[Bond Case Briefs]

Municipal Finance Law Since 1971

[Bill Proposed to Give Regulatory Protection to Puerto Rico Mutual Fund Investors.]

Seventy-five years ago, when the federal government set out to regulate mutual funds, investment firms in Puerto Rico were deemed too far off the beaten track to merit scrutiny. So mutual funds on the island, and other United States territories, were excluded from regulation under the Investment Company Act of 1940.

Now, Puerto Rico's economy is teetering, investors in its bonds have suffered big losses and at least one member of Congress says the 75-year-old exclusion has outlasted its shelf life. On Friday, Nydia M. Velázquez, Democrat of New York, introduced an amendment to the 1940 act that would give mutual fund investors in Puerto Rico the same regulatory protection that their counterparts have on the United States mainland.

The bill, if it becomes law, will not replace the money the investors have lost, but it will bar some of the activities that led to their losses — activities that are already illegal on the mainland.

Mutual funds cater to individual investors who want professionally managed investments. The 1940 act protects them by barring those professional investors from engaging in certain kinds of transactions that suggest self-dealing, among other things. But because of the exclusion, such transactions are still legal in Puerto Rico.

A transaction from 2008 shows the repercussions. UBS, a major provider of financial services on the island, advised Puerto Rico's pension fund for government employees and was hired to take an unusual $2.9 billion bond deal to market. The pension fund had a big shortfall, and officials hoped to borrow the money and invest on behalf of the retirees. The deal was expected to be successful as long as the investment rate of return was higher than Puerto Rico's borrowing rate. That did not happen and now the pension fund shortfall is even bigger.

UBS had difficulty selling the bonds in the tough market conditions of 2008. It ended up packaging about half of the issue in its own family of closed-end mutual funds, which were marketed to wealthy Puerto Ricans as a good, tax-sheltered source of retirement income.

The interest on pension obligation bonds is not exempt from federal income taxes, because the Internal Revenue Service considers these securities speculative. But residents of Puerto Rico do not pay federal income taxes, and the Puerto Rican government exempted the bonds from its own estate and gift taxes.

On the mainland, a bank underwriting a municipal bond issue would run afoul of the 1940 act if it packaged the bonds in mutual funds and sold them. But affiliated transactions are allowed in Puerto Rico.

"This practice constitutes a flagrant conflict of interest, and it must stop," Ms. Velázquez said. Her bill is co-sponsored by Representative Maxine Waters, Democrat of California, who is the ranking member of the House Financial Services Committee. Chances of passage are unclear because of widely divergent views on what should be done to address Puerto Rico's debt crisis. The Senate Committee on Finance has scheduled a hearing for Tuesday on some of the issues.

Puerto Ricans who invested in the affected mutual funds have filed more than 800 arbitration claims against UBS with the Financial Industry Regulatory Authority, known as Finra, a self-regulatory body. They are seeking more than $1.1 billion, basing their claims on regulations that are not part of the 1940 act's exclusion for territories.

The Securities and Exchange Commission has also penalized UBS under other laws and collected a $26.6 million settlement for distribution to the harmed investors.

But Ms. Velázquez said that without an amendment, such things could happen again.

"This archaic exemption is long overdue for repeal," she said.

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