No Panacea For Rising Rates*, FORBES (Dec. 17, 2014), http://www.forbes.com/sites/carlodonnell/2014/12/17/unconstrained-bond-funds-are-no-panacea-for-rising-rates [http://perma.cc/NZT9-G8U9] ("The ten largest unconstrained bond funds have an average credit quality of BB, which is just below investment grade, and substantially riskier than the AA-

are also characterized by high annual portfolio turnover.[46] According to some estimates, the average UMF has an annual turnover of around 198 percent.[47] In other words, in the course of a calendar year, by September 30 the average UMF could have turned over the entire securities portfolio it held as of the end of the preceding March.[48] Moreover, the complexity of UMF trading has increased so much that leading analysts struggle to assess UMF portfolios and their performance.[49] Some call UMFs "go anywhere" funds, because they are not linked to any specific index; frequently may invest in bonds, interest rates, currencies, and securities; and reserve the manager's right to trade even more types of securities and instruments in diverse markets, while also engaging in short selling.[50] However, these "go anywhere" features may impede a retail investor's ability to ascertain and understand the UMF's investments, and the risks associated with those investments.[51] More specifically, the lack of standard benchmarks for UMFs, the recent emergence of UMFs as an investment asset type, and the diversity among and complexity of UMFs' strategies and risk exposures make it uniquely challenging for retail investors to evaluate the risks of investing in UMF securities.[52] Some commentators have also voiced the concern that UMFs could "negate the role of fixed income as a portfolio's primary diversifier."[53]

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average of the Barclay's Aggregate Bond Index, according to Morningstar.").

[46] Jessica Toonkel & Jennifer Ablan, *"Go anywhere" Bond Funds Pose Risks That Investors Can't See*, REUTERS (Aug. 19, 2015), http://www.reuters.com/article/us-unconstrainedbond-investors-surprise-idUSKCN0QO1ZL20150819 [https://perma.cc/85WX-NGJY].

[47] *Id.*

[48] *Id.*

[49] *See id*. ("The problem is that every fund company discloses and values its derivatives differently, he said. 'It's a foggy area,' Martin said.").

[50] *See* Toonkel & Ablan, *supra* note 46; *Unconstrained Bond Funds Enjoy Surging Popularity*, ZACKS (Oct. 29, 2014), https://www.zacks.com/stock/news/152104/unconstrained-bond-funds-enjoy-surging-popularity [http://perma.cc/KFY5-KABL].

[51] Toonkel & Ablan, *supra* note 46.

[52] Kidd, *supra* note 36, at 3; Toonkel & Ablan, *supra* note 46.

[53] BRANDES INST., *supra* note 35, at 2.

III. Contrasting UMF and Private Fund Legal Frameworks

Unlike private funds, UMFs are subject to the extensive regulatory requirements of the Company Act.[54] Compliance with the Company Act means that UMFs may be marketed and sold to all classes of retail investors, including retail investors who have limited, or even no, experience investing in securities.[55] Private funds, in contrast, are not marketed to retail investors.[56] Instead, the opportunity to invest in a private fund is restricted to those who meet particular experiential and net worth investment criteria indicating that they are able to understand the risks associated with investing in the fund, including the risk that their investment could lose all or the greater part of its value.[57] Because private fund investments are restricted to investors deemed to be sophisticated—a category that does not include the majority of retail investors—private funds generally are exempt from the registration and other substantive provisions of the Company Act.[58]

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[54] 15 U.S.C. §§ 80a-1–64 (2012).

[55] *See id.*

[56] *See, e.g.*, American Beacon Flexible Bond Fund, Prospectus (Form N-1 A) (Dec. 29, 2015), https://www.sec.gov/Archives/edgar/data/809593/000113322815006547/e427440_485bpos.htm [http://perma.cc/C6JH-4EKR] ("Securities sold in private placement offerings made in reliance on the "private placement" exemption from registration afforded by Section 4(a)(2) of the Securities Act and resold to qualified institutional buyers under Rule 144A under the Securities Act ("Section 4(a)(2) securities") are restricted as to disposition under the federal securities laws, and generally are sold to institutional investors, such as the Fund, that agree they are purchasing the securities for investment and not with an intention to distribute to the public."); Anfield Universal Fixed Income Fund, Annual Report (Form N-CSR) (Oct. 31, 2016), https://www.sec.gov/Archives/edgar/data/1552947/000158064217000121/anfield_ncsr.htm [https://perma.cc/3LDU-3F3Y] ("The Fund may hold securities, such as private investments, interests in commodity pools, other non-traded securities or temporarily illiquid securities, for which market quotations are not readily available or are determined to be unreliable.").

[57] *See* §§ 80a-1–64.

[58] *See id.*

A. Mutual Fund Regulation

A number of different statutes, rules, and governance choices directly and indirectly influence the management, operation, and distribution of mutual funds (including UMFs), but do not necessarily similarly influence private funds.[59] The Company Act is the primary source of law directly applicable to mutual funds.[60] The Securities Act of 1933 (the Securities Act) governs the sale of a mutual fund's shares, and includes numerous requirements regulating the fund's registration statement when shares are sold to the public.[61] The Securities Exchange Act of 1934 (the Exchange Act)[62] governs the form and content of a mutual fund's proxy statements.[63] Moreover, the distribution and offering of mutual funds are subject to sales practice and other requirements interpreted and enforced by the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization regulating broker-dealers in the United States through which mutual fund shares generally are marketed and sold.[64]

In enacting the Company Act as the primary source of law directly applicable to mutual funds, Congress expressly articulated a

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[59] In theory, a mutual fund could be organized as a business or statutory trust, a corporation, a limited partnership, or a limited liability company. As a practical matter, however, most mutual funds are set up as Massachusetts business trusts, Delaware statutory trusts, or Maryland corporations. Laurin Blumenthal Kleiman, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, in MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION 1B-1, 1B.4.2 (Clifford E. Kirsch ed., 3d ed. 2015). Each of these forms offers significant advantages to mutual fund sponsors, including governance flexibility, the absence of a requirement to hold an annual meeting, and the absence of state income tax or franchise tax at the entity level. *Id.*

[60] *See generally* §§ 80a-1–64.

[61] 15 U.S.C. § 77 (2012).

[62] 15 U.S.C. §§ 78a–78pp (2012).

[63] 15 U.S.C. § 78n (2012); 17 C.F.R. § 240.14a-101 (Schedule 14A) (2016). In addition to the securities regulatory requirements imposed on mutual funds under these laws, mutual funds are also subject to important requirements under the Internal Revenue Code of 1986. *See, e.g.*, 26 U.S.C. § 851(b) (2012) (Subchapter M of the Internal Revenue Code) (stating that mutual funds must meet investment diversification standards and pass a test regarding the source of their income).

[64] *See Mutual Funds,* FINRA, http://www.finra.org/industry/mutual-funds [https://perma.cc/QY2B-ZW3S].

number of retail investor-protection objectives the legislation was intended to advance.[65] These policy objectives were to be achieved through a mutual fund's adherence to a number of substantive Company Act requirements.[66] Among other requirements, the Company Act commits the mutual fund to: (i) register as an investment company under the Company Act; (ii) comply with detailed periodic governmental reporting and investor disclosure duties; (iii) comply with structural and trading-related obligations (including, among others, restrictions on the fund's ability to invest in certain securities industry related issuers, and on its ability to short sell and engage in leveraged transactions); (iv) redeem investors' shares at their net asset value (NAV) on demand and promptly pay the proceeds of the redemption; (v) disclose the fund's diversified or non-diversified investment strategy; and (vi) disclose the fund's policy on investment concentration.[67]

At the same time that a mutual fund must be registered as an investment company under the Company Act, its offering of shares to the public must be registered under the Securities Act.[68] To register with the SEC, the mutual fund must file a notification of

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[65] 15 U.S.C. § 80a-1 (2012) ("It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.").

[66] *See, e.g.*, § 80a-1(b)(1)–(3), (5), (7); §80a-8(b)(1)(E).

[67] *See* § 80a-1(b)(1) (requiring mutual funds to provide investors with information about the character of fund securities, policies and financial responsibilities of fund management); § 80a-1(b)(2) (requiring that mutual funds are "organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons"); § 80a-1(b)(3) (prohibiting mutual funds from issuing "securities containing inequitable or discriminatory provisions, or [which] fail to protect the preferences and privileges" of mutual fund shareholders); § 80a-1(b)(5) (prohibiting mutual funds from "keeping their accounts" and "computing their earnings and the asset value of their outstanding securities" through "unsound or misleading methods" which are not subject to "independent scrutiny"); § 80a-1(b)(7) (prohibiting mutual funds from engaging in "excessive borrowing and the issuance of excessive amounts of senior securities," which could "increase unduly the speculative character" of the mutual fund's securities); § 80a-8(b)(1)(E) (detailing registration requirements and requiring disclosure of investment concentration).

[68] 15 U.S.C. § 77f (2012).

registration on Form N-8A[69] and a registration statement on Form N-1A.[70] Form N-1A includes extensive disclosure obligations relating to the mutual fund's investment objective(s), strategies, and related investment risks;[71] the fees to be charged by the mutual fund, and the operating and other expenses to which the mutual fund is subject;[72] performance information regarding the mutual fund;[73] and material information regarding the investment adviser to the fund.[74] As with the SEC's review of registration statements of other public companies (e.g., those filed by an industrial company), the SEC's staff generally reviews and comments on the mutual fund's registration statement, and may request that revisions be made to the document before it will be declared effective by the SEC.[75]

Further, because a mutual fund is considered to be involved in a continuous securities offering,[76] it must comply with detailed periodic governmental reporting and investor disclosure

[69] 17 C.F.R. § 274.10 (2016); U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0175, FORM N-8A.[make sure all of the CFR references on the next couple of pages are correct, and include cites to the Forms where appropriate]

[70] § 274.11A; U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0307, FORM N-1A .

[71] U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0175, FORM N-8A (Item 9 requiring "Investment Objectives, Principal Investment Strategies, Related Risks, and Disclosure of Portfolio Holdings.").

[72] *Id.* (Item 3 requiring a risk/return summary with shareholders fees and operating expenses).

[73] *Id.* (Item 4 requiring a summary of the fund's performance).

[74] *Id.* (Item 31 requiring disclosure of "Business and Other Connections of Investment Adviser."). The investment manager to a mutual fund must be registered with the SEC under the Investment Advisers Act of 1940 (Advisers Act), and is subject to the requirements of that legislation as well as relevant provisions of the Company Act. 15 U.S.C. § 80b-1–22 (2012). Among numerous other obligations, the Advisers Act and associated rules require that the investment manager comply with fiduciary obligations of care and loyalty; adopt and comply with written policies and procedures intended to detect and prevent violations of the securities laws; file periodic reports with the SEC relating to the fund's ownership of certain securities; and maintain certain records. *See id.*

[75] *See Review of Investment Company Filings,* U.S. SEC. & EXCHANGE COMM'N (June 26, 1998), https://www.sec.gov/about/oig/audit/273fin.htm [https://perma.cc/BL7V-UGCX].

