2 Mutual Funds

Meaning, Forms, and Operations

2.1 Introduction

The concept of mutual funds is based on the notion of pooling money from a large number of investors to be managed and invested by external professional management. While mutual funds have long been significant investments in financial markets, they are still not clearly understood, either by investors already involved in the industry or those thinking about investing in mutual funds. This chapter attempts to define mutual funds, with a focus on their meaning, forms, and operations.

Since this book analyses mutual funds from an investor protection perspective, utilising main financial regulations principles and theories, such as fiduciary duties, investor protection, and prudential regulation, this chapter is considered a foundation for the entire study. The analysis in this chapter will answer a significant question about what exactly makes a mutual fund so different from other businesses and financial institutions, demonstrating that its defining difference is its organisational structure. Mutual funds are separate from their managers. In other words, a mutual fund and its manager are distinct legal entities with different groups of owners that are related to each other mainly by contract. This, as will be discussed in Chapters 4, 5, and 6, poses significant challenges for regulators. This book will show that investor protection regulations in the mutual fund industry are paternalistic in nature and designed to address the risks that the separation poses: this chapter will help to understand why this extensive intervention is necessary. It will also demonstrate that mutual funds do not operate businesses, rather they invest in them, and that mutual fund investors are typically small or retail investors who lack professional expertise in investment: the nature of the investors is another important justification for the extensive regulatory intervention.

Since open-ended investment companies and unit trusts are the main types of mutual funds in the UK, this chapter will examine their legal nature and distinctively argue that, unlike ordinary trusts, a unit trust as an investment vehicle can perhaps best be considered as a form of commercial trust that combines components of trust and contract. This combination is designed to serve the creativity of the unit trust as an investment means. The chapter also argues that open-ended investment companies are collective investment schemes and take the corporate form. Specifically, they are property management institutions through which investments are made by a financial vehicle on behalf of investors.

This chapter has a number of goals. The first is to explore the concept of mutual funds, their importance as attractive financial institutions in the financial markets, and their organisational forms. The second goal is to investigate the array of unique advantages offered by mutual funds to investors, benefits which have contributed to the success of this industry. The third goal is to compare mutual funds with hedge funds to demonstrate the traditional distinction between them. Mutual funds and hedge funds are considered significant industries in financial markets, serving different classes of investors, and using different investment techniques. The fourth goal is to classify mutual funds into different categories based on their structure and investment objectives and to explain the main external service providers involved in the operation of mutual funds. The final goal is to examine the legal nature of open-ended investment companies and unit trusts, which are the main mutual fund forms in the UK. This examination is essential to understand the legal relationships between the external service providers and the investors, and the rights of the mutual fund investors. To achieve these objectives, this chapter is divided into eight sections.

2.2 Concept of Mutual Funds

Saving money, for various reasons, has always been a priority for many people. However, finding an appropriate and safe way to invest that money can be a daunting task. There are many opportunities and avenues available in financial markets, each with varying degrees of risks and returns. Investors, for example, can invest in the stock market, fixed deposits, corporate debentures and bonds, real estate, and mutual funds. Given the complexities of financial planning, careful selection of an appropriate investment form is important. For non-professional, retail investors, who often lack vast resources, time, professional expertise, and awareness of business and economic principles, to enable them to make successful investment choices, mutual funds offer a viable investment by bridging expertise and limited investment funds.

A mutual fund is considered one of the most important ways of raising funds from the public in the financial sector.[1] The term *mutual fund* reflects the mutual relationship between the investors and the fund. This professionally managed investment vehicle gives small investors a chance to participate in the rapid and robust growth of capital markets witnessed over the past few decades. Mutual funds also provide an effective way for small investors to obtain varied investment portfolios with professional management at a sensible cost. However, this

1 J Haslem, *Mutual Funds: Portfolio Structures, Analysis, Management, and Stewardship* (John Wiley & Sons, Hoboken 2009) xvii.

does not mean that mutual funds are only designed for retail investors, they are also an attractive investment for institutional investors. For instance, institutional investors use money market funds, a type of mutual funds, as important alternatives to cash accounts to manage liquidity.[2] Nonetheless, the majority of mutual fund investors are retail investors: in Europe, around seventy-five per cent of the undertakings for collective investment in transferable securities (UCITS) investors are retail investors,[3] while in the US, an estimated 101.8 million individual investors owned mutual funds in 2019, accounting for eighty-nine per cent of total mutual fund assets.[4]

2.2.1 Definition and Structure of a Mutual Fund

While authors have defined mutual funds in different ways, the focus of such definitions has been to show the main features of these vehicles. According to Johan Haslem, open-end mutual funds are 'pooled investment products where a large number of individual investors can each own a slice of investment pie'.[5] Mark Mobius defines a mutual fund as 'a company that pools money from a group of people with common investment goals to buy securities such as stocks, bonds, money market instruments, a combination of these investments, or even other funds'.[6] Both definitions stress the idea of pooling money from a large number of investors to be managed by a professional manager, according to the fund objectives.

Thus, a mutual fund can be defined as a common pool of money into which investors put their funds to be invested in accordance with an agreed objective by professional management. It offers, in addition to diversification, liquidity, by standing ready to redeem its shares at net asset value (NAV).[7] To diversify their portfolios, mutual funds generally invest their assets in equities, bonds, derivatives, deposits and near-cash assets, short-term money market instruments, or a mix of these investments.[8] This definition, like those aforementioned, attempts to show the main features of mutual funds (Figure 2.1).

Generally, mutual funds around the world are created in different organisational forms. First, the corporate form, where a mutual fund is usually treated

2 M Alshaleel, 'Money Market Funds Reforms in the US and the EU: The Quest for Financial Stability' (2020) 31 EBLR 303–335.

3 See, European Commission, 'Greater Protection for Retail Investors: Commission Welcomes European Parliament Adoption of Strengthened European Rules on UCITS' 2 (2014) available at http://europa.eu/rapid/press-release_STATEMENT-14-121_en.htm accessed 28 July 2020.

4 See, American Investment Company Institute, '2020 Investment Company Fact Book' (60th edn, 2020).

5 Haslem (n 1) 4.

6 M Mobius, *Mutual Funds: An Introduction to the Core Concepts* (John Wiley & Sons, Hoboken 2007) 1.

7 G P Mahoney, 'Manager-Investor Conflicts in Mutual Funds' (2004) 18 Journal of Economic Perspectives 161–182.

8 Haslem (n 1) 8.

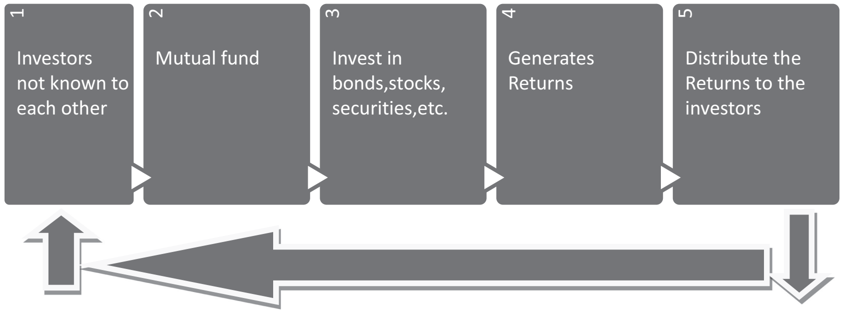

Figure 2.1 How mutual funds typically work.

as a separate entity. Second, the contractual form or the trust structure, where a mutual fund is established as a trust managed by a trustee for the benefit of the investors.[9]

In the UK, mutual funds are typically open-ended vehicles, which take one of two forms:

(1) Unit trust, an open-ended model that takes the trust form.
(2) Open-ended investment company (OEIC), an open-ended model that takes the corporate form.[10]

Unit trusts and open-ended investment companies are open-ended vehicles and are known in most countries around the world as mutual funds.[11] On the one hand, the legal basis of the unit trust is the trust, and it is constituted under

9 I G Sergeeva, 'Collective Investment Schemes Regulations' (2009) 1 3a Scientific Journal NRU ITMO 1–13.

10 In the UK, the term *collective investment scheme* is wider than the term *mutual funds* because collective investment schemes include, in addition to open-ended investment companies and unit trusts, investment trusts. An investment trust is a closed-ended fund. This type of collective investment scheme is listed on the stock market. Investment trusts are actually not trusts as may be understood from the name, but are publicly quoted companies that invest in the shares of other companies. Like open-ended investment companies and unit trusts, investment trusts pool investor assets for investments, but investment trusts are closed-ended. They have a fixed amount of assets divided into shares for purchase. The investment trusts do not buy their shares back from shareholders. However, shareholders are entitled to the ordinary rights of a shareholder in relation to the sale of shares and dividends. Investment trusts are registered under a company's legislation and the Financial Conduct Authority regulates their activities. The main differences between investment trusts and unit trusts were drawn in M&G Securities Ltd v Inland Revenue Commissioners, Chancery Division [1999] S.T.C. 315 case. For further information regarding investment trusts, see: B J Richardson, 'Ethical Finance in Britain: A Neglected Prerequisite for Sustainability' (2003) 5 Environmental Law Review 109-133.

