

U.S. and EU Mutual Funds: Key Legal and Regulatory Concepts

Strategic Issues and Challenges for the Investment Funds Industry

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Overview

- **Compare key legal and regulatory aspects** of organization and regulation of U.S. mutual funds and EU UCITS funds (Undertakings for Collective Investment in Transferable Securities)
- **Funds covered** have the following similar characteristics:
 - Redeemable interests
 - Offered to retail (public) investors
 - Capital raised by public offering
- **US: Investment Company Act/Investment Advisers Act** both enacted in 1940; amended periodically; interpreted/implemented by SEC rules and regulations (subject to public comment process)
- **EU UCITS: Framework regime** adopted in 1985 by EU Directive; amended in 3 additional EU Directives; implemented by EU member countries into own national laws and regulations
- **Caution:** U.S. mutual funds and UCITS funds subject to very detailed laws, regulations, interpretations and case law
 - Presentation necessarily only a summary; simplified/abbreviated
 - Numerous additional laws and regulations apply, including those applicable to service providers

Overview: Key Concepts

U.S. Mutual Funds

- Organized as corporations or business trusts under U.S. state law
- Fund directors play significant role; investor voting rights
- SEC registration and regulation of funds; single federal regulator
- SEC registration of adviser and other service providers and/or regulation of activities (custodian)
- Required disclosures to investors
- SEC inspection; enforcement
- Liability; statutory investor rights to bring law suits

UCITS Funds

- Organized as common contractual funds (contract law), investment companies (corporate statute), or trusts (trust law)
- UCITS regime implemented by member states under own laws; passporting concepts
- “Home country” regulator authorizes fund, management company and its senior managers, depository
- Required disclosures to investors
- Regulator oversight; enforcement
- Liability; investor civil law claims

Size of Mutual Fund Industry*

Total worldwide assets invested in mutual funds		\$ 23.1 trillion
US	Total net assets of U.S mutual funds	\$12.9 trillion**
	Number of U.S. mutual funds	7,589
	Number of U.S. individuals owning mutual funds	90.2 million
Europe	Total net assets of mutual funds in Europe	\$7.3 trillion
	Number of mutual funds in Europe	35,786
Brazil	Total net assets of mutual funds in Brazil	\$952 billion
	Number of mutual funds in Brazil	6,308

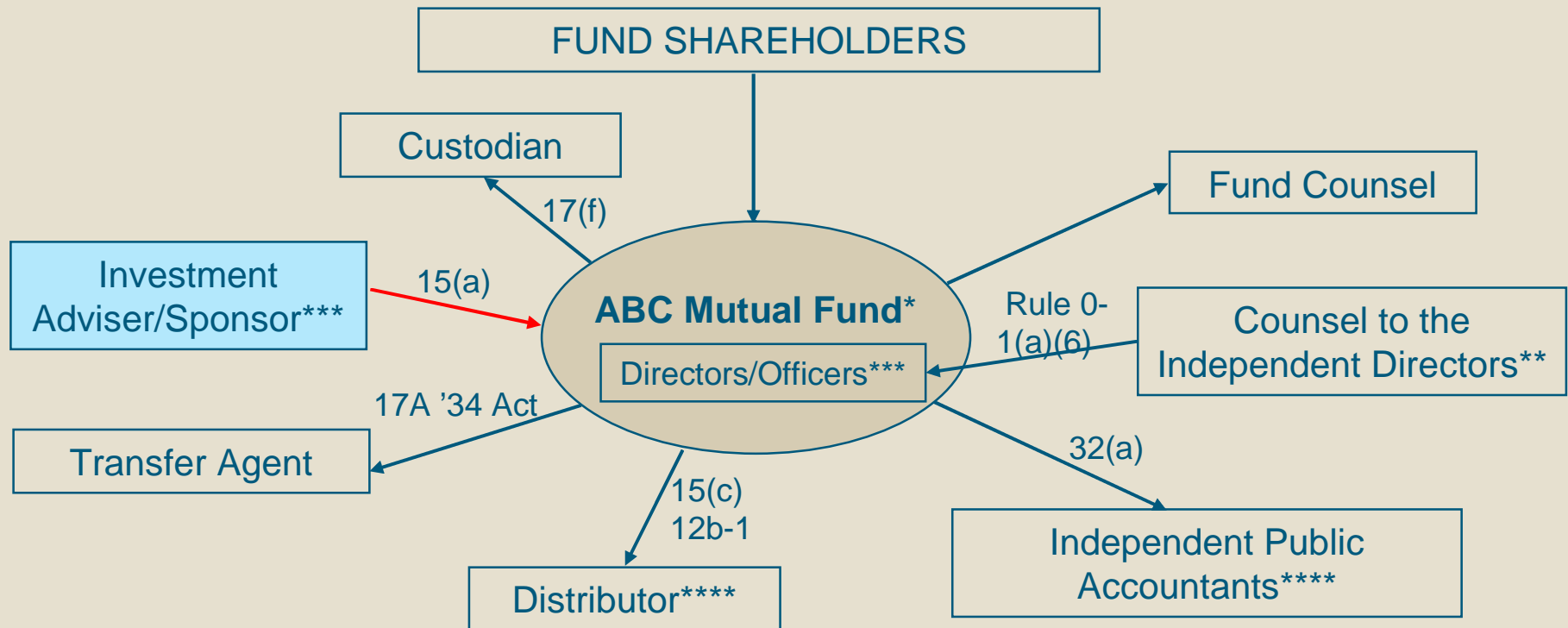
* Source: Investment Company Institute, Worldwide Mutual Fund Assets and Flows, Third Quarter 2011

