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

Strategic Issues and Challenges for the Investment Funds Industry

Comissão de Valores Mobiliários
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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

<table>
<thead>
<tr>
<th>U.S. Mutual Funds</th>
<th>UCITS Funds</th>
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</thead>
<tbody>
<tr>
<td>• Organized as corporations or business trusts under U.S. state law</td>
<td>• Organized as common contractual funds (contract law), investment companies (corporate statute), or trusts (trust law)</td>
</tr>
<tr>
<td>• Fund directors play significant role; investor voting rights</td>
<td>• UCITS regime implemented by member states under own laws; passporting concepts</td>
</tr>
<tr>
<td>• SEC registration and regulation of funds; single federal regulator</td>
<td>• “Home country” regulator authorizes fund, management company and its senior managers, depositary</td>
</tr>
<tr>
<td>• SEC registration of adviser and other service providers and/or regulation of activities (custodian)</td>
<td>• Required disclosures to investors</td>
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<tr>
<td>• SEC inspection; enforcement</td>
<td>• Regulator oversight; enforcement</td>
</tr>
<tr>
<td>• Liability; statutory investor rights to bring law suits</td>
<td>• Liability; investor civil law claims</td>
</tr>
</tbody>
</table>
## Size of Mutual Fund Industry*

<table>
<thead>
<tr>
<th>Region</th>
<th>Total worldwide assets invested in mutual funds</th>
<th>$ 23.1 trillion</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>Total net assets of U.S mutual funds</td>
<td>$12.9 trillion**</td>
</tr>
<tr>
<td></td>
<td>Number of U.S. mutual funds</td>
<td>7,589</td>
</tr>
<tr>
<td></td>
<td>Number of U.S. individuals owning mutual funds</td>
<td>90.2 million</td>
</tr>
<tr>
<td>Europe</td>
<td>Total net assets of mutual funds in Europe</td>
<td>$7.3 trillion</td>
</tr>
<tr>
<td></td>
<td>Number of mutual funds in Europe</td>
<td>35,786</td>
</tr>
<tr>
<td>Brazil</td>
<td>Total net assets of mutual funds in Brazil</td>
<td>$952 billion</td>
</tr>
<tr>
<td></td>
<td>Number of mutual funds in Brazil</td>
<td>6,308</td>
</tr>
</tbody>
</table>

** 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

FUND SHAREHOLDERS

Custodian

17(f)

ABC Mutual Fund*

Directors/Officers***

Rule 0-1(a)(6)

Counsel to the Independent Directors**

Fund Counsel

Investment Adviser/Sponsor***

15(a)

17A '34 Act

Transfer Agent

Distributor****

15(c)

12b-1

Independent Public Accountants****

12b-1

* 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

FUND INVESTORS

UCITS Fund (no legal personality)

Senior Management
MANAGEMENT COMPANY

INVESTMENT ADVISER

ADMINISTRATOR

DISTRIBUTOR

CUSTODIAN

Independent Auditors
UCITS Stock Fund with Variable Capital

INVESTMENT ADVISER

DISTRIBUTOR

ADMINISTRATOR

FUND INVESTORS

UCITS Fund
Public Limited Company

Independent Auditors

CUSTODIAN

Senior Management
Management Company
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
### 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, depositary; 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 wilfull 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

  – 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
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