Investor protection: Towards additional EU regulation of investment funds?

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Investor Protection

Towards Additional EU Regulation of Investment Funds?

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Aan John,
aan mijn ouders

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List of Abbreviations

ACD	Authorized Corporate Director (UK)
AFM	Authority for the Financial Markets (Netherlands)
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIMA	Alternative Investment Management Association
ALFI	Association of the Luxembourg Fund Industry
AMF	Authorité des Marchés Financiers (France)
ASR	Accounting Series Release
AUT	Authorized Unit Trust (UK)
BAFin	*Bundesanstalt für Finanzdienstleistungsaufsicht* (Germany)
BV	*Besloten Vennootschap* (Netherlands)
CCF	Common Contractual Fund (Ireland)
CCO	Chief Compliance Officer
CEA	Commodity Exchange Act
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission (US)
CIS	Collective Investment Scheme
COD	*Codecision* procedure
COLL	Collective Investment Scheme Sourcebook
COM	Commission documents (proposals for directives, regulations or decisions of the Council and/or the European Parliament, Green Papers, White Papers, political communications, consultations, reports and working documents)
CP	Consultation Paper
CPO	Commodity Pool Operator

CSSF	Commission of Surveillance of the Financial sector (Luxembourg)
CTA	Commodity Trading Advisor
CV	*Commanditaire Vennootschap* (Netherlands)
DBTA	Delaware Business Trust Act
DP	Discussion Paper
DGCL	Delaware General Corporation Law
DLLCA	Delaware Limited Liability Company Act
DRULPA	Delaware Revised Uniform Limited Partnership Act
DUFAS	Dutch Fund and Asset Management Association
EBA	European Banking Authority
EEA	European Economic Area
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
ECL	European Company Law
EFAMA	European Fund and Asset Management Association
ELTIF	European Long-term Investment Funds
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
EU	European Union
EuSEF	European Social Entrepreneurship Funds
EuVCF	European Venture Capital Funds
EXME	Midday Express (news from the European Commission's midday press briefings)
FATCA	Foreign Account Tax Compliance Act
FoF	Funds of Funds
FCP	*Fonds Commun de Placement* (France/Luxembourg)
FGR	*Fonds voor Gemene Rekening* (Netherlands)
FS	Feedback Statement
FSA	Financial Service Authority (UK)
GAAP	General Accepted Accounting Principles
ICI	Investment Company Institute
ICVC	Investment Company with Variable Capital (UK)
IDC	Independent Directors Council
IFRS	International Financial Reporting Standards
IFSL	International Financial Services London

IMF	International Monetary Fund
INI	European Parliament Own-Initiative Document
IORP	Institution for Occupational Retirement
IOSCO	International Organization of Securities Commissions
IP	European Commission press release
IPO	Initial Public Offering
IRC	Internal Revenue Code
ITC	Investment Trust Company (UK)
JAC	Joint Associations Committee on Retail Structured Products
KID	Key Information Document
KII	Key Investor Information document
KKR	Kohlberg Kravis Roberts
KVG	*Kapitalverwaltungsgesellschaft* (Germany)
LLC	Limited Liability Company (UK/US)
LP	Limited Partnership (UK/US)
MAD	Market Abuse Directive
MARKT	Commission Internal Market Directorate General document
MBS	Mortgage-Backed Securities
MBT	Massachusetts Business Trust (US)
MEMO	Commission memorandum
MFA	Managed Funds Association
MiFID	Market in Financial Instrument Directive
MMF	Money Market Fund
NAV	Net Asset Value
NASD	National Association of Securities Dealers (US)
NCCUSL	National Conference of Commissioners on Uniform State Laws (US)
NURS	Non-UCITS Retail Scheme (UK)
NYSE	New York Stock Exchange
NV	*Naamloze Vennootschap* (Netherlands)
OCIE	SEC's Office of Compliance Inspections and Examinations
OECD	Organisation for Economic Co-operation and Development
OJ	Official Journal of the EU
OTC	Over-The-Counter
PCC	Protected Cell Company
PRIIP	Packaged Retail and Insurance-Based Investment Product
PwC	PriceWaterHouseCoopers

REIT	Real Estate Investment Trust (UK/US)
RIAIF	Retail Investor AIF (Ireland)
RIC	Regulated Investment Company (US)
RULPA	Revised Uniform Limited Partnership Act
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission (US)
SICAV	*Société d'Investissement À Capital Variable* (France/Luxembourg)
SPPE	Securitization Special Purpose Entity (SSPE)
SRRI	Synthetic Risk and Reward Indicator
SSRN	Social Science Research Network
SWD	Commission Staff Working Document
TER	Total Expense Ratio
TFEU	Treaty on the Functioning of the European Union
UCITS	Undertaking for Collective Investment in Transferable Securities
UIT	Unit-Investment Trust
ULPA	Uniform Limited Partnership Act
UPA	Uniform Partnership Act
UPIA	Uniform Prudent Investor Act
US	United States
USTEA	Uniform Statutory Trust Entity Act
UCPD	Unfair Commercial Practices Directive
UTC	Uniform Trust Code
VaR	Value at Risk

CHAPTER 1
Introduction

1.1 INTRODUCTION

This book is about the protection of European retail investors in investment funds. Due to the significant growth of the worldwide fund industry and government policies promoting long-term investing and retirement savings in Europe, the retail fund market have become of central importance. Subsequently, the investor protection provided by funds in which retail investors invest has grasped the attention of national and European regulators. This financial crisis of 2007 has further highlighted the need for strong legal investors' protection for financial institutions, including investment funds, to mitigate the negative impact of future crises on investor confidence and financial markets. In this book, the investor protection regulations applying to funds that are available in the European Union (EU) are analysed and potential regulatory shortcomings as to the current level of investor protection are being identified and addressed.

The main cause to consider investor protection and fund regulation in the EU is the growth and increasing complexity of the fund industry. Over the past decade, the European fund industry grew from EUR 4,617 billion at the end of 2001 to EUR 11,341 billion at the end of 2014.[1] The US has the largest fund industry worldwide, accounting for, by 2013, over USD 17 trillion in assets under management.[2] The expansion of the fund industry has been one of the most notable trends in the financial markets of the past years. Even the financial crisis did not put a hold on the growth of the fund industry. In 2007, the year in which the financial crisis hit the world economy,

1. European Fund and Asset Management Association (EFAMA), *Trends in the European Investment Fund Industry in the Fourth Quarter of* 2014 and Results for the full-year 2014: Quarterly Statistical Release, No. 60, 3 (February 2015). This document can be found at EFAMA's website: http://www.efama.org/.
2. Investment Company Institute (ICI), *2014 Investment Company Fact Book*, 54th ed., 8 (2014). The fact book can be found at ICI's website: http://www.ici.org/.

European funds collected almost EUR 250 billion in new investments.[3] In addition, newly launched funds in 2008 were able to raise EUR 711 million over the first three months of the year.[4] Thus, despite rough market conditions, the demand for investment funds appears to remain strong throughout Europe.[5]

It is expected that the industry will grow even more in the future due to several demographic factors, most notably the increased ageing population and the related potential European pension crisis, which is likely to further increase investments in investment funds.[6] This is also recognized by the European Commission, highlighting the strategic importance of the fund industry by stating that investment funds can 'contribute significantly to adequate provisioning for retirement'.[7] In addition, investment funds are often assumed to play an important role in Europe's economy and have a positive impact on long-run economic growth.[8] The 2004 Asset Management Expert Group, for example, described the fund industry as playing a vital role in Europe's economy as they provide for a more efficient allocation of savings, foster the financial independence of European citizens during their working lifetime, and create added

3. EFAMA, *Trends in the European Investment Fund Industry in the Fourth Quarter of 2007 and Results for the Full-Year 2007: Quarterly Statistical Release*, No. 32, 4 & 10 (March 2008). This document can be found at EFAMA's website: http://www.efama.org/.
4. Lipper Research Series, *Fund Market Insight Report Pan-European ETF Report: Quarter End Analysis* 14 (31 Mar. 2008). The report can be found at Lipper's website: http://www.lipperweb.com/.
5. It has only shown a decline in assets in 2011, in which investment fund assets stood at EUR 7,960 billion at end 2011, compared to EUR 8,178 billion in 2010, after which assets grew again in 2012, 2013 and 2014. *See* EFAMA, *Trends in the European Investment Fund Industry in the Fourth Quarter of 2011 and Results for the Full-Year 2011: Quarterly Statistical Release*, No. 48, 3 (February 2012). This document can be found at EFAMA's website: http://www.efama.org/. However, the industry has been rather stable considering the impact of the global financial crisis. It should also be noted that total investment fund assets stood 29% higher at end 2011 than at end 2008.
6. *See* for example the Association of the Luxembourg Fund Industry (ALFI) stating that 'demographic realities and patterns in wealth accumulation, pension reform and insurance requirements, regulatory and tax changes, and international competition in financial services will stimulate the continued development of the fund industry'. ALFI, *Perception Study: Exploring the Future of the Fund Industry* 4 (2004). The study can be found at ALFI's website: http://www.alfi.lu/. *See* for an overview of the demographic situation in the EU anno 2008–2009 and the challenges and opportunities in an ageing society: European Commission (DG ECFIN) and the Economic Policy Committee (AWG), *2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008-2060)* (2 Apr. 2009) and Commission of the European Committees, Demography Report 2008: Meeting Social Needs in an Ageing Society, SEC (2008) 2911, 2008. The 2009 Ageing report can be found at the Commission's website: http://ec.europa.eu/.
7. Commission of the European Communities, Green Paper on the Enhancement of the EU framework for Investment Funds, COM (2005) 314 final, 12 Jul. 2005, 3. According to the 2006 Financial Integration Monitor, investment funds have acquired an important position in long-term investments in most European countries (12.8% of EU household assets), which makes them potential saving vehicles for retirement. *See* Commission of the European Communities, Commission Staff Working Document, Financial Integration Monitor 2006, SEC (2006) 1057, 26 Jul. 2006, 19.
8. N. Moloney, *EC Securities Regulation* 231 (2d ed., Oxford U. Press, 2008). Moloney also points out that a strong investment fund industry is typically associated with a strong securities markets. However, Black argues that investment funds are not essential institutions for strong securities markets and that a healthy investment industry is more a result than a cause of a strong securities market. B. Black, *The Core Institutions that Support Strong Securities Markets,* 55 Bus. Law. 1581 (2000).

value in terms of generating better returns for long-term savings.[9] Furthermore, the Organisation for Economic Co-operation and Development (OECD) Economic Survey of Luxembourg 2012 found that the number of jobs in the financial sector increased by roughly 4% between 2007 and 2010 and that 'Luxembourg is benefitting from the growth of the investment fund industry and of its reputation as a safe haven'.[10]

The increasing demand for funds among EU investors has also resulted in an increase in both number and types of investment funds. Today, there are more than 76,000 funds available to investors.[11] These funds include both EU and non-EU funds that may be offered, either directly via the open market or an intermediary, or indirectly via other fund structures, to retail investors in the EU.[12] The range of different types of investment funds established in different jurisdictions has multiplied, ranging from more basic funds such as equity and bond funds to highly complex funds such as (funds of) hedge funds and other 'alternative' funds. Because of the increasing choice in funds, investors may be confused as to which fund(s) would be most suitable for them to invest in. As a result, the potential for failures, such as misbuying/selling, misrepresentation (reports and valuations with false or misleading information), misappropriation of funds (fraud), may have increased.[13] Although it may be impossible to protect investors against every act of unfair or fraudulent behaviour of (the managers of) investment funds, it is generally believed that regulators have a responsibility to protect the interests of investors within their jurisdiction. At the same time, investors are responsible for ensuring that they understand certain aspects (e.g., with regard to costs and risk level) associated with investing in a particular fund or type of fund(s).

Since investment funds available in the EU can be established both inside and outside the EU, they may be subject to different investor protection regulations,

9. Asset Management Expert Group Report, *Financial Services Action Plan: Progress and Prospects* 6–7 (2004). This document can be found at the Commission's Internal Market website: http://ec.europa.eu/internal_market/. According to the International Monetary Fund (IMF), investment funds also contribute to financial stability by diversifying investment styles and asset allocations among investor portfolios. IMF, *Global Financial Stability Report: Market Developments and Issues* 77 (2005). This report can be found at IMF's website: http://www.imf.org/.
10. OECD, *Economic Surveys: Luxembourg 2012* 6 (December 2012). This document can be found at OECD's website: http://www.oecd.org/.
11. ICI, 2014 Investment Company Fact Book, 220 (data includes only mutual funds and excludes FoFs except for France, Italy, and Luxembourg).
12. *See* also section 1.3.2. It must however be noted that not all funds are being offered in the EU and that some European funds may only offer their product outside the EU. In addition, only about 8,000 funds are domiciled in the US, compared to 35,713 in Europe, which shows that although the US fund industry is much larger in terms of fund assets than the European industry, the number of funds is much higher in the EU resulting in a more fragmentized market and a smaller average size of the individual funds in Europe.
13. Similar points have also been raised in several policy documents. *See*, e.g., Technical Committee of the International Organization of Securities Commissions (IOSCO), *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors* (February 2003), Financial Service Authority (FSA), Wider-range Retail Investment Products, Consumer protection in a rapidly changing world – Feedback on DP05/03, FS06/03 (March 2006) and FSA, Funds of Alternative Investment Funds (FAIFs), CP07/06 (March 2007). The IOSCO report can be found at IOSCO's website: http://www.iosco.org/.

depending on where the fund is located. Consequently, different levels of investor protection may exist between investors investing in EU funds and investors investing in non-EU funds. This may lead EU investors investing in EU funds to be placed at a disadvantage compared to EU investors investing in non-EU funds, or the other way around. Furthermore, EU funds could also suffer a competitive disadvantage against non-EU fund players, which can arguably justify EU regulatory action. This book deals with this 'level playing field' issue for EU investors investing in funds. Since EU funds are predominantly regulated by EU securities law, I will primarily look at the two fund types distinguished by EU law: Undertakings for Collective Investments in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs). With respect to non-EU funds that are offered to EU investors, I have chosen to confine the regulatory assessment to funds established in the United States (US). Consequently, US investor protection regulations applying to US-based funds will be examined to determine how EU investors are protected when they invest in a US fund. See for the rationale behind choosing the US as primary non-EU jurisdiction section 1.4. The assessment of US law has been written during a research visit at Boston University School of Law under supervision of Professor Tamar Frankel.[14] Professor Frankel reviewed a copy of the chapter concerning US law (Chapter 4).