[76] Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L BUS. & FIN. 1, 27 (2009).

requirements.[77] For instance, a mutual fund must provide investors with: updated prospectuses or summary prospectuses, supplements to the fund's prospectus, an annual report and semi-annual report, and relevant tax information.[78] Beyond reporting to investors, a mutual fund must file reports with the SEC, which include: an annual update to the mutual fund's registration statement;[79] supplements to the mutual fund's prospectus;[80] the fund's annual report and semi-annual report, which must include the mutual fund's certified financial statements;[81] a quarterly report disclosing the fund's certified portfolio holdings;[82] and an annual report that includes the mutual fund's proxy voting record.[83]

Mutual funds can be marketed to retail investors through a public offering.[84] This means that shares in most mutual funds are widely available for purchase by a retail investor, regardless of the extent or nature of the investor's investment experience and personal or household net worth.[85] Mutual fund shares are generally marketed to retail investors through a broker-dealer that is a member of FINRA and is registered with the SEC under the Exchange Act.[86] Between

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[77] *See* 15 U.S.C. § 77m (2012); 17 C.F.R. § 230.415 (2016).
[78] Form N-1A requires mutual funds to provide a prospectus to investors and make a statement of additional information available to investors on request. *See* § 230.421; U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0307, FORM N-1A.
[79] § 230.497.
[80] *Id.*
[81] § 270.30e-1.
[82] § 210.12–14.
[83] § 274.129; U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0582, FORM N-PX. Further, many states require that mutual funds submit to the relevant state regulatory body an annual notice filing, accompanied by a filing fee, if shares of the fund are marketed and sold in that state. *See* Michael Glazer, *Prospectus Disclosure and Delivery Requirements*, in MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION 4.1.4 (Clifford E. Kirsch ed., 3rd ed. 2015) ("For a widely distributed fund, this generally means separate registration in most or all of the fifty states, in the District of Columbia, and in one or more territories.").
[84] *See* Kleiman, *supra* note 59, at §1B:1.
[85] *See* Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 606 (2014) ("[M]utual funds are . . . the primary way in which retail investors participate in the stock market.").
[86] U.S. SEC. & EXCH. COMM'N, OFFICE OF INV'R EDUC. & ADVOCACY, PUB. NO. 182, MUTUAL FUNDS AND ETFS – A GUIDE FOR INVESTORS 4 (2016)

the SEC's regulations and FINRA's sales practice and other rules, the broker-dealer marketing mutual fund shares has wide-reaching, detailed securities regulatory compliance obligations.[87] In marketing the mutual fund's shares, the fund must comply with the provisions of Rule 12b-1, which limits the use of fund assets to pay for the distribution of fund shares.[88] A mutual fund generally cannot use fund assets for marketing purposes unless the fund, through its board, has adopted a written Rule 12b-1 plan.[89] The extent to which particular costs and charges fall within the scope of the approved plan is a subject of detailed and rigorous SEC review, as well as ongoing enforcement efforts.[90]

[hereinafter MUTUAL FUNDS AND ETFS] https://www.investor.gov/system/files/publications/documents/english/mutual-funds.pdf [https://perma.cc/8XYA-FUVD]; U.S. SEC. & EXCH. COMM'N, DIV. OF TRADING AND MKTS., GUIDE TO BROKER-DEALER REGISTRATION (2008) https://www.sec.gov/divisions/marketreg/bdguide.htm#1 [http://perma.cc/62W6-YNH5]; *see* 15 U.S.C. § 78o(a) (2012) (making it illegal to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section."); § 78o-3(a) ("An association of brokers and dealers may be registered as a national securities association pursuant to subsection (b) of this section, or as an affiliated securities association pursuant to subsection (d) of this section . . . .").

[87] Among the most important marketing rules promulgated by FINRA is Rule 2111, the suitability rule, which requires a broker-dealer to have a "reasonable basis to believe" that a particular security, including securities issued by a UMF or other mutual fund recommended by the broker-dealer, is suitable for the customer. *See* FINRA RULE, 2111 (2014).

[88] 17 C.F.R. § 270.12b-1 (2016) (providing that, if a mutual fund wishes to finance the distribution of its shares, including advertising and other marketing activity like "printing and mailing of prospectuses," the company must have a detailed "written plan describing all material aspects of the proposed financing of distribution").

[89] *Id.* (stipulating registered, open-end management investment companies may only make payments in connection with the distribution of its own issued securities if such payments "are made pursuant to a written plan" approved by the board or by majority of outstanding voting securities, for public companies)

[90] *See*, *e.g.*, First Eagle Inv. Mgmt., Investment Company Act Release No. 31832, 2015 WL 5528211 (Sept. 21, 2015) (finding that the investment fund paid distribution and marketing expenses that were not covered by the

Mutual funds are also subject to a number of structural and trading-related obligations under the Company Act. For example, a fund sponsor's decision on branding the fund is subject to Section 35(d) of the Company Act (the Names Rule), which provides that a mutual fund may not utilize a misleading name.[91] Additionally, Company Act Rule 35d-1[92] requires that a mutual fund employing a name referring to a particular type of security (e.g., equities, fixed income, non-U.S., emerging markets, or large-cap), or which invests in particular industries, must develop and implement an investment policy to ensure that at least 80 percent of the fund's assets are invested in that type of security or in securities of companies in the industry (or industries) "suggested by" the fund's name.[93]

Further, mutual funds are subject to strict redemption and valuation obligations. A mutual fund must generally redeem an investor's shares at their NAV in response to the shareholder's demand, and pay any redemption proceeds to the shareholder within

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approved 12b-1 plan); U.S. SEC. & EXCH. COMM'N, DIV. OF INV. MGMT., IM GUIDANCE UPDATE: MUTUAL FUND DISTRIBUTION AND SUB-ACCOUNTING FEES 1 (2016) [hereinafter IM GUIDANCE UPDATE] (discussing "sweep examination[s]" of various organizations which analyzed "payment of fees to financial intermediaries characterized as non-distribution related sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees"). Both the cease-and-desist order issued against First Eagle, and the SEC's subsequent guidance update to the industry, relate to the agency's focus on so-called "distribution in guise" violations by mutual funds. *First Eagle Mgmt.*, at 3–5; IM GUIDANCE UPDATE, *supra* note 90, at 2. *See generally* Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Investment Adviser With Improperly Using Mutual Fund Assets to Pay Distribution Fees (Sept. 21, 2015), https://www.sec.gov/news/pressrelease/2015-198.html [https://perma.cc/73F2-SYHF] (describing the "Distribution-in-Guise Initiative" as a means for the SEC to 'determine whether some mutual fund advisers are improperly using fund assets to pay for distribution by masking the payments as sub-transfer agency . . . payments").

[91] More specifically, Section 35(d) of the Company Act makes it unlawful for "any registered investment company to adopt as a part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the SEC finds are materially deceptive or misleading." 15 U.S.C. § 80a-34(d) (2012).

[92] 17 C.F.R. § 270.35d-1 (2016).

[93] § 270.35d-1(a)(2)(i).

seven days.[94] In support of this requirement, Company Act Rule 22c-1 requires that mutual fund shares be priced each trading day on which markets are open.[95] In practice, to determine the NAV, the mutual fund, working with its investment manager and third-party pricing vendors, will generally determine the current mark-to-market valuation of the fund's assets, subtract the fund's liabilities, and divide the difference by the total number of outstanding shares.[96] The NAV determined through this process will then be communicated to the market, including to brokers who custody fund shares for their clients.[97]

Mutual funds' trading strategies are also subject to scrutiny. Among many other requirements applicable to a mutual fund's trading strategies and practices,[98] the Company Act requires that the fund elect to follow a diversified or non-diversified investment strategy.[99] In general, a mutual fund with a diversified investment strategy must invest at least 75 percent of its total assets in cash and cash equivalents, U.S. government (and certain U.S. government-related) securities, securities of other investment companies, and other (non-investment company) securities, provided that the

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94 Investment Company Act, § 22(e), 15 U.S.C. § 80a-22(e) (2012); MUTUAL FUNDS AND ETFS, *supra* note 86, at 10.

95 17 C.F.R. § 270.22c-1(b)(1) (2016).

96 MUTUAL FUNDS AND ETFS, *supra* note 86, at 54 (stating that to calculate "NAV per share, a fund subtracts the fund's liabilities from its assets and then divides the result by the number of shares outstanding"); BARBARA NOVICK ET AL., BLACKROCK, THE ROLE OF THIRD PARTY VENDORS IN ASSET MANAGEMENT 9, 11 (2016).

97 *Net Asset Value*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/nav.htm [http://perma.cc/947N-FZJ2] ("Most mutual funds publish their per share NAVs in the daily newspapers.").

98 Among other restrictions, the Company Act imposes numerous restrictions on a mutual fund's ability to invest in certain securities industry-related issuers. For example, the statute makes it unlawful for a mutual fund to purchase more than 3 percent of another registered investment company's voting securities, invest more than 5 percent of the fund's assets in securities of another registered investment company, or invest more than 10 percent of the fund's assets in securities of registered investment companies more generally. Investment Company Act, § 12(d)(1)(A)(i)-(iii), 15 U.S.C. § 80a-12(d)(1)(A)(i)–(iii) (2012)). Similarly, Company Act section 12(d)(3) restricts mutual funds' ability to invest in securities issued by a broker-dealer, an underwriter, or an investment adviser. § 80a-12(d)(3).

99 § 80a-5(b)(1)–(2).

investment in "other issuer" securities may not exceed 5 percent of the mutual fund's total assets, or 10 percent of the issuer's voting stock.[100] A mutual fund that cannot satisfy these requirements is considered non-diversified.[101]

A mutual fund is required to disclose its policy on investment concentration to investors.[102] A fund's concentration policy is considered fundamental to its investment strategy, and therefore cannot be changed without the affirmative vote of a majority of the fund's voting securities.[103] The SEC has stated generally that a mutual fund's investment strategy is deemed to be concentrated if the fund invests more than 25 percent of its net assets in securities of issuers in a particular industry or group of industries.[104] The SEC has promulgated definitions of particular industries with which a mutual fund implementing a concentrated investment strategy must comply.[105] Where the SEC has not established (broadly or narrowly) the scope of an industry, the

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[100] § 80a-5(b)(1).

[101] § 80a-5(b)(2). In addition to the diversification and non-diversification requirements under the Company Act, Subchapter M of the Internal Revenue Code imposes separate diversification requirements on mutual funds, including the obligation to comply with certain distribution and portfolio diversification requirements in order not to be subject to federal income tax on income and capital gains it distributes to shareholders. *See* 26 U.S.C. § 851(b)(2) (2012) (stating that a company must derive at least 90 percent of its gross income from dividends, interest, and gains from the sale of securities).

[102] Investment Company Act, § 8(b)(1)(E), 15 U.S.C. § 80a-8(b)(1)(E) (2012) (requiring a recital of the policy of the registrant with respect to "concentrating investments in a particular industry or group of industries"); § 80a-13(a)(3).

[103] § 80a-13(a)(3).

[104] *See* U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0307, FORM N-1A (Instruction 4 of Item 9 requiring a mutual fund to "[d]isclose any policy to concentrate in securities of issuers in a particular industry or group of industries (i.e., investing more than 25% of a Fund's net assets in a particular industry or group of industries)").

[105] Registration Form Used by Open-End Management Investment Companies, Exchange Act Release No. 6479 at Guide 19 (Aug. 12, 1983) ("This guide further noted that the staff will rely on the Directory of Companies Filing Annual Reports With the SEC (the 'Directory') in determining industry classifications.").

mutual fund has more flexibility to define the industry for investment concentration purposes in its investor disclosures.[106]

Additionally, mutual funds are subject to significant restrictions on leverage. The Company Act closely regulates the extent to which a mutual fund may borrow when executing its investment strategy, on the policy ground that a mutual fund's use of leverage could "increase unduly the speculative character" of the fund's securities.[107] Section 18(f)(1) of the Company Act[108] restricts a mutual fund from issuing "senior securities," a term defined to include bonds, debentures, notes, or other traditional debt instruments, and any class of stock with a distribution priority respecting the fund's assets or on the payment of dividends.[109] At the same time, the Company Act specifically permits a mutual fund to borrow from a bank, so long as the fund has "asset coverage" of at least 300 percent of the total amount of that borrowing.[110] Importantly, the SEC historically has taken the position that the restriction on borrowing under Section 18 also limits the ability of the fund to engage in short selling unless the fund "covers" its short position through holding one or more offsetting long positions in the

[106] *See* Registration Form Used by Open-End Management Investment Companies, Exchange Act Release No. 6479 at Guide 19 (Aug. 12, 1983) ("A registrant . . . may select its own industry classifications, but such classifications must be reasonable and should not be so broad that the primary economic characteristics of the companies in a single class are materially different."); Brief for Securities and Exchange Commission as Amicus Curiae Supporting Plaintiffs at 9, In re Charles Schwab Corp. Securities Litigation, No. C-08-01510 (N.D. Cal. Mar. 25, 2010) ("Although the 1983 guidelines do not apply to registration statements currently filed under Form N-1A [citation omitted], the Commission agrees with the portion of Guide 19 quoted above, upon which the investment company industry continues to rely (as reflected by the parties' arguments here)").

