Summary

Introduction

The task of the Committee has been to conduct an unconditional review of Swedish legislation on mutual funds and other undertakings for collective investment (dir. 1999:108). The Committee was also instructed in a supplementary directive to submit proposals on how the EU's new UCITS directives (2001/107/EC and 2001/108/EC) are to be transposed into Swedish law (dir. 2002:48).

The present interim report contains proposals for new regulations on savings in mutual funds. Under these proposals, the present law on mutual funds is to be replaced by a new law on investment funds. The new law regulates both mutual funds that fulfil the UCITS directive requirements, and special funds, i.e. funds that in one way or another fail to comply with these requirements and therefore may not be marketed or freely traded outside Sweden. Special funds were previously referred to as national funds. Mutual funds and special funds are now to be merged under the general heading of investment funds.

In its final report – due for delivery to the Government by the end of November 2002 at the latest – the Committee will deal with such issues as depositories, the termination, amalgamation and splitting of funds, the option of refusing to redeem fund units in certain cases, statements of holdings, and other rules aimed at enhancing consumer protection.

Basic premises

The prime reason for regulating fund savings is the desire and need to protect consumers/investors. The need for consumer protection is due both to the fact that fund savings often represent a major component in household finances and to the fact that the products and the considerations involved in this investment category tend to be complicated. Also, fund investors are at an informational disadvantage vis-à-vis management companies as the two parties arrive at an agreement before the results of the savings activity become known.

The Committee has not found any systemic risks in this savings category that are unique to the fund market and which might necessitate the regulation of fund saving. This form of investment is of course a part of the securities market, which in itself may involve risks of a systemic nature. But in that case this would not be due exclusively to the investment form involved.

Fund investors are, however, exposed to a financial risk, i.e. the possibility that returns will not live up to expectations. This problem is best dealt with by means of investment rules whereby a paramount requirement is that all funds coming under the law on investment funds must spread the risks. Fund investors also run the risk of being offered poor advice. The Committee has dealt with this risk only indirectly as a special inquiry into the issue has been under way simultaneously (SOU 2002:41). In addition, fund investors are exposed to an administrative risk, i.e. a risk that their savings will not be available when the time comes to withdraw them. This risk is dealt with, *inter alia*, by rules separating fund investors' assets from management company assets. Finally, the risk of a conflict of interests between the management companies and the unit trust holders is an important aspect that needs to be analysed and combated as far as possible.

The Committee's proposals are largely based on the new provisions in the UCITS directives. These directives mainly take the form of minimum requirements giving member states the possibility of prescribing stricter rules. Certain specific provisions in the directives, therefore, do not have to be transposed into national law; each member state makes its own assessment in this respect.

New rules for management companies

Fund management companies must be authorised by the Financial Supervisory Authority to manage investment funds. They are also allowed to accept mandates from other fund management companies to manage funds, help sell units or otherwise perform such tasks as fund management involves. A management company may not, however, provide what is termed individual portfolio management (mandates to manage portfolios under a separate agreement). In this area, the Committee has chosen not to introduce the right to purvey such a service as provided for by the UCITS Directive. This is primarily due to the conflicts of interest that could arise should fund management and individual portfolio management be mixed together in one and the same company.

Swedish fund management companies are allowed to operate freely and to sell units in mutual funds in the EEA zone. Similarly, foreign management companies authorised in accordance with the UCITS Directive are allowed to operate in Sweden.

Requirements for management companies

Under the Committee's proposals, only fund management companies will be allowed to manage investment funds. The previous rules whereby securities firms, for instance, were allowed to manage certain types of funds are now rescinded.

In accordance with the new provisions of the UCITS Directive, fund management companies must fulfil certain capital requirements. These requirements go further than the present ones. Furthermore, certain demands are placed on the executive board, the managing director and others in top executive positions in the company. Another new item is a requirement whereby fund management companies must describe their organisation in a program of activity. In addition, certain demands are placed on management company owners, and the proposed new law prescribes further rules regarding close links between a fund management company and other natural or legal persons. In line with other types of financial legislation, prudential rules and rules of conduct are also introduced specifying how the management companies should conduct their activities in order to retain the confidence of the general public.

Delegation mandates

Fund management companies may, via a special delegation mandate, transfer parts of their undertakings to other companies. This was allowed previously as well, under Financial Supervisory Authority practice. Explicit rules are now introduced into the law on investment funds to bring it into line with the new provisions of the UCITS directives.

Even if, for example, the management of a mutual fund is contracted out to another party, the fund management company is still legally accountable to the unit holders.