11 Sergeeva (n 9).

the trust deed.[12] There are two fiduciaries in the unit trust scheme, namely the manager and the trustee. The fund manager is responsible for making investment decisions under the supervision of the trustee. In addition, the unitholders in unit trusts are the owners of the deposited property.[13] The units in the unit trusts are bought and sold at different prices. The price the unitholders receive when selling units is generally less than the cost of purchasing units.[14]

On the other hand, an OEIC takes the corporate form with a depositary, and it is constituted under the instrument of incorporation. It is operated by the authorised corporate director (ACD) (or board of directors) and depositary. The role of the depositary, as will be seen later, is similar to the traditional role of the trustee of a unit trust, whereas the director (or board of directors) makes the investment decision on behalf of the OEIC. Because OEICs have a separate legal personality, the shareholders in the OEICs are not the owners of the property that forms the subject matter of the fund. Further, the shares in OEICs are bought and sold at the same price which represents the mid-market price of the underlying assets (NAV).[15]

While the mutual fund industry in the UK takes either the corporate or trust form, most countries adopt only the corporate structure because they do not recognise the concept of trust. Trust is a well-developed common law concept adopted by common law countries.[16] However, whether mutual funds take the corporate form or the trust form, they are open-ended vehicles where investors can redeem their shares/units from the fund directly at any time on demand, and there is no limit on the number of new fund shares/units issued to the public.[17]

2.2.2 Mutual Fund Investment Objectives

To achieve the specific stated investment objectives of the fund, mutual funds use the investors' contributions to buy their portfolio assets.[18] The investment objective defines the fund's fundamental investment aim. While some mutual funds aim to increase the value of the basic amount invested (growth funds), others seek to provide investors with a regular income through the payment of dividends (fixed income funds). Further information regarding types of mutual

12 Ibid.

13 See, Charles v Federal Commission of Taxation (1954) 90 C.L.R. 598 at 609.

14 For further information see Chapter 4 (4.4 Valuation and Pricing Regulations).

15 T Cornick, 'UK Introduces Open-Ended Investment Companies' (1997) 29 International Financial Law Review 29–32.

16 A trust is an equitable obligation binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called beneficiaries). For further information see: D Hayton, P Matthews, C Christopher, and J Mitchell, *Underhill and Hayton Law Relating to Trusts and Trustees* (18th edn, LexisNexis, London 2010).

17 Haslem (n 1) 19.

18 Collective Investment Schemes Sourcebook 2021, coll 4.2.5.

fund will be discussed later.[19] The investment objective will often indicate the type of assets that will constitute a key part of the fund's investment portfolio. Bond funds (fixed income), for example, will mainly buy debt instruments such as bonds, debentures, or government securities.[20] This applies to other types of mutual funds such as growth funds, balanced funds, and money market funds where fund managers must invest the assets according to the objectives of the funds, objectives accepted by the investors when they bought the shares/units of the funds. Because the purpose of investments may vary from person to person, investors usually choose the mutual funds that match their personal investment objectives. For instance, a money market fund invests in short-term debt securities such as treasury bills and commercial paper because these instruments are forms of debt, which mature in a short period.[21] The manager of a money market fund cannot buy instruments that mature over a long period because that would form a breach of the stated objectives of the fund:[22] investors seeking short-term investment would, therefore, prefer to invest in money market funds.

2.3 Role of Investment in Mutual Funds

Mutual funds have been successful financial institutions in financial markets since their creation in the nineteenth century.[23] The remarkable growth of this industry, as will be discussed in Chapter 3, over the past few decades, demonstrates this success. Many factors have contributed to this level of achievement, however, the range of unique advantages they offer to investors, benefits which are difficult to duplicate by most other investment methods, is a fundamental one. While some financial institutions may provide their investors with some of these advantages, the distinctive position of mutual funds is the combination of all those advantages in one vehicle. Those advantages can be summarised in the following sections.

2.3.1 ProfessionalManagement

Management quality is a significant element of success in any investment. It is no wonder, then, that professional management is a principal advantage of mutual funds. Professional management means that the assets of a mutual fund are invested and managed by a professional fund manager with the experience, resources, and expertise to manage the fund effectively, according to

19 A Northcott, *The Mutual Funds Book: How to Invest in Mutual Funds & Earn High Rates of Returns Safely* (Atlantic Publishing Company, Ocala 2009) 51.

20 Ibid.

21 H Kiymaz, H Baker, and G Filbeck, *Mutual Funds and Exchange-Traded Funds Building Blocks to Wealth* (Oxford University Press, New York 2015) 270.

22 Ibid.

23 The history of mutual funds is discussed in Chapter 3.

the fund investment objectives.[24] Mutual funds provide access to professional investment skills, which would otherwise only be available to more practised and wealthy investors. Making good investment decisions is a complicated process, requiring comprehensive research and market analysis. Professional management usually has investment research teams, with extensive access to research in different markets and sectors, to assess their prospects before making an investment decision. The opportunity for small investors to invest their funds by themselves is very limited. Thus, they delegate the task of making such investment decisions to specialist investment managers. Mutual funds provide such dedicated professional managers to those investors. Despite criticisms aimed at professional managers, that they obtain high fees compared with passive management such as tracker funds, mutual fund managers provide the required services in a proper manner.[25] Unlike passive management, mutual fund managers have a much greater level of freedom over the shape of their portfolios. Further, in exceptional market circumstances, such as market volatility, mutual fund managers can take a defensive stance to protect the investors, while passive management would have to follow the index.

2.3.2 Diversification (Reduction of Risk)

The idea of diversification is widely known from the adage 'do not put all your eggs in one basket'. The term *diversification* indicates the process of spreading the risk over a number of different investments, and probably across different markets, in order to mitigate investment risks.[26] Mutual funds introduce diversification to investors automatically by investing their assets in a wide range of bonds, stocks, securities, and other investment vehicles. While risk cannot be completely eliminated, by diversifying the fund portfolio, the professional management of mutual funds can help to moderate investment risks. To illustrate, if retail investors invest their funds in a single investment holding, they would suffer considerably should the value of that holding suddenly decline. On the contrary, if they invest their money in several investments, the impact of a decline in the value of one of those holdings is offset by the other holdings. Further, if a retail investor with a small amount of money, invested directly into bonds or shares, it would be very difficult to achieve a meaningful level of diversification. Given the cost of commission and bank charges on every single deal, the net investment funds would be reduced. Therefore, investing in a

24 Haslem (n 1) 43.

25 Trackers are known as passive investments because the fund manager does not make any 'active' decisions regarding markets or individual investments. In other words, when an index increases, the value of the fund rises with it, and conversely, when the index falls, the investment in the fund falls with it.

26 J Haslem, *Mutual Funds: Risk and Performance Analysis for Decision Making* (Wiley-Blackwell Publishing Ltd, Oxford 2003) 25.

mutual fund enables small investors to avoid all of these difficulties and obtain the required level of diversification.

2.3.3 Liquidity

The relative length of time it takes to convert an investment into cash has always been a concern to investors. Liquidity is one of the most significant service advantages of mutual funds generally. Liquidity is the ability of investors to access their money in an investment. Generally, mutual funds are required by law to provide liquidity to investors and are ready to buy back their shares/units every business day. In the UK, mutual funds managers must redeem units/shares at a price determined no later than the end of the business day immediately following the receipt and acceptance of an instruction to do so, except for the deferred redemption situation.[27] The price per unit/share at which an investor can redeem shares/units is known as the mutual funds' NAV. To enhance liquidity, many mutual funds provide flexible rules that allow investors to move between funds as long as they remain within the same mutual fund family. For example, Aberdeen Investment Funds ICVC entitles its shareholders to exchange shares of one class in a fund for the appropriate number of shares of another class, whether linked to the same or a different fund. [28]

2.3.4 Reduction of Costs

When investors buy shares/units in mutual funds, they gain the advantage of economies of scale: because of the large quantities in their transactions, mutual funds pay lesser costs.[29] The costs of transactions in most financial markets are related to the size of the transaction. Thus, the costs of individual investors' transactions on small dealings are generally much higher than those transactions carried out by institutional investors, where they deal in large volumes.[30] The following example clarifies this idea. In the London Stock Exchange (LSE), investors buy and sell shares through stockbrokers who trade on behalf of their clients and profit by charging the clients commission. If small investors wish to invest in the LSE, they should pay a commission on every transaction. To reduce the risk of investment in the stock exchange, investors usually seek diversification, making several transactions to minimise any potential loss. As a result, they will be charged for every transaction. However, it should be noted

27 Collective Investment Schemes Sourcebook 2021, coll 6, 6.2.16 (6).

28 For more information see the Aberdeen Investment Funds ICVC Prospectus available at https://www.aberdeenstandard.com/docs?editionId=767b3752-c316-4cc2-b7a9-bb7172124c69 accessed 22 July 2021.