** About 50% in individual retirement vehicles

U.S. Mutual Funds: Basics

- Actively managed portfolio of securities
- Satisfies diversification requirements, concentration, and leverage limits
- Open-end -- fund issues and redeems interests daily at NAV
- No tax at fund level if IRS regulations met
- Several other types of SEC-regulated funds sold to retail investors:
 - **Closed-end funds** (securities portfolios; fixed number of shares; shares not redeemable; traded on stock exchange)
 - **Exchange Traded Funds (ETFs)** (hybrids; legally classified as mutual funds but shares traded on stock exchanges)
 - **Unit Investment Trusts (UITs)** (similar to closed-end funds; issue fixed number of units; units redeemable by UIT sponsor which maintains secondary market; portfolio not actively traded)

U.S. Mutual Fund Organization



* Generally organized as a corporation or a business trust.

** Required if mutual fund relies on certain exemptive rules that Independent Directors have own counsel.

*** Subject to shareholder vote. In the case of the investment advisory agreement, renewal subject to Board approval annually.

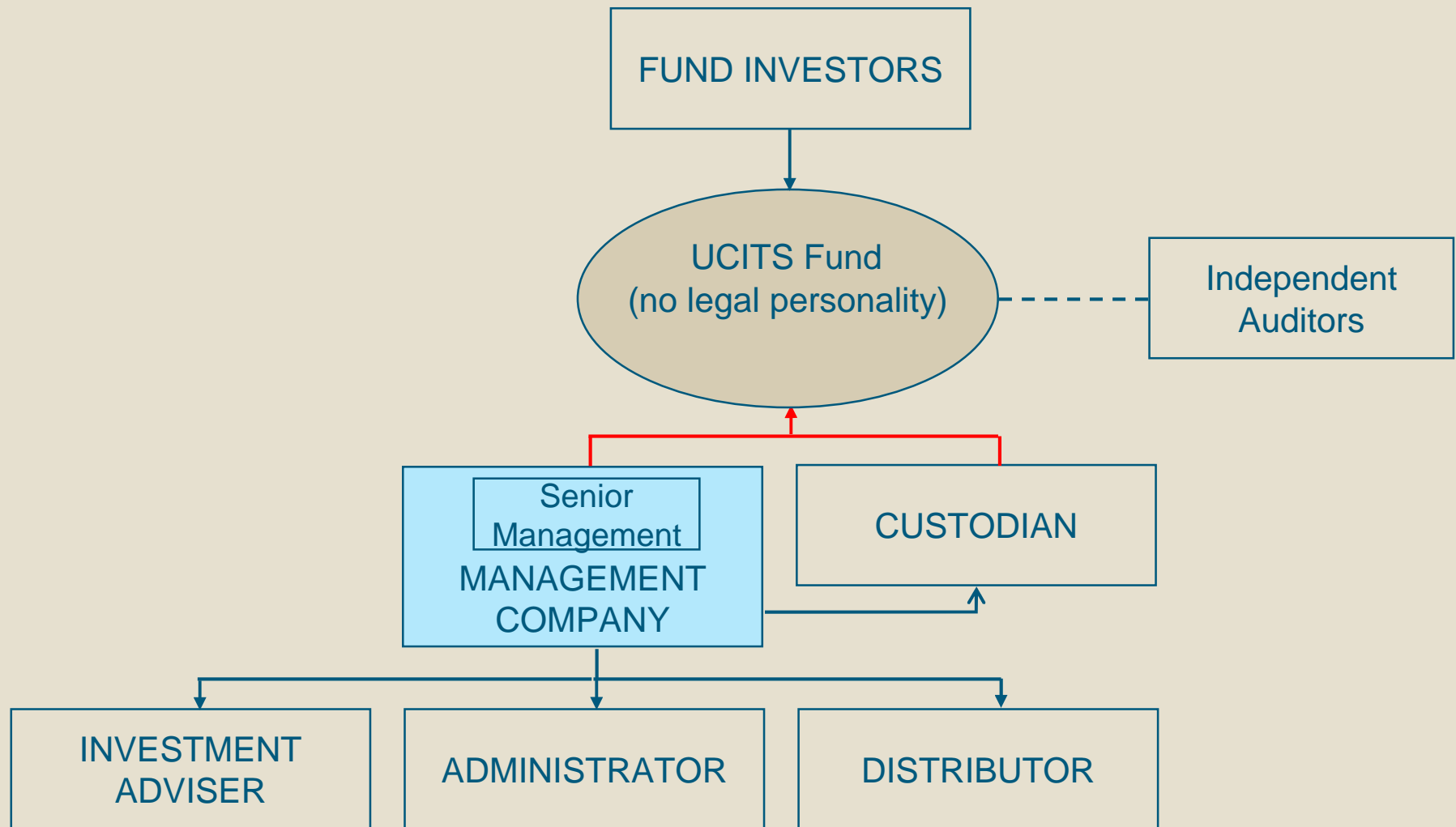
**** Typically subject to Board approval.

Section references are to the U.S. Investment Company Act of 1940 unless otherwise indicated.

