Regulation of Open-Ended Funds under UK, US and Chinese Law

Issues of Conflicts of Interest

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Yao Yuzuo

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List of Abbreviations

ACD	Authorized Corporate Director
ASM Model	Artificial Stock Market Model
AUT	Authorized Unit Trust
COLL	Collective Investment Schemes
CSRC	China Securities Regulatory Commission
DEPP	Decision Procedure and Penalties Manual
EEA	European Economic Area
EU	European Union
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FRA	Prudential Regulation Authority
FSMA	Financial Services and Market Act
ICI	Investment Company Institute
ICVC	Investment Company with Variable Capital
MAR	The Code of Market Conduct
NAV	Net Asset Value
NPC	National People's Congress
OEIC	Open-Ended Investment Company
OTC	Over the Counter
RDC	Regulatory Decisions Committee
SEC	Securities and Exchange Commission
SSE	Shanghai Stock Exchange
STT	Securities Transactions Tax
SYSC	Senior Management Arrangements, Systems and Controls
SZSE	Shenzhen Stock Exchange

PREFACE

Why Study the Regulation of Open-Ended Funds?

This question invites a positive response in a financial age, especially when the financial markets witness that open-ended funds have thrived in the UK, the USA and China recently. They become a matter of serious concern due to conflicts of interest, which are deeply embedded in both internal organizations of open-ended funds and their market behaviours. Nowadays, the regulation of open-ended funds has become even more central in regulating and fostering financial industry and it has been a more and more important subject in the area of financial law.

There is a need and importance of courses and a textbook about open-ended funds' law. This book is intended as a step in that direction. It discusses the constitution of open-ended funds, the authorization of them, the duties of the persons involved, the corporate governance and the supervision from the regulators. To deal with conflicts of interest, not only is this volume concerned with the existence of conflicts of interest, but also explores possible remedies including enhanced corporate governance and improved market supervision.

How to Use This Book?

This book has a number of characteristics which set it apart from previous books and guides in the financial law area:

- With regard to financial crisis, an amount of research has discussed the resolutions, by reforming the previous regulation of banking system, but this book considered the question of conflict of interest in open-ended funds.
- This volume examines and compares the regulation of open-ended funds in three jurisdictions—UK, US and China.
- The author converts the provisions of statutes into graphs that are easy for non-specialists to understand. Various countries use different terminology for open-ended fund so that this book tries to define and explain these terms clearly.
- This book collects market abusive cases that exposed critical weaknesses of investment behaviour of open-ended funds and examines the rules applied to them in practice.
- The author provides new insights into such measures as improvement on ownership structure, fund holder's derivative action, the limitation of investment, the management fees, the monitoring and notice alert system, insurance and the tax and subsidy mechanism.

The Intended Audience

This book would be a textbook for undergraduate or postgraduate courses for students who study in financial law area and want to develop a good understanding of investment funds.

The book covers the forefront of research in the financial law. The scholars will be interested in the new insights offered by the author on the particular topics including the resolution to financial crisis, the new Act about investment funds in China and the development of the regulatory regime in the UK.

The specific appeal of this book is also for the needs of fund managers and other market participants. It helps the fund companies improve their corporate governance and the managers understand the legal consequences

about their investment behaviour in the securities markets. In addition, this book cares practitioners developing new knowledge and skills for their particular roles.

In addition, this book will interest policy advisors as well as regulators. I hope these resources, both legal theories and applied approaches, will prove to be of great assistance to them.

INTRODUCTION

Background

Open-ended funds are a kind of collective investment vehicle. At the outset, the fund holder who provides the money subscribes or buys open-ended funds issued by the fund company at net asset value. Generally, net asset value is calculated by dividing the total fund's value of all the securities in its portfolio by the number of fund shares. Then, the fund company invests the money raised from the public in a range of securities and so on. Ultimately, the fund holder can redeem or sell his funds to the fund company based on the net asset value. This type of investment vehicles is referred to as 'open-ended funds' because their total funds' shares are unfixed.

The financial markets have witnessed that open-ended funds have flourished recently. The total net assets of UK domiciled unit trust/ OEIC[1] had increased to £700 billion by February 2013.[2] In the USA, the

1 OEIC stands for an open-ended investment company. The terminology of open-ended funds varies in different countries. Both the unit trust and the open-ended investment company are legal forms of open-ended funds in the UK. See Part 1.1.1 and Part 1.1.2 of Chapter 1.

