

The image features a dark purple rectangular box in the upper left corner containing the text "K&L GATES" in white, sans-serif, uppercase letters. The background of the slide is a blurred financial chart with a grid. The chart shows a line graph with a color gradient from blue to green to yellow. The line starts on the left, dips, then rises, and continues to rise with some volatility towards the right side of the frame.

K&L GATES

Global Management of Regulated Funds – A Comparison of UCITS and U.S. Mutual Funds

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Presentation Overview

- Structuring and Establishing New Funds
 - Forms of organization; corporate governance; capital structure; service providers; initial registration
- Portfolio Management
 - Types of investments investment limitations; derivatives
- Distribution and Marketing
 - Marketing & advertising; sales charges, fees and rebates; relationships with financial intermediaries

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Structuring & Establishing New Funds

RICs – What is an “investment company”?

- Investment Company Act of 1940 defines an “investment company” and regulates those entities which fall within definition (Section 3 of 1940 Act).
 - Generally a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities.
- Number of exceptions and exemptions from definition (private fund offerings, wholly-owned finance subsidiaries, certain real-estate funds, certain issuers of asset-backed securitizations)
- May be open-end (issues redeemable securities in a continuous offering), or closed-end
- Mutual funds, ETFs, Unit Investment Trusts, Master/Feeder, Fund-of Funds
- “diversified” or “non-diversified” funds – Section 5(b) (note: separate tax-related diversification issues)
- Inadvertent investment companies and transient investment companies



RICs – Organizing a U.S. Registered Fund

- Legal entity (the fund) organized under state law
 - Typically either a Massachusetts business trust, Delaware statutory trust, or Maryland corporation
 - Formed via declaration of trust, certificate of incorporation filed with the state
- Funds will typically be organized as “series” of a single legal entity (i.e. similar to an EU “umbrella” structure with sub-funds or compartments)
- SEC considers each “series” of a trust/corp. to be a separate investment company for purposes of their regulations and restrictions
- Series of a fund may have segregated liability between series per statute and by contract/organizational documents



RICs – Share Capital & Voting Rights

- Minimum share capital of \$100k
- Funds may be offered in different classes
 - Must comply with Section 18 of the 1940 Act and rules thereunder
 - May only be issued pursuant to a written plan
 - Expenses between classes can only vary by sales-related expenses – must charge the same advisory fee across classes of shares
 - Front end-sales charges, back-end sales charges, asset-based fees, service fees (subject to FINRA limits)
- Voting rights governed under state law; generally, one share, one vote
- Majority vote required for many matters; higher percentages may be required for others
- Dividends: IRC Subchapter M – 90% of income/gains must be distributed to shareholders



RICs – Fund Governance

- 1940 Act requires funds to have a board of directors
- Prevent “overreaching” by those affiliated with the fund—“watchdogs” of the funds
- Under 1940 Act, at least 40% of Board members must be disinterested.
- Practically a majority of board must be disinterested in order to take advantage of commonly used exemptive rules under the 1940 Act (e.g., rule 12b-1).
- Several provisions of the 1940 Act require that a majority of the disinterested directors separate from the full board approve various matters (advisory contracts, 12b-1 fees, etc.)
- Board may delegate certain responsibilities, but retains overall responsibility for proper operation of the fund (e.g., valuation).
- Board members must be elected by shareholders; vacancies may be filled without a shareholder vote as long as two-thirds of existing have been so elected
- Independent counsel for the independent directors
- Committees (audit, nominating, compensation, valuation) are common