29 See, Haslem (n 1) 36.

30 M Giles, E Alexeeva, and S Buxton, *Managing Collective Investment Funds* (2nd edn, John Wiley & Sons, Chichester 2005) 6.

that the cost of investing in mutual funds might also be high, as establishing, distributing, and managing a mutual fund will include some charges, such as management fees and custody costs.

2.3.5 InvestorProtection

Mutual funds around the world are usually regulated by government regulations, which principally aim at protecting investors from fraud and conflicts of interest. Compared to other financial institutions such as hedge funds, mutual funds regulations are extensive. Mutual funds must comply with a strict set of rules that are monitored by the legal authorities, including specific operating standards, transparency and disclosure requirements, and rules related to the separation of the functions and supervision obligations of the service providers. Mutual funds, for example, must publish a prospectus, a powerful tool that helps investors to make informed decisions about the fund.[31] As noted earlier, because most mutual funds investors are retail investors, such extensive regulations are necessary to provide them with a high level of protection. However, it is important to emphasise that mutual fund regulations do not help investors to choose the 'right' fund and do not prevent mutual funds from losing their money.

Although the advantages offered by mutual funds make them an attractive investment, a few disadvantages should be considered when investing in these schemes, including lack of control by investors, no guaranteed returns, and fund costs and expenses. Mutual fund managers are responsible for making investment decisions according to the fund's constitution and its most recent prospectus. These decisions are usually influenced by the market and economic circumstances, so the managers review and change their decisions where necessary. Generally, investors cannot instruct the manager and must accept the investment decisions made, even if they are not what some of them want. Further, like any other investments, returns on mutual funds are not guaranteed. Because the value of the fund portfolio assets might fluctuate according to the market, the value of a mutual fund unit/share can go up or down. As a result, the redemption price of the unit/share might be higher or lower than the purchase price. The investors, therefore, should not look at the fund's past performance as a critical indicator of potential return.

The costs of operating a mutual fund might offset some of the economies of scale. While mutual funds have traditionally been perceived as a low-cost investment, there might be several charges and costs that are incurred when investing in them. Fees and expenses vary from one mutual fund to another, and even between share/unit classes, and the amount investors pay may depend on the fund's investment strategy. They include the costs of running the fund, management and administration charges, and custody costs. These charges are

31 Collective Investment Schemes Sourcebook 2021, coll 4.2.5.

usually taken directly from the assets of the fund, so the value of the investors' investment might be lower.

2.4 Hedge Funds versus Mutual Funds

The recent development in the hedge fund industry raises a significant question about the traditional distinction between mutual funds and hedge funds. Mutual funds and hedge funds are considered leading sectors of the investment market, serving different classes of investors and using different investment techniques. The growth of the hedge fund industry has been consistent in the past couple of decades. According to Statista, the assets under the management of global hedge funds reached nearly $3.1 trillion in 2019.[32]

Despite the growing attention that hedge funds have received recently from regulators, there is no common definition of what constitutes a hedge fund. Instead, hedge funds are usually defined by particular characteristics rather than by any specific legal structure.[33] As the European Central bank states:

> Although there is no common definition of what constitutes a Hedge Fund, it can be described as an unregulated or loosely regulated fund which can freely use various active investment strategies to achieve positive absolute returns.[34]

In English law, there is no regulatory, statutory, or judicial definition of hedge funds. However, hedge funds are classified as alternative investment funds.[35] An alternative investment fund is a 'collective investment undertaking' that is not subject to the UCITS regime. It includes private equity funds, retail investment funds, and real estate funds, as well as hedge funds. Alternative investment funds invest in various types of global assets, including commodities and property. Typically, a UK hedge fund will be structured as a corporate vehicle. To enjoy tax advantages and flexible law, most UK managed hedge funds are domiciled in offshore zero-rated tax jurisdictions such as the Cayman Islands.[36]

32 Statista, 'Value of Assets Managed by Hedge Funds Worldwide from 1997 to 2019' (2020) available at https://www.statista.com/statistics/271771/assets-of-the-hedge-funds-worldwide/#:~:text=The%20assets%20under%20management%20of,trillion%20U.S.%20dollars%20in%202019 accessed 2 August 2020.

33 L Tiffith, 'Hedge Fund Regulation: What the FSA Is Doing Right and Why the SEC Should Follow the FSA's Lead' (2007) 27 Northwestern Journal of International Law and Business 497–532.

34 T Garbaravicius and F Dierick, 'Hedge Funds and Their Implications for Financial Stability' (2005) European Central Bank Occasional Paper Series no. 34.

35 M Sperlich, *Alternative Investments: Existing and Expected Legal Framework for the Operations of Hedge Funds in European and German Law* (Diplomica Verlag, Hamburg 2010) 10.

36 S Atiyah and A Walter, 'Hedge Funds: An Overview' (2004) 19 Butterworths Journal of International Banking and Financial Law 173–177.

Although mutual funds and hedge funds have evolved in different market and regulatory frameworks, they do have certain similarities. First, both financial institutions pool their capital from investors, rather than bank loans or other sources of capital. Second, they invest their assets in publicly traded securities such as equities and bonds. Third, the capital collected from the investors is managed or invested by professional fund managers.[37]

However, hedge funds differ from mutual funds in terms of the authorisation and transparency of all information, liquidity, oversight, and systemic risks. Arguably, hedge funds were originally designed to circumvent legislative strictures, and other compliance requirements imposed on financial institutions raising funds from the public for their activities. When the first hedge funds came into existence in the US in the 1940s, they were designed to avoid the Securities and Exchange Commission (SEC) regulations and fulfil versatility in their investments.[38] However, after enacting The Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the SEC has become increasingly active in monitoring the activities of hedge funds to ensure that investor interests are protected.[39] The Dodd-Frank Act has changed the scope of exemptions applicable to hedge fund managers. The Act requires hedge fund managers to maintain filed reports and records containing such information as the SEC deems necessary and appropriate in the public interest and for protecting the investors' interests or for the assessment of systemic risk by the Financial Stability Oversight Council.[40]

In the UK, even though hedge funds constitute unregulated schemes, those entities conducting investment business in the UK on behalf of those schemes, such as the manager, promoter, and prime broker, are regulated by the FCA, such as the Conduct of Business Sourcebook, and, to this extent, investors are afforded a degree of regulatory protection. It is significant to know that in 2013 the Alternative Investment Fund Managers Regulations (AIFM) 2013 were enacted.[41] The AIFM Regulations are applicable to alternative investment funds (AIF). A fund managed by an AIFM is an AIF for the purposes of the AIFM Directive and is indirectly affected by its provisions. Alternative investment fund managers are defined to mean legal persons whose regular business is managing one or more alternative investment funds. Hedge fund managers are typically also 'investment firms' under the Markets in Financial Instruments Directive 2004 (MiFID) regime and are subject to the

37 I Nelken, *Hedge Fund Investment Management* (Butterworth-Heinemann, Oxford 2005) 78.

38 Tiffith (n 33).

39 Available at http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf accessed 1 January 2022.

40 The Financial Stability Oversight Council is a US federal government organisation, established by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act to identify and monitor excessive risks to the US's financial system.

41 Alternative Investment Fund Managers Regulations 2013.

rules implementing MiFID II in the UK. These rules mainly affect the fulfilment of the fund's marketing and investment strategies.[42]

Since hedge funds are unregulated collective investment schemes, the main consequence of non-authorisation is that they cannot promote their products to the public. The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (SI 2001/1060) and the FCA's Conduct of Business Rules define the way that unregulated collective investment schemes, including hedge funds, may be marketed in the UK. According to these regulations, unregulated collective investment scheme products can only be marketed to intermediate or market counterparties, 'sophisticated investors', specific categories of investors that meet particular net worth tests, and other private customers if the person marketing has taken reasonable steps to ensure that the product is suitable for the investor in question.[43] This implies that while hedge funds may be appropriate investment vehicles for institutional and wealthy investors, they are not suitable for smaller, 'less practised' investors who are not in a position to appreciate the risk of their investment strategies and demand disclosure.