2 Investment Management Association, 'February-2013 Monthly Press Release' (13 February 2013), <http://www.investmentfunds.org.uk/assets/files/press/2013/stats/stats0213-08.pdf> accessed 17 June 2013.

Investment Company Institute (ICI)'s report shows that at year-end 2012, mutual funds[1] increased to $13.045 trillion.[2] Correspondingly, the pace of change in the fund industry is very fast in China. There were ¥2.813 trillion managed by 1,238 open-ended funds in May 2013.[3]

Open-ended funds become a matter of quite serious concern when such fund holders find that the money they invested is not operated reasonably, effectively and free from scandal, especially when the financial crisis leads them to suffer severe loss. The fund industry used to enjoy a reputation for serving the needs of small investors, but the resulting loss and scandals in the financial crisis have pushed the conflict of interest problems into the spotlight.

The conflict of interest problems are not isolated occurrences. It can be deduced that these problems with conflicts of interest have their roots in both internal organization within open-ended funds and their market behaviour.

The first question is why open-ended funds are not always managed by individuals/entities that do have their fund holders' best interests in mind. The separation of investment persons from control in the corporation appeared to have introduced the fiduciary relationships that are the foundation on which the conflicts of interest have rested. Currently, the investment company and the trust are two legal forms of the open-ended funds that separate the fund holders who provide money and the fiduciaries who deal with money. Inevitably, the conflicts of interest facing the fiduciaries-fund manager, the fund depositary and so on arise where they possess the assets and own the fiduciary duties to administer the property for the benefits of fund holders. Since there is then a conflict between that their fiduciary duty to the fund holders and the interests of themselves, or other clients,[4] the fiduciaries could seek high profits of their own regardless of the return for the fund holders. Once open-ended

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1 In the USA, mutual funds denote investment companies and their shares (or funds) are generally open-ended. See Part 1.2.1 of Chapter 1.

2 Investment Company Institute, '2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry' (30 April 2013), <http://www.ici.org/pdf/2013_factbook.pdf> accessed 17 June 2013.

3 Asset Management Association of China, 'Zheng Quan Tou Zi Ji Jin Shi Chang Shu Ju (2013 Nian 5 Yue)' (Statistical Report in 13 June 2013), <http://www.amac.org.cn/tjsj/xysj/jjgssj/384240.shtml> accessed 17 June 2013.

4 See Part 1.1 of Chapter 2.

funds are unreliable, people come to the view that it is not sensible to buy them, which will lead to the collapse of the whole industry.

This leads to the second question: why the market behaviours of open-ended funds influences the financial stability? The cases during the financial crisis illustrate that because of conflicts of interest open-ended funds influence the financial stability.[1] The business goals of fiduciaries differ from the fund holders. This is because fees paid to the fiduciaries are related closely to the scale of the funds, which means the bigger the size of open-ended funds, the more management fees they will receive. This means the fiduciaries care more about the ranking of the fund rather than the fund holders' real interests.[2] Therefore, during the bullish period of the financial crisis, the securities markets are characterized by exponential growth of the open-ended fund industry. The fund managers make use of their huge amount of assets and inside information to manipulate the stock market, driving up securities' prices intensively that open-ended funds heavily hold for a better ranking. Unlike the fund holders, the fiduciaries are short-sighted and conduct inside trading for themselves. Moreover, the interest of individual funds may differ from that of the whole securities markets. If most open-ended funds build the similar investment package regardless of the stability of the whole financial markets, it seems that whole markets are driven by their herding dynamics. All of the above market behaviours of open-ended funds, including inside trading and market manipulation and herding, as well as the limited cognitive abilities of other investors in the financial market, can lead to large aggregate fluctuations. After the peak, because open-ended funds take risks, they cannot make up lost value from their portfolio. Finally, the confidence of the fund holders is ruined. The investors withdraw their money from the securities markets resulting in a dramatic decrease of the index. In a nutshell, it is the conflicts of interest of open-ended funds that might trigger a 'bubble economy' or 'crunch' of the financial industry.