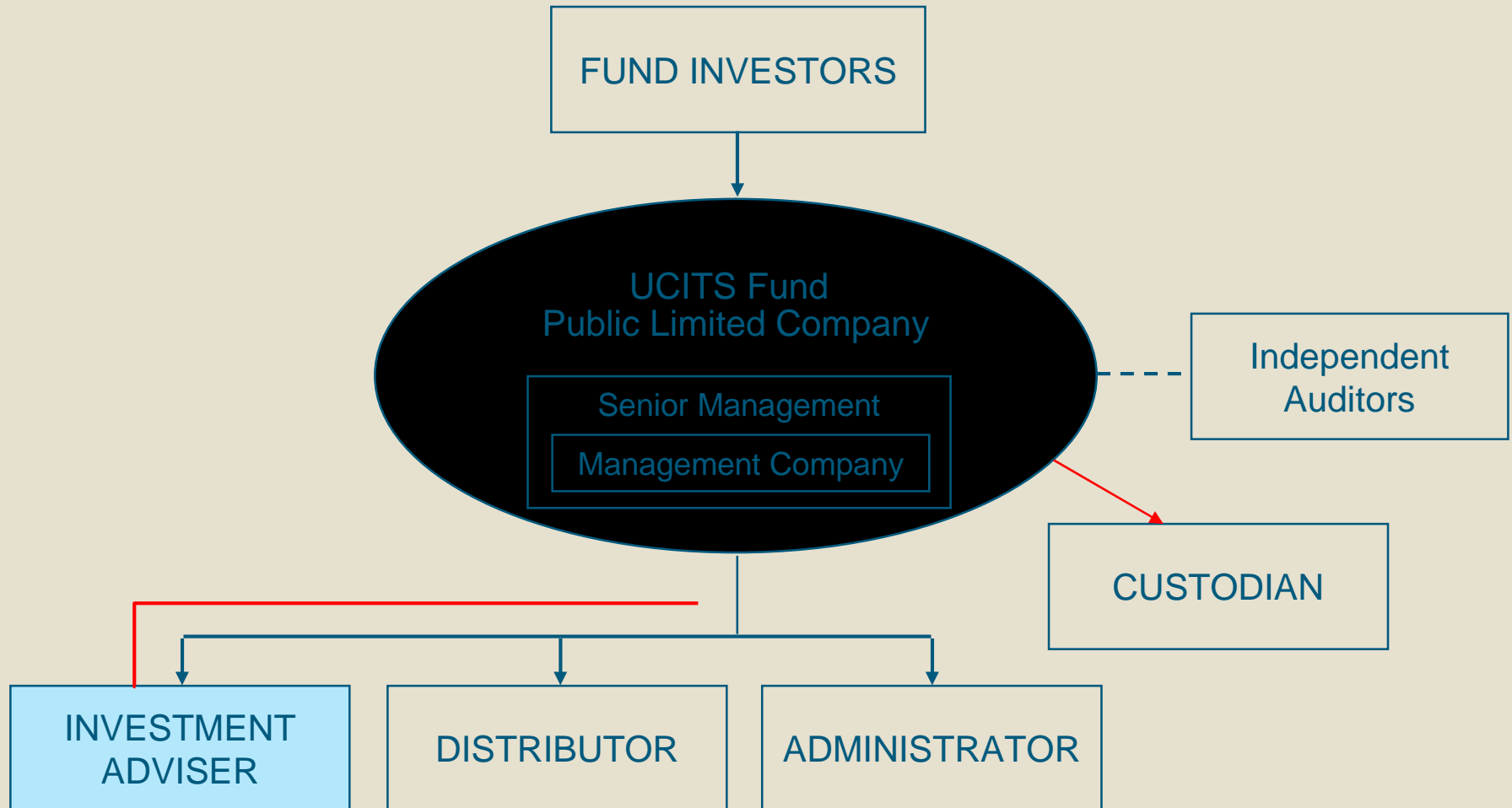
UCITS Funds: Basics

- Actively managed portfolio of transferable securities
- Invests in eligible assets; meets investment criteria in EU UCITS Directives and member country implementing regulations, including leverage limits
- Open-end – fund issues and redeems interests at NAV (typically daily, at least 2x monthly)
- No tax at fund level (member country tax laws)
- EU passport for fund; passport for management company (UCITS IV)
- Other types of EU Funds
 - **Exchange Traded Funds**
 - **Closed-end funds** (listed and traded on stock exchange)
 - **Alternative UCITS** (invests in hedge-fund type investments; sold to sophisticated investors and institutions)

UCITS Common Contract Fund



UCITS Stock Fund with Variable Capital



Directors

U.S. Mutual Funds

- Directors act as “watchdogs” for fund investors
- Must be “informed and act with deliberateness”
- Approve contracts with adviser and distributor annually
- Oversight responsibility; not involved in day-to-day management
- At least 40% must be “independent”; majority independent if fund relies on certain exemptions
- No “bad actors” permitted to serve
- Must satisfy duties of loyalty and care under state law statutes

UCITS Funds

- “Senior Management” conducts the business of the management company
- No independence requirements for Senior Management; must be of good repute and have appropriate experience; subject to prior approval by regulator
- Generally, EU requirements for fund directors apply to exchange listed funds
- Rules of conduct for management company personnel implemented by member states; some industry codes of conduct for directors

Investor Rights

U.S. Mutual Funds

- Specific investor voting rights under U.S. Investment Company Act
 - Elect directors (at least initially)
 - Approve advisory contract; terminate advisory contract
 - Vote on changes to fund's investment objectives and policies
- Specific rights under state law
 - Call shareholder meetings
 - Elect and remove directors
 - Amendment of constituent documents (if required)

UCITS Funds

- UCITS Directives silent on investor voting rights
- Investor rights function of fund organizational structure (corporation, trust, or common contract) and member state legal concepts (e.g., contract law, company law, trust law; common law or civil law)
- Management company and contract approved by regulator
- Management companies must have procedures to handle customer complaints free of charge