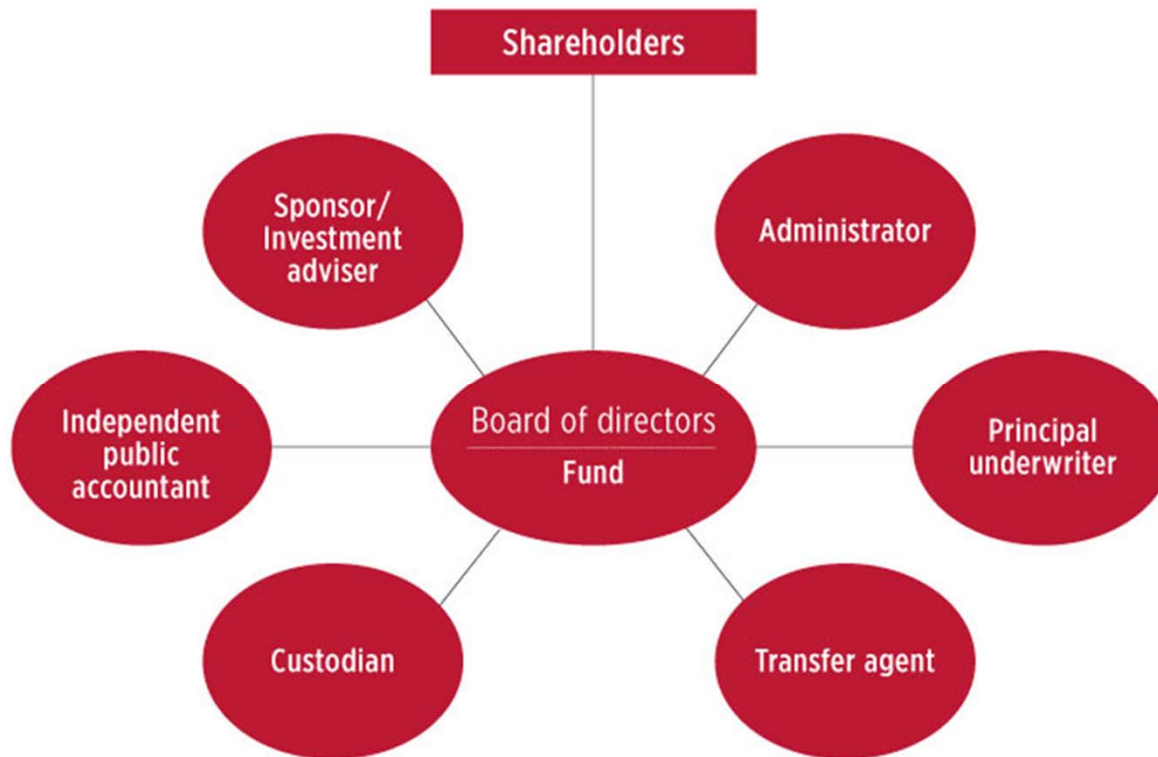


RICs – Chief Compliance Officer Function

- Chief Compliance Officer
 - 2003 SEC adopted Rule 38a-1, requiring funds to designate an individual as chief compliance officer (“CCO”).
 - CCO must have sufficient authority to compel other to adhere to fund policies.
 - CCO must provide annual written report to Board.
 - Fund Board must: (1) approve designation of CCO, (2) approve CCO compensation and (3) approve termination of CCO.



RICs – Service Providers



RICs – Registration and Offering Documents

- New fund must file notification of investment company with SEC (Form N-8A), this registers entity under the 1940 Act as an investment company
- New mutual funds file on Form N-1A, which satisfies the disclosure requirements under the 1940 Act and registers the fund under the Securities Act of 1933 allowing for public distribution of fund shares
- Form N-1A consists of 3 parts: Part A--prospectus, Part B--statement of additional information and Part C—other information (where a list of material contracts and related information is disclosed).
 - All parts are filed with the SEC and considered part of a fund’s “registration statement.” Only the prospectus is required to be delivered to investors and the SAI must be made available upon request.
- Because open-end fund continuously offer the shares, the prospectus must be current/evergreen specifically financial information contained therein cannot be more than 16 months old.
 - Financial highlights, fee and expense tables



RICs – Specific Disclosure Issues

- Section 8(b) requires funds to disclose certain enumerated policies and investment practices.
 - Use of leverage
 - Concentrating in industry <25%
 - Making loans
 - Investing in real estate or commodities

- Certain policies must be “fundamental” policies meaning can only be changed by shareholder approval
 - Change from diversified to non-diversified fund
 - Policies with respect to leverage, concentration, real estate, commodities, loans, etc.