A second important difference between hedge funds and mutual funds is the lack of transparency regarding the assets, strategy, and leverage of a hedge fund. Transparency is related to the quality of operational information being clear, understandable, and without any ambiguity. Because the majority of mutual fund investors are retail investors, transparency is considered crucial in the mutual fund industry, as demonstrated by the publication of a prospectus, as mentioned earlier.[44] In contrast, hedge funds are generally not subject to transparency obligations. The consequence of a lack of disclosure in hedge funds is dangerous, to the investors and/or the market, because it enables hedge fund managers to engage in fraud, and investors may not know what a hedge fund manager is investing in until it is too late. In the US between 1999 and 2004, the SEC brought fifty-one cases of hedge fund fraud, totalling $1.1 billion in losses to investors.[45]

This having been said, following the global financial crisis in 2008, the hedge fund industry has seen some substantial regulatory changes regarding registration and disclosure requirements. In the US, for example, the aforementioned Dodd-Frank Act (2010), for the first time in the history of hedge

42 The MiFID is the EU legislation that regulates firms that provide services to clients linked to financial instruments and the venues where those instruments are traded.

43 A certified high net worth investor is an individual who has signed, within the period of twelve months ending with the day on which the communication is made, a statement in specific terms. See, Conduct of Business Sourcebook, COBS 4.12.6.

44 Collective Investment Schemes Sourcebook 2021, coll 4.2.5.

45 G Sami, 'A Comparative Analysis of Hedge Fund Regulation in the United States and Europe' (2009) 29 Northwestern Journal of International Law and Business 275–308.

funds, now requires most managers of hedge funds to register with the SEC.[46] However, the registration and disclosure requirements under the Dodd-Frank Act are considerably less burdensome than those applicable to mutual funds.[47] In the UK, AIFM regulations contain rules relating to the transparency of hedge funds. These rules require AIFMs to disclose to investors certain important information such as all associated risks, maximum leverage levels, and a description of investment strategies.[48] By establishing those rules, the AIFMD aims to avoid the consequences of a lack of transparency, which could have negative effects on financial markets. However, similar to the US, these disclosure provisions are still less onerous than the mutual fund extensive disclosure provisions.

Another fundamental difference between hedge funds and mutual funds is the lack of liquidity. Unlike mutual funds, hedge funds are not able to stand ready to repurchase shares on a daily basis. Rather, they generally impose some constraints on investors such as liquidity dates, pre-specified times of the year when investors are allowed to redeem their shares, and lock-up period, the period for which the investors must keep their initial investment in the fund.[49]

As noted previously, compared with mutual funds, hedge funds in many jurisdictions are not strictly regulated and lack regulatory oversight. This might lead to potential conflicts of interest between the hedge fund manager and investors. This does not mean that strict regulatory oversight in the mutual fund industry prevents all conflicts of interest; however, clear and proper regulations might mitigate such potential conflicts. For example, in the UK, mutual fund regulations require the mutual fund manager to disclose in the prospectus any arrangements that may cause conflicts of interest and how these conflicts will be resolved.[50]

Additionally, hedge funds can be highly leveraged asset management organisations. Systemic risk refers to 'the risk that a major market participant's losses in the financial markets may cause widespread loss to other firms in the market, or cause disruptions to other industries or to the entire worldwide financial system'.[51] A substantial drop in the hedge funds' underlying assets, due to turmoil in financial markets for example, might cause the hedge funds to fail. Because of the significance of the hedge fund industry in financial markets, this failure could cause serious damage to the financial market. In contrast, mutual

46 See, SEC, 'SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act' (2011) available at https://www.sec.gov/news/press/2011/2011-133.htm accessed 31 December 2021.

47 W Kaal, 'Confluence of Mutual and Hedge Funds' in W Birdthistle and J Morley (eds) *Research Handbook on the Regulation of Mutual Funds* (Edward Elgar Publishing, Cheltenham 2018) 289.

48 Alternative Investment Fund Managers Regulations 2013, reg. 5.

49 D Capocci, *The Complete Guide to Hedge Funds and Hedge Fund Strategies* (Palgrave Macmillan, New York 2013) 91.

50 Collective Investment Schemes Sourcebook 2021, coll 4.6.8.

51 A McClean, 'The Extraterritorial Implications of The SEC's New Rule Change to Regulate Hedge Funds' (2006) 38 Journal of International Law 105–122.

funds are much less leveraged, and so these funds would appear to be at little risk.[52] Transparency to regulators, through the information that needs to be provided regularly concerning both mutual funds asset positions and leverage levels, would reduce any potential systemic risk in the mutual fund industry.

To sum up, the main difference between mutual funds and hedge funds lies in the degree of regulation applied to each. Unlike mutual funds, hedge funds are not required to adhere to strict financial regulations. The idea that hedge funds are completely unregulated, however, is not accurate; it is more correct to say that these vehicles were originally structured to take advantage of exemptions in the regulations. As a result, investment in these funds is more suited to seasoned or 'professional' investors, who possess the knowledge, expertise, and experience to make their own investment decisions and assess the potential risks that the investment may incur. In contrast, mutual funds are subject to comprehensive and strict regulations that govern the operation of the funds and the service providers. Those regulations are designed principally to protect investors and the industry.

2.5 Classification of Mutual Funds

Classifying mutual funds into different categories is significant for two main reasons: (1), to identify relevant investment limits applicable to them under mutual fund regulations and other relevant laws, and (2), to help investors understand what they are investing in and the risks associated with their investment, thus enabling them to compare various types of funds and choose the appropriate one that helps them to achieve their personal investment plans and objectives. Therefore, mutual fund regulations require mutual funds to expressly state their investment objectives—for instance, growth, income, or balanced—in their prospectus and how they aim to achieve these objectives.

Since their creation in the eighteenth century, a wide variety of mutual funds has been established worldwide to cater to the investors' needs, such as risk tolerance and returns expectations. This flexibility is one of the main reasons for the success of the mutual fund industry and its exceptional growth. It is important to understand that each mutual fund has different risks and returns. Generally, the higher the potential return, the higher the degree of risk and, in turn, the loss. While some mutual funds are less risky than others, all funds hold some degree of uncertainty.

There is no common classification of mutual funds, so the following discussion strives to distinctly classify them. Based on their structure, mutual funds can be classified into open-ended and closed-ended mutual funds (Figure 2.2). According to their investment objectives, mutual funds can be classified into growth, income, balanced, and money market funds (MMFs).

52 For further information see Chapter 5 (5.3 Mutual Fund Risk Management).

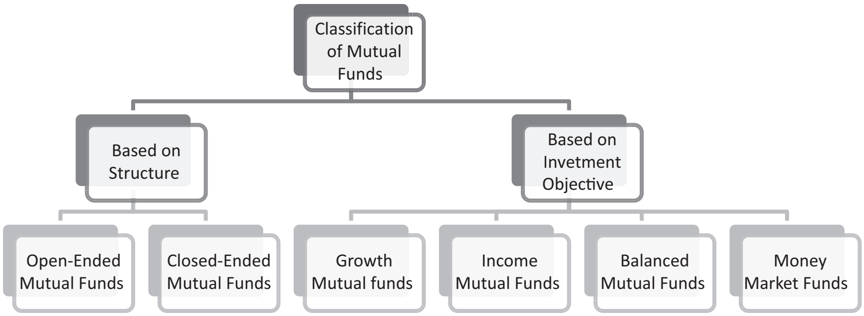

Figure 2.2 Classification of mutual funds.

2.5.1 Based on Structure

Although it is agreed that the definition of mutual funds excludes closed-ended funds, mutual funds may be classified, in a few jurisdictions, according to their capital structure into open-ended and closed-ended funds.[53] However, the term *mutual fund* in the leading countries of this industry, such as the UK, the US, Ireland, and Luxembourg, refers only to open-ended funds. The distinction between an open-ended and a closed-ended fund is significant in terms of the investors' rights and operation of the fund.

2.5.1.1 Open-ended Mutual Funds

The defining characteristic of open-ended mutual funds is the continuous offering of new shares/units to the public. Investors in open-ended funds can redeem their shares/units on demand at any time.[54] This means that there is no specific duration for redemption. The prices of the shares/units fluctuate daily as the value of the fund's underlying assets changes according to market circumstances. Therefore, open-ended funds price their shares/units daily at NAV, which is calculated by taking the total market value of the fund assets, less its liabilities, and dividing the remainder by the number of the fund's shares/units. Similarly, the number of the funds' shares/units fluctuate as they are bought and redeemed continuously.