1 See Part 1.2 of Chapter 2.
2 See Part 1.2 of Chapter 2.

Rationale

Research into open-ended funds

Coping with conflicts of interest between the fund holders and the fiduciaries is conducive to providing good investment vehicles for the old if the population starts aging soon and needs safe retirement investment. Managing conflicts of interest between the individual open-ended fund and the whole securities markets is pivotal for financial stability, reshaping a liquid and efficient financial market. This is why the main goal of this book is to address conflicts of interest concerning open-ended funds.

This book is concerned with not only the existence of conflicts of interest, but also possible remedies including enhanced corporate governance[1] and enhanced market supervision. Generally, this book aims to investigate regulatory frameworks dealing with conflicts of interest in relation to open-ended funds in the UK, the USA and China and to consider their future development in China.

Questions

There are some main questions to be addressed in this book:

1. What are different legal natures of open-ended funds in the UK, the USA and China?

2. Why can conflicts of interest arise?

3. What are the existing regulations of open-ended funds for dealing with conflicts of interest in the UK and in the USA?

4. With regard to internal structural measures, is there anything in need of improvement in China?

5. In what ways can China deal with open-ended fund market

1 Corporate governance, which is the system by which companies are directed and controlled, deals with the relationships among the shareholders, board of directors, management, and others (e.g. fund holders, creditors and employees) with respect to the control of corporations. See the Committee on the Financial Aspects of Corporate Governance, 'Cadbury Report' (released in December 1992), <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 13 July 2013. In this regard, the tenet of the corporate governance refers to the ownership, the board of directors, and the management in a fund company.

behaviours in the securities markets?

Methodology

An interdisciplinary subject of my book poses many problems for me, because the author is supposed to analyze the whole topic not only within the legal system, but also from the perspective of history and economics. In this regard, the author adopts a multi-method analysis to provide a richer picture of the subject under consideration and to provide a more robust framework for analysis. These methods consist of a doctrinal analysis; comparative method; and case study.

This book adopts the doctrinal legal method to find what the laws are and how they have been applied to open-ended funds. 'The "black-letter law" method or doctrinal research relies extensively on using court judgments or statutes to explain law'.[1] The author examines concepts in relation to different types of open-ended funds, such as the collective investment scheme; the unit trust; the authorized unit trust; the unit trust under UCITS scheme;[2] the open-ended investment company; fiduciary duty; affiliated persons; insider dealing; and regulator under the statutes. The author also looks at the relevant regulations regarding Chinese wall, separation of business, the board of directors, the general meeting of fund holders, disclosure, legal remedies, restrictions on affiliated transactions investment objects limitation and market abuse.

'If the statutes themselves can provide a plausible answer, that is typically the end of the matter. There are other cases in which the language does not provide an answer and those in which the language provides a bad answer'.[3] The latter cases, as opposed to relying on the statutes themselves, focus heavily on deriving the principles and values from the sourcebook, guidelines, cases and even practice outside the statutes.

Thus, the author focuses on the use of the principles in practice when

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1 Mike McConville and Chui Wing-Hong (eds), *Research Methods for Law*, Edinburgh University Press, Edinburgh, 2007, 3.

2 UCITS is an acronym for undertakings for collective investment in transferable securities. UCITSs are a kind of collective investment scheme and they are able to be promoted in the European Economic Area (EEA) with a single market passport.

3 Frederick Schauer, *Thinking like a Lawyer: A New Introduction to Legal Reasoning*, Harvard University Press, Cambridge, 2009, 157.

the language seems too vague or abstract—for example, by considering detailed rules provided by the regulators, involving corporate governance imposed by the SEC to solve conflicts of interest in the USA[1], the COLL Sourcebook[2] guidelines in the UK[3] and the China Securities Regulatory Commission (CSRC) guidelines[4] as explanation of statutory laws. Case law analysis is used to interpret concepts in UK and US law, e.g. fiduciary duties[5], improper disclosure[6], requiring or encouraging others[7] prescribed by the statutory law.