[107] 15 U.S.C. § 80a-1(b)(7) (2012).

[108] § 80a-18(f)(1).

[109] § 80a-18(g). According to the SEC, in enacting Section 18, Congress was concerned with, among other things, "(i) potential abuse of the purchasers of senior securities; (ii) excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities; and (iii) funds operating without adequate assets and reserves." Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Exchange Act Release No. 29776, 76 Fed. Reg. 55,237, 55,242 (Sept. 7, 2011) (footnotes omitted).

[110] § 80a-18(f)(1).

same securities.[111] The SEC also has interpreted Section 18 as restricting a mutual fund from becoming a party to derivative and other transactions (e.g., through entering into a reverse repurchase agreement or futures contract), which could enhance the risk of loss to the fund, unless the fund segregates a portion of its assets sufficient to satisfy its obligations under the relevant agreements.[112] The SEC's interpretations of Section 18 have effectively limited a mutual fund's ability to engage in derivative transactions, unless the fund can satisfy its contractual obligations through economically offsetting "covering transactions,"[113] or by segregating fund assets directly by placing liquid securities in one or more separate accounts.[114] In sum, the SEC's position has meant that a mutual fund is not subject to a statutory limitation or cap on its ability to borrow through the use of derivative instruments, if the fund adheres to its asset segregation obligations.[115]

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[111] Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter, CCH Mut. Funds Guide ¶ 12379 (June 22, 1987).

[112] *See id*. ("So long as two investment companies comply with the staff's segregation requirements or 'cover' positions, the staff would not raise objections under Section 18(f) if the investment companies engage in four types of transactions without limiting them to the 300-percent asset-coverage requirement. The investment companies will: (1) sell securities short; (2) purchase and sell futures contracts; (3) purchase and sell options on specific securities, stock indexes, or interest rate futures contracts; and (4) purchase and sell forward contracts on currencies.").

[113] A "covering transaction" could include, for example, covering a long position in a futures contract by purchasing a put option on the same futures contract with a strike price at least as high as the price of the futures contract. *Id*.

[114] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25,128, 25,131–32 (Apr. 27, 1979).

[115] In December 2015, the SEC proposed new Company Act Rule 18f-4, which would allow a mutual fund (among other entities) to enter into derivative and other "financial commitment transactions" regardless of Section 18's prohibition on registered funds issuing "senior securities," on the condition that the mutual fund (a) complies with either of two "alternative portfolio limitations" on the fund's exposure to derivative transactions; (b) offsets the risks to the fund from derivative and "financial commitment transactions" by maintaining "qualifying coverage assets" in an amount sufficient to meet the fund's obligations under the relevant contracts; and (c) depending on the nature and scope of the fund's derivatives use, develops and implements a "formalized derivatives risk

B. Private Fund Regulation

In contrast with mutual funds, private funds are generally not required to comply with the substantive requirements of the Company Act. This means, for example, that a private fund need not: (i) register with the SEC, (ii) register a class of shares with the SEC, (iii) provide periodic financial and individual portfolio holdings

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management program." Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80,884, 80,884–85 (proposed Dec. 28, 2015) [hereinafter SEC Derivatives Release]. Proposed Rule 18f-4 is intended to enhance regulation of mutual funds' use of derivatives as a trading product, given the "dramatic growth in the volume and complexity of the derivatives market over the past two decades[.]" *Id.* at 80,885. The proposed rule has been the subject of extensive industry comment, mostly regarding the proposed rule's potential to reduce the ability of mutual funds to enter into derivative and similar arrangements. *See, e.g.*, Investment Advisor Association, Comment Letter on Use of Derivatives by Registered Investment Companies and Business Development Companies (Mar. 28, 2016), https://www.ici.org/pdf/16_ici_sec_derivatives_ltr.pdf [https://perma.cc/8ZQ8-VUJ6] ("[T]he proposed rule would break new ground in severely restricting funds' ability to use derivatives"); SIFMA, Comment Letter on Use of Derivatives by Registered Investment Companies and Business Development Companies (Mar. 28, 2016), https://www.sifma.org/comment-letters/2016/sifma-amg-submits-comments-to-the-sec-on-proposed-rule-18f-4/ [https://perma.cc/KN3U-E6TX] ("[T]he proposed Portfolio Limits are not tailored to, and we believe that they are not the best means to address, the policy objectives that the SEC has identified under Section 18 . . . ."); Managed Funds Association & Alternative Investment Management Association, Comment Letter on Use of Derivatives by Registered Investment Companies and Business Development Companies (Mar. 28, 2016), https://www.sec.gov/comments/s7-24-15/s72415-127.pdf [https://perma.cc/TV3B-RP22] ("We also have serious concerns that the Proposed Rule's notional-based leverage limits are too blunt a risk mitigation tool for most derivatives used by funds."). Of course, derivatives are only one of a wide variety of products that a UMF would typically be permitted to invest in or trade. The effectiveness of proposed Rule 18f-4, if adopted as proposed, in mitigating significant liquidity or other risks in a UMF portfolio is therefore potentially (highly) limited, as material leverage, counter-party, liquidity, and other risks to a particular UMF could arise from the fund's investments in a range of non-derivative instruments, and from a variety of non-derivative-based trading strategies, given the broad investment authority typically granted to UMF managers.

information to the SEC or to investors, (iv) comply with Rule 12b-1 regarding the use of fund assets to pay fund marketing expenses, (v) comply with the requirement to strike a NAV on a daily basis, (vi) pay investor redemption proceeds within seven days, or (vii) limit its short selling or borrowing, including through the use of derivative contracts.[116] Moreover, unlike for mutual funds (including UMFs), private funds are not required to have independent directors.[117]

Operating a private fund without the duty to comply with the Company Act obligations that apply to mutual funds[118] provides the private fund manager with significant benefits. The private fund manager has far greater flexibility to pursue diverse investment strategies and to structure the terms of the contract between the fund and its investors.[119] In particular, the manager may structure the fund to attain objectives that would be inconsistent with investor protection mandates common to mutual fund advisers.[120] Those objectives may include: (i) investing in sectors outside of the manager's specialization, using any type of equity or fixed income securities or derivative instruments; (ii) investing heavily in illiquid securities; (iii) engaging in no hedging of fund positions; (iv) taking

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[116] *See* LHABITANT, *supra* note 4, at 46–47.

[117] 17 C.F.R. § 270.0-1 (2016); Role of Independent Directors of Investment Companies, SEC Release Nos. 33-7932; 34-43786; and IC-24816, 66 Fed. Reg. 13,234 (Jan. 2, 2001).

[118] *See Investment Company Registration and Regulation Package*, U.S. SEC. & EXCH. COMM'N (Feb. 19, 2013) https://www.sec.gov/divisions/investment/invcoreg121504.htm#P84_14584 [https://perma.cc/ZA4B-8RSW].

[119] Kara M. Stein, Comm'r, U.S. Sec. & Exch. Comm'n, Speech at Brookings Institution: Mutual Funds—The Next 75 Years (June. 15, 2015), https://www.sec.gov/news/speech/mutual-funds-the-next-75-years-stein.html [https://perma.cc/B5ZF-HRD5] ("Private funds, like hedge funds, operate more on a disclosure basis. They receive certain exemptions as long as only a certain category of investors is involved. They are allowed substantial leeway and are generally not subject to the same substantive rules as registered funds, so long as all material terms of the investment are disclosed.").

[120] This presumes that the private fund's investment manager has a performance record generating sufficient demand among prospective investors to raise adequate investment capital to operate, and that the fund's offering and subscription documentation are in compliance with applicable disclosure obligations under the SEC's anti-fraud rules. 15 U.S.C. § 80b-6 (2012); 17 C.F.R. § 240.10b5 (2016). Both mutual funds and private funds are subject to these anti-fraud rules.

concentrated positions in the securities of a particular issuer, or the securities of several issuers in a particular sector or geographic market (including in non-U.S. markets); (v) borrowing heavily against the fund's positions and cash; (vi) reporting infrequently to investors regarding fund performance; (vii) severely limiting the amount of information provided to investors regarding the fund's portfolio, including by not disclosing any information regarding significant positions which the fund has taken; (viii) limiting the number of redemption requests that an investor may submit in a particular period (e.g., for any trailing twelve-month period); (ix) limiting the amount of capital that an investor may redeem at one time; (x) suspending redemptions by investors entirely, where it is consistent with the investment manager's fiduciary duty to do so; and (xi) calculating the fund's NAV according to a methodology selected by the investment manager.[121] Finally, private fund advisers benefit from staying exempt from the Company Act[122] by avoiding the

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[121] *See* LHABITANT, *supra* note 4, at Chapter 5.

[122] To preserve these benefits for the private fund, private fund sponsors generally attempt to assure that the Company Act does not apply to the fund. Most private fund sponsors pursue this objective by making use of the exceptions to the definition of the term "investment company" found in Company Act Sections 3(c)(1) and 3(c)(7). 15 U.S.C. § 80a-3(c), 3(7) (2012). The first of these provisions carves out from the definition of "investment company" a fund "whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons," and "which is not making and does not presently propose to make a public offering of its securities." § 80a-3(c)(1). The private placement requirement referred to in Section 3(c)(1) is satisfied if the offering of securities by the fund takes place in compliance with Section 4(2) of the Securities Act or with Rule 506 of Regulation D. *See 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N (Jan. 16, 2013), https://www.sec.gov/answers/rule506.htm [https://perma.cc/NLJ4-SF7N]. The exception available under Section 3(c)(1) is self-executing; accordingly, no report must be filed with the SEC for a private fund to make use of it. *Id*. The second exception from the definition of investment company—under Section 3(c)(7)—applies on a self-executing basis to any issuer (such as a private fund) whose outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers," and which is not making and does not at the time propose to make a public offering of such securities. § 80a-3(c)(7). As with the exception available under Section 3(c)(1), the Section 3(c)(7) private placement requirement is fulfilled if the fund engages in a non-public offering under Section 4(2) of the Securities Act or complies with the

significant expenses incurred in registering and operating a mutual fund (including a UMF) subject to the Company Act.

The significant differences in how mutual funds and private funds are regulated under the Company Act reflect Congress's retail investor protection priorities. In passing the Company Act, Congress sought to protect retail investors in mutual funds by imposing extensive public reporting and investor disclosure obligations on those entities, and requiring, among other things, that the funds not stray from their investment objectives, and that they maintain liquidity standards, promptly pay investor redemption demands, and calculate and publish a daily (NAV) for the fund.[123] These Company Act objectives are to be attained by, for example, imposing restrictions on the ability of the fund to trade certain categories of securities, and to take on debt or engage in derivative transactions.[124] Congress also authorized the SEC to expand these retail investor protection policies through rulemaking.[125]

Congress's retail investor protection objectives do not currently apply to private funds.[126] Unlike mutual funds, private funds are generally exempt from the Company Act and not open to retail investors.[127] To qualify for the exemptions, investors in private funds must be "accredited investors" or "qualified purchasers" under U.S. securities laws.[128] As Congress stated, "[g]enerally, these

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private placement requirements of Rule 506 of Regulation D. *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N (Jan. 16, 2013), https://www.sec.gov/answers/rule506.htm [https://perma.cc/NLJ4-SF7N] (describing the standards that can be satisfied to ensure compliance with the private placement requirements). In contrast with the Section 3(c)(1) exception, if the requirements of Section 3(c)(7) are satisfied, then a private fund operating in compliance with that provision could theoretically have an unlimited number of "qualified purchaser" investors. *See* § 80a-3(c)(7).