2.5.1.2 Closed-ended Funds

Closed-ended funds are similar to regular companies as their shares are fixed after public offerings. To illustrate, closed-ended funds shares are not

53 G Haight, G Ross, and S Morrell, *How to Select Investment Managers & Evaluate Performance: A Guide for Pension Funds, Endowments, Foundations, and Trusts* (John Wiley & Sons, Hoboken 2008) 213.

54 M P Fink, *The Rise of Mutual Funds: An Insider's View* (2nd edn, Oxford University Press, New York 2011) 11.

redeemable. They are not required to buy their shares back from investors upon request. Therefore, closed-ended funds are not concerned with the fund liquidity, so they can usually buy less liquid securities and assets such as real estate. Their shares are publicly traded in the secondary market, generally in a stock exchange.[55] Since the total number of shares is fixed and new investors can only buy shares from the existing shareholders, the price of shares is determined by the supply and demand for that fund. Closed-ended funds usually have perpetual lives.[56] In the UK, closed-ended funds are known as 'investment companies'.

2.5.2 Based on Investment Objective

Mutual funds can be classified into four types by objectives, namely: growth, income, balanced, and money market funds (Figure 2.3).

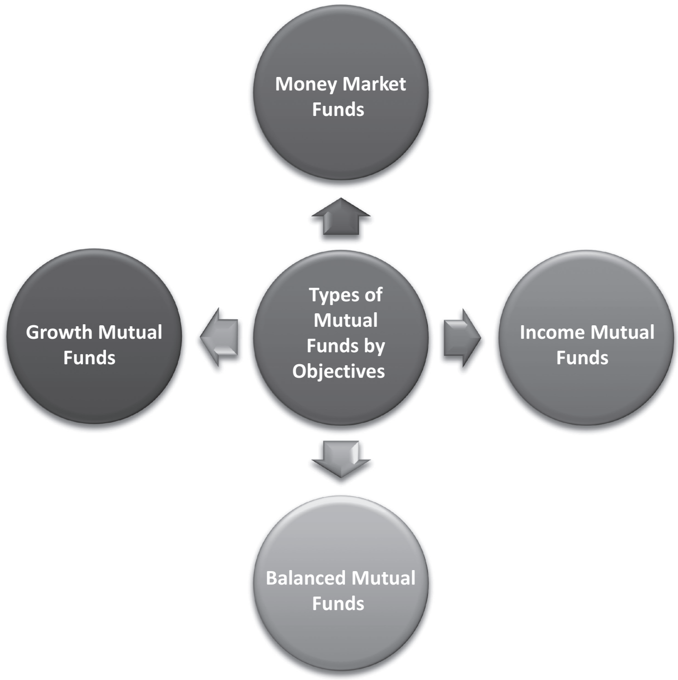

Figure 2.3 Types of mutual funds by objectives.

55 C J Stein, 'Why Are Most Funds Open-End? Competition and the Limits of Arbitrage' (2005) 120 The Quarterly Journal of Economics 247–272.

56 Haslem (n 26) 11.

2.5.2.1 *Growth Mutual Funds*

Growth mutual funds aim at providing capital appreciation over a medium to long term with a small income.[57] To achieve this objective, they usually invest a large part of their assets in equities. An Equity is a security or investment representing ownership in a company. Despite income being an important consideration in growth funds, it is generally a secondary aim. As a result, growth mutual funds are suitable for investors with a long-term vision who are seeking appreciation over a long period. Growth mutual funds have relatively high risks. In the UK, mutual fund regulations do not impose any obligation upon the growth funds regarding the length of period for which they can invest their assets.

2.5.2.2 *Income Mutual Funds*

Income mutual funds are those that generate regular and steady income for their investors on a periodical basis. They generally invest their assets in fixed-income securities, including bonds, government securities, corporate debentures, money market instruments, and cash equivalents.[58] Because income funds are usually not affected by fluctuations in the equity markets, they are less risky compared with equity mutual funds. Nonetheless, possibilities of capital appreciation are limited in these funds. The NAV of an income mutual fund is usually affected by the changes in interest rates, and this reflects the nature of its investments. When the interest rates increase, the NAV is likely to fall in the short run and vice versa. It is worth mentioning that the terms *fixed income* and *income* are usually used synonymously. Because income mutual funds invest primarily in bonds, they are also referred to as *bonds funds*.

2.5.2.3 *Balanced Mutual Funds*

The objective of balanced mutual funds is to provide a balanced mixture of capital appreciation and regular income. To attain this aim, they invest in a combination of fixed income and equities at the percentage disclosed.[59] A typical balanced fund might have a weighting of fifty per cent equity and fifty per cent fixed income. Because balanced mutual funds invest in equities, their NAV can be affected by fluctuations in the markets. However, they are likely to be less volatile compared with equity or growth funds. This kind of fund is ideal for investors seeking a mix of income and moderate growth. The level of risk in balanced mutual funds is medium to high depending on the split between equities and fixed income.

57 Mobius (n 6) 21.

58 Northcott (n 19) 51.

59 C Turner, *International Funds: A Practical Guide to their Establishment and Operation* (Butterworth-Heinemann, Oxford 2004) 26.

2.5.2.4 *Money Market Funds*

MMFs are a type of mutual funds that invest in short-term debt instruments.[60] They provide financing for financial institutions, corporations, and governments. MMFs typically invest in certificate of deposits (CD), commercial paper (CP), asset-backed commercial papers (ABCP), short-term bonds issued by private issuers, repurchase agreements, shares of (other) money market funds, and government securities. The nature and purpose of MMFs distinguish them from other types of mutual funds. Unlike other types of mutual funds, whose NAV can fluctuate daily, MMFs seek to maintain a stable NAV, typically $1.00 per share in the US and €1 in the EU.[61] MMFs' ability to maintain a stable share price is considered the key reason for their popularity. Investors have often viewed MMFs as bank equivalents. They invest their money in MMFs because MMFs offer features analogous to bank deposits: stability of the value of the principal invested and instantaneous access to liquidity.[62] Generally, the returns for money market funds are lower than for those in bond or equity funds.[63] It is important to mention that MMFs regulations in the US and EU have been subject to substantial changes in terms of their operation and structure. These changes have considerably affected their popularity among retail investors.[64]

2.5.3 Multiple Mutual Fund Structures

Due to competition in financial markets, and to attract more investors, the mutual fund industry has created multiple fund structures, such as umbrella funds and funds of funds. An umbrella fund is a family of sub-funds established as a single legal entity.[65] An umbrella fund must comprise at least two sub-funds. Each sub-fund has its own discrete portfolio of underlying assets and its own investment objectives. In other words, each smaller fund is treated as if it were its own mutual fund.[66] Some sub-funds would mainly be based on investing in stocks, while others might be based on making investments in bonds or commodities. The umbrella fund structure provides favourable switching facilities between its sub-funds, and investors can easily move from one sub-fund to another.

A fund of funds is a mutual fund that invests all its assets in other mutual funds (Figure 2.4). It enables investors to obtain greater diversification by

60 A Lyon, 'Money Market Funds and Shareholder Dilution' (1984) 39 The Journal of Finance, 1011–1020.

61 Alshaleel (n 2).

62 Ibid.

63 See, Testimony on 'Perspectives on Money Market Mutual Fund Reforms' by Chairman Mary L. Schapiro, US Securities and Exchange Commission available at http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489510 accessed 2 May 2021. It addresses the risks posed by money market funds to the financial system in the financial crisis of 2008.