The issue of creating a level playing field for market participants, including investors in investment funds, can be seen as key to the integration of EU securities markets.[15] By rectifying regulatory asymmetry between EU funds and US funds sold in the EU, a uniform level of investor protection may be achieved across the EU. This could ensure a general high level of investor confidence, as a result of which investors would be more willing to make investments across the EU.[16] Consequently, the EU securities regulatory regime appears to be increasingly focusing on achieving pan-European investor confidence through imposing various regulatory investor protections standards on markets and financial institutions.[17]

Arguably, the aim of creating a level playing field of a sufficiently high standard may result in a 'race to the top' approach towards EU securities regulation, meaning a situation where the EU regulator adopts more and more stringent rules in an attempt to

14. Professor Tamar Frankel has written and taught in the areas of securitization, mutual funds, financial system regulation, fiduciary law and corporate governance. Among her books are *The Ponzi Scheme Puzzle: A History and Analysis of Con Artists and Victims* (Oxford University Press 2012), *Fiduciary Law* (Oxford University Press 2011), *Trust and Honesty: America's Business Culture at a Crossroad* (Oxford University Press 2006), *Securitization* (2nd. ed, Fathom Publishing Company 2006), and *The Regulation of Money Managers: Mutual Funds and Advisers* (2nd ed. with Ann Taylor Schwing) (2nd ed. Aspen Law & Business 2001). She has published numerous articles and book chapters, see her website: http://www.tamarfrankel.com/.
15. *See*, e.g., I.H.-Y. Chiu, *Regulatory Convergence in EU securities Regulation* 9 (Kluwer Law International 2008).
16. *Ibid* and J.C. Coates IV, *Private vs Political Choice of Securities Regulation: A Political Cost-Benefit Analyses*, 41 Virginia Journal of International Law 531 (2001).
17. *See*, e.g., N. Moloney, *Confidence and Competence the Conundrum of EC Capital Markets Law*, 4 J. Corp. L. Stud. 12 (2004) (considers the underlying rationales of EC securities regulation and identifying the revision of the ISD as a shift in emphasis in regulatory policy towards prioritizing the protection of investors).

improve the quality of regulation and the level of protection for investors across the EU. This could result in the particular industry to explore ways around the rules to avoid high regulatory compliance costs or to pass on these costs to investors by imposes higher prices for their products or services. Therefore, the benefits of potential increased (investor protection) standards with an aim of achieving a level playing field should be balanced against the costs of regulatory intervention, which could provide motivation for avoidance or a substantial increase in the costs of investing for investors.[18]

In light of the foregoing, the central question that will be addressed in this book is whether there is a level playing field between EU investors investing in EU funds and EU investors investing in US funds and if not, if there is a legal basis in current EU law for the EU regulator to adopt additional investor protection rules applying to investment funds. As mentioned, such potential regulation should be seen in light of the general view of EU policymakers that the concept of 'level playing field' has a positive economic effect, as it increases investor confidence and, thereby, investments in investment funds. Adjustments to the EU regulatory regime for investment funds should therefore be made, as long as these adjustments are not so severe that they could lead to regulatory evasion and/or excessive costs for investors.

This book will accordingly address three questions. What features of funds are most relevant to the protection of retail investors in relation to activities of fund managers, and should therefore be addressed by the EU regulator (Chapter 2)? How are EU retail investors currently protected when investing in EU and US funds (Chapters 3 and 4)? Does this protection provide for a level playing field between investors investing in EU funds and investors investing in US funds and if not, is there a legal basis for the EU regulator to adopt additional regulation in this area (Chapter 5)? It considers the basic characteristics of investment funds and how they function in practice. In general, the way in which funds are regulated depends on a number of factors, including their operational structure, investment strategies employed, and legal structure used. Some of these factors can be considered to be important factors in the context of this research, and some are of less relevance. Subsequently, the regulatory response to the key fund aspects relating to fund management activities that affect the protection of investors will be analysed. This book will close with a

18. *See also* G.S. Willemaers, *The EU Issuer-disclosure Regime: Objectives and Proposals for Reform* 35 (Kluwer Law International 2011) (noting that, with respect to mandatory disclosure requirements, the benefits of (increased) investor protection regulation, i.e., reduction of market failures and general economic growth, should be balanced against compliance costs and indirect costs of regulatory intervention) and K. Alexander, *Establishing a European Securities Regulator: Is the European Union an Optimal Economic Area for a Single Securities Regulator?*, Cambridge Endowment for Research in Finance, Working Paper No. 7, 12 (2002), http://www.cfap.jbs.cam.ac.uk/publications/downloads/wp07.pdf (accessed on 1 Oct. 2015) ('Regulations may adversely affect consumers by imposing higher prices for goods and services, and result in reduced consumer choice and lower quality goods and services. For both investors and issuing companies, excessive or inefficient securities regulation can result in higher costs for capital'). *See* on this issue also, in particular, section 5.8. *See* on the relationship between investor protection and economic growth, e.g., J.I. Haidar, *Investor protections and economic growth,* 103 Economic Letters 1-4 (2009).

discussion whether or not this response provides for a level playing field with regard to the protection of EU retail investors investing in EU and US funds, and if this is not the case, which additional rules can be adopted by the EU regulator to reduce or eliminate differences in investor protection level, without imposing severe costs on the fund industry (which may lead to evasion or avoidance and/or the passing on of costs to investors).

In this context, it is also important to note that this book will focus on the level of investor protection in relation to the (risky) activities of funds and their managers, from portfolio construction and modelling, to execution, risk management, (fee) transparency, cost structure, and investor reporting, but not also on the protection of investor assets themselves. Consequently, rules on ring-fencing, segregation or separation of assets, liabilities, activities or operations, will not be taken into account, unless this would be feasible for the assessment of investor protection regulations affecting the activities of funds and their managers.[19] Although these rules are equally important in the context of investor protection, they do not, by themselves, also necessarily reduce risk-taking behaviour by fund managers or protect investors against misseling or fraud.

The most common function of ring-fencing is to protect a financial institution from becoming subject to liabilities and other risks associated with bankruptcy. It thus provides for an 'ex-post' protection to investors, i.e., assets held in a segregated account may be protected from creditors in the event of bankruptcy, so they can be an effective way to safeguard (part of) investors' assets. So, in the context of investment funds, it means that if the fund manager goes bankrupt, the assets of investors in the fund are protected. The focus of this research lies on the (ex-ante) aspects of investor protection. More particularly, it is concerned with the rules and regulations that allow for an effective matching process to take place between investors and investment funds (or fund managers) to prevent misseling of investment fund products and mitigate the risk of mismanagement. Consequently, it is limited to an assessment of the rules regarding fund managers' skills and behaviour and the information that must be provided to ensure that investors are able to make informed investment decisions.[20] In line with this purpose, the term 'investor protection regulation' within the meaning used in this book includes those rules that aim to reduce risks for investors associated with the activities (investments) of the fund or fund manager themselves., i.e., so-called micro-prudential risks[21], and the potential information asymmetry and

19. *See*, e.g., section 4.6.2, which discusses the segregation rules for US funds in relation to the ability of fund managers to invest in derivatives.
20. Nevertheless, it can be noted that the rules and regulations regarding the *information* that must be provided by fund managers about their ring-fencing and segregation policies do fall within the scope of this research as they aim to educate investors in order to make informed investment decisions.
21. These risks include liquidity risk, credit risk, market risk, and, most notably, operational risk. Liquidity risk is the risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss or make the required profit. Credit risk the risk that a counterparty or debtor will default. Market risk is the risk of adverse movement in interest rates, exchange rates, and the prices of equities and commodities. Operational risk is the risk of loss from failures in a fund's systems and procedures or from external events. *See* Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, COM (2009) 207, 30 Apr. 2009, 71.

market power imbalances between the industry and investors. More particularly, they aim to reduce potential incentives for misselling by helping to clarify conflicts of interest and the costs borne by investors.

Since most national law applying to the financial services industry, including investment funds, is derived from EU law,[22] I confine the research to potential improvements to EU law (instead of proposing improvements to the different national laws of EU Member States). Under several provisions of the Treaty on the Functioning of the European Union (TFEU),[23] the EU regulator has a legislative power to adopt measures.[24] Thus, any EU measure should have a legal basis in the TFEU in order for it to be valid.[25] In addition, it can be noted that there are multiple regulatory EU institutions endowed with legal powers to provide investor protection and ensure the orderly operation of financial markets. The three main institutions involved in EU legislation are: the European Commission, the European Parliament, and the Council of the EU. Together, these institutions are referred to as the EU regulator. Next to these regulatory agencies, there are a number of other EU institutions that play an important role in the legislative and/or rulemaking process with respect to investment fund regulation at an EU level, including, among others, the Court of Justice of the EU (ECJ), the European Central Bank (ECB), the European Banking Authority (EBA), and the European Securities and Markets Authority (ESMA). Logically, it will also be referred to these institutions and their work where relevant to the research question.

The structure of this first chapter is as follows. Firstly, the aims of the research will be described (section 1.2). After this, the scope of the research will be defined (section 1.3). Then, it will be outlined which methods will be used in this research (section 1.4). And finally, an overview of the structure of this book will be presented (section 1.5).

22. Over the last years, the EU has taken a dominant position in regulating the financial services markets. Following the adoption of the Financial Services Action Plan in 1999 (European Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM(1999)232, 11 May 1999), and its finalization in 2005, an extensive package of EU measures supporting the integration of the EU financial markets has been adopted, such as the Prospectus Directive, Transparency Directive, the Investment Services Directive and Markets in Financial Instruments Directive and (the amendments to) the UCITS Directive. *See* also Moloney, *EC Securities Regulation*, 4 (concluding that 'the EC can now be regarded as the primary regulator of the EC's financial market').
23. The TFEU came into force on 1 Dec. 2009 following the ratification of the Treaty of Lisbon, OJ C 306, 17 Dec. 2007, 1, which made amendments to the EU and EC Treaty. *See* for the latest version of the TFEU Consolidated version of the Treaty on the functioning of the European Union, OJ C 326, 26 Oct. 2012, 47.
24. *See*, e.g., Article 50 TFEU (relating to the freedom of establishment), 56 (related to the freedom of capital) and the general harmonization provisions of Articles 114 and 115 TFEU.
25. *See* on the legal competence of EU action in the field of company law and corporate governance, G.J. Vossestein, *Modernization of European Company Law and Corporate Governance: Some Considerations on Its Legal Limits* (European Company Law Series, vol. 6, Kluwer Law International 2010).

1.2 RESEARCH AIMS

In light of the fact that this topic has not yet been the subject of elaborate research, the general aim of this book is to explore the general level of investor protection of investment funds that offer their shares or other participation rights to retail investors in the EU.

In this context, this book aims to give answers to the following three questions:

(1) Which key features of investment funds in relation to the activities of fund managers are relevant to the issue of the retail investor protection?
(2) How are EU and US funds available to EU retail investors currently regulated relating to the protection of investors?
(3) Is there is a level playing field between EU investors investing in EU funds and EU investors investing in US funds and if not, is there a legal basis for the EU regulator to adopt additional regulation in this area? The potential need for more regulation will be examined by assessing both the differences in legal investor protection between EU and US law and the legal competence of the EU regulator to adopt additional rules. This assessment also requires the balancing of the benefits of additional regulation against the costs of the industry.[26]

1.3 SCOPE OF THE RESEARCH

Since the key issue of this book is the protection of EU retail investors in funds, it is important to identify which investors are meant to be included in the term 'retail investors' for the purpose of this research. Furthermore, as pointed out by the second and third questions of this book, I will investigate current investor protection regulation applying to investment funds and advise on whether or not these regulations should be adjusted. Consequently, it is necessary to also consider what types of investment funds the research will focus on to and which specific rules fall into the scope of the research. These issues will be discussed in the following subparagraphs.

1.3.1 Investors: Retail versus Non-retail

In general, two types of investors can be identified: institutional investors and retail investors. Institutional investors can be defined as institutions, such as investment banks, pension funds, insurance funds and investment funds, which are considered to be financially more sophisticated and trade more frequently and in higher volumes than retail investors. Retail investors can be generally described as individuals who purchase and redeem small amounts of securities for their personal account. At the EU

26. *See* also n.18 and accompanying text, *supra*.

level, the Market in Financial Instrument Directive (MiFID 2)[27] also distinguishes between two types of investors: 'professional investors', and 'retail investors'.[28] Professional investors includes institutional investors, such as credit institutions, investment firms and investment funds and companies meeting at least two out of the three following criteria: (1) a total balance sheet equal or exceeding EUR 20,000,000, (2) a total net turnover equal or exceeding EUR 40,000,000, (3) a total own capital equal or exceeding EUR 2,000,000.[29] In addition, retail investors can 'opt' to be treated as professional investors for purposes of the MiFID 2.[30] Retail investors are investors that do not belong to one of the other categories. This group of investors has the highest level of protection.

So which investor should be protected? Logically, it can be assumed that retail investors are most in need of protection considering that they are not sophisticated market players as they generally do not have the competence to assess the risks associated with financial investments.[31] But is this the case for all retail investors? What about retail investors that have sufficient financial resources? And investors that are experienced in the area of investing?