- Form N-1A has prescriptive requirements for disclosure of fund investment parameters, risks, fund management and other policies.
 - Name test rule – Rule 35d-1
 - Name cannot be “misleading”
 - Name suggesting investment in certain investments or industries or in certain countries or geographical regions or tax-exempt funds
 - Must adopt policy to invest at least 80% of total assets in type of investment or region
 - May not change policy unless disclose in prospectus fund will provide 60-days prior written notice to shareholders of such change



UCITS - Typical Jurisdictions and Types

Jurisdictions

- EU UCITS Directive 1985
- Luxembourg, Ireland, UK
- Can be any EU Member State
- Subject to home state regulatory oversight

Fund types

- Open ended only
- Vehicles
 - Variable capital investment company (ICVC) or authorised unit trust
 - Investment company (SICAV or SICAF) or common fund (FCP)
 - Common contractual funds
- ETFs / MMFs



UCITS – Key documents and service providers

Issuing documents

- Prospectus and KIID documents
- Contents subject to UCITS rules (detailed requirements for KIIDs)

Service providers

- Promoter
- Management Company / ACD
- Depositary
- Administrator / Fund Accounting / Transfer Agent
- Marketing intermediaries



UCITS – Establishment

- Apply to home state regulator
- Promoter, investment manager and any third parties who have contracted with the fund have the expertise, integrity and adequate financial resources
- Directors and shareholders of the management company are of good reputation and have appropriate financial resources
- Persons appointed as a Director or Manager have the necessary qualifications, skills and experience to perform the duties of that position
- Promoter does not have to be located in jurisdiction but must be authorised and subject to regulation. The promoter should be of good repute, have sufficient financial resources and a relevant track record in the promotion/organisation of a CIS



UCITS – Minimum Capital Requirements

- Fund: EUR 1,250,000 within 6 months of authorization
- Management company must maintain at least EUR 125,000 at all times (A self-managed fund must have an initial capital of at least EUR 300,000)
- Where the net assets of the funds under management exceed EUR 250,000,000, the management company must provide additional own funds equal to 0.02% of the excess
- Promoter must have at least EUR 635,000 in shareholders' funds.



UCITS – Fund Governance

- Management Company / Directors
 - Responsibility for regulatory compliance
 - May delegate, but still responsible
 - Day-to-day management
 - Fiduciary obligations to investors
 - Act in the investors' best interests
- Depositary
 - Oversight of manager
 - Pricing, dealing, valuation, investment/borrowing restrictions
 - Safeguarding assets
 - Protecting interests of investors
 - Must take reasonable care to ensure that manager is discharging its duties
 - Independent from manager
 - UCITS V
- Independent Auditor



UCITS – Delegation

- Substantive administration and control must remain
- Depositary must be in home state
- Delegation by management company to investment manager outside jurisdiction is permitted, as well as other sub-delegations



UCITS – Share Capital

- Multiple share classes permitted
 - Multi-currency
 - Hedged / Unhedged
 - Accumulating / Distributing
 - UK Reporting Funds
- No minimum investments
- Can vary management fee and performance fees
 - Subject to treating investors fairly
 - Note UK restrictions on commission payments for advised sales and potential MiFID extension



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Portfolio Management

RICs – Eligible Investments

- US RICs can invest in a wide variety of investments, including other funds (subject to limitations)
- Definition of a “security” very broad – regulatory focus on disclosure of permitted investments and related risks
- A fund is may, but is not required to, designate its investment objective as fundamental (one that may only be changed upon shareholder approval)