[123] *See* § 80a-1.

[124] *See* § 80a-7.

[125] *See, e.g.,* Fabozzi, *supra* note 6; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (2003) (describing the SEC's ability to engage in rule-making).

[126] *See* § 80a-3(c)(1).

[127] *Id.*

[128] *Id.* The terms "accredited investor" and "qualified purchaser" each refer to natural person or institutional investors that have some level of investing experience, and which possess the financial wherewithal to bear the loss of all or most of their investment in the private fund. Regulation D Revisions;

investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption rights."[129] Accordingly, if a private fund's offering process successfully limits its investors to either "accredited investors" or "qualified purchasers," the retail investor protection principles of the Company Act will not apply to the private fund's trading, operation, and governance.

IV. Data

The authors used Morningstar index categories to identify mutual funds that could be categorized as UMFs.[130] The Morningstar Nontraditional Bond index formed the basis for the data collection. This category, introduced in 2011, includes funds "that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe," and which often were self-described as "absolute return portfolios" or "unconstrained portfolios."[131] The additional feature that makes this index especially relevant to selecting UMFs for this study is that, like private funds, "[f]unds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios."[132] However, it should be noted that this category includes many funds that defy standard analyst categorization.[133]

The Morningstar Nontraditional Bond index category used in this study included a total of 448 constituents, most of which are

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Exemption for Certain Employee Benefit Plans, Release No. 33-6683, 52 Fed. Reg. 3015, 3017 (proposed Jan. 16, 1987) ("intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.").

129 S. REP. NO. 104-293, at 10 (1996).

130 *See* MORNINGSTAR, THE MORNINGSTAR CATEGORY CLASSIFICATIONS (Apr. 30, 2014), http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/MorningstarCategory_Classifications.pdf [https://perma.cc/TF8B-UYLA].

131 *Id.*

132 *Id.*

133 *See id.* ("The Nontraditional Bond category contains funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe.").

mutual funds and some of which are different share classes of the same fund. The authors assessed funds at the fund level, rather than at a share class level, significantly reducing the number of prospectuses in the study. The authors used this selection process because the funds ultimately provide for the same investor permissions and restrictions across shares classes (i.e., a single prospectus is issued for all share classes of the fund), and because each share class has roughly the same holdings. Using Lexis Securities Mosaic, the authors pulled the most recent prospectus for the remaining 114 non-traditional funds identified by Morningstar. Each prospectus was then reviewed for the nature and extent of the fund manager's authority to engage in pursuing an "unconstrained" investment strategy.

The authors coded the final list of the most recent fund prospectuses (N=114) using binary coding, in the following eleven categories: (i) limit on type of fixed income security or instrument that the fund may purchase,[134] (ii) limit on the sector of issuers of securities that the fund may trade,[135] (iii) no limit on non-investment grade securities (type or amount) that the fund may purchase,[136] (iv)

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[134] *See, e.g.*, CEDAR RIDGE UNCONSTRAINED CREDIT FUND, SUMMARY PROSPECTUS 2 (2015), https://www.sec.gov/Archives/edgar/data/1587982/000139834415002255/fp0013886_497k.htm [http://perma.cc/7JRQ-SK8P] (defining credit-related instruments in which the fund must invest 80 percent of the value of its net assets, plus the amount of any borrowings for investment purposes); CMG TACTICAL BOND FUND, SUMMARY PROSPECTUS 2 (2015), http://www.cmgmutualfunds.com/wp-content/uploads/2016/09/CMG-Tactical-Bond-Fund-Summary-Prospectus_Aug-29_2016.pdf [http://perma.cc/9ZJB-G4BY] (defining bond instruments in which the fund must invest at least 80 percent of its assets).

[135] *See, e.g.*, PIONEER LONG/SHORT BOND FUND, SUMMARY PROSPECTUS 7 (2015), https://www.sec.gov/Archives/edgar/data/1341256/000119312513466746/d639963d497k.htm [http://perma.cc/KS4S-LTCY] (describing the alternative strategies employed by the fund to "isolate sources of return associated with specific investment opportunities which are not generally correlated with directional, market-oriented return").

[136] *See, e.g.*, CEDAR RIDGE UNCONSTRAINED CREDIT FUND, *supra* note 134, at 2 ("The Fund may invest its total assets, including borrowings for investment purposes and proceeds from short selling, if any, without restriction in debt securities of any maturity and credit quality, including . . . 'junk bonds.'); ALPS/WESTPORT RESOURCES HEDGED HIGH INCOME FUND, SUMMARY PROSPECTUS 5 (2015),

limit on agency securities (whether by issuer, amount, type, etc.) that the fund may purchase, (v) limit on the fund's authority to purchase bank loans,[137] (vi) limit on the duration of the portfolio,[138] (vii) an applicable benchmark or index for the fund,[139] (viii) limit on fund's authority to invest in or trade derivatives (direct or for hedging, amount, type of instrument),[140] (ix) limit on the jurisdictions of

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https://www.sec.gov/Archives/edgar/data/915802/000119312513478988/d606582d485bpos.htm [http://perma.cc/X46P-3E83] ("The below-investment grade fixed income securities in which the Fund may invest are commonly referred to as 'high-yield' or 'junk' securities.").

[137] *See, e.g.,* AAM-HIMO UNCONSTRAINED BOND FUND, PROSPECTUS 1 (2015) https://www.sec.gov/Archives/edgar/data/1318342/000139834415007438/filename6.htm [htpp://perma.cc/X3FL-FPXZ] ("Bond-like instruments include . . . bank loans and loan participations."); ALPS/WESTPORT SUMMARY PROSPECTUS, *supra* note 136, at 2.

[138] *See, e.g.*, PIONEER SUMMARY PROSPECTUS, *supra* note 135, at 7 ("The fund invests in securities with a broad range of maturities and maintains an average portfolio maturity that varies based upon the judgment of the fund's adviser. The maturity of a fixed income security is a measure of the time remaining until final payment on the security is due.").

[139] *See, e.g.*, 1290 Unconstrained Bond Managers Fund, Prospectus (Form N-1A) 18 (June 30, 2015), https://www.sec.gov/Archives/edgar/data/1605941/000119312515241318/d934054d485bpos.htm [http://perma.cc/K3TZ-7D23] ("As an 'unconstrained' fund, the Fund has the flexibility to utilize various investment strategies in a broad array of fixed income sectors to achieve its investment objective. The Fund is not managed to be compared to any specific index."); Anfield Universal Fixed Income Fund, Prospectus (Form N-1A) 3 (Feb. 28, 2015), https://www.sec.gov/Archives/edgar/data/1552947/000158064215000951/anfield485b.htm [http://perma.cc/S46S-JQ2W] ("The Fund is not managed relative to an index and has broad flexibility to allocate its assets across different types of securities and sectors of the fixed income markets.").

[140] *See, e.g.*, CEDAR RIDGE UNCONSTRAINED CREDIT FUND, *supra* note 134 ("The Fund may use exchange traded funds (ETFs), and derivatives, such as options, futures contracts, forward currency contracts and swap agreements (including, but not limited to, interest rate swaps, credit default swaps and total return swaps), both for hedging purposes and to seek investment returns consistent with the Fund's investment objective."); ALPS/WESTPORT RESOURCES HEDGED HIGH INCOME FUND, *supra* note 136, at 2 ("The Fund may also invest in derivative instruments, including options, financial futures, [and] options on futures and swaps, that seek to provide the same or similar economic impact as a physical investment in the above securities"); Tactical Fixed Income, Prospectus (Form N-1A) 5 (Apr.

issuers of securities that the fund may purchase,[141] (x) limit on the fund's authority to purchase illiquid securities,[142] and (xi) a required minimum investment of less than $10,000 (for a non-institutional

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29, 2015), https://www.sec.gov/Archives/edgar/data/1314414/000158064215001904/bts485b.htm [http://perma.cc/4YQE-GLTE] ("The Fund may invest in credit derivative products to be used by the Fund to gain exposure to specific asset class sectors.").

[141] *See, e.g.,* UBS FIXED INCOME OPPORTUNITIES, SUMMARY PROSPECTUS 3 (2015) https://www.sec.gov/Archives/edgar/data/886244/000110465915073529/a15-19661_13497k.htm [https://perma.cc/T6LV-U25E] ("Investments in fixed income securities may include, but are not limited to, securities of governments throughout the world (including the United States)."); CEDAR RIDGE UNCONSTRAINED CREDIT FUND, *supra* note 134, at 2 (2015) ("'Credit-related instruments' are debt securities, instruments and obligations of U.S. and non-U.S. government, non-governmental and corporate entities and issuers and include (i) debt issued by or on behalf of states, territories, and possessions of the United States, (ii) U.S. and non-U.S. corporate bonds, notes and other debentures, (iii) securities issued or guaranteed by the U.S. government, its agencies, instrumentalities or sponsored entities, [and] (iv) sovereign debt, including emerging markets debt."); PIONEER LONG/SHORT BOND FUND, SUMMARY PROSPECTUS (2015), https://www.valic.com/Images/Pioneer-Disciplined-Value-Fund_tcm182-453877.pdf ("The fund may invest without limit in non-U.S. securities. The fund may invest in both developed and emerging markets without limit. In addition to investing in securities denominated in non-U.S. currencies, the fund may hold non-U.S. currencies and purchase and sell forward currency exchange contracts in non-U.S. currencies.").

[142] *See, e.g.*, American Beacon Flexible Bond Fund, *supra* note 56, at 12, ("The Manager and the sub-advisor will carefully monitor the Fund's investments in Section 4(a)(2) securities offered and sold under Rule 144A, focusing on such important factors, among others, as valuation, liquidity, and availability of information. Investments in Section 4(a)(2) securities could have the effect of reducing the Fund's liquidity to the extent that qualified institutional buyers no longer wish to purchase these restricted securities."); Anfield Universal Fixed Income Fund, *supra* note 139 ("The Fund may hold securities, such as private investments, interests in commodity pools, other non-traded securities or temporarily illiquid securities, for which market quotations are not readily available or are determined to be unreliable. These securities will be valued using the 'fair value' procedures approved by the Board.").

class of shares).[143] Funds with the applicable characteristics were coded "1", while funds without the characteristics were coded "0". Funds with a "9" score or better were categorized as UMFs, while funds with a score lower than "9" were removed from the UMF sample. A total of 54 funds scored "11," 11 funds scored "10," 18 funds scored "9," and 21 funds scored "8" or less. The final sample of purely unconstrained mutual funds (i.e., those which were the focus of this study) (N=84) included only those UMFs that scored a "9" or better out of a total of 114 funds identified in the Morningstar Nontraditional Bond index.

The authors' data evaluation indicates, among other things, that UMFs are predominantly credit-oriented funds intended to be sold on a retail basis, but which nonetheless authorize the investment manager, similar to a private fund manager, to trade any type of credit security or derivative, without position or other limitations on, the issuer or the issuer's sector or jurisdiction, and without being subject to liquidity, duration, or benchmark requirements.

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[143] *See, e.g.*, CATALYST FUNDS, CATALYST/STONE BEACH INCOME OPPORTUNITY FUND FACT SHEET (Dec. 31, 2014), http://www.catalystmutualfunds.com/i/u/6149790/f/CatalystStoneBeachIncomeOpportunityFund/Fact_Sheet-Catalyst-Stone_Beach_Income_Opportunity_Fund-2014-12.pdf [https://perma.cc/48AE-FP6W] (setting forth a minimum initial investment of $2,500).