Because institutional investors typically have more voting power on their investments than individuals due to the larger blocks of shares they obtain and have an incentive to develop specialized expertise in making and monitoring investments, they are able to play a more active role in the decision-making process in the companies in which they invest.[32] Their greater access to firm information, coupled with their concentrated voting power, is the main reason why institutional investors are covered by fewer protective regulations than retail investors; they are assumed to be knowledgeable and (financially) strong enough to safeguard their own interests. Or, in other words, where there are few large investors who are capable of monitoring the quality of companies themselves, there is less justification for regulatory intervention.[33]

By contrast, retail investors are generally considered to be too dispersed and not knowledgeable enough to protect themselves sufficiently. From a research perspective, it would therefore be most sensible to focus on the protection of retail investors. However, the Madoff scandal showed that investors presumed to be sophisticated, such as pension funds and banks, are not immune from investment fraud as they

27. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 349 ('MiFID 2'). MiFID 2 will have to be transposed into national laws by July 2016.
28. Article 4(10) and (11) of MiFID 2. MiFID 2 also mentions a third type of category of investors: 'eligible counterparties'. Eligible counterparties can however be considered to be a sub-category of professional investors. This category only applies in respect of certain investment services. They include companies that are active in the financial sector and who are deemed to have the experience to take investment decisions, on the basis of their corporate profile. This group has the lowest level of protection. See article 30 MiFID 2.
29. Annex II.I MiFID 2.
30. Annex II.II MiFID 2.
31. Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform,* 34.
32. S.M. Bainbridge, *Shareholder Activism and Institutional Investor*, UCLA School of Law, Law-Econ Research Paper No. 05-20, 10 (2005). Available at SSRN.
33. J. Franks & C. Mayer, *Risk, Regulation and Investor Protection: The Case of Investment Management* 16 (Oxford U. Press 1990).

suffered millions in Madoff-connected losses.[34] It could therefore be argued that the protection of institutional investors may need to be strengthened as well and therefore should be looked at correspondingly. However, it is impossible to provide protection against all forms of investment fraud as some frauds go undetected for a long period, despite due diligence practices performed by investors.[35] In any case, the fact remains that these investors are likely to have the 'in-house' knowledge to look after themselves and to be aware of an investment that seems to be too good to be true or at least have the financial means to seek financial advice. It could therefore also be argued that since institutional investors are considered to be able to protect themselves, they are (at least partly) to blame themselves when something goes wrong.

I have chosen to confine this book to the issue of the protection of retail investors. The primary reason for this choice is the fact that these investors are obviously *most* in need of protection. Secondly, the choice is also inspired by the fact that regulators are also increasingly giving priority to this type of investor. As a substantial part of the book is devoted to investigating current investor protection regulation applying to investment funds (which will be discussed in Chapter 3 and 4), the choice in favour of retail investors is also in part a practical choice.

Whereas the above given, rather general, definition or retail investors provides some guidance relating to what kind of investor is meant by 'retail investors', the question arises whether it is clear enough for research use. On the one hand, the description of retail investors set out above is very broad, since it includes all individuals who buy and sell securities on their own account or via an intermediary or other entity (such as an insurance or pension fund). It makes, for example, no distinction between a person who has no experience with investing and a person who has significant work experience in the financial industry. On the other, the definition is also rather narrow as it includes only individuals who purchase and redeem *small* amounts of securities. Apparently, the definition does not apply to investors who invest a large, or not small, amount of money. Besides the fact that it is difficult to determine which amount would qualify for a 'small' investment and which not, the question arises whether these investors (small investors and wealthy investors) should be treated the same as investors with work experience in the financial field or whether it would be better to apply different investor protection regulations to them.

In my opinion, high-net-worth individuals may not necessarily have the appropriate level of investment experience and the capacities to seek their own remedies. For example, a medical doctor or dentist with substantial personal wealth may have no, or

34. *See Madoff's Victims*, The Wall Street Journal (6 Mar. 2009).
35. Due Diligence can be described as the process of evaluating all actual and potential risks involved in an investment. *See also* I. Vancas, *Due Diligence and Risk Assessment of an Alternative Investment Fund* 8 (Diplomica Verlag 2010). In the case of investing in an investment fund, it would consist of evaluating the fund and the investment style of the fund manager. In essence, it includes everything that can lead to the decision whether to buy, hold, sell or avoid shares or other participation rights offered by a certain fund manager into a certain fund. However, when someone, as was the case with Madoff, deliberately makes false statements or conceals information as to their operations, a duly performed due diligence research will not expose the investment fraud.

very limited, understanding of the financial risks associated with investing in investment funds. The same could be said about a person who has otherwise acquires a substantial amount of money and has decided to invest it in investment funds without having any experience in investment and knowledge about the functioning of the markets in general.

It is clear from these examples that the level of professionalism of one individual investor is not so much determined by his wealth, but rather by the extent to which that particular investor rationally understands and processes the information that is available about the investment. Even if a high-net-worth investor obtains financial advice on a certain investment, he may still not sufficiently understand the complex information related to business and legal matters regarding the investment and the risks associated with the investment due to his lack of (financial) education.[36] In addition, it can be argued that if there is any doubt about whether or not a certain type of individual investor should fall within the definition of retail investors, it would be prudent from an investor protection point of view to broaden the definition to include these investors. Thus, because high-net-worth investors may not operate with sufficient experience and knowledge of investment funds, this group of investors should be included in the definition of retail investors.

A similar line of reasoning could be followed for investors with work experience in the financial sector. The level of their knowledge may differ significantly depending on the kind of position they fulfil, the length of their work experience and the kind of investment transactions they have experience with. For example, a financial investment adviser may have more market knowledge than a bank employee who works at a cash register. But, on the other hand, an accountant who in his spare time gathers and analyses information about the market in general and/or a particular investment may possess much more market knowledge than a mortgage broker who only conducts mortgage-brokering activities. As the level of knowledge of this group of investors differs from person to person, they should not be presumed to possess enough market knowledge and experience to make their own investment decisions from the outset. Furthermore, even if they have significant work experiences in the specific market in which they intend to invest, they may focus on a specific investment in isolation missing the 'big picture' of investing and market moves. They may choose to put all their savings into one investment, which, in case it fails, could get them into serious financial difficulties. It is because of this risk that these investors are, as well as high-net worth investors, included in the definition of retail investors.

As a result of the above, in this book, the term 'retail investors' will refer to all *individual* investors regardless of their net worth of income and work experience (i.e., all non-institutional investors). Retail investors are thus considered to include both 'small' individuals as well as other, more 'professional' individual investors, but who

36. *See also* N. Moloney, *How to Protect Investors: Lessons from the EC and the UK* 81 (Cambridge U. Press 2010) (referring to the 'trusting investor model' as basis for investor protection regulation, which reflects the vulnerabilities of the trusting investor, i.e., the investor that relies heavily on investment advice, and 'allows that investor to become empowered, while accommodating and supporting the robust, informed and empowered investor').

may lack adequate investment knowledge. Since these investors may either lack the financial literacy to invest in financial instruments, including fund shares or other participation rights, or experience in the field in which they invest, they may not be able to make informed investment decisions with respect to all investment products. This could lead to high-risk investment portfolios for risk-averse investors and potential high investment losses which cannot be recovered. It is because of these potential failures that this investor category will be looked at when measuring the effectiveness of investor protection regulation applying to funds offered in the EU. In the remainder of this book, when referring to 'retail investors', it is meant to refer to both small and 'professional' retail investors, including both high-net worth and individual investors with work experience in the financial sector. For explanatory purposes, sometimes the terms 'small retail investors' and 'professional retail investor' are used to refer only to the first respectively the latter category.

1.3.2 Investment Funds

In order to be able to assess how investment funds offering to EU retail investors are regulated, it should be firstly considered which type(s) of investment fund(s) will be looked at. As the research focuses on the protection of retail investors, it can be considered feasible to only analyse regulation applying to investment funds that directly offer their products to this type of investors. However, as will be discussed in more detail in Chapter 2, non-retail orientated investment funds, originally designed for institutional investors, such as hedge funds, private equity funds and non-retail real-estate funds, are becoming increasingly available to retail investors as well.[37] The question is thus whether to also look at these investment funds, in addition to traditional, retail-orientated funds.

Today, EU retail investors can invest into EU and US non-retail funds through various ways. In the first place, they can invest directly into such funds that have their shares listed and traded on European stock exchanges, thereby becoming public funds. An example of a private equity firm that listed fund shares on Euronext Amsterdam includes KKR Private Equity Investors, a Guernsey-based private equity fund of the buyout giant Kohlberg Kravis Roberts (KKR). As of 2010, however, KKR Private Equity

37. PricewaterhouseCoopers (PwC), *The Regulation and Distribution of Hedge Funds in Europe* 2 (2005) ('hedge funds and hedge fund-like products are available to "mass affluent" investors and some are even available to retail investors'), PwC, *The Retailisation of Non-harmonised Investment Funds in the European Union* 13 (2008) (stating that, by 2007, retail investors represent a 'moderate' 24% of the assets under management of 'other non-harmonized' funds (i.e., non-retail funds that are not real-estate funds, private equity funds, venture capital funds, hedge funds or funds of hedge funds) and 13% of the non-harmonized real-estate assets), Technical Committee of the IOSCO, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors* 2 ('The results of the questionnaire suggested that there was growing retail participation in highly leveraged instruments, including those offered by hedge funds'), and Technical Committee of the IOSCO, *Report on Hedge fund Oversight* 17 (2009) ('(…) hedge funds have became increasingly accessible to retail investors by means of funds of hedge funds or allocation of traditional funds assets in hedge funds') The IOSCO reports can be found at IOSCO's website: http://www.iosco.org/. The PwC studies can be found at PwC's asset management website: http://www.pwc.com/assetmanagement/.

Investors trades on the New York Stock Exchange (NYSE).[38] Besides direct investments, retail investors can also invest in these types of funds through other funds that are open to them, also referred to as Funds of Funds (FoFs). These funds are popular among retail investors because they can spread their investments across several (non-retail) funds.[39] Finally, several investment banks have launched products that have given retail investors an easy way of getting exposure to non-retail funds without actually investing in them. These products attempt to replicate ('clone') some of the strategies used by certain non-retail funds, most notably hedge funds, which enable them to generate returns equal to these funds. Merrill Lynch, Goldman Sachs, State Street and Deutsche Bank have each launched products that attempt to do just that.[40] In this respect, it can be noted that there are two layers of protection: the first layer concerns the protection provided by the issuer of the fund shares or other participation rights and the second layer relates to the protection provided by a financial intermediary or adviser. Financial intermediaries are financial institutions, typically a bank or broker-dealer, that facilitate transactions between two parties by pooling the savings or investments of many people and lend or invest the money to other companies or people, including investment funds, to earn a return. A financial adviser advises on those transactions. This book is only concerned with the first layer of protection. It thus does not deal with the investor protection issues related to intermediaries and advisers and the regulations applying to them.

It is expected that retail participation in funds originally focused on the non-retail market, whether established in the EU or in the US, or similar products available to retail investors will continue to grow, either through 'sophisticated' FoFs or direct access in these funds.[41] This raises various regulatory issues especially related to retail

38. D.P. Stowell, *Investment Banks, Hedge Funds, and Private Equity* 334 (Academic Press 2012).
39. Although, according a 2008 PwC study, participation of retail investors in funds of hedge funds remains relatively low, accounting only for 10% of total funds of hedge fund investments. *See* PwC, *The Retailisation of Non-harmonised Investment Funds in the European Union* 13. However, retail investors generally invest significant smaller amounts than most institutional investors. Their total amount of investments will therefore logically be significant lower than institutional investors' investments. Furthermore, the study does not state the total number of retail investors, which may be considerably higher than the number of institutional investors. Additionally, retail participation in FoFs also includes investments in other non-retail funds than hedge funds, such as private equity and venture capital funds, and retail FoFs investing in non-retail funds, including hedge funds. Based on Alix Capital figures, retail funds of hedge funds numbers have grown significantly over the last three years rising from thirty-two funds in January 2008 to 114 in March 2012, with a total of EUR 4.6 billion assets under management. Alix Capital, *UCITS Alternative Index Trends Survey* 2 (June 2012). The survey can be found at Alix Capital's website: http://www.alixcapital.com/.
40. S. Johnson & E. Kelleher, *Cloned' Strategies Offer Investors Better Options*, The Financial Times (22 Mar. 2008).
41. *See*, e.g., PwC, *The Retailisation of Non-harmonised Investment Funds in the European Union* 16 and M.J. Schmidt, '*Investor Protection' in Europe and the United States: Impacting the Future of Hedge Funds*, 25:1 Wis. Intl. L. J. 177–178 (2007) ('UCITS III legislation has opened the door to create UCITS that invest heavily in derivatives, which are primarily a hedge fund strategy' and '[t]his new opportunity is leading to an expanded market for UCITS III products'). Direct participation can occur through investments in listed funds and via non-retail funds that are regulated under the AIFM Directive.

investor protection.[42] Such issues include fund valuation, past performance, lock up periods and issues specific to FoFs, such as due diligence on underlying funds, transparency of investments towards investors, and 'double' fees.[43]

Thus, now that retail investors are able to invest in both retail and non-retail funds, it would be sensible to analyse the regulation of both these types of funds with a focus on the protection of retail investors. Therefore, this research concentrates on analysing and developing investor protection regulation for all investment funds which are active in the EU, regardless of whether or not they are being directly sold to retail investors, although the emphasis for possible new regulations lies on the protection of retail investors instead of institutional investors.

1.3.3 Investor Protection Regulations

To be able to answer the second research question relating to the way in which funds are currently regulated ('How are EU and US funds available to EU retail investors currently regulated relating the protection of EU retail investors?'), a prerequisite determination of the investor protection rules that will be looked at is needed. In general, a broad range of investor protection regulation may, directly or indirectly, impact investment funds. In the EU and the US, this translates into different rules with varying scopes and applying to for different kinds of funds and in different kinds of situations.

Before turning to these rules, it can be noted that it is not just the existence and quality of the investor protection rules analysed that matters. The way in which they can be enforced in practice is also of importance. When investor protection regulations cannot be effectively enforced, the management of the fund might have no reason to honour these rules, which may result in a steady breach of these rules. This book does not provide an inventory of the enforcement of investor protection rules, but rather provides for a guide of these rules which can potentially be enforced. Thus, the way in which investor protection regulation can be enforced against the fund and/or its individual managers, both within and outside insolvency situations, falls outside the scope of this research and thus will not be discussed, although it contains interesting research possibilities at the US or EU level (or both).[44] However, in case a particular

42. Technical Committee of the IOSCO, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors* 2, Technical Committee of the IOSCO, *Report on Funds of Hedge Funds* 7 (2008). The IOSCO report can be found at IOSCO's website: http://www.iosco.org/.
43. *See* for an overview of these issues: Technical Committee of the IOSCO, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investor*.
44. Some potentially interesting areas for further research relating to the enforcement of investor protection regulation include: the conditions under which investors are permitted to bring class actions or individual lawsuits against fund directors, the possibilities for investors to file a derivative suit for recovery on a corporate cause of action, and the ability of EU investors to pursue fraud claims in the US against a US fund or EU fund (or corporation) with a link to the US. *See* on the latter matter, e.g., W.A. Kaal & R.W. Painter, *Extraterritorial Application of US Securities Law: Will the US Become the Default Jurisdiction for European Securities Litigation?*, 7:3 ECL 90–97 (2010). With regard to the enforcement of laws by the supervisory authorities, it may be interesting to look at potential conflicts of interests between the SEC and EU regulators

investor protection rule is not enforceable by individuals at all due to, for example, regulatory constraints concerning the private enforceability of that right, mention will be made of this fact.