64 See, Alshaleel (n 2).

65 A Hall, *Getting Started in Mutual Funds* (2nd edn, John Wiley & Sons, Hoboken 2010) 20.

66 Ibid.

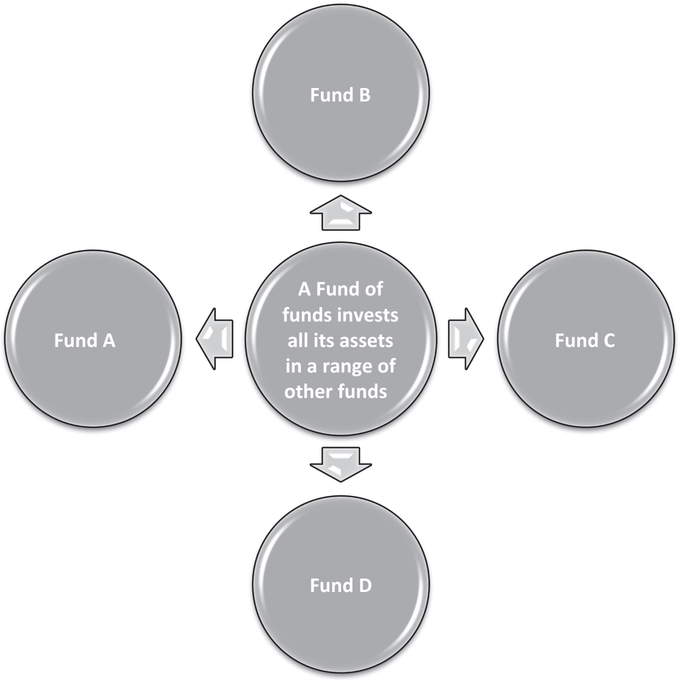

Figure 2.4 Fund of funds.

investing in one vehicle.[67] Mutual fund regulations usually impose investment limits upon a fund of funds such that a fund of funds must not invest in a fund of funds or any sub-fund of an umbrella fund that is a fund of a fund. A UCITS fund of funds, for instance, cannot invest its assets in another fund that itself is allowed to invest more than ten per cent of its assets in funds. This is intended to avoid the potential consequences of levels of layering which could bear the risk of multiple charges.[68] A UCITS fund of funds is also not permitted to invest more than thirty per cent of its assets in non-UCITS funds.[69]

2.6 Operation of a Mutual Fund

Unlike other business enterprises, a mutual fund is externally managed. This implies that it does not operate on its own and has no employees in the

67 S Hodge, 'Open-Ended Investment Companies' (1995) 3 Journal of Financial Regulation and Compliance 321–328.

68 Turner (n 59) 189.

69 Ibid.

Figure 2.5 Mutual fund main players.

traditional sense. Rather, a mutual fund relies upon third parties' services to perform the mutual fund activities and invest its assets.[70] Those service providers might be either affiliated organisations or independent contractors. Despite mutual funds being externally managed, they are usually required by law to have written policies and procedures that govern the operations of the fund. The following discussion focuses on the parties involved in the operation of a typical mutual fund and their roles. It is significant to mention that in some countries, other parties might also be involved (Figure 2.5).

2.6.1 The Mutual Fund Manager

As noted earlier, one of the main reasons for investing in mutual funds is to acquire the advantage of professional management. A typical mutual fund manager, a body corporate in the UK, has the responsibility for directing the fund's investments and handling its day-to-day business affairs in accordance

70 Haslem (n 26) 2.

with the fund's investment objectives and policies.[71] It is also responsible for preparing the mutual fund prospectus. The fund manager also prepares the fund's reports.[72] Although fund managers are usually entitled to delegate some of their functions to third parties, they remain responsible for the actions taken by delegates in case they fail to perform their functions properly.[73] To make sure that mutual funds are managed effectively, mutual fund regulations usually require the fund manager to be a body corporate that has its own employees. Due to the crucial nature of the mutual fund managers' duties, they are subject to numerous standards and legal restrictions, including restrictions on transactions that may pose potential conflicts of interest between their self-interest and investor interests.[74] It is important to note that in some jurisdictions, the mutual fund manager is replaced by other functionaries. For instance, the OEICs in the UK have an authorised corporate director (ACD). Here, it is worth mentioning that in the US, the mutual fund manager is called the investment adviser.

2.6.2 The Investment Adviser

Although mutual fund managers are responsible for managing the fund, as mentioned earlier, they are usually entitled to delegate some functions to third parties. A mutual fund manager may delegate specific functions to an investment adviser,[75] whose main role, generally, is to assess investment opportunities and suggest the most effective strategy complying with the fund's objectives.[76] However, the investment adviser is not entitled to make decisions on behalf of the fund. They can only make recommendations to the fund manager who, in turn, makes the investment decisions based on those recommendations. This implies that the manager will be responsible to the investors for any loss caused by those decisions.[77] In some cases, the mutual fund manager may delegate specific functions to another manager rather than an investment adviser.[78] In this situation, the external investment manager will be able to make decisions, within their limits, without approval from the mutual fund manager.

2.6.3 Administrator

While most mutual fund regulations do not require the appointment of an administrator, mutual fund managers usually delegate the administration functions to an administrator. Essentially, an administrator is responsible for

71 Collective Investment Schemes Sourcebook 2021, coll 6.6.3 (3).
72 Ibid, coll 4.5.2.
73 Delegation of functions is discussed in Chapter 4.
74 Conflicts of interest are discussed in Chapter 6.
75 Shepherds Investments Ltd v Walters [2006] EWHC 836 (Ch). [9].
76 Ibid.
77 Collective Investment Schemes Sourcebook 2021, coll 6.6.15.
78 Ibid, coll 6.6. 15.

coordinating the functions of the other service providers to perform the business of the fund effectively.[79] The scope of the administrator's duties varies broadly, but generally, the administrator provides, among other things, office space, clerical personnel, data processing, preparing and filing tax returns, preserving the mutual fund's records, and publishing the NAV and other reports. In some cases, the investment adviser may perform the activities of the mutual fund administrator.[80]

2.6.4 Directors/Trustee/Depositary

The role of a trustee in the operation of any mutual fund is crucial to protect the interest of the investors. In the UK, a unit trust trustee, commonly a credit institution, typically has a dual role: (1), to oversee how a mutual fund is managed, and (2), to safeguard the property of the fund.[81] This means that in addition to its main duty to supervise the activities of the manager, the trustee carries out the role of a custodian. Further, the OEICs' Regulations require OEICs to appoint a depositary who stands in place of a trustee of a unit trust.[82] The depositary role includes both the custodianship of the OEICs' property and supervision of the ACD and other service providers.

In the US, where mutual funds are governed by a board of directors, independent directors perform the oversight function. However, unlike the trustee, the independent directors do not maintain custody of the mutual funds' assets. Therefore, the Investment Company Act 1940 requires all mutual funds to appoint a custodian to maintain strict custody of fund assets, separate from the assets of the adviser. Independent directors play a vital role in protecting the shareholders' interests. This includes approving the mutual fund's investment advisory arrangements, reviewing agreements with other service providers, and monitoring the fund's investment performance.[83]

2.6.5 Distributor/Underwriter

A distributor, also called an underwriter, is an intermediary between mutual funds and investors. Mutual funds regulations and policies of the funds usually determine how the shares/units are sold to the public. Generally, a mutual fund may distribute its shares/units to the public either directly at a price equal to their current net asset value or through an independent professional intermediary that is authorised to sell fund shares.[84] In this case, the distributor earns

79 Kiymaz, Baker and Filbeck (n 21) 405.

80 D Riggs and C Park, 'Mutual Funds: A Banker's Primer' (1995) 112 Banking Law Journal 757–785.

81 Abbey National Plc v Customs and Excise Commissioners [2006] S.T.C. 1136. [84].

82 Open Ended Investment Company Regulations 2001, reg. 5.

83 The role of independent directors is discussed in detail in Chapter 6.

84 D J Romanski, 'Role of Advertising in the Mutual Funds Industry' (1972) 13 Boston College Industrial and Commercial Law Review 959–1020.

a commission for bringing investors into the mutual fund, which is considered an expense for the fund. When marketing the shares/units, the distributors must provide the prospective investors with accurate and clear information and any additional information that they may ask for.[85] They must also treat all prospective investors fairly.[86]

2.6.6 Auditors

In most jurisdictions, mutual funds regulations require mutual funds to appoint auditors. In the UK, for example, regulation 69 of the OEICs regulations requires every OEIC to appoint an auditor or auditors.[87] The main obligation of the auditors is to certify the mutual fund's financial statements and reports, providing assurance that they are prepared in conformity with generally accepted accounting standards and fairly present the mutual fund's financial position.[88] Auditors are generally appointed by the trustee, or the independent directors in the US, and the law requires the auditor to be independent of the manager and the trustee. The audit fees are usually paid directly from the assets of the fund.[89]

2.6.7 LegalCounsel

The main role of legal counsel is to advise the mutual fund manager and other service providers on a wide range of matters. The role of the legal counsel usually begins before the establishment of the mutual fund because the legal counsel drafts and reviews registration statements and other regulatory requirements. The legal counsel may also advise the fund on different matters, such as taxation issues, permitted distribution methods, reviewing public filings, and drafting contracts between the mutual fund and third parties.[90]

As noted above, the service providers involved in the operation of a mutual fund vary among jurisdictions. In the US, for instance, the Investment Company Act 1940 requires mutual funds to appoint a chief compliance officer whose appointment must be approved by the fund's board and who must provide the board with an annual report regarding the adequacy of the fund's compliance policies and procedures and the efficiency of their implementation.[91] Unlike the US, in the UK, mutual funds are not required to appoint a chief compliance officer.