Supervision by the Financial Supervisory Authority

As before, the Financial Supervisory Authority is to be responsible for supervising fund management companies. Under the new rules, however, the Authority will have greater powers to intervene against them. Where necessary, for instance, it may revoke authorisations, issue warnings or order a fund management company to take remedial action. Its decisions may also be accompanied by the imposition of fines.

Information

Fund management companies must prepare and distribute information to unit holders. As before, prospectuses are required and semi-annual and annual reports are to be drawn up. A new requirement is that the fund management companies must also prepare simplified prospectus presenting important data about the company and the fund in a clearer, more straightforward manner. These simplified prospectuses must be similar in content throughout Europe and are designed to make it easier for unit holders to compare funds from different companies and member states.

This simplified prospectus must be offered to all persons wishing to buy fund units. Other information is to be sent free of charge to any unit holder requesting it.

Mutual funds

The Committee proposes introducing new rules for mutual funds in accordance with the provisions of the UCITS directives. In addition, more specific rules are introduced concerning what applies if a management company, as part of its management undertakings, assumes obligations on behalf of a fund.

The basic fund structure is retained. Thus the various unit holders jointly own the assets that make up a mutual fund. The fund management company deals with all matters concerning the fund and decides, *inter alia*, in which assets to place the fund's money. Assets are to be kept in a depository, usually a bank. The fund management company and the depository come under the supervision of the Financial Supervisory Authority.

Permitted types of assets

Under the new provisions of the UCITS directives and of the law on investment funds, mutual funds may invest in a wider range of assets than before. Money may be placed in transferable securities, money market instruments, deposits with credit institutions, fund units and financial derivative instruments (e.g. options, futures contracts, etc, the value of which depend on an underlying financial asset such as shares, bonds, etc.). Previously, too, fund management companies were allowed to use various kinds of derivatives, but only in order to make their management undertakings more efficient. Under the new provisions, money may be invested in derivatives in the same way as for investments in shares, bonds and the like.

The new provisions also allow for the operation of 'funds of funds', i.e. funds that invest in other funds.

For funds to possess assets such as securities, money market instruments or derivative instruments, these must be quoted or traded in an exchange market or in some other regulated market. The principal reason for this is that the assets are thereby easily assigned a value so that a rate may be determined for the fund units. Also, the assets can more easily be sold should unit holders wish to redeem their fund units. To some extent, however, the fund will be allowed to invest in unquoted securities and money market instruments. In addition, a fund will be able to invest in

OTC derivatives, i.e. derivative instruments traded not via a regulated market but directly between the parties concerned. In such cases, special demands are placed on the other party.

The requirement whereby all assets must be quoted and traded on regulated markets is to apply to all financial assets that a fund is allowed to invest in.

Risk spreading

A fund must spread its risks. To this end, a number of provisions are included to prevent excessive investment in individual assets. The rules on risk spreading are largely unchanged in the case of shares and bonds. Generally speaking, a fund may not invest more than 5 per cent of its capital in one and the same share or bond. As before, however, there are a number of exceptions to this rule. A new feature, however, is that index funds will now be allowed to invest up to 20 per cent of their capital in one and the same security if the purpose is to replicate the composition of a certain stock or dept securities index. In some exceptional cases, this limit may be increased to 35 per cent of the fund's capital, but then only for a single share or bond.

Risk-spreading rules are also included for other types of assets that a fund invests in.

Other provisions for consumer protection

Besides the requirements governing assets and the provisions on risk spreading, there are a number of further rules aimed at enhancing consumer protection. As before, a fund management company is required to inform unit holders about its investment strategy, but a new condition requires it to specify whether the fund can be expected to vary significantly in value as a result of the way the capital is invested. The law on investment funds also includes a number of constraints on management companies, such as one that prevents them from exacting certain kinds of charges in funds of funds that invest in other funds managed by the same company. In addition, a fund management company may not borrow money in any way it pleases.

Rules limiting a fund's influence

Nor may a fund management company acquire, on behalf of a mutual fund, a sufficiently large holding to enable it *to exercise a significant influence* over the management of an issuing body. This rule harmonises with the UCITS directive but is a new feature in the Swedish regulatory framework. Under the present rules, a fund may only hold shares corresponding to a maximum of *5 per cent of a company's voting power*. Under the new proposals, this percentage limit is replaced by a more descriptive rule.

Corresponding rules – expressed, however, in percentage rates – exist for dept securities, fund units and other types of assets.