Investment Adviser (U.S.); Management Company (UCITS) 1/2

U.S. Mutual Funds

- Typically, investment adviser sponsors fund; directs SEC registration process
- Adviser provides professional investment advice (subject to director oversight)
- U.S. regulation does not distinguish between managers and advisers
- Must be registered with SEC under Investment Advisers Act
- Provides officers and affiliated directors of fund board; no required qualifications; not subject to SEC approval
- No minimum capital required for adviser registration; provides fund required “seed capital” of \$100,000

UCITS Funds

- Typically, management company or adviser is “promoter”; management company directs approval process
- Management company’s regular business must be management of UCITS fund; implements general and specific fund policies
- Approved by regulatory authority of home member state; assessment of quality of management company
- Individuals in charge of management company must be of good repute and have appropriate experience; subject to prior approval by regulator
- Initial capital requirements for UCITS management company

Investment Adviser (U.S.); Management Company (UCITS) 2/2

U.S. Mutual Funds

- Adviser owes fiduciary duty to fund and investors (statutory obligation to act in best interests of fund; undivided loyalty; good faith)
- Statutory fiduciary duty with respect to compensation; shareholders bring excessive fee cases
- Fund may retain sub-advisers but must be registered under the Investment Advisers Act; subject to same standards as principal adviser
- Adviser (and fund) must have compliance officer and detailed compliance policies, procedures and internal controls

UCITS Funds

- Management company general duty to act solely in the interests of the fund; act honestly and fairly; with due skill, care and diligence
- Management companies may delegate advice to regulated third-parties but liability not affected
- Management company must have sufficient financial resources to satisfy potential investor claims for mismanagement
- Management company must have independent compliance function and compliance officer; compliance policies; adequacy assessed by regulator

Custodian

U.S. Mutual Funds

- Typically, must be U.S. regulated bank; SEC rules permit SEC stock exchange member firm to have custody; may use central securities depository, but must observe due care standard
- Protection of fund assets; assets must be separate from assets of adviser
- Foreign assets can be held by qualified foreign bank; board delegates oversight to custodian or adviser
 - Foreign custody contract must have indemnification or insurance to protect against loss

UCITS Funds

- Generally, must be EU licensed credit institution or depositary bank
- Responsible for safekeeping of assets separate from manager; directors must be of good repute; sufficient relevant experience
- “Watchdog” to ensure obligations in agreement between management company and custodian are enforced
- Can appoint third-party depositaries; depositary liability not affected
- Custodian liable to investors for loss “for unjustifiable failure” or improper performance of obligations
- Proposed UCITS changes (single depositary; investors can sue directly depositary or through management company; no passport)

Investor Protection/Disclosure

U.S. Mutual Funds

- Registration statement filed with SEC; reviews; declares effective
- Statutory prospectus, statement of additional information, financial statements; updated annually
 - Fees and expenses; investment objectives; risks; performance; investment adviser and individual principal portfolio manager; third-party contract arrangements; how to buy shares
- Summary prospectus permitted with standardized key information
- Annual audited financial statements and semi-annual reports
 - Publicly accessible, free
 - Audited by independent accountants; certify GAAP

UCITS Funds

- Statutory prospectus approved by regulator
 - Investment objectives; how to buy shares; name of manager, adviser, depository; fees; risks and fund risk profile
- Key Investor Information Document (“KIID”) required (2 pages)
 - Management company; investment objectives; policies; risks and reward explanation and “synthetic indicator” ; fees and charges; authorization details
- Annual audited financial statements and semi-annual reports
 - Available on website
 - Audited by independent auditor

Supervision and Inspection

U.S. Mutual Funds

- SEC statutory authority to inspect funds, advisers and distributors
- Routine and “for cause” compliance inspections
- Conducted by SEC employees
- Deficiency letters
 - Require corrective action
- May refer serious cases to SEC Enforcement Division
- Bank custodians supervised by bank regulator

UCITS Funds

- Regulatory authorities have supervisory and investigatory powers over managers, advisers and custodians
- Carry out inspections (usually for cause); can delegate to auditors or other experts
- Notification to and cooperation with other regulators in certain cases
- Deficiencies require corrective action
- Serious cases referred to public prosecutor