RICs – Investment Limits/Restrictions

■ Limitations on Leverage

- 1940 Act prohibits complex capital structures by limiting funds use of leverage
- Section 18 limits issuance of “senior securities”
- Senior security—any issuance of debt that takes priority over the fund’s shares—e.g. a loan or preferred stock
- Mutual fund may only borrow from a bank, subject to 300% asset coverage
- SEC takes broad view—selling securities short and various derivative instruments may create senior security
- Any future obligation to pay violates Section 18 unless fund “covers” the obligation
- Fund can cover by: (1) owning offsetting obligation underlying the obligation (e.g. fund takes short position in stock X—can comply with Section 18 by owning equivalent long position in stock X) or (2) earmark or segregate liquid assets equal in value to fund’s exposure



RICs – Related Party Transactions

- Section 17 of the 1940 Act contains a number of prohibitions on transactions between fund and fund insiders or affiliated organizations
- Three main prohibitions on “affiliated transactions”:
 - No direct transactions between and affiliates (entities are on the “opposite side of the table”)
 - No joint transactions where fund and affiliate acting together with respect to a third 3rd parties (entities are on the “same side of the table”)
- Number of exemptions by rule and SEC exemptive order process



RICs – Liquidity (non-MMFs)

- Mutual funds cannot invest more than 15% of assets in illiquid securities
- Illiquid securities are generally considered, those that cannot be readily sold at their approximate market value within 7 days
- Ties to the 1940 Act requirement to meet redemption requests within 7 days



RICs – Diversification Rules

- “Diversified fund” – Section 5(b) of the 1940 Act: With respect to 75% of total assets, must consist of cash, cash items, government securities, securities of other funds, and investments in other securities which, with respect to any one issuer:
 - represent neither more than 5 percent of the assets of the fund nor
 - more than 10 percent of the voting securities of the issuer.

- Internal Revenue Code Subchapter M:
 - At least 50 percent of the value of the fund’s total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities which, with respect to any one issuer:
 - represent neither more than 5 percent of the assets of the fund nor
 - more than 10 percent of the voting securities of the issuer.
 - No more than 25 percent of the fund’s assets may be invested in the securities of any one issuer (other than government securities or the securities of other funds), the securities (other than the securities of other funds) of two or more issuers that the fund controls and are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.
 - Min 90% of income/gains distributed to shareholders; 98%+ to avoid excise tax



RICs – Investments in other Funds

- Section 12(d)(1)(A) prohibits a fund from:
 - acquiring more than 3% of a registered fund's outstanding voting stock (applies to registered and unregistered funds),
 - investing more than 5% of its total assets in a given registered fund, and
 - investing more than 10% of its total assets in registered funds in the aggregate.
- Similar rules apply to a fund with respect to the sale of its shares
- Exemptive rules allowing for investments in excess of these restrictions, subject to certain conditions



UCITS – Eligible Investments

	Permissible investment	Maximum limit
Approved securities (e.g. shares, bonds, deposits, depositary receipts)	Yes	None
Transferable securities that are not approved securities	Yes	10%
Government and public securities	Yes	None
Regulated schemes other than qualified investor schemes	Yes	None
Unregulated schemes and qualified investor schemes	No	N/A
Warrants	Yes	None
Investment trusts	Yes	None
Deposits	Yes	None
Derivatives	Yes	None
Immovables (i.e. real property)	No	N/A
Physical Commodities (e.g., gold, oil, etc.)	No	N/A
Hedging	Yes	None
Stock lending	Yes	None
Underwriting	Yes	None
Borrowing	Yes	10% (temporary only)
Cash and near cash	Yes	None



UCITS – Investment and Borrowing Powers

- Focus is on portfolio diversification and liquidity
- No more than 10% of net assets may be invested in transferable securities or money market instruments issued by the same body and further aggregate limitation of 40% of net assets on exposures of greater than 5% to single issuers (the "**5/10/40**" rule)
 - Exceptions for investments issued or guaranteed by governments, local authorities or certain public international or supranational bodies
 - Index replicators can take exposures up to 20% of net assets to single issuers, with up to 35% to a single issuer in exceptional market conditions
- The maximum aggregate exposure to securities/instruments (other than CIS, derivatives and cash) not listed or traded on a recognised market is 10% of net assets
- Additional general provisions apply including concentration limits, prohibitions on taking legal/management control of issuers, prohibitions on uncovered sales