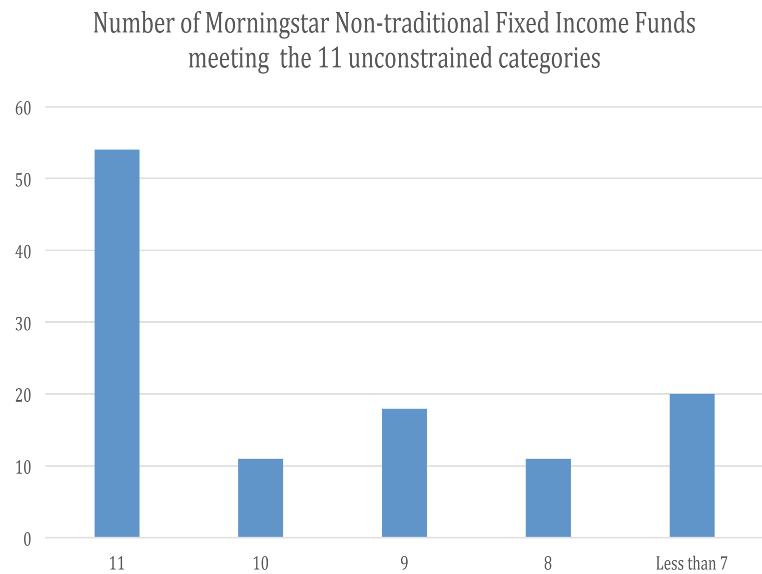

Figure 1—Number of Morningstar Non-Traditional Fixed Income Funds meeting the 11 unconstrained coding categories.

Figure 1 shows the number of funds in the Morningstar category "Non-Traditional Bond" that meet the authors' unconstrained methodological definition. Out of 114 identified mutual fund prospectuses in the Morningstar Non-Traditional Bond index category, the clear majority meets at least 10 of the coding criteria. The data reviewed in this study originate from the 2016 mutual fund prospectuses for each fund available through Morningstar.

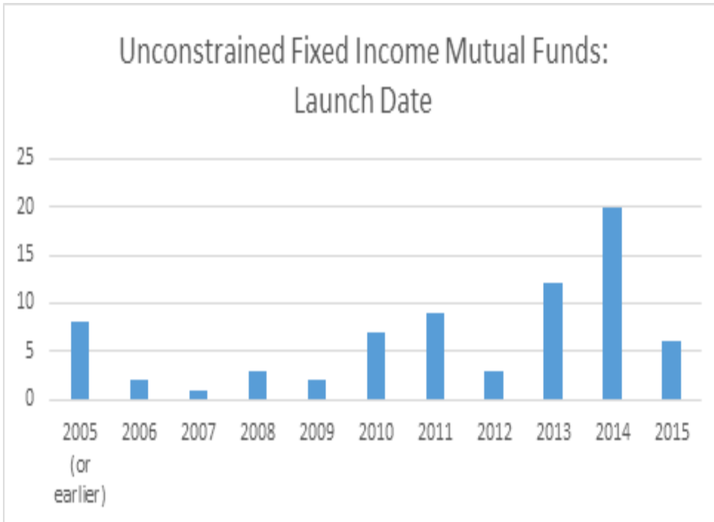

Figure 2—Unconstrained Fixed Income Mutual Funds: Launch Date.

Figure 2 shows the launch dates for UMFs in the sample (N=84) from 2005 (or earlier) through 2015. Data for Figure 2 were generated through fund inception information in the respective funds' annual reports available through Morningstar.

UMFs are proliferating at a significant rate. Figure 2 demonstrates that since 2007 the number of UMFs has grown at a steady pace. Although 2012 was a weaker year for UMF formation, the overall trend between 2010 and 2015 shows a steady increase in the launch of UMFs. Several factors may have contributed to this growth. First, in the unprecedented low interest rate environment that has prevailed since 2005, investment managers have responded to retail investors "reaching for yield" by offering a product (UMFs) that authorizes absolute return strategies in the fixed income world.[144] Second, the Dodd-Frank Act decreased the number of eligible private fund investors by raising the minimum net-worth requirement for individuals to qualify as "accredited investors," a lower standard to satisfy than the requirements applicable to "qualified client."[145] As a result, investors who no longer are eligible

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[144] Kaal, *supra* note 22, at 4.

[145] Investment Adviser Performance Compensation, 77 Fed. Reg. 10,358, 10,358–59 (Feb. 22, 2012) (to be codified at 17 C.F.R. § 275.205–3) ("The amendments revise the dollar amount thresholds of the rule's tests that are

as "accredited investors" to invest in private funds since the effective date of the revisions to the Title IV qualified investor standards[146] are likely to seek out "alternative" mutual funds,[147] such as UMFs, which pursue private fund-like investment strategies.[148]

A. UMF v. Mutual Fund Characteristics

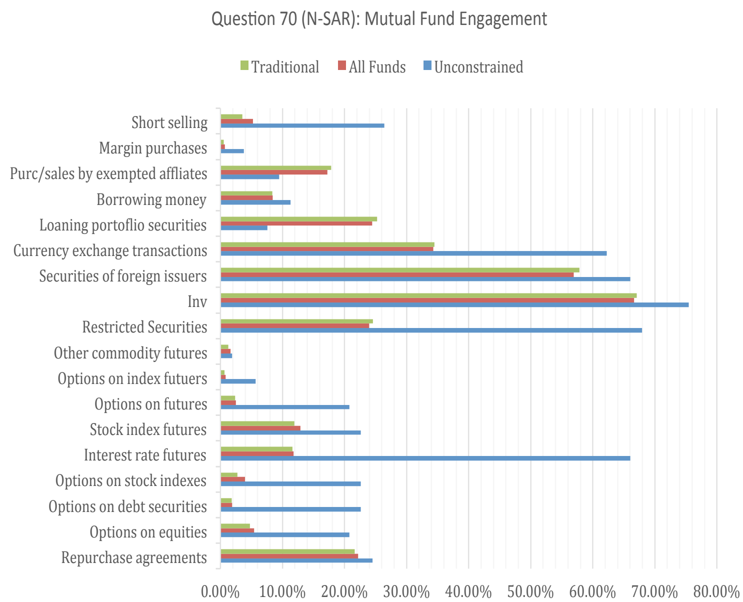

Figure 3—Question 70 (N-SAR): Mutual Fund Engagement.

Figure 3 shows mutual fund responses to the SEC's request for information regarding security and instrument trading in Question 70 of Form N-SAR, the semi-annual report required to be filed by mutual funds. The term "engagement," for purposes of Question 70, refers to the fund's trading of or investment in each of these types of securities and contract during the applicable reporting period. The authors obtained the data on "Traditional" and "All Funds" from a

used to determine whether an individual or company is a qualified client."); *see also* Kaal, *supra* note 22, at 18.

[146] 15 U.S.C. § 77b (2012) (removing the value of the primary residence from the calculation of net worth for purposes of accredited investor status, thereby reducing the number of accredited investors); *see* 17 C.F.R. § 230.501(a) (2016).

[147] 15 U.S.C. § 77b (2012); 17 C.F.R. § 230.215 (2016).

[148] *See* Kaal, *supra* note 22, at 6.

December 2015 SEC report (SEC Report).[149] The SEC Report defines "Traditional Funds" as all funds that are not considered alternative funds by Morningstar,[150] while "All Funds" includes the entire universe of mutual funds and "alternative" mutual funds filing an N-SAR.[151] UMF data come from the sample of 84 "unconstrained" funds' latest N-SAR filings in March 2016.

Figure 3 demonstrates that UMFs exceed the typical mutual fund engagements in almost all quantifiable categories. UMF trading of the referenced security and contract types clearly exceeds—indeed, is often double or quadruple the number of—the average engagements for mutual funds as a group. For instance, in terms of short selling, UMFs exceed other funds by more than 20 percent in engagements. Similarly, in currency exchange transactions, UMFs exceed other funds by almost 30 percent, in restricted securities by over 40 percent, and in interest rates futures by over 50 percent. Investment categories where UMFs exceed other funds by around 20 percent include options on futures, options on stock indexes, options on debt securities, and options on equities. Only in the categories of purchase/sale by exempt affiliates and in loaning portfolio securities do UMFs have fewer engagements than other funds.

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[149] DANIEL DELI ET AL., U.S. SEC. & EXCH. COMM'N, DIV. OF ECON. & RISK ANALYSIS, USE OF DERIVATIVES BY REGISTERED INVESTMENT COMPANIES 22 tbl. 3 (2015), https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf [https://perma.cc/ZSL8-BLXT].
[150] *Id*. at 7 n.20.
[151] *Id*. at 5 n.15.

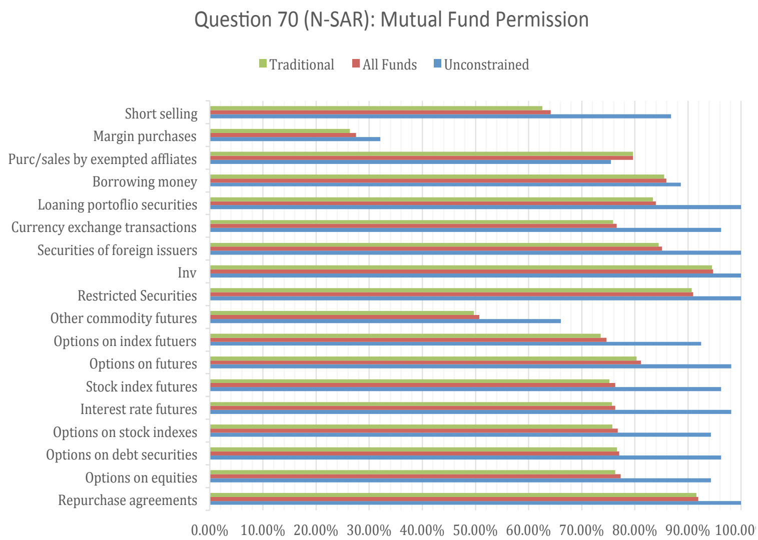

Figure 4—Question 70 (N-SAR): Mutual Fund Permission.

The data presented in Figure 4 were also obtained through mutual fund filings in response to N-SAR Question 70 for the same reporting period, relating to the manager's authority to cause the UMF to trade or invest in particular types of securities and contracts. As with the Figure 3 data, the authors obtained the data on "Traditional" and "All Funds" from the SEC Report.

Figure 4 shows that UMFs consistently exceed mutual funds in relation to almost all investment categories. In particular, Figure 4 demonstrates that UMFs exceed other mutual fund "permissions" by around 10–20 percent in short selling, currency exchange transactions, securities of foreign issuers, restricted securities, commodity futures, options on index futures, options on futures, stock index futures, interest rate futures, options on stock indexes, options on debt securities, and options on equities. The volume of UMF trading by instrument is roughly consistent with other mutual funds only in relation to margin purchases (approximately 5 percent higher for UMFs), purchase and sale by exempt affiliates, borrowing money, and repurchase agreements (approximately 8 percent higher for UMFs).

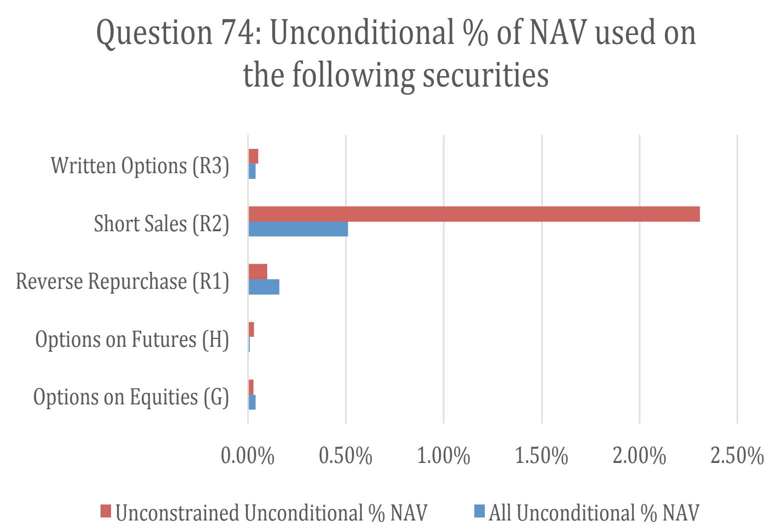

Figure 5—Question 74: Unconditional % of NAV used on securities.