[A] EU Level

At the EU level, fund regulation follows the traditional distinction between open-end and closed-end funds.[45] Traditionally, open-end funds qualifying as UCITS have been regulated by the UCITS Directive, lastly amended by UCITS V in 2014.[46] EU law that applies to closed-end funds included the Prospectus Directive,[47] the Transparency Directive,[48] and, when not expressly excluded by Member States, the Shareholders Rights Directive.[49] With the adoption of a directive for alternative fund managers (AIFMs) in 2011, i.e., the AIFM Directive,[50] investment funds that fall outside the scope of the UCITS Directive have -indirectly- become subject to additional EU securities law. The AIFM Directive lays down rules for the authorization, ongoing operation and transparency of AIFMs managing all types of non-UCITS or 'alternative investment funds' (AIFs), including US AIFs that are being marketed to EU investors. Consequently, open-end funds that do not qualify as UCITS and closed-end funds have become subject to these new rules.

In addition, closed-end funds which are specialized in venture capital and social entrepreneurship investment who manage portfolios of AIFs whose assets under management do not exceed a threshold of EUR 500 million,[51] can be marketed in the EU

and among EU regulators in the supervision of international funds and gaps or overlap in supervision and enforcement regulation relating to investment funds within and between the US/EU.

45. *See* on the differences between open- and closed-end funds, section 2.6.2.
46. Directive 2009/65/EC of the European Parliament and of the Council of 13 Jul. 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast), as amended by Directive 2014/91/EU, OJ L 302, 32 ('the UCITS Directive').
47. Directive 2003/71/EC of the European Parliament and of the Council of 4 Nov. 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, as amended by Directive 2010/73/EU, OJ L 345, 64 ('the Prospectus Directive').
48. Directive 2004/109/EC of the European Parliament and of the Council of 31 Dec. 2005 on the harmonization of transparency requirements with regard to the information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 38 ('the Transparency Directive').
49. Directive 2007/36/EC of the European Parliament and of the Council of 11 Jul. 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 17 ('the Shareholders Rights Directive'). *See* Article 1(3)(a) and (b) of the Shareholders Rights Directive.
50. Directive 2011/61/EU of the European Parliament and of the Council of 8 Jun. 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010, OJ L174, 1 ('the AIFM Directive').
51. Provided that the portfolios consist of AIFs that are unleveraged and have no redemption rights that are exercisable during a period of five years from the date of initial investment in each AIF. *See* on these conditions, section 3.3.2[B].

under the European Venture Capital Funds (EuVCF) or European Social Entrepreneurship Funds (EuSEF) regimes.[52] AIFMs that manage closed-end 'long-term investment funds', i.e., funds that invest in certain eligible assets with a time frame of several years to several decades, may use the proposed European Long-term Investment Funds (ELTIF) framework, if adopted, for the marketing of participation rights to both professional and retail investors in the EU.[53]

Other EU legislation that may be relevant to funds include, among others, the Takeover Directive (in case a fund performs takeover activity),[54] the MiFID 2 (when a fund manager provides other services in addition to investment fund management and/or outsources the fund management to an investment service provider or when an intermediary facilitates the purchase of fund participation rights), the Unfair Commercial Practices Directive (UCPD)[55] (in case of unfair business practices performed by the fund), and the Market Abuse Directive (MAD) (when a fund is involved in insider dealing or market manipulation).[56]

In this respect, the proposed EU regulations on Packaged Retail and Insurance based Investment Product (PRIIP)[57] and on Money Market Funds (MMFs),[58] can also be noted. The proposed PRIIP rules intend to provide for harmonized rules regarding comparable and complete information on any 'packaged' or 'wrapped' investment product sold to retail investors, including investment funds.[59] The proposed rules on MMFs, i.e., funds that invest in short-term debt securities, such as money market instruments issued by banks and governments, aim to ensure that MMFs can better withstand redemption pressure in stressed market conditions by enhancing their liquidity profile and stability.[60] Although the MMF proposal does not aim to address

52. Regulation (EU) No. 345/2013 of the European Parliament and of the Council of 17 Apr. 2013 on European venture capital funds, OJ L 115, 1 ('the EuVCF Regulation') and Regulation (EU) No. 346/2013 of the European Parliament and of the Council of 17 Apr. 2013 on European social entrepreneurship funds, OJ L 115, 18 ('the EuSEF Regulation').
53. Final compromise proposal on the proposed Regulation on European Long-term Investment Funds, 2013/0214 (COD), 16386/14, 5 Dec. 2014 ('the ELTIF Proposal').
54. Directive 2004/25/EC of the European Parliament and of the Council of 21 Apr. 2004 on takeover bids, OJ L 142, 12 ('the Takeover Directive').
55. Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No. 2006/2004 of the European Parliament and of the Council, OJ L 149, 22 (UCPD).
56. Directive 2003/6/EC on the European Parliament and of the Council of 28 Jan. 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 16 (MAD).
57. Position of the European Parliament adopted at first reading on 15 Apr. 2014 with a view to the adoption of Regulation (EU) No .../2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance based investment products (PRIIPs), P7_TC1-COD(2012)0169 ('the PRIIP Proposal').
58. Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds, COM(2013) 615 final, 4 Sep. 2013 ('the MMF Proposal').
59. PRIIPs are products that contain an element of packaging or wrapping to an underlying investment opportunity that are being sold to retail investors. Besides investment funds, they include retail structured products and unit-linked insurance contracts. *See* recital 6 to the PRIIP Proposal.
60. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the MMF Proposal, SWD(2013) 315 final, 4 Sep. 2013, 13.

investor protection issues, they may indirectly impact the way in which investors in these funds are protected and could therefore be of relevance to the research question.

[B] Limitations with Respect to EU Rules

For the purpose of this research, I will only look at EU instruments that are specifically drafted for investment funds and/or rules that provide some sort of protection to individual investors that invest in funds. These laws primarily include the UCITS Directive (and its two implementing directives)[61] and the AIFM Directive, including ESMA guidance's regarding these directives. These two directives form the core basis for the assessment of EU law. Where appropriate to address a particular issue related to investor protection, the EuVCF, EuSEF, (proposed) ELTIF and MMF rules will also briefly be mentioned, and with respect to the information that has to be provided to retail investors, the PRIIP proposal will be addressed.

The Shareholders Rights Directive, Prospectus Directive and Transparency Directive are not fund-specific, but provide individual protection to investors regarding investor rights and disclosures for (listed) companies, including closed-end funds, that offer or sell shares to the public. However, since these directives have a very broad application, as they apply to all listed companies (Shareholders Rights Directive) or all public offers and admissions to stock exchanges (Prospectus and Transparency Directives), they will only be referred to if they are relevant to the particular issue under consideration.

The UCPD applies to all commercial activity in so far no specific EU rules on commercial practices apply.[62] As the UCITS and AIFM Directive cover the marketing of fund participation rights, the UCPD complements these directives and will only come into play if, for example, the fund manager uses aggressive selling methods. The UCPD will not be assessed in this book, since it concerns EU private law. This research deals with the EU rules that are included in *public* laws that aim to protect investors from misleading or fraudulent conduct by fund managers. The way in which EU public rules can be enforced and the rules set out in EU private laws affecting fund managers, including their enforcement, falls outside the scope of this research. Nevertheless, it can be noted that unfair practices involving the marketing of fund participation rights

61. Directive 2010/42/EU implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure, 1 Jul. 2010, OJ L 178, 28 and Directive 2010/43/EU implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, 1 Jul. 2010, OJ L 176, 42.
62. Recital 10 to the UCPD (stating that the UCPD 'applies only in so far as there are no specific Community law provisions regulating specific aspects of unfair commercial practices, such as information requirements and rules on the way the information is presented to the consumer. It provides protection for consumers where there is no specific sectoral legislation at Community level (…)').

may also be covered by the UCITS and the AIFM Directive, although these public rules cannot be enforced by investors.[63]

MiFID 2 falls outside the scope of this research as it deals with the protection of investors and companies, including investment funds, who are serviced by investment service providers (also referred to as financial intermediaries or investment firms) rather than the protection of investors who invest (with or without assistance of an investment service provider) in investment funds. Therefore, this book will not address investor protection issues under the MiFID 2 as it assesses the appropriate response of EU regulators with respect to fund regulation.

The remaining EU laws mentioned above, including the Takeover Directive and the MAD rules, are also not dealt with in this book as they are not specifically drafted for investment funds nor provide rules aimed at protecting the rights and interests of individual investors in funds. Instead, they apply to all market participants (in case of the Takeover Directive and MAD), and aim at protecting the financial system and financial stability as a whole, while providing certain protection for all investors on the subject area.

[C] US Level

US law for investment funds is generally divided into laws applying to public funds and laws applying to non-public funds. Public funds should comply with US federal securities law and state law applying to companies. They must register with the US Securities and Exchange Commission (SEC)[64] in case they offer or sell their shares or other types of participation rights to the public. Non-public funds are generally exempt from registration under federal law, as a result of which only limited (federal and state) investor protection provisions apply. There are two main federal statutes that are relevant to investment funds: the Investment Company Act of 1940 ('the 1940 Act') and the Investment Advisers Act ('Advisers Act').[65] A public fund may furthermore be required to register with the SEC and publish a prospectus under the Securities Act of

63. For example., the depositary of a UCITS or AIF is required to monitor whether the sale of the shares or other participation rights of the fund is in accordance with national law, which includes provisions on unfair commercial practices derived from the UCPD. In addition, the UCITS Directive provides that all marketing communications to investors should be 'fair, clear and not misleading' and the Commission Delegated Regulation on AIFM provides that professional liability risk includes 'misrepresentations or misleading statements made to the AIF or its investors' and that the periodical information provided to investors should be 'presented in a clear and understandable way'. *See* Articles 22(3)(e) and 77 of the UCITS Directive and Articles 21(9)(e) of the AIFM Directive and 12(2)(b) and 108(1) of Commission Delegated Regulation (EU) No. 231/2013 of 19 Dec. 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, OJ L 83, 1 ('Commission Delegated Regulation on AIFM').
64. The SEC is an independent regulatory agency aimed at providing protection to investors and enforcing the federal securities laws and regulating the financial industry in the US.
65. Pub. L. No. 768, 22 Aug. 1940, current version at 15 U.S.C. §§ 80a-1, et seq. ('the 1940 Act') and Act of 22 Aug. 1940, 54 Stat. 847, 15 U.S. Code, §§ 80b-1, et seq. ('the Advisers Act').

1933 ('the 1933 Act') and file various reports under the Securities and Exchange Act of 1934 ('the 1934 Act').[66]

[D] Limitations with Respect to US Rules

In general, federal law supersedes related state law in case this is expressly stated in the particular federal law. With respect to the 1940 Act and the Advisers Act, however, both acts preserve state law, unless it conflicts with any provision of the acts or any rule, regulation or order there under.[67] Thus, for the purpose of this research, the 1940 Act and the Advisers Act will be assessed in conjunction with state law governing investment funds to determine what rules apply and thus, how investors are protected under US law. With respect to the US laws applying to certain activities of investment funds, such as takeover activities, market abuse, and the use of credit ratings (to assist fund managers in making investment decisions or to rate the (debt) fund itself), it is referred to the above-mentioned related to EU law. Consequently, US law concerning these topics is not taken into account it is not especially drafted for investment funds and generally aim at protecting the public interest instead of the individual fund investor.

1.4 RESEARCH METHODS

The research will be conducted by studying both EU and US law applying to investment funds that are active in the EU. As mentioned above with respect to the scope of the investor protection rules (in section 1.3.3), I will confine this study to EU and US sector-specific public rules and general public rules applying to certain fund types or situations. Although the European part of this study focuses on EU law, national law that applies to investment funds may be discussed in case this is considered necessary for the purpose of this research. For example, in Chapter 2, it will be assessed, among other things, which legal structures can be used by fund managers to operate their funds. As the EU Member States have jurisdictions over the types of legal structures in which business organization are structured, the general characteristics of the most commonly used legal fund structures by most EU funds are briefly examined and compared.

The primary reason for examining US law in addition to EU law is the fact that the US is one of the most popular registration locations for investment funds and accounts for almost 50% of the worldwide assets of registered funds.[68] In addition, the US, most notably the state of Delaware, appears to attract many funds that are not required to

66. 48 Stat. 74, 27 Mar. 1933, codified at 15 U.S.C. § 77a, et seq. ('the 1933 Act') and 48 Stat. 88, 6 Jun. 1934, codified at 15 U.S.C. § 78a, et seq. ('the 1934 Act').
67. Article 50 of the 1940 Act and Article 222 of the Advisers Act (generally preserving the jurisdiction of state officials over their subject matters).
68. ICI, *2010 Investment Company Fact Book*, 50th ed., 182 and 183 (2010). (stating that by the end of 2009, there were 7.691 US registered funds managing USD 11.120,726 in assets, accounting for around a half of the worldwide total net assets under management). The fact book can be found at ICI's website: http://www.icifactbook.org/.

register with the respective securities authority or are subject to limited regulations, such as hedge funds.[69] Consequently, an important part of the non-EU fund industry is domiciled in the US. In this respect, it can however be noted that non-EU funds are also often located in so-called offshore jurisdictions,[70] most notably the Cayman Islands and British Virgin Islands.[71] Despite the popularity of offshore jurisdictions, however, the laws in force in such jurisdictions governing funds will not be discussed in this book for a number of reasons.