These rules are intended to limit the amount of influence that funds can exercise in a given company and to prevent a fund from acquiring an excessively large share of the dept securities distributed by an issuer. These rules supplement the general risk spreading rules, which focus exclusively on investment in relation to a fund's capital. If a large mutual fund, for example, were to acquire shares corresponding to 5 per cent of its capital (in accordance with the general rules on risk spreading) in a small or medium-sized joint stock company, it might thereby become the largest shareholder or secure significant influence in the company. This would constitute a separate risk over and above the purely market-related risks involved.

A new condition is that under the fund provisions, management companies must specify how they intend to proceed with respect to ownership issues arising out of a fund's holdings. This rule supplements the industry's own self-regulating practices.

Responsibility for fund obligations

The basic principle is that a mutual fund may not incur obligations. At the same time, however, there are a number of rules in Swedish fund legislation that allow management companies to incur obligations on behalf of a fund. For example, a management company may, on behalf of a mutual fund, raise small, short-term loans. Another example is that surety is often required for investments in derivative instruments. According to earlier preparatory statements, fund management companies should also be given the opportunity to use fund property as security.

Now, the law on investment funds includes an explicit rule to the effect that funds may not incur obligations *of a greater magnitude than specified by the law*. In such cases, the management company may also put up fund property as security for obligations entered into on the fund's behalf.

Special funds

The rules concerning special funds are made clearer in relation to the current rules for what are termed national funds. The law on investment funds specifies what rules apply in the case of mutual funds and which rules special funds can be exempted from. Mutual funds and special funds, however, are subject to the same regulations in such areas as the depositing of fund assets and supervision.

Special funds must invest their money in accordance with the principle of risk spreading. In contrast to the provisions for mutual funds, no percentage limits are specified for individual holdings. Instead, special funds are required to specify in their fund provisions the investment strategy they intend to adopt and describe this in a relevant manner. The fund provisions must also show how the risk-spreading requirement is to be met.

Special funds may also be given greater powers to invest in different kinds of assets, for instance to invest in unquoted companies to a greater extent than is permitted in the case of mutual funds. Similarly, special funds may seek exemption from other rules such as the ones on borrowing and short selling, etc.

All special funds must specify in their provisions the level of risk they are seeking to maintain in their fund management. In addition, unit holders in the fund are to be informed of the actual level of risk (realised volatility) attained so that they can compare risk levels between different funds.

Special rules for hedge funds

Ordinarily, a traditional investment fund is dependent on rising market prices in order to achieve favourable returns. Hedge funds are the generic term for funds that are managed more freely and where the aim is normally to achieve favourable returns irrespective of market trends. The manager can use a wide range of methods and strategies, and as a rule takes advantage of the managing organisation's specific competence in a given field. Accordingly, hedge funds are a particularly heterogeneous fund category, and are much more dependent on managerial skills in their search for favourable returns than traditional funds tend to be. For investors, or fund subscribers, therefore, hedge funds should be seen as an asset class in a portfolio of securities or funds.

Nowadays, hedge funds can be established under the rules governing national funds. More specific considerations have not been included, however, in previous preparatory work. In other countries, investment in hedge funds is usually reserved for institutional investors alone. The Committee has therefore considered the possibility of introducing additional provisions for hedge funds with a view to protecting consumers in an adequate manner.

When hedge funds direct their selling of fund units at consumers, they may only do so via a fund of funds. The manager of a fund of funds can put together a portfolio of several different hedge funds, thereby spreading the investor's risks. Under the Committee's proposals, the fund of funds is not required to invest exclusively in hedge fund units but may compose a portfolio mixing hedge funds and traditional funds. In such cases, managers are required to ensure that the hedge fund comprises a reasonable share of the total investment.

No comparable restrictions have been imposed for the sale of hedge fund units to institutional investors or what are known as qualified investors.

Alternative investment assets

The Committee has considered whether special funds should be allowed to invest in other types of assets than those permitted in the case of mutual funds. In Germany and the UK, for instance, funds are allowed to invest in real estate. In principle, the Committee sees no need for constraints on this kind of investment by special funds. Real estate investment is a savings form that is similar in many respects to investment in securities. Under the present rules, however, real estate owned via funds would be in a more favourable tax position than is the case for real estate owned today. It is not part of the Committee's brief to discuss possible solutions to this problem in closer detail. Furthermore, extensive revision of fund legislation concerning both the basic structure of funds and their investment provisions, etc, would be required if funds were to be allowed to invest in real estate. Accordingly, the Committee is not presenting any proposals relating to what are known as real estate funds.

It is proposing, however, to allow special funds – with the approval of the Financial Supervisory Authority – to invest their assets not only in financial derivative instruments but also in derivative instruments that have other, underlying assets. A precondition, however, is that the derivative is traded in a properly functioning financial market and does not represent a vehicle for physically delivering or receiving the underlying asset.