85 Bernard L Madoff Investment Securities LLC, Re [2010] EWHC 1299 (Ch). [19].

86 J Benjamin and D Rouc, 'Providers and Distributors: Responsibilities in Relation to Retail Structured Products' (2007) 1 Law and Financial Markets Review 413–421.

87 Open Ended Investment Company Regulations 2001, sched, 5 reg. 69. 4.

88 Ibid, reg. 67.

89 Turner (n 59) 109.

90 Ibid, 111.

91 See, Kiymaz, Baker and Filbeck (n 21) 75.

2.7 Legal Nature of Open-Ended Investment Companies and Unit Trusts

In the UK, the two primary organisational forms for mutual funds are the trust form (unit trusts) and the corporate form (OEICs). Since the main discussion in the following chapters addresses mutual fund regulations and governance in the UK, it is important to explore the legal nature of unit trusts and OEICs. This will help in understanding the nature of the obligations and responsibilities of the main service providers involved in mutual funds, and the rights of the investors.

2.7.1 Legal Nature of the Unit Trust

The unit trust is the original form of mutual funds in the UK. It is based on the English common law concept of trust. The concept of trust owes its origin to equity, arising in English history as early as the thirteenth century as a way of recognising that a group of people might have simultaneous rights of use over land.[92] Typically, a trust is established where the owner of the property (the settlor) vests the legal title in that property in a person (the trustee) to hold that property on trust in accordance with the terms of a trust deed for the benefit of another person (the beneficiary) who has an equitable interest in the property (Figure 2.6).[93] The trust deed defines the duties and powers of the trustee and specifies how the beneficiaries are to benefit.[94] Generally, there are different types of trusts, namely private trusts and public trusts. Private trusts can also be divided into trusts created by the intention of the parties, known as express private trusts, and trusts that are implied by law, namely resulting and constructive trusts.

Because a trust is not an entity, it has no separate legal personality under English law. This has, also, other legal implications, including that the trust cannot make contracts in its own name or enter into litigation on its own account.[95] Trusts, therefore, are characterised by the relevant document constituting the trust between the trustee and the beneficiaries.

2.7.1.1 Commercial Nature of Unit Trusts

The trust form was mainly established as a property institution, and because of its flexibility to deal with various aspects of ownership, especially control and title, it efficiently serves the property owners. This flexibility has encouraged traders to use the concept of trust in the commercial field, particularly to obtain

92 A Hudson, *The Law on Investment Entities* (Sweet & Maxwell Limited, London 2000) 65.

93 A Hudson, *Equity and Trusts* (3rd edn, Cavendish Publishing, London 2014) 32.

94 Ibid, 32.

95 J Garton, G Moffat, G Bean and R Probert, *Moffat's Trusts Law: Text and Materials* (Cambridge University Press, Cambridge 2015) 19.

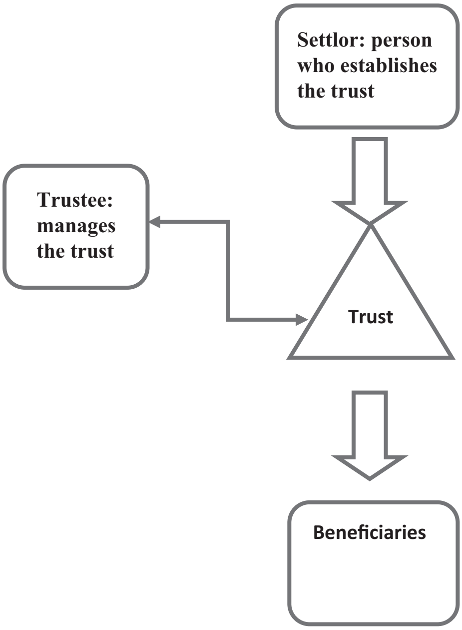

Figure 2.6 Trust structure.

co-ownership by individuals or groups. Due to its success in direct trading businesses, the trust has also been used in indirect investment. Under indirect investment, the concept of the unit trust was developed.

To understand the legal nature of the unit trust and the relationship between the parties involved in the operation of the fund, it is necessary to explain how unit trusts operate. Typically, a unit trust works as follows. The unit trust is established under a trust deed between the manager and the trustee. The trust deed defines the terms and provisions under which the trust is created. It also determines the fund investment objectives. Given the diversification and spreading risks requirements, the trust deed also specifies the limitations of investments which the manager should comply with when formulating the investment strategy of the scheme.[96] The manager of the unit trust must be a management company,[97] which will be empowered by the terms of the trust deed to acquire specific types of securities defined in said deed.

Once the securities are bought, they will be transferred to the trustee appointed in the trust deed. As the manager, the trustee must also be a

96 D Loader, *Fundamentals of Fund Administration: A Guide* (Butterworth-Heinemann, Oxford 2006) 8.
97 Financial Services and Markets Act 2000 s.243 (5) (a).

company under the provisions of the FSMA 2000.[98] The trustee does not make any investment decisions but has a fundamental role in ensuring the manager's compliance with the regulations and the fund objectives.[99] This implies that the main functions of the unit trusts are divided between the fund manager and the trustee. The profits generated from the fund investments are allocated proportionately between the units held. Each investor has the right to a pro-rata cash return for each unit held. This means that investors have, mainly, a contractual right against the unit trust manager equal to the value of each investor's pro-rata unit of the total profits of the fund.

Since the unit trust is constituted by a trust deed and performed by the manager and trustee, some academics argue that a unit trust is not a trust. Fan Sin, for example, in his book 'The Legal Nature of the Unit Trust' argues that a unit trust is considered a contract containing a trust rather than a trust in itself. In his argument, Sin focuses on specific areas in which trust law principles do not apply to the unit trust. This mainly includes the absence of the settlor, the split of functions between the manager and the trustee, and some rules of formalities that do not apply to the unit trust. To illustrate, Sin sees that in the unit trust, because there is no settlor with donative intent, it cannot be considered as a form of trust. This raises a significant question about whether the trust is always intended to be established by the settlor. The settlor might unintentionally act in a way that the law considers as the creation of a trust.[100] In an Australian case, for example,[101] *Famel Pty. Ltd. v Burswood Management Ltd.*, French J. considered the manager as the settlor in the unit trust.[102] In English law, in *Re A.E.G. Unit Trust (Managers) Ltd.'s Deed*, Wynn-Parry J. held that section 164 of the Law of Property Act, 1925, did not apply at all to the trust deed.[103] This implies that unit trust investors are not settling a property when buying units, but that they participate in the fund for the receipt of contractual rights resulting from the investment of the unit trust.

Additionally, as noted previously, traders have used the trust structure to deal with the management of some property while specified commercial transactions are carried out. Two important points should be considered in commercial trusts: (1), the trust is usually part of a contract whereby a number of parties establish the trust, and (2), commercial trusts do not require the existence of a single settlor expressing a donative intent to be regarded as trusts.[104]

98 Ibid.

99 For further information about the role of the trustee and the fund manager see Chapter 6 (6.4.2.1 Unit Trust Governance Structure).

100 See, for example, *Paul v Constance* [1977] 1 WLR 527.

101 The unit trust structure in Australia is similar to the unit trust in the UK regarding the dual structure: the manager and the trustee.

102 Famel Pty. Ltd. v Burswood Management Ltd (1989) 15 Australian Company Law Reports (ACLR) 572.

103 Re A.E.G. Unit Trust (Managers) Ltd.'s Deed [1957] Ch. 41.5.

104 Hudson (n 92) 200.

As a result, while the unit trust might not be considered as a traditional trust due to the lack of the settlor, it can be some other form of trust. If this were not the case, all commercial trusts, such as pension funds, would not be trusts at all.

Sin also sees that another problem with the unit trust is the division in the functions between the fund manager and the trustee. As explained earlier, while the fund manager is responsible for investing the fund's assets and other daily activities, the trustee safe keeps the fund assets and supervises the manager's activities. However, this split in functions in the unit trust is not, per se, exceptional, because even in ordinary trusts different trustees might have distinct responsibilities.[105] One trustee, for example, might be responsible for management whereas another might have the responsibility of collecting the investment income. Therefore, the separation of functions in the unit trust does not preclude it from being labelled as a trust.