UCITS – Other CIS schemes and master/feeders

- Up to 100% of net assets can be invested in other collective investment schemes (CIS), provided no more than 20% invested in any one CIS, with an aggregate restriction of 30% of net assets applying to investment in non-UCITS CIS as well as strict rules applying to the nature of CIS in which a UCITS can invest, as well as limiting investment to a maximum of 25% of the units of the underlying CIS
- Master-feeder structures are now permitted under UCITS IV and, accordingly, UCITS may invest by way of derogation from the above limits at least 85% of its assets in the units of another UCITS



UCITS – Use of Derivatives

- Investments in/through derivatives may be made/taken to assets in to which a UCITS can invest directly including financial instruments having one or several characteristics of those assets, and to financial indices, interest rates, FX rates and currencies; the maximum exposure to a single OTC derivative counterparty is 5%, increasing to 10% for certain credit institutions; various aggregations of the above restrictions apply
- UCITS are permitted to use techniques and instruments relating to transferable securities and money market instruments for efficient portfolio management (“EPM”) (economically appropriate and are entered into with the aim of reducing risk, reducing cost or generating additional capital or income (with a level of risk consistent with the UCITS risk profile))



UCITS – Borrowing and lending

- No more than 20% of net assets can be invested in cash deposits with any one credit institution and up to 10% of net assets may be held for ancillary liquidity purposes with other credit institutions (which 10% limit is raised to 20% in the case of deposits made with the custodian/trustee)
- Borrowings are limited to 10% of net assets and can only be used for temporary purposes (for liquidity)



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Distribution & Marketing

RICs - Distribution

- Mutual funds distribute their shares to individuals, fiduciaries and institutional investors through a variety of distribution channels: self-distribution, distribution through a distributor and distribution using a supermarket fund platform
- Self-distribution
 - 1940 Act permits funds to act as its own distributor—deal directly with investors
 - Section 12 provides a mutual fund may not act as a distributor of its own shares, except pursuant to section 10(d)
 - Section 10(d) requirements very difficult to comply with so practically very few funds self-distribute—most funds engage a separate entity (affiliated or unaffiliated) to serve as distributor



RICs - Distribution

- The Distributor
 - Principal underwriter purchases shares from the fund for distribution directly to investors or to other intermediaries
 - Contractual agreement subject to Section 15 of the 1940 Act, requires annual Board approval
 - Must be registered with SEC as a broker/dealer and FINRA member
 - Sales reps must be registered with FINRA
 - Files advertising and sales materials with FINRA and are subject to rules under 1933 Act
- Sales Load Limits
 - 1940 Act does not limit sales loads—Section 22(d) delegates to FINRA authority to impose limits
 - FINRA Rule 2830 sets specific limits as to front-end, CDSC and asset based (12b-1) fees
 - Prohibits brokers/dealers from selling fund shares that do not comply with 2830



UCITS - Distribution

- Similar to the U.S.
 - Direct or via intermediaries/platforms/banks
 - Investors must be able to receive KIIDs free of charge prior to subscription
 - Prospectus and latest annual accounts on request (and free of charge)
- UCITS IV
 - Cross-border marketing in the EU
 - Streamlined notification procedure (regulator-to-regulator)
 - Accelerated timetable
 - Remains subject to local distribution rules
- Globally recognised – may benefit from fast-tracking in other non-EU jurisdictions
- FCA COBS 4.12 Category 13



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Other Key Issues & Considerations

Practical Issues Managing UCITS and RICs

- Fair valuation of securities
- The Battle of the Compliance Programs
- Conflicts of Interest
 - Personal Trading
 - Trade allocation/aggregation
- Best execution
- Payments to Intermediaries
- Global Distribution



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