Restrictions on fund entry and withdrawal

Investment funds as a savings form are reserved for collective investment and must therefore be spread to a wide circle of subscribers. The Committee proposes, however, that special funds be allowed to limit their range of subscribers on condition that the target group is not too narrow and that it can easily be defined. This would allow special funds to focus exclusively on the employees of a given company, for instance, or on the members of an employee organisation.

A special fund is also allowed to refuse an investor permission to acquire fund units should such a sale for instance contravene the law or some other provision.

The basic principle is that investment funds are open-ended, which means unit holders are entitled to have their holdings redeemed whenever they wish. There may be reason, however, to curtail this right under certain conditions. Restrictions may be approved, therefore, if fund subscribers have been advised beforehand as to when the managing company redeems units. A special fund must, however, be open for the redemption of units at least once a year.

The Committee has considered the alternative of totally closed funds, in which unit holders lock their investments for an extended period. The need for such an alternative may arise, for instance, in cases where the fund supplies risk capital to smaller, unquoted companies that have only just begun operating (risk capital funds, entrepreneurial funds). For other reasons, however, investment funds are not suitable for extensive investment in smaller, unquoted companies.

Investment companies that trade on the stock exchange represent an alternative to totally closed funds. The business idea of this kind of company is to generate dividends for its shareholders and its investments are subject to a risk-spreading requirement. Consequently, these resemble investments in investment funds.

Special funds for qualified investors

Fund investment, as a savings form is primarily intended for a broad community of consumers. Often, however, institutional investors place money in funds as well. The reason is that they represent a good alternative to their own capital management.

The infrastructure afforded by legislation in this area brings order and clarity to the relationship between investors and managers and between investors individually. Also, the industrial law aspects of fund legislation, including authorisation and supervision, often work to the advantage of institutional investors as well.

The Committee proposes, therefore, to allow fund legislation to extend to special funds intended for investors who do not require the usual kind of consumer protection. These funds can be granted unlimited exemption from the legal requirements concerning investment and information and can also be totally closed. A condition of exemption is that these funds only direct their activities at investors who place at least SEK 500,000 in the fund at one and the same time.

Funds subject to company law

In legal terms, fund investment is based on the fund's capital assets. In Sweden as in the other Nordic countries, Germany and elsewhere, funds do not have independent legal status. It is the fund unit holder who owns unincorporated units in the fund capital and it is the fund management company that deals with all matters concerning the fund. The unit holders and the fund management company agree on how the fund is to be managed and how the entitlement deriving from the fund capital is to be distributed. The contractual framework is described in the relevant legislation and in the fund provisions. The Swedish version is usually referred to as model under the law of contract.

Besides this model, many countries also have a model based on company law. This is the case, for instance, in the US, France, Luxembourg and the UK. In these countries, fund capital is owned by a joint stock company (investment company) rather than by the unit holders. Instead, fund unit holders own stock in the company. The company either manages its fund capital itself or assigns the task to an outside fund management company. The latter alternative is the most common one.

The Committee is discussing the question of whether Sweden should introduce rules governing company law-based funds. One of the advantages is that unit holders (i.e. shareholders) would be given a more specific role similar to that which applies in ‘ordinary’ joint stock companies. Shareholders can vote at annual company meetings and thus would have a potentially greater legal influence on the fund’s activities. The managers of the joint stock company also have a clearer mandate, and certain formal conflicts of interest are thus avoided. The introduction of an option to establish company law-based funds, however, does present considerable difficulties. Swedish legislation for joint stock companies and incorporated associations would have to adapt to the need to keep the funds open-ended. This is because under the present Companies Act, joint stock companies are not allowed to issue new shares should someone wish to invest in a fund and nor can companies withdraw shares on redemption. There are also a number of other provisions in relation to company law that would require special consideration.

Accordingly, the Committee finds that there are certain benefits to be derived from structuring a fund in accordance with company law, and recommends further considerations in this area. Further deliberations are required, however, on a number of issues that do not constitute a part of the Committee’s brief or which cannot be considered within the allotted time.

Transitional provisions

According to the transitional provisions in the UCITS directives, Member states shall apply the laws, regulations and administrative provisions necessary no later than 13 February 2004. The UCITS directives allow management companies and mutual funds, authorised in accordance with the previous provisions of the UCITS directive, to continue their activities until 13 February 2007. Thus Swedish management companies and investment funds that want to continue their activities shall obtain authorisation in accordance with the provisions in the new law of investment funds no later than 13 February 2007.