When all of the above laws or rules made by the legislature could not provide a definite answer or their rules apparently conflicting with each other, this book tries to make sense of them by including a principle from the practicing work. For example, it is still unresolved to ascertain under what circumstances the SEC could consider the parent company and its subsidiaries as one collapsed entity. This question is primarily important for determining whether the persons in question could be affiliated persons and be subject to the restrictions imposed by the Act. In order to give an answer, this book takes the SEC no-action letter and practicing lawyers' arguments into consideration and tries to justify the principle in practice.[8]

This book fully exploits the comparative method. Because this book aims to propose further development of Chinese open-ended funds, the regulations that the author attempts to trace are, of course, not confined to China. A considerable amount of parallel research took place in the United Kingdom and the United States. By looking at all of these legal systems, it is hoped to benefit the legal reform in China.

Law is not a completely autonomous system but is embedded in the history and culture of different countries. Before comparing different legal systems, first and foremost the author looks at how the regulations arise in the different societies and whether they could be compared or

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1 See Chapter 4.
2 COLL stands for Collective Investment Scheme.
3 See Part 1.2.2 of Chapter 3.
4 See Part 2 of Chapter 6.
5 See Part 1.1 of Chapter 3 and Part 2.3 of Chapter 4.
6 See Part 2.2.2 of Chapter 3.
7 See Part 2.2.8 of Chapter 3.
8 See Part 3.1.2 of Chapter 4.

what aspects of them could be compared. The historical review[1] of this book describes how the different types of open-ended funds took place in the past and finds that the separation of investment and management are similarly the source of conflicts of interest in the modern UK and the USA.[2] Although China has a short history of open-ended funds, it faces the same issue of conflicts of interest and has diverse and inclusive cultures. Despite the various types of open-ended funds arising from distinct cultural, political and economical backgrounds, the investment needs, possibility of separation of investment and management and conflict of interest problems are similar in the UK, the USA and China. The historical review also shows that the company and the trust interact intimately in the UK and the investment company becomes the sole form of open-ended funds in the USA. Chinese open-ended funds are like the offspring of the trust and the company. The relationship between the fund holders and the fund management company and the depositary is trust. The fund management company is an incorporated body. Thus, it is possible for China, as a developing country, to borrow ideas from these two legal systems-notably learning the trust arrangements from the UK and adopting the corresponding corporate governance measures in the USA.

Moreover, the practical needs and investment connections promote this book to compare the various regulations of market behaviour. Nowadays, open-ended funds have developed dramatically and play an important role in financial markets in these three countries. All of them need a safe investment vehicle and hope open-ended funds to operate well, especially during the financial crisis. The comparison is possible and provides China with an opportunity to select effective rules from other mature legal systems.

The comparative method needs to consider the doctrines existing in the present laws for integration. 'This model should respect legal frames developed in private law'.[3] The term 'trust' in China, from a comparative

1 The historical review provides the answer to one question (which is inevitably essential to the comparative approach) about whether the foreign rules can be transplanted in the open-ended funds area and how the new rules will be harmonized with the internal legal regimes.

2 See Part 1 of Chapter 1.

3 Juha Karhu, 'How to Make Comparable Things: Legal Engineering at the Service of Comparative Law' in Mark Van Hoecke (ed), *Epistemology and Methodology of Comparative Law* (Hart Republishing, Portland, 2004) 86.

perspective, is a little different from that in the UK. In the UK, the trust is involved with the transfer of legal title to the trustee and the equitable title is transferred to the beneficiaries. Conversely, the ownership title cannot be divided into legal title and equitable title in China and there is only one ownership title. Besides, Chinese Trust Law shows that the trust property is separate from the trustor's assets.[1] Taking into consideration all of these existing principles in the Chinese legal system, the author proposes that the ownership should be one and transferred to the beneficiaries in the new law.[2] The integrity is one important element of the comparative analysis considered in this book.

The comparative analysis is right-based. The author compares the functions of independent directors in China with those in the USA. The role of independent directors seems more important in solving the conflicts of interest facing the majority shareholders in China. Independent directors prevent the shareholders form controlling the management company for their own interests and protect the fund holders. However, the ratio of independent directors in China is lower than that is in the USA.[3] Ultimately, this book argues that China, in order to protect the fund holders' rights, should improve the ratio of independent directors. In the same way, this book compares the scope of affiliated persons[4], the scope of inside information[5] and the scope of insiders.[6] For the protection of fund holders, this book proposes a broader scope for supervision.

