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Legislation to Lift the Investment Company Act Exemption for Funds Based in U.S. Territories

Introduction

Overseen by the Securities and Exchange Commission (SEC), the Investment Company Act (ICA; P.L. 76-768) is the principal body of federal securities law regulating pooled investment entities that offer securities to the public known as investment companies (most commonly in the form of mutual funds). The ICA requires mutual funds to register with the SEC and subjects them to SEC enforcement and regulatory oversight. It also delineates the responsibilities and sets parameters for investment companies in areas such as required disclosure, investor fees, investment limitations, use of leverage, fiduciary duties, and prohibitions on self-dealing by fund managers.

According to H.Rept. 115-103 (which accompanied H.R. 1366, U.S. Territories Investor Protection Act of 2017), when the ICA was enacted in 1940, Congress determined that it would be problematically costly for the SEC to travel to and inspect investment companies located beyond the continental United States in U.S. territories, such as Alaska, Hawaii, the Philippines, the Panama Canal Zone, Puerto Rico, Guam, and the U.S. Virgin Islands. As a result, mutual funds organized in those locales were exempted from the ICA and were not required to register with the SEC. In various instances, those jurisdictions later enacted their own individual mutual fund regulations. However, those regulatory schemes reportedly have generally lacked the ICA's comprehensiveness and rigor. Subsequently, while some territories such as Alaska and Hawaii lost their territorial status when they became states, remaining territories such as Puerto Rico, the United States Virgin Islands, and Guam, still retain the ICA exemption.

Legislation

Several legislative proposals would change this territorial exemption from the ICA. Section 506 of S. 2155, which passed the Senate; S. 484; H.R. 1366, which passed the House; and Section 1161 of H.R. 2429, three years after enactment, would repeal the historical exemption from ICA compliance enjoyed by mutual funds organized in U.S. territories, such as Puerto Rico and the Virgin Islands. The legislation would also give the SEC the option to extend the three years before the ICA exemption is lifted by another three years.

The Potential Impact of the Current Legislation

The most common argument for repealing the ICA's territorial exemption is that the historical logistical challenges of getting to the non-continental U.S. territories, a central rationale for the exemption, clearly no longer applies.

In addition, an oft-cited illustration of the harmful potential of territorial mutual funds being outside of the ICA's purview involved a Puerto Rican unit of the Switzerland-based global financial group, UBS Group AG and one of its Puerto Rican units, UBS PR. In the early part of the current century, UBS PR became an adviser to the Puerto Rican pension agency, the Employee Retirement System (ERS). Later, in 2008, it served as the principal underwriter (an entity that assumes the risk of acquiring newly issued securities, hoping to later resell them to the public) of ERS bond offerings, reportedly acquiring $3 billion in ERS bonds. The unit reportedly then faced challenges selling the bonds in the difficult market environment of 2008. As a consequence, it resorted to selling nearly $1.7 billion of the bonds to about two dozen mutual bond funds that it either managed or co-managed. In turn, shares in the funds, which held significant amounts of ERS bonds, were sold to Puerto Rican residents. Subsequently, according to reports, the value of the bonds markedly declined, resulting in the funds with the ERS bonds losing about 70% in value by 2013. As a consequence, fund shareholders reportedly suffered millions of dollars in losses.

H.R. 1366's sponsor, Representative Nydia Velazquez, has characterized the developments surrounding the UBS funds as a kind of cautionary tale. Correspondingly, she has argued that had the Puerto Rican funds been under the ICA's regulatory regime, a considerable amount of the island's citizens' losses from the UBS managed funds may have been prevented.

Other observers have identified two potentially problematic aspects of the UBS Puerto Rican operations that they say directly resulted from the absence of the ICA regulatory regime:

- The UBS managed funds were said to be excessively leveraged to the greatest extent allowable under Puerto Rican securities law, levels that increased their riskiness. According to Craig McCann, a former SEC official, and now the principal of Securities Litigation and Consulting Group, a securities litigation consultant, those leverage levels would not have been allowed under the ICA.

- The Puerto Rican-based UBS operations underwrote a municipal bond offering (ERS). It then packaged them into mutual funds whose shares were sold to the public. Some observers, including Craig McCann, have said that such "affiliated party transactions" involving UBS underwriting bond offerings that it then packaged into funds that it also managed would not have been allowed under the ICA.

The current legislation has garnered little criticism. In all likelihood, it would result in territorial-based investment companies incurring additional costs to comply with the new investment company regulatory protocol. This point was echoed in comments made by a corporate law firm, Sullivan & Worcester. In 2016, referencing similar legislation in the 114th Congress, the firm wrote that if it became law, "investment companies located in Puerto Rico, the Virgin Islands, and other U.S. possessions will face significant new legal and regulatory challenges."

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