Figure 5 presents mutual fund responses to the SEC's request for information regarding trading of certain instruments, provided in response to N-SAR Question 74. The "All Funds" data come from the SEC Report.[152] The term "Unconditional % of NAV" refers to the percentage of a mutual fund's NAV invested in the following derivatives: Written Options 70R3, Short Sales 70R2, Reverse Repurchase Agreements 70R1, Options on Futures 70H, and Options on Equities 70G. This calculation includes funds that report zero.[153] Data reported by 84 UMFs in the authors' sample were generated from those funds' March 2016 N-SAR filings.

Figure 5 shows that UMFs use a significantly higher proportion of short sales (as a percentage of their respective NAVs) than other mutual funds. In particular, Figure 5 demonstrates that a UMF may have short-selling exposures of more than 2 percent of the fund's NAV, while another mutual fund may have short-selling exposure of only around 0.5 percent of its NAV. Put differently, a UMF may take on almost four times the short-selling exposure of other mutual funds.

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[152] DELI ET AL., *supra* note 149 (providing data regarding mutual fund responses to questions about trading of instruments).

[153] *Id*. at 9 ("'[U]nconditional average as % of NAV' captures values for all funds with non-missing responses.").

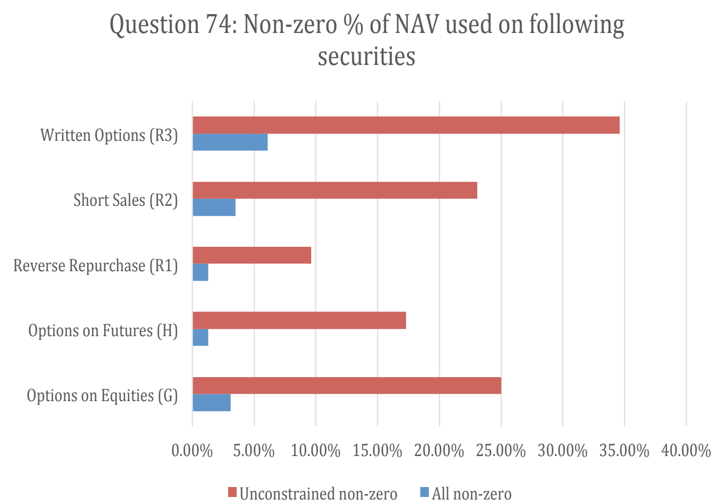

Figure 6—Question 74: Non-zero % of NAV used on securities.

Figure 6 shows additional mutual fund responses to N-SAR Question 74. The "All Funds" data come from the SEC Report.[154] "Non-zero % of NAV" refers to the percentage of mutual funds that reported investing in the following derivatives: Written Options 70R3, Short Sales 70R2, Reverse Repurchase Agreements 70R1, Options on Futures 70H, and Options on Equities 70G.[155] "Unconstrained non-zero" uses the same methodology but applies it to the authors' sample of March 2016 UMF N-SAR filings (N=84).

Figure 6 shows that UMFs consistently exceed other mutual funds in relation to their use of written options (over 25 percent more), short sales (almost 20 percent more), reverse repurchase agreements (approximately 7 percent more), options on futures (over 15 percent more), and options on equities (around 22 percent more).[156] Overall, the data in Figure 6, with the data presented in Figures 3–5, indicate that UMF trading of a broad range of security and instrument types is more consistent with trading by a private fund, which is not typically limited through statute or regulation (or contract) to investing in a narrow set of securities and instruments, than it is to the trading engaged in by other mutual funds.[157]

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[154] DELI ET AL., *supra* note 149, at 9.
[155] *Id.*
[156] *Id.*
[157] *See generally supra* Section III.B.

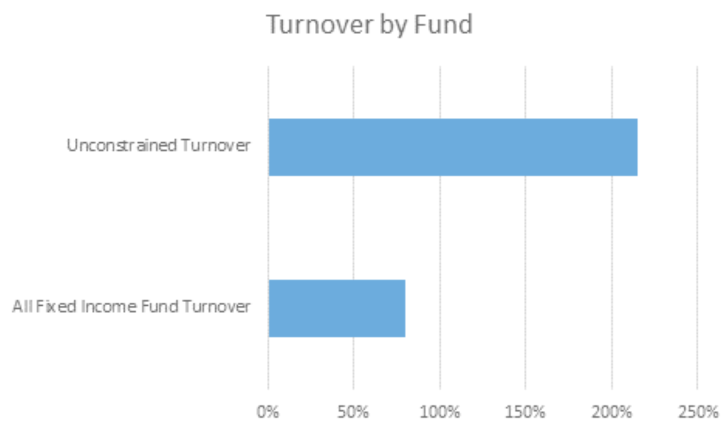

Figure 7—Turnover by fund.

Figure 7 shows Morningstar's Turnover data as of March 2016 for the applicable fund categories. Figure 7 compares the turnover for the UMF sample of this study (N=84) with the turnover among all Morningstar-universe fixed income mutual funds (Fund Category = All Taxable Bond, N=5543 Funds). Turnover is measured by taking the lesser of purchases or shares (excluding all securities with maturities of less than one year) and dividing them by average monthly net assets.[158]

UMFs display a substantially higher turnover rate than other mutual funds trading fixed income instruments. In particular, UMF turnover on average exceeds the turnover for other fixed income mutual funds by over 150 percent. The comparatively higher UMF turnover rate can be partially explained by the strategies pursued by UMFs, including their relatively greater use of derivatives.[159] The high UMF turnover rate is a characteristic that distinguishes these funds from other mutual funds, and makes them directly comparable to private funds, which typically engage in high trading levels due to the absence of any statutory or contractual limitation on the fund's

[158] *Morningstar Investing Glossary: Turnover Ratio*, MORNINGSTAR, http://www.morningstar.com/InvGlossary/turnover_ratio.aspx [https://perma.cc/KNH5-QM9E].

[159] Matthew Tucker, *Q&A on Bond Funds and Churn: Why Turnover Can Be Misleading*, BLACKROCK BLOG (Sept. 13, 2011), https://www.blackrockblog.com/2011/09/13/qa-on-bond-funds-and-churn-why-turnover-can-be-misleading/ [https://perma.cc/RN9A-V934].

obligation to pay all trading-related costs and expenses (including all commissions).[160]

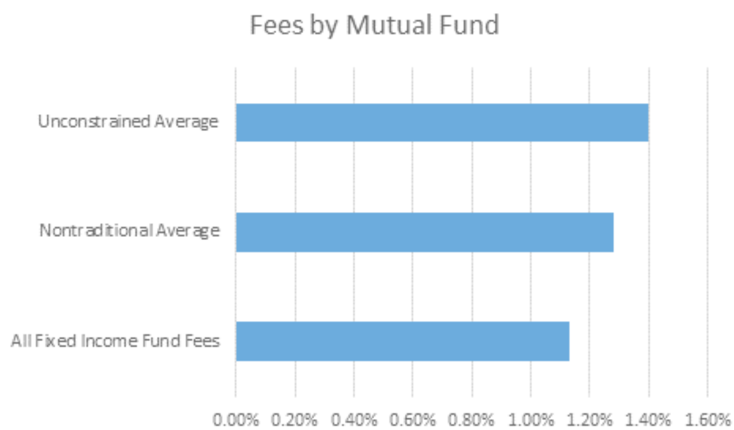

Figure 8—Fees by mutual fund.

Figure 8 shows Morningstar's "Expense Ratio" data for applicable fund categories as of March 2016. Morningstar uses the term "Expense Ratio" to mean a fund's total annual operating expense ratio, gross of any fee waivers or expense reimbursements.[161] "All Fixed Income" is defined as all taxable bond funds within the Morningstar universe (N=5543).[162] The "Nontraditional Average" is based on the Morningstar expense ratio average for the category for 2015.[163] UMF data in Figure 8 are based on the sample of this study (N=84).[164]

Figure 8 demonstrates that UMF fees generally exceed those of other mutual funds. While the average fee charged by a UMF (1.40 percent) exceeds the average fee charged by those mutual funds in the Morningstar "non-traditional category" (1.25 percent) and the average fee charged by all credit mutual funds as a group (1.15

[160] *See generally* LHABITANT, *supra* note 4; *infra* Section III.
[161] *Morningstar Investing Glossary: Expense Ratio,* MORNINGSTAR, http://www.morningstar.com/InvGlossary/expense_ratio.aspx [https://perma.cc/AMA5-MTE3].
[162] *See* MORNINGSTAR, MUTUAL FUND DATA DEFINITIONS, http://quicktake.morningstar.com/DataDefs/FundSnapshot.html [https://perma.cc/W8RB-N276].
[163] *See id.*
[164] *See id.*

percent), the fees charged by UMFs are only marginally higher than those charged by other mutual funds. Nonetheless, charging a relatively higher fee is another characteristic that UMFs share with private funds.[165]

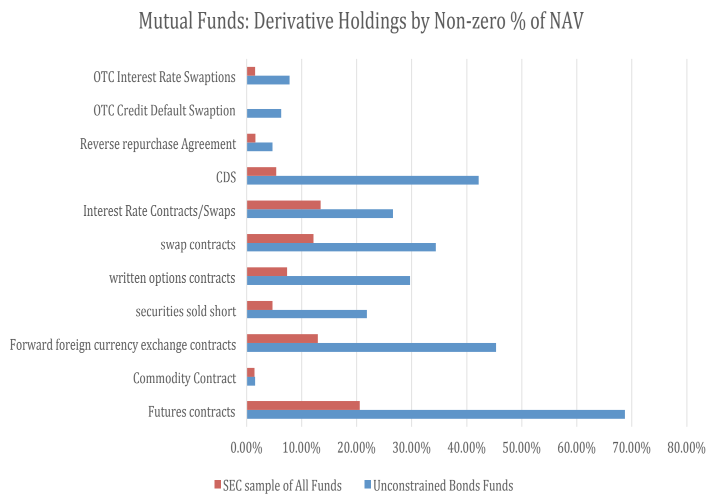

Figure 9—Mutual Funds: Derivative holdings by Non-zero % of NAV.

The figures presented in Figure 9 are based on data from the SEC Report regarding mutual funds' derivative use,[166] and were used to compare derivative use data of the UMFs included in this study (N=84). The term "Non-zero % of NAV" means that the fund transacted in each of the referenced categories: futures, commodity futures, currency forwards, sold short securities, wrote options contracts, swap contracts, interest rate contracts, credit default swaps, repos, Over the Counter (OTC) credit default swap-options swaptions), and OTC interest rate swaptions.[167] UMF data for purposes of preparing Figure 9 were sourced from the schedule of investments from each fund's latest N-CSR filing as it appears in Lexis Securities Mosaic (i.e., April 2016).

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[165] High performance fees are a defining characteristic of private funds (or at least of their managers). *See, e.g.*, Joe Rich & Paul Lajbcygier, *The Gap Between Desert and Entitlement: Performance Fees in Hedge Funds* (July 31, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2461100 [https://perma.cc/3YSJ-RL5Y].
[166] DELI ET AL., *supra* note 149.
[167] *Id*. at 24 tbl. 4.

UMFs engaged in transactions involving the derivatives and other instruments referenced in Figure 9 to a far greater extent than the mutual funds included in the SEC Report. Figure 9 shows that UMFs display the largest disparities with other mutual funds in their holdings of CDSs (almost 40 percent more than other mutual funds), interest rate contracts/swaps (over 10 percent more than other mutual funds), swap contracts (over 20 percent more than other mutual funds), written option contracts (over 20 percent more than other mutual funds), securities sold short (almost 20 percent more than other mutual funds), forward foreign currency exchange contracts (over 30 percent more than other mutual funds), and, most importantly, futures contracts, where UMFs engaged in almost 50 percent more transactions than other mutual funds. These statistics reflect the scope and nature of derivative use by UMFs, and are consistent with what the authors would expect of derivative use by a private fund.