Finally, Sin argues that certain rules of formality that apply to ordinary trusts do not apply to the unit trust. Given the purpose of creating unit trusts, pooling money from many investors, these differences arise from their structure, rather than from any requirement that the unit trust should be viewed as a different type of investment form from the normal trust. It is significant to stress that the three certainties, intention, subject matter, and objects, are satisfied regarding the unit trust. The certainty of intention is evidenced by the trust deed signed by the trustee and the manager to carry out certain functions. The certainty of objects is also evident by reference to the purchase of units by the unitholders. Regarding the certainty of the subject matter, the relationship between the unit trust manager and unitholders is expressed by the means of the units. The unit trust property is held by the trustee. The segregation of property held on trust by the trustee to achieve the fund objectives demonstrates that the unit trust relationship goes beyond only a contract and shows an intention to create a trust.

Based on the foregoing discussion, the unit trust as an investment vehicle can perhaps best be considered as a form of commercial trust that combines components of trust and contract. This combination is designed to serve the creativity of the unit trust as an investment means, one which pools money from a large number of investors. The trust is used contractually as a device to attain collective ownership of the unitholders themselves.

2.7.2 Legal Nature of Open-Ended Investment Companies

From economic and legal respects, the functional similarities between unit trusts and OEICs far outweigh the differences. The provisions that distinguish OEICs from unit trusts come from the corporate structure of OEICs. To understand the legal nature of OEICs, it is essential to analyse the definition of

105 For more information about if there is more than one trustee see, R Clements and A Abass, *Equity & Trusts: Text, Cases, and Materials* (2nd edn, Oxford University Press, Oxford 2011) 298.

OEIC. This will help in defining the criteria that should be met to describe a body corporate as an OEIC.

An OEIC is defined in the Financial Services and Markets Act 2000 as: 'a collective investment scheme which satisfies both the property condition and the investment condition'.[106]

These definitional conditions reflect the conventional understanding of an OEIC. In *Seymour v Ockwell*, HHJ Havelock-Allan QC stated that:

> An open-ended investment company is a company which runs an investment fund. It is 'open-ended' in the sense that the fund grows and more shares in it are created as more investors invest. The fund shrinks and shares are cancelled as people withdraw their money. The price of each share reflects the value of the investments held in the fund. These investments may include the shares of other companies or other securities.[107]

Therefore, for a body corporate to be an OEIC as defined in the FSMA 2000, (1), it must be a collective investment scheme (CIS), (2), it must satisfy the property condition in s. 236 (2), and (3), it must satisfy the investment condition in section 236 (3).

The first element of the definition is that OEICs are corporate structures of a collective investment scheme. This means that OEICs must have the features defined in section 235 of the FSMA 2000.[108]

In addition, if a body corporate comes within the definition of a CIS, the second element in the definition is whether the property to which the scheme relates meets the property element. The property condition is a requirement that:

> The property belongs beneficially to, and is managed by or on behalf of, a body corporate ('BC') having as its purpose the investment of its funds with the aim of— (a) spreading investment risk; and (b) giving its members the benefit of the results of the management of those funds by or on behalf of that body.[109]

Section 236 (2) makes it clear that the OEIC itself is the beneficial owner of the property, and the reference to body corporate is a reference to the OEIC rather than to the authorised corporate director or the depositary.[110] However, the shareholders of the body corporate may not have a beneficial interest in that property; they will only have rights against the body corporate. The term

106 Financial Services and Markets Act 2000 s.36 (1).

107 Seymour v Ockwell [2005] 1137 at [116].

108 For more information about the definition of the CIS and its features, see A Hudson, *The Law of Finance* (Thomson Reuters Limited, London 2009) 1269.

109 Financial Services and Markets Act 2000 s.36 (2).

110 Hudson (n 108) 1283.

property is not defined in the FSMA, but it could be understood from the context that it refers to the investment assets held for the purpose of the CIS, whether including money or other forms of property. However, it must be possible to value the property if the requirements of the investment condition concerning NAV are to be met.

The property condition raises an important question about whether the assets invested by the body corporate with the objective of spreading risk are not affected by the levels of risk contained in specific investments. In fact, the value of each body corporate investment could be subject to a high level of risk. It could be said that this would not itself breach the property condition as long as the total of different investments affirmed that the aim was to spread investment risk.

Further, the third element that must be satisfied is the investment condition. The investment condition itself provides that:

> In relation to BC, a reasonable investor would, if he were to participate in the scheme—(a) expect that he would be able to realize, within a period appearing to him to be reasonable, his investment in the scheme (represented, at any given time, by the value of shares in, or securities of, BC held by him as a participant in the scheme); and (b) be satisfied that his investment would be realized on a basis calculated wholly or mainly by reference to the value of property in respect of which the scheme makes arrangements.[111]

Under the investment condition, a reasonable investor is looking to satisfy two aspects: the expectation test and the satisfaction test. These aspects are vital in making the investment decision.

It should be noted here that the FSMA 2000 used the term *reasonable investor* and not *reasonable person*. This means that the objective standard that must be applied is that of a reasonable investor. This creates a presumption that the reasonable investor has some knowledge of the characteristics of collective investment, and possesses judgement based on good sense.

The first aspect, the expectation test, provides that reasonable investors contemplating investing in the fund must expect that they will be able to redeem their shares within a period that is reasonable to them. In making the assessment, different factors will be relevant, including the terms of the body corporate constitution, any public representations that have been made by the body corporate, the nature of the investment objectives or policy of the body corporate, and the actual behaviour of the body corporate.[112]

In addition, it seems clear that the realisation of investment means converting an asset into cash or money, and with it, an expectation that if securities or

111 Financial Services and Markets Act 2000 s.36 (3).

112 Collective Investment Schemes Sourcebook 2021, coll 2.8.9.

shares of the body corporate are to be exchanged for other shares or securities, redemption and realisation will not be considered unless the entire process can be completed within a reasonable time.

The second aspect of the investment condition is the satisfaction test. The satisfaction test provides that reasonable investors must be satisfied that their investment would be realised on a basis calculated wholly or mainly by reference to the NAV. Generally, the investment condition focuses on how the body corporate operates over time, and not by reference to specific issues of shares or securities.[113]

To meet the satisfaction test, many circumstances or a combination of circumstances should be taken into consideration, including the basis of net asset valuation stated in the constitutional documents of the body corporate and any separate agreement or arrangement made outside those documents.

It should be noted that the satisfaction test will not be met if realisation happens through a secondary market because the market price of securities, which is determined by the rules of supply and demand, may not exactly reflect the NAV of the company's assets. However, if the body corporate undertakes actions to ensure that the price of its securities is based on the NAV, then this would satisfy the satisfaction test. Here, it is worth mentioning that the FSMA uses the phrase 'wholly or mainly' to give some flexibility. Therefore, minor departures from the NAV basis such as the deduction of redemption charges, in some funds, are not fatal as long as the NAV is the core basis of realisation.[114]

Based on the foregoing discussion about the factors of the OEIC definition, the following points can be concluded. First, the OEIC is a collective investment scheme, and it takes the corporate form. Specifically, it is a property management institution through which investments are made by a financial vehicle on behalf of investors. The investment of the OEIC's assets is managed by a body corporate known as the ACD, while the property of the OEIC will be entrusted to the depositary.

Second, the requirements of the definition aim to provide investors with proper protection. Spreading risk and realisation of securities on the basis of NAV within a reasonable period are the most important features of OEICs that distinguish them from traditional companies. Thus, the FSMA specifies these features in the definition of the OEIC to guarantee that any body corporate wishing to be an OEIC must fulfil these requirements.

2.8 Conclusion

This chapter has focused on defining mutual funds. It demonstrated that mutual funds are one of the most important ways of raising funds from the public in

113 Ibid, coll 2.9.2.

114 See, the FCA Handbook, AUTH App 2, 2.9.7 available at https://www.handbook.fca.org.uk/handbook/AUTH/App/2/9.html?date=2005-03-01 accessed 2 August 2021.

the financial market. They have allowed small investors to participate in the rapid and strong growth of capital markets in the past few decades. One of the key reasons for the success of this industry is the range of unique advantages they offer, including professional management, liquidity, diversification, reduction of risk, and investor protection. Although some financial institutions may offer some of these advantages such as hedge funds, which are managed by professional management, the distinctive feature of mutual funds is the combination of those advantages in one financial vehicle. Another significant reason that makes mutual funds attractive is flexibility. Flexibility means that there is a wide range of types of mutual funds that cater to investors' needs, including risk tolerance and return expectations.

The chapter also examined the legal nature of OEICs and the unit trust, the two main types of mutual funds in the UK. While investors in unit trusts obtain an equitable interest in the fund, investors in OEICs acquire shares because OEICs have a separate legal personality. The analysis showed that the unit trust combines components of trust and contract. The purpose of the unit trust as a collective investment scheme, pooling money from many investors, necessitates this combination, and this combination also ensures the protection of the interests of unitholders regarding the ownership.