The comparative analysis keeps the efficiency and implementation of law in mind. This book selects the most effective insider trading supervision mechanism according to the economic explanation. For instance, one remarkable advantage of the registration of insiders under UK law is that the insiders must be disclosed to the public. In the USA, the public can have access to the information online.[7] However, Chinese

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1 Trust Law of the People's Republic of China, 2001 s 15, s 16 and s 18.
2 See Part 1.3 of Chapter 1.
3 See Part 2.1 of Chapter 5.
4 See Part 4.1 of Chapter 5.
5 See Part 2.1.1 of Chapter 6.
6 See Part 2.1.2 of Chapter 6.
7 In 1984, the investors in the USA can search information through the EDGAR System. In response to the US Securities and Exchange Commission (SEC)'s disclosure requirement, the current information on mutual funds is available at http://www.sec.gov/edgar/searchedgar/mutualsearch.htm.

inside trading supervision is very expensive and time consuming.[1] Hence, this book suggests that China establish an online public access system which is kept up to date in order to reduce the costs and promote the implementation.

The case study method is used to discover the common underlying characteristics of their real abusive practices. There is no doubt that my book is concerned with the behaviour of open-ended funds in financial markets.[2] The case study has a great advantage of providing in-depth details over other research methods, allowing for finding problems in a complex background.

From the outset, the author formulates the question as to how open-ended funds' behaviours tainted by conflicts of interest influence the securities markets. After that, the author embarks on the task of collecting market abuse cases. To avoid bias, the author finds all of the cases that have occurred in China. The cases provide me with enough facts and the decisions in the inappropriate circumstances where the Chinese Securities Regulatory Commission cracked down on illegal practices. Finally, the author summarizes the features of these behaviours, on the basis of which the author attempts to find why the open-ended funds influence the stability of the securities markets.

Contributions

This book contributes to a better understanding of open-ended funds and managing their conflicts of interest in the following aspects.

First of all, this book finds conflicts of interest facing main parties in the trust or the fund companies by making relationship analysis. Because there are a lot of regulations involving a number of parties-fund holders, shareholders, the fund management company, the depositary, the board of directors, the investment adviser and other employees-the relationships between them are complicated. In order to illustrate the different relations, this book incorporates certain graphs. The author converts the provisions of statutes into pictures that are easy to understand. The author

1 See Part 2.1.4 of Chapter 6.
2 See Part 1.2 of Chapter 2.

displays the duties of parties and finds their conflicts in the context of different relationships.

This book finds conflicts of interest between the managers or the individual open-ended fund and the whole securities markets by using case studies. The market abusive cases exposed critical weaknesses of investment behaviour of open-ended funds, not just because of divergence of interest in internal corporate governance but also because of conflict of interest between individual fund companies and the whole financial markets. What is best for individual persons/entities may not be the best for the stability of the whole financial system.

This book provides new insights into structural measures for Chinese fund management companies.

This book argues that securities companies, trust companies and banks are not supposed to be the holding shareholder of the fund management companies, that is, the proportion of shares holding by them shall be reduced. Moreover, the data analysis of open-ended funds' performances supports the view that ownership dispersion is better than ownership concentration in most cases, because ownership dispersion helps to minimize problems with conflicts of interest.

There is another contribution to fund holder's derivative action. Fund holders need to bring a derivative suit on behalf of the company if their funds assets may be endangered. The fund management company raises money from fund holders for investment, and although they cannot intervene in the affairs of the company, they are in fact important stakeholders of the company. This book indicates that the fund holders shall have the right to bring the derivative action against the third party on condition that they prove that they have a valid standing to such a suit. Furthermore, this book suggests various requirements such as the exhaustion of intro-corporate remedies; the minimum value of the open-ended funds they hold; or the good faith that entitles the fund holder to recover part of litigation fees even if the case is unsuccessful. If the fund holders meet these requirements, they can protect their interest by making a derivative claim.

This book argues that the general meeting of the fund holders has the function of bringing lawsuits to protect the fund holders' interests. The scattered fund holders indeed face a predicament in bringing a lawsuit. But this problem is not insurmountable. The general meeting of the fund