Firstly, the company law of offshore jurisdictions generally does not provide sufficient difference compared to the laws applying to funds in the US. US-based funds operate on the basis of state corporate, trust or limited partnership law of the US state in which they are organized. Delaware is one of the most popular states to establish investment funds in. Other states in which US funds are generally organized in are Maryland and Massachusetts.[72] Maryland and Delaware are the leading jurisdictions of formation for funds organized as corporations and Massachusetts has historically been the most popular jurisdiction of the trust form for funds.[73] However, since the adoption of liberal Delaware business trust law in the 80's, Delaware has also attracted many trust business to its state.[74] Delaware is furthermore often indicated as the leading market for limited partnerships, including LP funds.[75] In this book, the analysis with

69. According to research by the International Financial Services London (IFSL), the US was is most popular onshore location for hedge funds accounting for nearly two-thirds of the total number of onshore hedge funds. *See* IFSL Research, *Hedge Funds 2009* 2–3 (April 2009). This document can be found at IFSL's website: http://www.ifrs.org.uk/. It must be noted that there are also a significant number of unregulated funds which fall under available exemptions for registration under US law and therefore are not included in the above figures. Although most data that is available on the location of non-EU funds relates to hedge funds, it can be assumed that other types of non-EU funds are also predominantly established to these jurisdictions for similar (often tax-related) reasons.
70. *Ibid*. Around half of the number of hedge funds in 2009 were registered offshore. Of these funds, 67% were located in the Cayman Islands, followed by the British Virgin Islands (11%) and Bermuda (7%). An offshore jurisdiction can be described as a low-tax, lightly regulated jurisdiction which specializes in providing the corporate and commercial infrastructure to facilitate the use of that jurisdiction for the formation of offshore companies and funds. Offshore jurisdictions include, among others, the Cayman Islands, the British Virgin Islands, the Channel Islands of Jersey and Guernsey, Bermuda, the Bahamas, Panama, and the Netherlands Antilles. *See*, e.g., SEC, *Staff Report to the United States Securities and Exchange Commission: Implications of the Growth of Hedge Fund* 10 (2003). The staff report can be found at SEC's website: http://www.sec.gov/.
71. *Ibid*.
72. C.E. Kirsch (ed.), *Mutual Fund Regulation* 1-8 (2nd ed., Practising Law Institute 2009).
73. *See* R.A. Robertson, Fund *Governance*: *Legal Duties* of *Investment Company Directors* 2-12 (n. 1 & 3) (Law Journal Seminars Press 2001) and V.E. Schonfeld & T.M.J. Kerwin, *Organization of a Mutual Fund*, 49 Bus. Law. 115 (1993) (noting that both Maryland and Delaware have implemented corporate law favourable to investment companies) and S.A. Jones, L.M. Moret & J.M. Storey, *The Massachusetts business trust and registered investment companies*, 13Del. J. Corp. L. 422 (1988) (stating that, among a sample of new investment companies organized between 1985 and 1987, half were organized as Massachusetts business trusts).
74. J.H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L. J. 187 (n. 133) (1997).
75. S. Levmore, *Uncorporations and the Delaware Strategy*, 1 University of Illinois Law Review 201 (2005). Levmore refers to Bromberg and Ribstein, who ascribe the popularity of Delaware's limited partnership to the fact that Delaware has frequently amended its version of RULPA to

respect to US state law is therefore confined to the rules applying to the above-mentioned specific types of fund structures, more specifically: Delaware/Maryland corporations, Delaware/Massachusetts business trusts, and Delaware LPs. Most offshore fund jurisdictions offer a similar favourable regulatory climate for business organizations in terms of organizational requirements and taxation as these three US states. For example, both offshore jurisdictions and Delaware aim at providing a flexible and pro-business legal environment, making them particular attractive places to domicile many types of business organizations, including funds. In general, there are not many differences in the law between offshore fund law and state law applying to (most) US funds.[76]

Secondly, the securities regulations of offshore jurisdictions generally do not provide for more regulatory protection than the securities regulations in force in the US that apply to all funds offered to US investors. In fact, most offshore funds are not subject to securities regulations and supervision by the respective supervisory authority at all, except for certain provisions on money laundering, terrorist financing, and securities fraud. For example, in the Cayman Islands, funds that offer their participation rights to fewer than fifteen investors, including institutional investors, are generally exempt from the licensing requirements under Cayman Islands securities law and are not required to comply with other, continuing requirements of securities regulations.[77] In the British Virgin Islands, so-called private funds having no more than fifty investors or only making an invitation to subscribe for or purchase fund interests on a private basis and 'professional funds' only offering their shares or other participation rights to specified professional investors are subject to lighter regulation than public funds.[78] Other offshore jurisdictions offer similar exemptions/regimes for funds offering within their jurisdiction. In general, offshore funds doing business outside their home country rely on these light rules and/or exemptions, as a result of which local securities regulations generally do not apply. In view of this, there is no compelling need to assess this offshore securities law applying to funds. Although the analysis of offshore securities law thus stops here, it may, however, still be interesting for future research to look at ways to improve the lack of protection in funds that are based in offshore jurisdictions that offer their securities to EU investors.

The third and last reason for limiting the non-EU research part to US law is the fact that US fund managers may decide to transfer their offshore funds to the US to

accommodate newly perceived needs of organizers and managers of LPs (A.R. Bromberg & L.E. Ribstein, *Bromberg and Ribstein on Partnership,* 12.25(c) (Aspen Publishers 1998).

76. *Cf.*, e.g., Article 102(b)(1) of the Delaware General Corporation Law (DGCL) (Delaware Code Ann., tit. 8, § 101 et seq., as amended, August 2014), with Article 10 of the Cayman Islands Companies Law (2010 Revision, The Cayman Islands Gazette, No. 15, 19 Jul. 2010) and 501 DGCL with Article 6 of the Cayman Islands Tax Concessions Law (1999 Revision, The Cayman Islands Gazette, No. 6, 15 Mar. 1999).
77. Article 4(1) and 4(1)(4)(a) of the Cayman Islands Mutual Fund Law (2009 Revision, The Cayman Islands Gazette, No. 15, 20 Jul. 2009).
78. Articles 2(1) and 19(1) of the British Virgin Islands Mutual Funds Act 1996, as amended in 1997. The act can be found at http://www.bviifc.gov.vg/. Local private and professional funds cannot be denied recognition under the BVI Act unless they fail to prove that they are private or professional funds within the meaning of the Act and are lawfully constituted.

prevent new tax rules from applying or as a reaction to proposed tax rules. The US Foreign Account Tax Compliance Act of 2009 (FATCA), which became law on 18 March 2010 as part of the Hiring Incentives to Restore Employment Act, aims at curbing tax evasion by US persons through the use of foreign financial accounts.[79] For example, the FATCA requires US taxpayers to make disclosures related to their interest in a non-US institution totalling USD 50,000 or more and imposes a 30 % US withholding tax on any payment made by a US institution to a non-US institution.[80] Consequently, as a result of the actual or potential transfer of offshore funds to onshore jurisdictions, the relevance of studying the law applying to funds established in offshore jurisdictions is less self-evident than initially envisaged on the basis of the latest available figures on fund domicile. This fact, in combination with the reasons mentioned previously, serves to justify the limitation of the legal analysis on US law as only non-EU jurisdiction.

In addition to looking at the EU and US (case) law itself, various legal literature will be studied. The focus of this literature study lies on studying relevant international and national legal and scientific literature relating to investment funds in general and investor protection regulation of investment funds in particular. Finally, relevant development of law of the EU will be examined and reviewed in order to provide, as much as possible, an up-to-date overview of EU regulatory requirements and procedures concerning the protection of investors in investment funds. The analysis of EU law, US law and literature will ultimately result in some general observations regarding the level of investors' protection of EU investors investing in investment funds and whether or not this should be improved. Studying the regulation of investment funds in the US could furthermore be useful in providing insight as to the type of investor protection rules that may need improvement under EU law.

1.5 STRUCTURE

The structure of this book follows the three research questions of the book. In Chapter 2, the first question ('Which key features of investment funds in relation to the activities of fund managers are relevant to the issue of the protection of EU retail investors?'), will be addressed. It is dedicated to what investment funds are, what there key features are, and which features are (most) relevant in the context of investor protection with respect to fund management activities. It starts with providing a general definition of investment funds, after which it describes the core elements of investing in investment funds. Furthermore, Chapter 2 analyses some typical features of investment funds, including, among other things, the role and function of the different parties involved in funds, their fee structure, and legal forms used by investment funds. The overall aim of this chapter is to determine the fund features that play an important role in the protection of investors and, therefore, should be

79. *See* for the FATCA: Hiring Incentives to Restore Employment Act (H.R. 2847, 111th Cong., 2nd Sess., 25 Aug. 2010). The act can be found at http://www.govtrack.us/, under 'Title V', 'Subtitle A'.
80. Articles 501 and 511 of the FACTA.

addressed by the EU regulator in order to create a level playing field between investors in funds.

The next two chapters concern the second research question ('How are EU and US funds available to EU retail investors currently regulated relating to the protection of EU retail investors?'). Chapter 3 examines EU law affecting investment funds that aim to address investor protection issues related to the selected fund features set out in Chapter 2. This chapter analyses the investor protection regulation of the investment fund industry in the European context. In Chapter 4, US investor protection law applying to investment funds established in the US that may, in addition to the US, operate in the EU are analysed. The central objective of both chapters is to come to an overall assessment of the current degree of investor protection of EU and US funds that are available to EU retail investors.

Chapter 5 of this book is devoted to the third research question and key issue of this book: 'Is there is a level playing field between EU investors investing in EU funds and EU investors investing in US funds and if not, which rules should be adjusted?'. It examines the main differences between EU and US investor protection rules applying to investment funds and examines whether this should lead to adjustments to the existing EU framework for funds. In this context, it will be analysed whether substantial differences in protection level exist and if so, whether they provide EU investors investing in EU funds with substantial disadvantages regarding the way in which they are protected by these laws vis-à-vis EU investors investing in US funds, or the other way around. If the research proves it would be feasible, general recommendations regarding these potential adjustments will be made. In addition, the legal limits of the EU regulator's competence to adopt these adjustments will be discussed. More particularly, it will be examined whether there is a legal basis for the EU regulator to adopt additional investor protection measures.

Finally, in Chapter 6, the general conclusions are presented.

CHAPTER 2

Investment Funds: Key Features

2.1 INTRODUCTION

This chapter provides an answer to the first research question of this book: 'Which key features of investment funds in relation to the activities of fund managers are relevant to the issue of retail investor protection?'. In other words, it will be assessed where the EU regulator should focus on when protecting EU retail investors in funds in order to limit (micro-prudential) investor risks.[1] To be able to analyse the key features of funds that are relevant with respect of this research, it is necessary to know what investment funds are, what they do, and how they differ from other vehicles available to investors. Therefore, the chapter starts with providing an overview of the general concepts of investment funds, the terminology used to describe funds, and the general regulatory categories of funds (section 2.2). Furthermore, it will examine the main features of funds, starting with the key parties typically involved in a fund structure (section 2.3). In the next two paragraphs, the shares (or other types of participation rights) issued by funds and the fee structure that fund managers typically employ will be discussed (sections 2.4 & 2.5). Next, the main operational structures and investment strategies of funds will be analysed (section 2.6). After this, it will be analysed how funds are legally structured, i.e., which forms of business structures are generally used to establish a fund in (section 2.7). The chapter will close with a conclusion which includes a summary of the key fund features discussed. The conclusion also determines which fund features are most relevant in the context of investor protection and which investor protection rules can be linked to these features (section 2.8).

1. *See* on these risks and the general focus of this book, section 1.1.

2.2 WHAT ARE INVESTMENT FUNDS?

2.2.1 General Concepts

Investment funds are, fundamentally, a way to collectively invest money in securities or other assets rather than directly purchasing those securities or assets on the market. Collective investing refers to the combining of assets of various individuals and/or entities to create a larger portfolio than could have been by an individual investor. There are different types of funds for different investment needs and goals. So are there funds that invest exclusively in stocks or bonds or in a combination of different securities, and funds that focus on a specific market or industry, such as real estate funds, bio funds and green funds. In addition, there are funds that focus only on the retail market, funds that aim at sophisticated investors, or a combination of both forms. Although there is no universally accepted definition of the term 'investment fund', it can be generally described as a pool of money provided by investors, which is professionally managed and invested for the sole purpose of generating income on a collective basis for the investors. It follows from this description that the pooling of money and is a key component of investment funds.

[A] Pooling Money

Putting money together with others to buy securities or other assets creates a so-called pool of money, which can be defined as a collection of money from multiple, different investors to create a large pool of assets which is invested collectively in securities or other assets. Consequently, investments in investment funds are therefore sometimes also known as 'collective investments'. The term 'collective investment' is an investment made through an investment fund or another collective investment vehicle as opposed to an 'individual investment' or 'direct investment', which is an investment made without a collective investment vehicle as intermediary.[2]

When someone invests directly in securities, he or she makes his own buy and sell decisions, typically through a brokerage account at a bank. In these cases, investors hold the securities, such as stocks and bonds, themselves. They are in fact the legal owners of the securities they have in their portfolio. In case someone invests directly in other assets than securities, for example, real-estate, he or she becomes the legal owner of the real-estate. However, when someone invests through an investment fund (either directly or through an intermediary), the fund manager makes the decisions as to what to buy and when to buy it as long as they are in accordance with the investment policy of the fund. In that case, the investment fund is owner and direct holder of the 'underlying' securities or assets, although the qualification as to who becomes the legal owner of the securities depends on applicable national law (see sections 2.7.2 & 2.7.3).