Potential Liabilities: U.S

- **SEC**
 - Any person for violation of Investment Company Act/Investment Advisers Act
 - Breach of fiduciary duty involving personal misconduct by officers, directors, investment adviser, principal underwriter
 - Controlling person liability
 - Remedies: injunctions; cease/desist orders; money penalties; deregistration
- **Shareholders (on behalf of fund)**
 - Federal civil suits against investment adviser for excessive compensation; no need to prove personal misconduct; actual damages only
 - Fraud actions for false or misleading prospectus; other fraud; embezzlement
- **Shareholders under state law**
 - Director liability for breach of fiduciary duty to fund
 - Director defenses: good faith with reasonable care and skill; reasonable belief in best interests of corporation; care of ordinarily prudent person; rely on officers, employees, lawyers, etc. believed to be reliable and competent
- **State law securities fraud-type statutes (market-timing cases)**
- **Criminal cases** (usually for fraud) by Department of Justice -- fines, imprisonment
- No fund indemnity if willful misfeasance, bad faith, gross negligence, reckless disregard of duty; similar D&O/E&O insurance exclusions

Potential Liabilities: EU

- Generally, actions brought by national regulator against management company for violation of statutory or other legal requirements
- Administrative fines and penalties; removal of management personnel
- Criminal cases referred to public prosecutor; remedies include criminal fines and imprisonment
- Depositaries act as “watchdog” over assets and management company compliance; potential depositary liability to investors in cases of loss due to unjustifiable failure or improper performance; regulator actions
- Some member state national laws permit investor contract law claims against management company for losses (absence of privity of contract inhibits claims against upstream control persons)
- Some member state national laws permit investors to bring civil law claims in tort against management company for losses
- Investors make complaints to regulators

The Future: More Regulation, Not Less

- **U.S. Dodd-Frank Act**
 - Regulation and registration of advisers to hedge funds, private equity funds, venture capital funds, etc.
 - Most required to register or file reports with SEC (March 30, 2012)
 - Extraterritorial effects on non-U.S. advisers
 - Form PF for large registered advisers; Volcker Rule
- **E.U. Alternative Investment Fund Manager Directive (AIFM) (2012-2018?)**
 - Regulation of managers and advisers of alternative funds (non-UCITS)
 - Detailed strict requirements for licensing, supervision, delegation, custody, valuation
 - Delegation to non-EU managers/distributors contemplated
- **Key regulatory concepts**
 - Reduce “systemic risk”; collect and share more and detailed information about funds/investments/leverage; regulatory cooperation

Appendix

Fund Director Actions Required under U.S. Investment Company Act

- Annual approval of contract with investment adviser (including separate approval by a majority of the independent directors) at an in-person meeting
- Annual approval of contract with distributor
- Annual approval of fund compliance policies and procedures
 - Written policies and procedures to prevent violation of federal securities laws
 - Written code of ethics (for fund, investment adviser, and distributor)
- Approval of anti money-laundering compliance program; customer privacy

U.S. Legal Requirements for Adviser Contract with Fund

- Written contract; describes compensation; initial shareholder approval; subject to annual director approval; terminable at any time by directors or shareholders; automatic termination if assigned
- Investment Company Act imposes duties in contract deliberations
 - Directors: must request and evaluate such information as is reasonably necessary to evaluate the terms of the contract
 - Adviser: must furnish such information reasonably necessary/requested
- Investment Company Act imposes federal fiduciary duty on investment adviser with respect to compensation, including indirect compensation
- SEC and fund shareholders can bring suit against investment adviser for breach of fiduciary duty for compensation; numerous “excessive fee” cases
 - U.S. Supreme Court Harris decision (2010)
 - No rate setting; emphasis on board process; must take all relevant circumstances into account
 - Legal standard: Fee so disproportionately large that it bears no reasonable relationship to services rendered, and could not be result of arm’s-length bargaining

UCITS Manager Contract

- Management contract with fund and fees subject to regulator approval
- Form and substance conform to statutory requirements (vary by country)
- No approval required by investors
- New proposals for UCITS manager remuneration (not adopted yet)
 - Criteria for calculating performance-based compensation of manager's staff
 - Rules for fixed and guaranteed variable components
 - Apply to Senior Management; board of directors; supervisory personnel
 - Manager's board of directors required to adopt and implement remuneration policy; subject to review by compliance officer
 - Some compensation flexibility due to size, nature, or complexity of manager activities