B. UMF vs. Private Fund Characteristics

Analyzing multiple metrics, UMFs share important investment strategy and risk attributes with private funds.[168] UMFs and private funds use similar strategies and investment products; UMFs and private funds use dynamic trading strategies and derivative holdings to avoid parametric normal distributions, and UMFs use a higher proportion of derivatives than the average mutual fund.[169] Because of these shared investment strategy and risk attributes, the average UMF's risk profile is substantially more complex, and generally involves more risks, than the average mutual fund, and is rather more similar to that of a private fund.[170]

UMFs and private funds use similar strategies and investment products. The average private fund is authorized to use dynamic trading strategies, leverage, and derivatives in order to deliver alpha to investors.[171] Figures 3, 6 and 9 show that UMFs use

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[168] *See* Kaal, *supra* note 22, at 12.
[169] *Id.* at 6.
[170] *See id.*
[171] Vikas Agarwal & Narayan Y. Naik, *Risks and Portfolio Decisions Involving Hedge Funds*, 17 REV. FIN. STUD. 63, 64 (2004) ("Unlike mutual funds, hedge funds are not evaluated against a passive benchmark and therefore can follow more dynamic trading strategies.").

a higher proportion of derivatives than do other mutual funds.[172] Moreover, private funds employ a broad range of investment instruments, including the following: 15.3 percent employ strategies involving forward contracts, 21.2 percent employ strategies involving futures contracts, 21.8 percent employ strategies involving options, 17 percent employ strategies involving swap contracts, and 29.1 percent employ one of the prior listed four instruments.[173] While these percentage holdings are generally consistent with the traditional role of a mutual fund in a portfolio (i.e., as part of a "long-only, buy-and-hold" investment strategy based on an allocation to standard asset classes),[174] Figures 3, 6 and 9 show that UMF trading of these instrument types in the aggregate exceeds most of these thresholds.[175] UMFs therefore appear to follow instrument selection and trading strategies comparable to those employed by private funds.[176]

Like private funds, UMFs use dynamic trading strategies and derivative holdings to avoid parametric normal distributions.[177] Because of their use of options, UMFs, like private funds, can generate options-like returns[178] and exhibit non-normal payoffs.[179]

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[172] *See supra* Figures 3, 6 & 9.

[173] Yong Chen, *Derivative Use and Risk Taking: Evidence from the Hedge Fund Industry*, 46 J. FIN. & QUANTITATIVE ANALYSIS 1073, 1078 tbl. 1 (2011).

[174] Agarwal & Naik, *supra* note 171, at 64 ("Mutual funds typically employ a long-only buy-and-hold-type strategy on standard asset classes, and help capture risk premia associated with equity risk, interest rate risk, default risk, etc.").

[175] *See supra* Figures 3, 6 & 9.

[176] *See* Kaal, *supra* note 22, at 12 (outlining the similarities in trading strategies between UMFs and private funds).

[177] *Id.* at 6 (outlining the UMF trading strategy).

[178] William Fung & David A. Hsieh, *The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers*, 14 REV. FIN. STUD. 313, 314 (2001) ("[H]edge fund managers typically employ dynamic trading strategies that have option-like returns with apparently no systemic risk."); *See* Agarwal & Naik, *supra* note 171, at 64 ("[T]he risk return characteristics of the hedge fund strategies . . . nonlinear and stress the importance of taking into account option-like features inherent while analyzing hedge funds."). *See generally* Mark Mitchell & Todd Pulvino, *Characteristics of Risk and Return in Risk Arbitrage*, 56 J. FIN. 2135 (2001) (discussing risk arbitrage returns).

[179] Agarwal & Naik, *supra* note 171, at 66 ("Hedge funds may exhibit nonnormal payoffs for various reasons such as their use of options, or

However, while private funds' unique management incentives combined with their flexibility in investment strategy (e.g., the authority to use potentially unlimited leverage and derivatives, and to take highly concentrated positions and engage in potentially unlimited short selling) can help explain their performance advantage over mutual funds,[180] the performance record for UMFs is less clearly distinguished from that of other mutual funds.[181]

UMFs use a higher proportion of derivatives in their portfolio than do other mutual funds.[182] According to some estimates, a total of 71 percent of private funds trade derivative securities, which is over three times larger than the number of mutual funds trading such securities.[183] Figures 3, 6 and 9 demonstrate that derivative transactions engaged in by UMFs greatly exceed the number of derivative transactions engaged in by other mutual funds.[184] This is a core characteristic that UMFs share with private funds, and another important point of contrast with other mutual funds.[185]

UMFs' greater use of derivatives relative to that of other mutual funds concomitantly increases those funds' risk profiles above that of the average mutual fund. While the literature is divided on the relationship between private funds' returns and the risks

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option-like dynamic trading strategies or strategies that lose money during market downturns.").

[180] Carl Ackermann et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833, 870 (1999) ("This combination of incentive alignment and investment flexibility gives hedge funds a clear performance advantage over mutual funds . . . . [W]e find that the average (median) hedge fund Sharpe ratio is 21 (11) percent higher than [the] comparable mutual fund Sharpe ratio.").

[181] Eric Jacobson, *supra* note 40 ("Not a single fund in the category managed to beat the Barclays Aggregate last year, which ended on a 7.8% gain.").

[182] *See* Jennifer Lynch Koski & Jeffrey Pontiff, *How Are Derivatives Used? Evidence from the Mutual Fund Industry*, 54 J. FIN. 791, 792 (2002) ("From our sample of 679 general, domestic equity mutual funds, only 21 percent use derivative securities."); *supra* Figure 3 (demonstrating that derivative transactions engaged in by UMFs exceed the number engaged in by other mutual funds).

[183] *See* Chen, *supra* note 173, at 1077; Koski & Pontiff, *supra* note 182.

[184] *See supra* Figures 3, 6 & 9.

[185] *See id.*; Koski & Pontiff, *supra* note 182.

associated with their use of derivatives,[186] mutual funds display no systemic difference in risk or return measures between funds that do and do not use derivatives.[187] Figures 3, 6 and 9 demonstrate that UMFs engage in a higher number of derivatives transactions than the average mutual fund.[188] The authors suggest that such UMF derivative use can increase a UMF's risk profile above that of the average mutual fund. There is some evidence that mutual funds that use derivatives engage in less risk-shifting than mutual funds that do not use derivatives, and that there is little influence through derivative use on the fund flow-performance relationship.[189] Figures 3, 6 and 9, however, show that derivative use by UMFs is closer to that of a typical private fund, which may mean that the absence of evidence on risk-shifting by the average mutual fund that engages in derivatives transactions is less relevant.[190]

The average portfolio turnover rate for UMFs identified in this study suggests a level more consistent with the turnover rate of a private fund. Figure 7 demonstrates that the average turnover rate for a UMF exceeds the portfolio turnover rate for fixed income mutual funds by more than 150 percent.[191] As with other categories of data surveyed in this study, the turnover rate in UMF portfolios relative to that of other mutual fund portfolios suggests that UMFs trade at levels consistent with those of private funds.[192] The higher UMF turnover rate relative to that of other mutual funds can be partially explained by the strategies pursued by UMFs, including the

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[186] *Compare* William Fung & David A. Hsieh, *supra* note 178 (showing that hedge fund returns relate to conventional asset class returns and option-based strategy returns affected by systemic risk factors), *with* Robert Kosowski et al., *Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis*, 84 J. FIN. ECON. 229, 231 (2007) (footnote omitted) (showing that "after controlling for hedge fund exposures to these systematic risk factors, the managerial specific component of fund returns persist[s], and for the top funds, cannot be attributed to luck").

[187] Koski & Pontiff, *supra* note 182, at 793 ("Although we find substantial variations in risk related to self-stated investment objectives, we find no differences between funds that use derivatives and those that do not.").

[188] *See supra* Figures 3, 6 & 9.

[189] Chen, *supra* note 173, at 1103–04.

[190] *See supra* Figures 3, 6 & 9.

[191] *See supra* Figure 7.

[192] *See supra* notes 46–48 and accompanying text (discussing the high UMF turnover rate).

extensive use of derivatives among UMFs as identified in Figures 3, 6 and 9.[193]

V. Policy Implications

The growth in the number of UMF launches, in combination with important investment strategy and risk attributes shared by UMFs and private funds, raise several potential retail investor protection concerns. When promulgating the Company Act, Congress intended to address retail investors concerns principally through reliance on robust and continuous disclosure requirements relating to the mutual fund's management, strategies, financial performance, use of leverage, investment risks, redemption processes, and other topics.[194] However, the ability of a retail investor to purchase shares in a UMF that possesses many important investment strategy and risk attributes of a private fund, an entity in which the retail investor otherwise would not be permitted to invest, calls into question whether Congress's retail mutual fund investor protection objectives are attainable exclusively through the Company Act's disclosure requirements.[195] Given the complexity of the fund's strategy and trading, and the broad scope of the manager's investment authority to "go anywhere,"[196] a reliance on prospectuses and other disclosures by a UMF that in all material respects complies with the Company Act may be insufficient to protect retail investors.

Several factors call into question the effectiveness of the Company Act's existing disclosure regime for retail UMF investors.[197] First, it is questionable whether retail investors typically have the experience or training to fully appreciate the risks disclosed in UMF prospectuses.[198] It seems unlikely that the average retail

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[193] *See supra* Figures 3, 6 & 9.
[194] *See supra* Part III.A.
[195] *See supra* Part III.A.
[196] *See supra* notes 50–53 and accompanying text (discussing why UMFs are called "go anywhere" funds").
[197] *See* Kidd, *supra* note 36, at 3 ("Investors assessing unconstrained bond funds must piece together a mosaic of qualitative and quantitative data without many of the conventional evaluation metrics. Placing greater emphasis on the qualitative aspects of manager due diligence can help address some of the shortcomings in quantitative data.").
[198] *See* Toonkel & Ablan, *supra* note 46 ("Understanding the mechanics of these funds has gotten so difficult that even analysts at fund research shops

investor will, on the basis of the information disclosed in the UMF's prospectus, understand: (i) the impact of the fund's use of particular derivatives on the fund's overall expenses (a significant determinant of long-term fund performance)[199] and risk profile; (ii) the risks of negative performance caused by the manager's selection of a particular combination of domestic and foreign bonds of varying durations, investment ratings, and liquidity; or (iii) the impact of the manager's decision to exit these positions to an entirely different combination of varying-duration fixed-income and derivative securities on the fund's risk profile or on the performance of the portfolio.[200] As a corollary, the typical UMF does not ordinarily pursue a single and narrowly framed investment strategy, as would be the case with a mutual fund executing, for instance, a large-cap equity or a short or intermediate-term bond strategy.[201] Instead, UMF

Morningstar and Lipper can't get a handle on what these portfolios are doing, analysts told Reuters.").

[199] *See, e.g.*, OFFICE OF INV'R EDUC. & ADVOC., U.S. SEC. & EXCH. COMM'N, SEC PUB. No. 164, HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO (2014), https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf [https://perma.cc/8SMH-W2GZ] ("These fees may seem small, but over time they can have a major impact on your investment portfolio."); John F. Wasik, *The Erosive Effect of Expenses on a Portfolio's Value*, N.Y. TIMES, (Oct. 15, 2013), http://www.nytimes.com/2013/10/16/your-money/the-erosive-effect-of-expenses-on-a-portfolios-value.html [https://perma.cc/6W3L-WB75] ("[T]he fund expense ratio understates total costs investors pay. In addition to costs included in the expense ratio, investors need to look at transaction fees, sales charges and the 'drag' of a fund manager who holds assets in cash, which pays almost nothing these days.").