2. T. Viitala, *Taxation of Investment Funds in the European Union* 12 (IBFD Publications 2005).

The investor receives fund shares or another type of participation right representing a pro rata interest in the fund when investing in the fund (see also section 2.4). He thus has a direct investment in the investment fund and an indirect investment in the underlying securities together with the other investors.[3] This also means that the individual investor has no single legal title to the underlying securities and the name of the investment fund appears on the securities or assets register (in case of registered securities).[4]

Pooling money can be considered to be beneficial for the average or 'small' retail investor, who under normal circumstances would find it too expensive and difficult to construct a portfolio of assets similar to that of an investment fund. In general, one can say that investment funds offer these investors a service that puts them on the same, or merely the same, level with institutions and high-net-worth investors in terms of investment possibilities. Investors with a relatively small amount to invest are unlikely to be able to achieve the same level of diversification as investment funds. They will often not have sufficient money to buy the amount of assets necessary to benefit from diversification, and even if an individually managed portfolio achieves diversification, the extent of diversification would still be very limited.[5] In addition, in case of a relatively small amount of available investment money, adequate portfolio diversification comes with significant transaction costs.[6]

Investment funds, on the other hand, although charging fees to investors (see section 2.5), can obtain large savings on brokerage fees and commissions because they typically trade large blocks of securities, which reduces the transaction costs for the fund and thus ultimately for the investors. Funds managers generally have access to a wide range of resources and research data and are 'close to the market', which makes it possible for them to spot trends and opportunities.[7] Consequently, when investing in an investment fund, an investor is provided with access to professional management skills and diversification possibilities that would not, or not to the same extent, be available when he would invest individually.[8] Because of these advantages, many fund managers diversify their fund portfolios by spreading across a number of different

3. *See also* C.P. Jones, *Mutual Funds: Your Money, Your Choice ... Take Control Now and Build Wealth Wisely* 12 (Financial Times Prentice Hall books Series, Pearson Education 2003) and C. Turner, *International Funds: A Practical Guide to Their Establishments and Operations* 6–7 (Elsevier 2004).
4. E. Micheler, *Property In Securities: A Comparative Study* 119 (Cambridge U. Press 2007).
5. G.N. Gregoriou (ed.), *Encyclopedia of Alternative Investments* 361 (Chapman & Hall/CRC 2008). Diversification is the spreading of investments. Spreading your investments reduces risk as fluctuations of a single investment will have less impact on your portfolio as a whole. H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 Colum. L. Rev. 794 (1976).
6. Transaction costs refer to the costs incurred in making an economic exchange, such as information costs, bargaining and decision costs and policy and enforcement costs. R.H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1–44 (1960).
7. R. Russel, *An Introduction to Mutual Funds Worldwide* 33 (John Wiley & Sons 2007).
8. Although it can be mentioned that investors may use a professional investment adviser to obtain advice about securities that is of the same 'quality' as the skill possessed by the professional fund manager. But they will generally have higher brokerage and transactions costs and less diversification options.

assets and/or by spreading across different asset classes or markets, depending on the fund's particular investment and asset allocation policy.[9]

When an investment fund invests in a number of different securities or assets, the risk associated with one individual investment will be reduced. This risk is also known as 'unsystematic' risk, as opposed to the risk of the whole market or market segment, known as 'systematic' risk.[10] For instance, in case someone invests his money directly into the shares of a particular company, he could lose all his money if the company goes into liquidation. However, if he invests it in an investment fund whose portfolio consist of a wide selection of individual shares (including the one he wants), the liquidation of the company would be a relatively small loss within the fund's portfolio (and thus the investor's portfolio). When a fund holds investments across different industries, sectors or asset types, the impact on the risk exposure of the fund is even greater as it both reduces unsystematic risk of a particular investment and systematic risk inherent in a particular market or segment.

[B] Conflicting Interest

While the above shows that there are a number of advantages that can be associated with investing in 'pooled' investment funds, such as professional management and diversification (costs) benefits, some aspects of funds are less advantageous to investors. The organizational structure of an investment funds inherently embodies a conflict of interest between the interest of the fund investors and the fund manager managing the fund. This conflict particularly arises because part of the fund manager's fees is paid by the fund, which reduces investor's returns. Fund managers typically receive a fee to compensate for the manager's services and serve as revenue for the manager's owners. Because the level of fees paid to the manager represents its revenue from the fund, the fund manager has an incentive to maximize this revenue which could conflict with the goal of investors to reduce fees. In addition, it might lead to excessive risk-taking by the fund manager in an attempt to enhance the fund's performance and, subsequently, the manager's fee, which might have a negative impact on future capital gain of the fund investments.

A second potential conflict arises between investors. In general, an investor in a fund is not the only investor as funds usually allow multiple investors to invest in them (see also below). These investors may purchase new fund participation rights or, in case of an open-end fund, redeem their shares or other rights from the fund (see section 2.6.2). Generally, when investors subscribe to fund participation rights or redeem them, the fund manager will purchase and/or sale underlying investments in the fund portfolio, that would incur trading costs and other costs, such as transaction charges, brokerage fees, taxes and bid/offer spreads. The aggregate costs arising from such

9. Turner, *International Funds: A Practical Guide to Their Establishments and Operations*, 12.
10. Russel, *An Introduction to Mutual Funds Worldwide*, 31.

purchase and/or sale of the underlying fund investments would be charged to the fund and will thus dilute the performance of the fund. This impact, known as the 'dilution effect' may affect the interests of the investors of the fund. Since the costs associated with this in- and outflow are effectively borne by all investors, the existing investors are places at a disadvantage as opposed to new or former investors.

In order to mitigate these two potential conflict risks, some measures can be taken. For example, investors may require the fund manager to have a 'skin in the game' in order to align its interest with those of the investors. In such a case, the manager generally receives a share of the fund's net profits in the form of an ownership interest in the fund when the fund's performance reaches a certain threshold (also referred to as 'carried interest').[11] However, although equity stakes may lead managers to mitigate risk, the profit share in the form of carried interest can also have a potentially negative influence on risk-taking. As overall performance of a fund declines, for example, a fund manager may be motivated in the short-term to increase the risk of investments to move his call option back above the given threshold. With respect to the dilution effect affecting existing investors when fund shares or other participation rights are purchased or redeemed, the fund may charge investors a fee when entering or leaving the fund. As this will assign the extra costs resulting from the purchase/redemption of fund shares to the trading investors only, the performance of the fund remains unaffected. However, in general, such a fee is only charged in the case of large redemptions.[12] See on carried interest and entry/exit fees in more detail, sections 2.5.1 & 2.5.3.

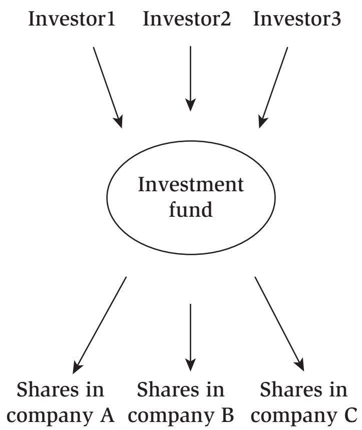
[C] General Definition

In light of the above, the following general definition of investment funds is used for the purpose of this research: An investment fund is a professionally managed entity that pools money from investors who, in return, receive fund shares or other participation rights representing a pro rata interest in the fund, and invests that money in one or multiple assets in accordance with its investment policy.

Figure 2.1 shows a basic structure of an investment fund which investment portfolio consists of shares of three different companies.

11. R. Bender, *Corporate Financial Strategy* 299 (Routledge 2013).
12. M. St Giles, E. Alexeeva & S. Buxton, *Managing Collective Investment Funds* 153 (2d ed., John Wiley & Sons 2003).

Figure 2.1 Investment Fund: Investments into and by the Fund



This above-mentioned definition is very broad compared to some other (mostly legal) definitions of investment funds, as it does not limit the investments of investment funds to securities.[13] As a consequence, in case a fund for instance invests directly in property or real estate projects instead of buying securities in companies that invest in these assets, it is also considered an investment fund for the purpose of this research. In addition, the definition does not require funds to diversify their investments (although most of them will do so). As a result, funds that only invest in one security will technically be also included in the definition.[14]

[D] Number of Investors

In addition to the above, it can be noted that in case an entity has only one investor, it may be considered to be an individual portfolio manager, not a fund.[15] In this view, an entity can only then be considered to be a fund in case its organization aims at collecting more than one investor and enables multiple investors to invest in it.[16] So, when a fund has marketed its participation rights to a number of investors, but only one investor has shown interest thus far, it can nevertheless be qualified as a fund (and may need to request a fund license with the relevant regulator(s) in which the fund

13. As opposed to, e.g., the definition of an investment company in Article 3 of the 1940 Act.
14. As opposed to, e.g., investment funds that fall within the definition of UCITS as set out in Article 1 of the UCITS Directive.
15. N.V. Ponsen & P. Klemann, *Beleggingsinstellingen nader belicht: preadviezen voor de Vereniging voor Effectenrecht* 7 (Serie monografieën vanwege het Van der Heijden Instituut, vol. 63, Kluwer 2000).
16. *See also* R.H. Maatman, *Een beleggingsinstelling met één deelnemer: contradictio in terminis?*, 5 Tijdschrift voor Effectenrecht 101 (1999) (arguing that in determining whether or not an entity is a fund it should be looked at whether the entity and the parties involved with it aim at investing money from multiple investors and have provided the infrastructure that enables that; thus not whether or not the entity actually has multiple investors).

operates). In my opinion, however, the aim and organization of a single-investor fund should be reviewed periodically to determine the status of the entity. In case the entity has only one investor and stops marketing the securities to multiple investors, it may lose its status as investment fund after some time.

On this line of reasoning, it can be concluded that whether or not an entity can be qualified as an investment fund is not dependent on the existence of a pool of money from multiple investors, although most funds, especially those aimed at (small) retail investors, will generally have more than one investor. Similarly, in the context of the application of the AIFM Directive, ESMA has considered that a fund with only one investor that is not prevented by national law or its internal governance instrument to acquire more investors should also be regarded to be an AIF that raises capital from a number of investors.[17] Therefore, in this book, it will be assumed that investment funds have multiple investors, unless expressly stated otherwise.

[E] Raising of Capital

Next to its views on the number of investors needed to constitute an investment fund, ESMA provided a number of other general interpretations on common concepts of the AIFM Directive. These interpretations, although technically only applying to AIFs, are relevant for other EU funds as well (i.e., UCITS) as they provide guidance on issues arising when determining whether or not an entity can be qualified as an investment fund.

In its guidelines, ESMA clarifies the scope of the activity of raising capital from investors. Investment funds will raise capital from investors in private or public offerings in order to become operative. According to ESMA, however, 'capital raising' does not concern processes of a purely passive nature.[18] As a result, if several persons come together and actively pool money, without any action performed by a fund manager entity, this cannot be considered as 'capital raising' and such an entity will not be considered a fund (or, actually, an AIF, since the ESMA guidelines technically only applies to AIFs).[19] In addition, ESMA noted that raising capital must involve some kind of commercial activity performed by the fund or fund manager in order to seek capital from prospective investors.[20] This thus excludes so-called passive marketing or reverse solicitation where the initiative is at the investor.

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17. ESMA, Final report – Guidelines on key concepts of the AIFMD, ESMA/2013/600, 24 May 2013, 32 (under 17).
18. ESMA, Discussion paper – Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM, ESMA/2012/117, 22 Feb. 2012, 9 ('Raising capital for the purpose of collective investment is an activity which could take place in many situations').
19. Investments in an undertaking made by a member of a pre-existing group, consisting of a group of persons connected by a close familial relationship that pre-dates the establishment of the undertaking, is not likely to be within the scope of the 'raising of capital' criterion. ESMA, Final report – Guidelines on key concepts of the AIFMD, 32 (under 16).
20. *Ibid.*, 32 (under 13). 'Commercial activity' concerns, according to ESMA, 'taking direct or indirect steps' by the AIFM 'to procure the transfer or commitment of capital by one or more investors to the undertaking for the purpose of investing it in accordance with a defined investment policy'. *Ibid.*

[F] Defined Investment Policy

ESMA also identified a number of factors that indicate the existence of a 'defined investment policy', although it also noted that the absence of all or any one of them would not conclusively demonstrate that no investment policy exist.[21] The investment policy of the fund generally describes, among other things, a fund's general investment philosophy and objectives and the investment strategy or strategies that the fund has decided to implement, in accordance with this policy.

According to ESMA guidelines, a defined investment policy should be understood as being 'a policy about how the pooled capital in the undertaking is to be managed to generate a pooled return for the investors from whom it has been raised'.[22] The factors mentioned by the ESMA include whether or not the investment policy: (1) the is determined and fixed, (2) set out in the fund rules or instruments of incorporation, (3) is legally enforceable by investors, and (4) specifies investment guidelines that determine investment criteria of the fund.[23]

With respect to the term 'investment guidelines', ESMA determines that 'any guidelines given for the management of an undertaking that determine investment criteria other than those set out in the business strategy followed by an undertaking having a general commercial or industrial purpose should be regarded as investment guidelines' (quotation marks omitted).[24]

Consequently, an entity that is regarded as an undertaking pursuing a business strategy with a commercial and/or industrial purpose rather than an investment strategy, has not implemented a 'defined investment policy'. This aspect of ESMA's guidelines concerns the difference between investment and general business activities. In its guidelines, ESMA described the general commercial or industrial purpose as a purpose of pursuing a business strategy which includes characteristics such as predominantly running a commercial and/or industrial activity. Examples of such activities include, among other, the purchase and sale of goods and commodities and the production of goods.[25] In this context, respondents to ESMA's discussion paper on key concepts of the AIFM Directive mentioned several characteristics which may provide Member States with additional insight into what may constitute 'general commercial or industrial activity': (1) having a 'business purpose' as opposed to an investment policy, (2) making profits out of production, services or trading, but not (at least not primarily) from the investment of capital, (3) a perpetual and continuously evolving business model, as opposed to seeking new investors on the basis of a defined investment policy, (4) generating returns for its own account which may be reserved, reinvested or distributed to shareholders at the absolute discretion of the company

21. *Ibid.*, 20 (under 95) ('On the discretion left to competent authorities and market participants to conclude that a defined investment policy exists even in the absence of the factors mentioned in the guidelines') and 53 (under 18).
22. *Ibid.*, 33 (under 20).
23. Such as the assets investing in, strategies pursued, restrictions on leverage, minimum holding periods, and other restrictions designed to provide risk diversification. *Ibid.*
24. *Ibid.*, under 21.
25. *Ibid.*, 29.

(subject only to shareholder vote), (5) organizing the production, logistic or design process in a manner which goes beyond giving directions to managers in companies owned by the entity.[26] See on the difference between collective investment undertakings and companies with respect to AIFs also section 3.3.2[C].

2.2.2 Terminology

Because investment funds thus generally pool investors' money and then invest that money, or most of it,[27] collectively, they are sometimes also referred to as 'collective investment funds' or 'collective investment schemes'.[28] However, other terms are also used in different jurisdictions to refer to (certain types of) collective investments. In the US (and Canada), the term 'mutual funds' is commonly used to describe a legal entity that is similar in nature to a unit trust structure found in the United Kingdom and in other jurisdictions that are based on UK common law.[29] However, in the rest of the world, it is used as a generic term for various types of collective investment vehicles, regardless of their legal form and structure. Another fund term globally used to describe listed index funds that track indices such as the S&P 500 include Exchange-Traded Funds (ETFs). These funds trade shares throughout the day, and, at the same time, issue and redeem existing shares in large blocks ('creation units') to large institutional investors ('authorized participants').[30] In addition, funds may also be classified by their investment activities and strategies employed. For example, the terms 'hedge fund', 'private equity fund' and 'venture capital fund' are commonly used terms to identify funds tha employ (complex) alternative investment strategies (see also section 2.6.6).

In fund legislation, again different terms are used. In France and Luxembourg, collective investment funds are commonly known as 'Fonds Commune de Placement' (FCP), whereas in other jurisdictions they are generally referred to as investment

26. *Ibid.*, 16 (under 72).
27. In order for an entity to be an investment fund it must primarily engage in collective investment. Entities that are primarily engaged in a business or businesses other than investments can be qualified as ordinary (holding) companies and not as investment funds. Whether or not an entity that invests money of investors can be qualified as an investment fund will depend on the interpretation of the word 'primarily' and the particular regulations that apply to that entity.
28. *See*, e.g., P.R. Wood, *Regulation of International Finance* Ch. 13 (The Law and Practice of International Finance Series, vol. 7, Sweet & Maxwell 2007), and Moloney, *EC Securities Regulation*, Ch. III.
29. A mutual fund is a type of investment fund in the US regulated primarily under the 1940 Act and the rules and registration forms adopted under that Act. Mutual funds are also subject to the 1933 Act and 1934 Act. For details on the UK unit trust and its relationship with US mutual funds, see K.F. Sin, *The Legal Nature of the Unit Trust* (Oxford U. Press 1998).
30. Creation units are usually sold in exchange of a basket of securities that correspond with the index that the ETF is designed to track. After purchasing a creation unit, an investor often splits it up and sells the individual shares on a secondary market. This permits other investors to purchase individual shares (instead of creation units). Investors can also usually sell the creation units back to the ETF. *See* on ETFs also J. Ruan, *Three Essays in Financial Economics* 65–66 (ProQuest 2008).

companies, mainly in a legal way. This is for instance the case in the US and the UK.[31] On an EU-wide level, as mentioned, funds are categorized into two different types, namely 'UCITS' and 'non-UCITS', depending on whether or not the fund falls within the scope of the UCITS Directive.

In order to prevent the confusion that may occur as to the exact distinctions between these terms, the term 'investment fund' is used in this book as it covers all forms of collective investment funds that are offered to investors in Europe. However, it should be noted that in cases where the intention is to refer to an investment fund that is established under the law of a particular Member State, either the official legal denomination of a particular fund with the nationality (e.g., 'French FCP') or the simple term 'investment fund' or 'fund' with reference to its origins (e.g., 'German investment fund' or 'French fund') is used.

In cases where the distinction between funds qualifying as UCITS and funds that do not is of importance, the terms 'UCITS' respectively 'non-UCITS' will be used. With respect to non-UCITS, it may however be also referred to AIFs, which follows from the AIFM Directive that regulates the activities of managers of all funds that do not fall under the UCITS Directive.[32] Thus, AIFs and non-UCITS are interchangeable terms. In the chapter concerning US funds (Chapter 4), again different terms, specifically based on US law, will be used.[33]

The foregoing shows that there are different terms in use for different sorts of funds among jurisdictions and within a particular jurisdiction. Reason for this is the fact that over time the industry has created many different types of funds with varying legal and operational structures and investment policies. In order to make sure that some funds would be more tightly regulated or regulated differently than others, national regulators have independently from each other adopted various laws and regulations for different types of funds. For example, in Luxembourg, regulators have made a distinction between funds with and without legal personality, respectively a Société d'Investissement à Capital Variable (SICAV) and a FCP.[34] In the UK, on the other hand, funds have been broadly categorized according to their investment public. As a result of this, only so-called Authorized Unit Trusts (AUTs) and Investment Company with Variable Capital (ICVC), can be sold to retail investors in the UK.[35]

31. Articles 3 of the 1940 Act and 236 of the UK Financial Services and Markets Act of 2000. The act can be found at http://www.legislation.gov.uk/.
32. Article 3(1)(a) and (b) of the AIFM Directive (defining an AIF as an collective investment undertaking, which: '(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC [UCITS Directive]' and AIFMs as 'legal persons whose regular business is managing one or more AIFs').
33. *See* sections 4.2 & 4.3 (making a distinction between US 'registered' and 'unregistered' funds depending on whether or not a fund is required to register with the SEC under the 1940 Act).
34. SICAVs and FCPs are both established under Part II of the Luxembourg Undertakings of Collective Investments (UCI) Law, Mémorial C, Journal Officiel du Grand-Duché de Luxembourg, A 2004, No. 239, 24 Dec. 2010.
35. *See* Article 1.2.1(1) and (2) of the UK Financial Services Authority's Collective Investment Schemes Sourcebook (COLL), Release 149, May 2014. The COLL can be found at http://fshandbook.info/. It introduced two types of AUTs for retail investors in the UK: (1) UCITS schemes and (2) Non-UCITS Retail Schemes (also referred to as 'NURS').

However, it is worth noting that the fact that a particular fund is set up in a certain country does not mean that the same fund is by definition only regulated in that country. If an investment fund engages in activities beyond its national borders, in the sense that it either invests in other countries or has participants who live abroad, it may be subject to (some form of) regulation of these countries as well. For example, a US-based fund that offers its shares or other participation rights to both US and non-US investors may not only have to comply with US regulations governing investment funds but also with several rules regulating the marketing and advertisement of the fund in the 'host countries' and local investor protection regulations. This legislation may be based on the UCITS or AIFM Directive (or other EU law applicable to EU and non-EU funds) or be determined, in addition to the EU rules, at the national level.

2.2.3 Regulatory Fund Categories

How are investment funds in the EU and US generally categorized? As mentioned, at the EU level, funds have been categorized in AIFs, covered by the AIFM Directive, and UCITS, regulated under the UCITS Directive. These fund types generally differ in investment strategies employed and assets that are invested in, although some convergence between the two categories has also been taken place.[36] funds can be categorized as being either 'regulated' or 'unregulated' by federal law, as a result of which they fall either under the scope of the 1940 Act or not.

[A] EU Funds

Funds that are UCITS are open-end in nature, liquid, well-diversified, and can only invest in certain 'eligible' liquid assets (namely quoted securities, money market instruments, deposits, certain derivatives and units in other UCITS) and can only employ limited leverage, i.e., use borrowed money to finance an investment in an attempt to magnify the gains on the investments or through the use of derivatives, or a combination of both.[37] AIFs are all funds that that cannot be qualified as UCITS under the UCITS Directive.[38] Consequently, they include all closed-end funds and all open-end funds that do not meet the investment criteria set out in the UCITS Directive marketed in the EU, including non-EU funds.

36. F. Stefanini et al., *Newcits: Investing in UCITS Compliant Hedge Funds* ix & x (John Wiley & Sons 2011) (stating that the AIFM Directive and 'the arrival in 2011 of the UCITS IV Directive, are strong incentives towards the convergence of an alternative and the traditional form of assets management' and '[t]his pushes alternative asset management to implement some investment strategies into vehicles that are UCITS III compliant').
37. Articles 1(2) and 49–57 of the UCITS Directive. It can be noted that the term 'leverage' is also used to indicate an entity's risk exposure, in which case it is a measure of economic risk relative to capital. *See* Report of The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* 4 (1999), The report can be found at: http://www.treasury.gov/.
38. Article 4(1)(a)(ii) of the AIFM Directive.

An important difference between UCITS and AIFs is that AIFs can only be marketed to professional investors in the EU with an EU passport.[39] AIFs may only be marketed to retail investors without an EU passport in case allowed by the particular Member State.[40] In such a case, the Member State may impose stricter or additional requirements on those AIFs, as long as these requirements are not stricter than those applicable to domestic funds. For example, in Ireland, so-called Retail Investor AIFs (RIAIFs) are allowed to sell their shares or other types of participation rights to retail investors. RIAIFs are subject to less stringent investment and eligible investment requirement than those applying to UCITS.[41] In Luxembourg, AIFs may also be marketed to retail investors, provided that they are subject to equivalent rules relating to investor protection to those set out in the AIFM Directive.[42] By contrast, when marketing AIFs to retail investors in the Netherlands, the AIFM becomes subject to the more extensive Dutch 'top-up' regime. This regime is inspired by the rules that apply to the marketing of UCITS funds in the Netherlands.[43]

A UCITS management company can freely market its UCITS, under the European passport, to any type of investors throughout the EU.[44] Under the AIFM Directive, which refers to the definition of professional clients used in MiFID 2, a professional investor is an investor who 'possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs'.[45] Such investors include, among others, credit institutions, investment firms, other institutional investors, and individual investors meeting certain criteria and request to be treated as professional investors.[46] It can be noted that some of these individual investors may be considered to be retail investors for the purpose of this research.[47]

39. Articles 31–39 of the AIFM Directive.
40. Article 43 of the AIFM Directive.
41. Irish AIF Rulebook, 13 (defining a RIAIF as '[a]n alternative investment fund authorized by the Central Bank which may be marketed to retail investors'). RIAIFs may invest up to 20% of their net assets in unlisted securities or securities of a single issuer, up to 30% in any open-end fund, and up to 20% of their net assets in unregulated open-end funds. By contrast, UCITS may invest no more than 5% of their net assets in unlisted securities or securities of a single issuer and no more than 10% of their net assets in a single fund. *See ibid* and Articles 52(1) and 55(1) of the UCITS Directive.
42. Article 46 of the Luxembourg Law on Alternative Investment Fund Managers (Mémorial C, Journal Officiel du Grand-Duché de Luxembourg, A 2013, No. 119, 12 Jul. 2013).
43. Article 115p-dd of the Decree on the Supervision of the Conduct of Financial Enterprises pursuant to the Dutch Financial Supervision Act (Besluit Gedragstoezicht financiële ondernemingen Wft), The Netherlands Bulletin of Acts (Staatsblad) 2008, 546, 9 Dec. 2008, as amended).
44. Article 5(1) and (3) of the UCITS Directive. A UCITS management company authorized by its home Member State is allowed to provide the full range of collective portfolio management services to UCITS, i.e., to distribute the shares or other participation rights of UCITS to EU Member States, including all associated functions and tasks and the provision of investment management, administration and/or other marketing services to other management companies.
45. Annex II to the MIFID 2.
46. *Ibid*. and 4(1)(ag) of the AIFM Directive. An individual investor can be treated as a professional investor in case he has carried out transactions, in significant size, on the relevant market (ten transaction per quarter over the previous four quarters), the size of the investor's portfolio exceeds EUR 500,000 and the investor has worked or works in the financial sector for at least a year in such a position which require knowledge of the transactions or services envisaged (thus, investments in funds of, I presume, the AIF type (not UCITS)). *See ibid*. II.1.
47. *See* section 1.3.1.

With respect to AIFs, the AIFM Directive allows the marketing of AIFs to professional investors by non-EU AIFMs and non-EU AIFs by EU AIFMs via the national private placement regimes (through which Member States may impose additional rules), on a transitional basis.[48] On 30 July 2015, the ESMA issued its advice to the European Commission on the application of a passport regime for these AIFMs.[49] In its advice, ESMA assessed six jurisdictions - Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the US. In order for ESMA to determine whether or not the passport should be extended to these countries, it looked at whether or not significant obstacles exist in these countries regarding (1) investor protection, (2) market disruption, (3) competition and (4) the monitoring of systemic risk.[50] In light of these criteria, ESMA advices positively regarding Guernsey, Jersey, and, after the adoption of certain pending legislation, Switzerland.[51] No definitive view has been reached on the other three jurisdictions due to concerns related to competition, regulatory issues and a lack of sufficient evidence to properly assess the relevant criteria.[52] However, since the broad intent behind the directive is to ultimately provide for harmonized rules for all AIFMs, including EU AIFMS marketing non-EU AIFs and non-EU AIFMs marketing either EU or non-EU AIFs, it is very likely that the passport will be extended to non-EU AIFs and AIFMs established in Hong Kong, Singapore and the US and other non-EU countries in the near future, and that the national placement regimes will be abolished.[53] Therefore, in this book, when referring to AIFs, it will be referred to AIFs of

48. Articles 36 and 42 of the AIFM Directive.
49. ESMA, Advice – ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, ESMA/2015/1236, 30 Jul. 2015.
50. *Ibid.,* at 8 and Article 67(4) of the AIFM Directive.
51. *Ibid.*, 30, 35 & 47. With respect to these countries, the Commission is required to adopt within three months, so by the end of October 2015 at the latest, a delegated act which will permit AIFs established in these countries to be distributed on a pan-EU basis, provided certain criteria are met. *See* Article 67(1), (2) (6) of the AIFM Directive and recital 85 to the AIFM Directive. In 2018, the function of the AIFM Directive will be reviewed by ESMA. At this point, the national private placement regimes may be abolished. *See* Article 68 of the AIFM Directive.
52. *Ibid.*, 24, 41 & 52. With respect to the US investor protection rules, ESMA however considers that 'overall, the rules in the US seem comparable to the rules in the EU (diversification, disclosure requirements, limitation in ability to borrow money etc.)', but that 'the system with self-custody would not be accepted for AIFMs' and that 'remuneration rules as set out in the AIFMD do not seem to be currently applied in the US'. *Ibid.*, 19 & 20 (under 54 &58).
53. This follows from Article 67(6) of the AIFM Directive which states that '[i]f there is an objection to the delegated act [of the European Parliament and the Council] (…), the Commission shall re-adopt the delegated act pursuant to which the [passport] shall become applicable in all Member States (…) at a later stage which seems appropriate to it, taking into account the criteria listed in paragraph 2 and the objectives of this Directive, such as those relating to the internal market, investor protection and the effective monitoring of systemic risk'. *See* also ESMA, Advice – ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, 4 ('ESMA will continue to work on its assessment of other non-EU countries not covered in this advice with a view to delivering further submissions to the European Parliament, the Council and the Commission in the coming months'). ESMA will furthermore issue its opinion on the functioning of the passport for EU AIFMs and the national private placement regimes. *See* ESMA, Opinion - ESMA's opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes, 2015/ESMA/1235, 30 Jul. 2015, 17 (stating that 'the delay in the implementation of the AIFMD

which the AIFM is required to be authorized with an EU competent authority to market its shares or other types of participation rights with a passport in the EU, unless expressly stated otherwise.[54]

[B] US Funds

The securities regulations in force in the US applying to investment funds represent a regulatory distinction between registered and unregistered funds. Under the 1940 Act, an investment fund should register with the SEC in case it offers or sells it shares/other participation rights publicly and does not qualify for an exemption.[55] Once registered, the fund is subject to the 1940 Act's regulatory regime. Most unregistered funds are generally exempt under the 1940 Act special provisions Article 3(c)(1) and 3(c)(7) for non-public funds.[56] Specifically, this means that they either have no more than 100 investors ('3(c)(1) fund')[57] or only qualified investors ('3(c)(7) fund')[58] and do not make or propose to make a public offering of its shares to US investors.