[200] *See* Hunnicutt, *supra* note 43 (explaining how the inability of retail investors to appreciate the risks associated with investing in UMFs could give rise to widespread disappointment in UMF returns as a class).

[201] *See*, *e.g.*, *Fidelity Blue Chip Value Fund*, FIDELITY, https://fundresearch.fidelity.com/mutual-funds/view-all/316389857 [https://perma.cc/JSX4-JU99] (stating an objective of capital appreciation through investing at least 80 percent of the fund's capital in stocks issued by companies in the S&P 500 or Dow Jones Industrial Average, or in companies with a market capitalization of at least $1 billion if they are not included in either of those indices); *T. Rowe Price Short-Term Bond Fund*, T. ROWE PRICE, https://www3.troweprice.com/fb2/fbkweb/objective.do?ticker=PRWBX [https://perma.cc/6DGV-A4CJ] (stating an objective of producing a high

managers typically have authority to, among other things: (i) invest in a broad range of fixed-income securities and derivatives, (ii) take concentrated positions in securities of a particular issuer or in issuers in a specific sector and market, or in illiquid securities, and (iii) materially change the duration of the fund's portfolio as the manager determines.[202] This broad investment authority exposes retail UMF investors to fluid trading and investing patterns and behaviors that the "average" retail investor is unlikely to sufficiently appreciate, regardless of the nature and quantum of disclosure to the investor regarding the fund's trading and holdings.

Additionally, the performance of a UMF typically will not be assessed relative to a benchmark, including, in particular, any of the well-known or established benchmarks frequently referenced in the fixed-income markets.[203] Therefore, it is left to the retail UMF investor to assess the fund's performance without the type of contextual information routinely available in relation to other mutual funds pursuing more "traditional" credit strategies.

Retail investors may also be led to believe that UMFs are "safe" products relative to other fixed income mutual funds, because they are marketed, offered, and regulated as mutual funds. This is a risk that is unique to retail investors in UMFs. A private fund investor, who by definition is relatively more sophisticated and wealthier than a retail investor, would have no reason to believe that

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level of income through investing a large majority of the fund's capital in a portfolio of investment grade securities with a maturity of less than three years).

[202] *See supra* notes 36–39 and accompanying text (discussing UMF managers' authority).

[203] Kidd, *supra* note 36; *see, e.g.*, *Bloomberg Barclays Capital Aggregate Bond Index*, BLOOMBERG INDICES, https://www.bloombergindices.com/bloomberg-barclays-indices/ [https://perma.cc/HGG9-54NM] (assessing the performance of funds investing in investment grade bonds issued in the U.S.); CITI, CITI FIXED INCOME INDICES (2016), https://www.yieldbook.com/x/ixFactSheet/factsheet_monthly_hyi.pdf [https://perma.cc/9VU8-BKRH] (assessing the performance of funds investing in high-yield debt of U.S. and Canadian companies); ISHARES BY BLACKROCK, J.P. MORGAN EMB INDEX (2016), https://www.ishares.com/us/literature/fact-sheet/emb-ishares-j-p-morgan-usd-emerging-markets-bond-etf-fund-fact-sheet-en-us.pdf [https://perma.cc/E7NL-FYXD] (assessing the performance of entities investing in bonds of issuers in emerging markets).

there is active government regulation of the private fund in a manner conceptually similar to what the SEC requires of mutual funds, such as the SEC's review and approval mutual fund prospectuses, and conducting examinations of mutual fund governance and supervisory processes.[204] Figures 3–4, 6–7, and 9, individually and in the aggregate, demonstrate that in relation to security and instrument selection and trading tactics, UMFs resemble private funds much more than any mutual fund pursuing a "traditional" fixed-income strategy.[205] Nonetheless, the mutual fund characteristics of a UMF may cause the average retail investor to conclude that the investor's past experience selecting mutual fund investments for his or her personal portfolio will provide adequate grounding to understand the risks associated with purchasing UMF shares.[206] Such a conclusion would be mistaken, as the data-driven findings in this study demonstrate that retail investors in UMFs face many of the same types of investment strategy and other risks as those faced by wealthier, more sophisticated investors in private funds, a group that the SEC has determined can "fend for themselves."[207] Accordingly, retail investors' experience investing in "traditional" mutual funds is likely to be a poor indicator of whether a retail investor will understand the risks associated with investing in a UMF.

Beyond the retail investor-protection concerns referred to in this article, the growth in the number of UMFs poses an important question regarding the continuing relevance of the public/private divide in federal securities regulation. The academic literature on this topic[208] has examined a blurring of the traditional boundary lines

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[204] *See* S. REP. NO. 104-293, at 10 (1996) ("The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.").

[205] *See supra* Figures 3, 6 & 9.

[206] *See supra* Part IV.A.

[207] U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 2 (2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf [https://perma.cc/T6W7-M2NX].

[208] *E.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO L.J. 337, 339 (2013) ("[T]hese boundary issues along the public–private divide are

between regulated companies and activities, and "private" firms and transactions,[209] including such blurring caused by the enactment of new legislation, such as the JOBS Act and the Crowdfunding Act.[210] The confluence of mutual funds and private funds is an important example of the blurring of the public/private distinction in federal securities regulation.[211]

The proliferation of UMFs has contributed to the confluence of mutual and private funds, and weakened the traditional public/private distinction in federal securities regulation. Figures 3–9 illustrate that UMFs share many important investment strategy and risk attributes with private funds.[212] However, as mutual funds, UMFs are technically on the "public" side of federal securities regulation, while private funds are on the "private" side.[213] The overlapping investment mandates and risk attributes of UMFs and

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under theorized and, up until recently, left to resolution by reference to regulatory legacies from a time far different from today's trading markets."); Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1629, 1631 (2014) ("Publicness is therefore a public–private dialectic that derives from the increasingly visible nature of corporations."); Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1012 (2013) ("This Article develops a theory of public governance as a form of publicness by exploring corporate governance and decision making."); Hillary A. Sale, *The New "Public" Corporation*, 74 L. & CONTEMP. PROB. 137, 148 (2011) ("Public company fiduciaries must address the expectations of shareholders and Main Street about what the company can and will do.").

[209] *See* Langevoort & Thompson, *supra* note 209 at 342 n.13 (mentioning blurring caused by private investment in public equity ("PIPE") transactions and reverse mergers).

[210] Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 485 (2014) ("This article focuses narrowly on the [Crowdfunding] Act as a reaction to two historically significant public/private distinctions in U.S. federal securities law: the line between public offerings and private offerings and the division between public companies and private companies – ways of understanding and categorizing business associations for the purposes of U.S. federal securities regulation.").

[211] Kaal, *supra* note 22, at 19–20.

[212] *See supra* Figures 3–9.

[213] *See generally* Langevoort & Thompson, *supra* note 209 (discussing the general question of "when a private enterprise should be forced to take on a public status").

private funds provide some evidence of the diminishing importance of the public/private distinction in federal securities regulation.[214]

VI. Conclusion

This article demonstrates that UMFs and private funds share important investment strategy and risk attributes. However, the Company Act's retail investor protection policies do not take these risks sufficiently into account. Moreover, the SEC has in the past expressed concern about the "retailization" of private funds, whereby retail investors purchase private fund-like interests that are traditionally reserved for qualified investors.[215] Given the risks to retail investors of investing in relatively complex UMFs, and the SEC's overall concern about the "retailization" of private funds, it is unclear why the SEC has not taken action to enhance protections for retail investors seeking to purchase shares of a UMF.

Several explanations for the SEC's inaction seem possible. First, the SEC may see the threat of overlapping UMF and private fund investment risk attributes as a natural outgrowth of the development of the mutual fund industry over many years, including specifically in reaction to the low interest rate environment. Second, the SEC may not have acted because the agency is unaware of the degree and nature of the overlap in investment and other risks shared by UMFs and private funds, and the risks that UMFs as a retail product therefore could pose to investors.[216] Third, considering its

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[214] *Id.* at 354 n.76 ("Within a discussion of determining metrics for publicness, this issues seems of lesser importance and ought not to deter a move away from listings as a focus for publicness.").

[215] U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 83–85 (2003), https://www.sec.gov/news/studies/hedgefunds0903.pdf [https://perma.cc/7BSA-YUQ6] (finding that the private fund sector as a whole generally lacks fraud protection and disclosure requirements and poses overleveraging and other risks particularly inimical to retail investors); Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Adviser Act Release No. 2333, 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004) ("[O]f significant concern is the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy.").

[216] In contrast, proposed Company Act Rule 18f-4, which aims to enhance regulation of mutual funds' use of derivatives, followed a review by the

very crowded rulemaking and enforcement agendas, the SEC may simply not have had the time or the resources to devote to analyzing the risks at the root of the authors' study.

Regardless of the SEC's reason for inaction, the authors believe that the SEC should re-evaluate its reliance on the Company Act's disclosure regime in its current form as the best means of protecting retail investors in relation to the risks posed by investing in UMFs.[217]

SEC's staff of the "benefits, risks, and costs associated with funds' use of derivatives . . . including in particular whether funds' current practices, based on their application of [SEC] and staff guidance, are consistent with the investor protection purposes and concerns underlying Section 18" of the Company Act. SEC Derivatives Release, *supra* note 115, at 8–9; *see supra* note 115 (discussing the reduction in use of derivatives potentially caused by Rule 18f-4). In proposing Rule 18f-4, the SEC emphasizes the leverage and liquidity (including, ultimately, the default) risks it believes are associated with a mutual fund investing heavily in derivative instruments. SEC Derivatives Release, *supra* note 115, at 53; *see supra* note 115. However, the SEC articulates no concern in the release that retail investors may or will struggle to understand the nature of the liquidity or other risks to a fund from investing in derivatives, including in relation to the fund's trading of relatively complex instruments. The absence of this concern seems to reflect the SEC's continued reliance on disclosure as a means of mitigating the risks to investors from investing in UMFs and other mutual funds irrespective of the complexity of their portfolios and strategies, and irrespective of whether retail investors typically have the education and investing experience to understand the nature of those risks. It likely also reflects the SEC's view that the broker-dealer through which the leveraged ETF interests (or UMF shares) are sold will assure that the retail investor is appropriately educated at the point of sale regarding the risks of the product. *But see* Press Release, Financial Industry Regulation Authority, FINRA Orders Stifel, Nicolaus and Century Securities to Pay Fines and Restitution Totaling More Than $1 Million for Unsuitable Sales of Leveraged and Inverse ETFs, and Related Supervisory Deficiencies (Jan. 9, 2014), https://www.finra.org/newsroom/2014/finra-orders-stifel-nicolaus-and-century-securities-pay-fines-and-restitution-totaling [https://perma.cc/387A-GJ7T]; Press Release, Financial Industry Regulation Authority, FINRA Sanctions Four Firms $9.1 Million for Sales of Leveraged and Inverse Exchange-Traded Funds (May 1, 2012), https://www.finra.org/newsroom/2012/finra-sanctions-four-firms-91-million-sales-leveraged-and-inverse-exchange-traded [https://perma.cc/WL5D-N6PC].

[217] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Release Nos. 33-8393; 34-49333; IC-

26372, 69 Fed. Reg. 11,244, 11,248 (2004); *see* U.S. SEC. & EXCH. COMM'N, MUTUAL FUND FEES AND EXPENSES (2014), https://www.sec.gov/files/ib_mutualfundfees.pdf [https://perma.cc/F6SA-L4BC]. Indeed, the absence of any current requirement to present risks associated with a UMF portfolio at this level of detail seems to raise the question of whether UMF prospectuses at present provide "adequate, accurate, and explicit information, fairly presented, concerning the character of [mutual fund] securities," as required by Section 1(b)(1) of the Company Act. 15 U.S.C. § 80a-1(b)(1) (2012).