Furthermore, fund managers of US funds may need to register as they will qualify 'investment advisers' under the Advisers Act. An investment adviser is defined in the

together with the delay in transposition in some Member states make a definitive assessment [of the opinion on the functioning of the national private placement regimes] difficult' and that 'ESMA would see merit in the preparation of another opinion on the functioning of the [national private placement regimes] after a longer period of implementation has passed in all Member States').

54. However, it can be noted that final application of these passport rules may be preceded by a new political debate on the EU passport for AIFMs marketing non-EU AIFs, which will delay the entry into force of the extension of the EU passport. Furthermore, once applicable, the Commission will likely adopt implementing standards on the further details on the requirements regarding rules for cooperation arrangements, rules on depositaries, reporting requirements and leverage calculation, and rules ensuring an equivalent level of investor protection. *See* Articles 35(1) and (16) and 37(1) and (23) of the AIFM Directive. At the time of writing of this book, these rules are not available and are thus not taken into account when determining the level of investor protection. Any conclusions based on the application of the provisions of the directive related to the passport for non-EU AIFs and AIFMs must therefore be interpreted with caution.
55. Article 8 of the 1940 Act.
56. The 1940 Act also excludes a number of other entities from the definition of 'investment company' or specifically exempts them from regulation under the Act, including issuers primarily engaged in noninvestment business (Article 3(b)(1) and (2)), underwriters, brokers and dealers in securities (Article 3(c)(2)), banks and certain other financial institutions (Article 3(c)(3), (4), (5), (6) and (11)), and companies designed to promote investment in small business (Article 6(a)(2)). *See* for an extensive analysis of these and other exceptions and exemptions T. Frankel and T. Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, Chs 6 and 7.
57. In case the investor is another fund, each investor in that fund is counted as an investor of a 3(c)(1) fund for the purpose of the 100-investor (or 100-owner) limit if the fund owns 10% or more of the 3(c)(1) fund's outstanding voting securities. *See* Article 3(c)(1)(A) of the 1940 Act.
58. Qualified investors (or, in the terminology of Article 2(a)(51) of the 1940 Act, 'qualified purchasers') include individuals who hold at least USD 5,000,000 in investments (as defined in rule 2a51-1 of the 1940 Act) and an entity that in the aggregate owns and invests on a discretionary basis not less than USD 25,000,000 in investments. For a complete definition of qualified purchaser see Article 2(a)(51) of the 1940 Act. Pursuant to rule 2a51-3 of the 1940 Act, a qualified purchaser also includes a company not meeting the above requirements as long as all of the beneficial owners of the securities of that company are qualified purchasers.

Advisers Act as a person or institution that gives advice about securities to clients, including investment funds.[59] The 2nd Circuit of the US Court of Appeals has stated in this respect that the latter group in fact 'advise' the funds by exercising control over their portfolios.[60] Unless an exemption applies, fund managers are required to register as an investment adviser with the SEC.[61]

2.3 FUND PARTIES

To determine how EU and US funds available to EU retail investors are currently regulated, the different parties associated with funds are of crucial importance. Besides the fund itself, other connected or related parties may also be subject to certain regulatory obligations that protect investors in funds against mismanagement, high costs, and/or excessive risk taking behaviour. In fact, some regulations, such as the AIFM Directive, even explicitly target at the fund manager instead of funds to ensure that the whole fund industry (active in the EU) is being captured by the directive. So who are the key parties associated with investment funds?

The previous sections show that the fund manager plays an important role in the organization and operation of an investment fund. In fact, the performance of the fund manager, or submanager in case the management function is delegated to a third party (see section 2.3.1[B]), forms the most important selection criteria for investors when investing in a fund.[62] However, next to the fund manager, there are a number of other third parties involved in investment funds, most notably the fund board, consisting of the board members in case of a corporate or trust fund or the general partner(s) in case of a LP fund (see also section 2.7), the depositary, the custodian, and the auditor. These parties are generally provided with some control over the fund manager to ensure that investors' investments are protected.

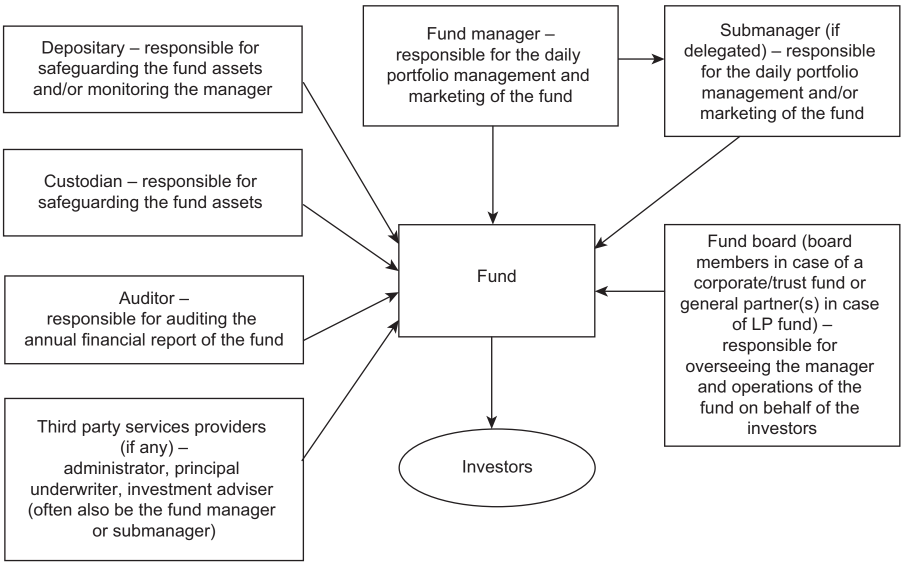
Other fund parties that provide services to the fund without any control functions include, among others, the administrator, principal underwriter, transfer agent, and investment adviser. The fund's administrator provides administration services to the fund, including accounting and pricing/valuation services. The fund's principal underwriter is a broker-dealer engaged in the purchasing and reselling of the fund's participation rights to the public either directly or indirectly through other broker-dealers or financial institutions. To market the fund, the principal underwriter prepares

59. Article 202(a)(11) of the Advisers Act, which defines an investment adviser as 'any person, who, for compensation, engages in the business of advising others, either directly or through publications or writing, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities (…)'.
60. *Abrahamson v. Fleschner*, 568 F.2d 862, at 871 (2nd Cir. 1977) ('These provisions [i.e., Articles 202(a)(11), 203(c), 205, and related provisions of the Advisers Act] reflect the fact that many investment advisers "advise" their customers by exercising control over what purchases and sales are made with their clients' funds').
61. As a result, the fund manager must file a registration form with the SEC and various disclosure, reporting and other obligations are imposed on the manager.
62. Two other important selection criteria are the fund manager's reputation and the number of funds offered by the family. M.C. Yates, *New Perspectives on the Determinants and Consequences of Individuals' Investment Decisions* 11 (ProQuest 2007).

sales materials, brochures, and advertisements.[63] In general, the underwriter is usually the fund manager or a broker-dealer that is affiliated with the manager. In many cases, the manager also performs the function of administrator.[64] A transfer agent is a financial institution that, for a fee, maintains the books and record of a fund. A transfer agent processes all purchases and redemptions of the fund.[65] Finally, an investment adviser provides investment advice to the fund. In general, the investment adviser is also the manager of the fund.

In Figure 2.2, the different parties typically involved in a fund and their general role and obligations are set out. In the following subparagraphs, the key fund parties involved in funds, i.e., the fund manager, fund board, depositary, and custodian are discussed in more detail.

Figure 2.2 Fund Parties



2.3.1 Fund Manager

Legally, there are two key ways in which a fund can be managed: (1) externally by a separate entity or (2) internally or 'self-managed' by the internal fund board (see also

63. C.E. Kirsch, *Financial Product Fundamentals: Law – Business – Compliance* 6–10 (Practising Law Institute 1999) and W.P. Rogers & J.N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. Rev. 1063, note 10 (1982).
64. *Ibid.*
65. M.L. Fein, *Banking and Financial Services: Banking, Securities, and Insurance Regulatory Guide* vol. 2, 13–103 (Aspen Publishers 2006).

section 2.3.2). Most investment funds are managed externally.[66] EU funds have a designated manager with responsibility for investment management. This is the UCITS management company or AIFM in case of an externally managed fund or the UCITS or AIF itself (represented by the fund's board) in case of an internally managed fund. The designated manager may however on its turn delegate this function to a third party investment management company (typically referred to as 'investment adviser' in the US), i.e., the submanager or delegated manager. Below, the general business of the (external of internal) fund manager [A], the concept of management delegation [B], and the different (regulatory) management options [C], are discussed in more detail.

[A] Fund Management Business

The business of a fund manager is that of a professional investment services provider which offers investment portfolio management or asset management services to investment funds.[67] Fund managers can manage multiple funds that have different investment styles and goals. Most large fund managers manage a broad scale of fund with various investment styles. For example, as of 2011, Fidelity had more than 175 different funds in its family that retail investors can invest in.[68] The fund manager is the one who usually has established the funds, i.e., the fund sponsor, although the sponsor may also be a separate party.[69]

It is often claimed by fund managers that they are able to earn high returns during both normal and stress periods due to their management skills. A study published in the Journal of Portfolio Management in 1992 supports this view by stating that 92% of the professional managers tracked by MoniResearch Newsletter outperformed the

66. *See*, e.g., P.G. Mahony, *Manager-Investor Conflicts in Mutual Funds*, 18 J. Econ. Persps. 163 (2004) ('Most mutual funds are created and managed by a mutual fund management (…)'), J.C. Bogle, Re-Mutualizing *The Mutual Fund Industry-The Alpha and the Omega,* 45 Boston L. Rev. 392 (2004) (stating that most trust funds are managed not by their own trustee(s), but by an external corporation that not only performs investment management but also administration, operations, distribution, and marketing services) and W.D. Allen, *Essays on Closed-End Funds: Internal versus External Management and Insider Trading* 25 (University of Missouri-Columbia 2006) ('Most funds of both types [i.e., open- and closed-end] contract with an external investment advisory firm for portfolio selection and management' and 'a very limited number of funds are internally managed, paying salaries to a professional portfolio management staff instead of contracting for the services'). However, *see also* T. Frankel & C.E. Kirsch, *Investment Management Regulation* 239 (3d ed., Fathom Publishing Company 2005) (noting that the second largest US fund management company, Vanguard, internally manages its funds).
67. *See* for a definition of asset management services in relation to investment funds, e.g., Emerging Markets Committee of the IOSCO, *Guidance for Efficient Regulation of Conflicts of Interest Facing Market Intermediaries* 9 (October 2010). (Defining asset management service in relation to investment funds as 'operating funds raised from more than one investor without any control by investors over the investment decision, and distributing benefits of the investment'). The report can be found at IOSCO's website: http://www.iosco.org/.
68. *See* http://personal.fidelity.com/products/funds/content/FidelityMutualFunds/browse_funds.shtml.cvsr/ (last accessed on 22 Apr. 2012).
69. Turner, *International Funds: A Practical Guide to Their Establishment and Operation*, 93 ('The sponsor of a fund is the party "behind" [the fund's] establishment: the motivator for its being set up (most likely because it sees an opportunity to make a profit from doing so). The sponsor may be the same party as the manager (…)').

market averages in the 1987 collapse, as did 96% during drops in January 1990 and August 1992.[70] However, the track record used in this research only concerned fund managers who performed market-timing services to their clients, managing for the most part no-load US mutual funds.[71] Furthermore, the fact that this research is performed by market timers, which may more easily conclude that market timers perform better than other managers as opposed to outsiders to the fund business, may also pose some questions. However, according to more recent research, some evidence was found that active mutual fund managers indeed successfully market time in bad times and select stocks in good times due to specialized knowledge and using public information.[72] Another study related to hedge fund managers supports this view.[73]

At any rate, the question can be raised whether managers using other strategies than market timing strategies or managing other funds have also performed better than the markets during stress periods. A study published in the Journal of Investment Management in 2008 analysing US funds investing in Mortgage-Backed Securities (MBS)[74] from 1992 to 2003, provides some insight in this matter. It distinguishes between two different types of MBS funds: MBS hedge funds and MBS mutual funds. According to this study, MBS hedge funds have outperformed the market index during the period of research while, at the same time, MBS mutual funds have underperformed the index.[75] This may relate to the fact that the high incentive fee structure of hedge funds draws skilled managers away from mutual funds.[76] In line with this, a 2014 research provides evidence that hedge fund managers possess more skill than mutual fund managers in managing downside risk.[77] However, even if this is the case, it still does not explain whether high returns can be solely based on management skill

70. J. Wagner, S. Shellans & R. Paul, *Market Timing Works Where it Matters Most… in the Real World*, 18 J. Portfolio Mgt. 86–90 (1992).
71. *Ibid.*, 86.
72. M. Kacperczyk, S. Nieuwerburgh & L. Veldkamp, *Time-Varying Fund Manager Skill*, Working Paper 17615, National Bureau of Economic Research 3 (Nov. 2011) ('Not only do we find that managers correctly forecast firm-specific fundamentals in booms and market fundamentals in recessions, these results are even stronger than those in which timing and picking are based on stock market information').
73. W.R. Gray & A.E. Kern, *Do Hedge Fund Managers Have Stock-Picking Skills?* 2 (Nov. 2009). Available at SSRN.
74. MBS are debt obligations that are based on a pool of mortgages. The income stream received from the mortgages is used to pay the investors who have bought these securities. MBS can be sold either as pass-through or in structured form, also known as collateralized mortgage obligations (CMOs). *See* F.J. Fabozzi (ed.), *The Handbook of Mortgage-Backed Securities* 4 (5th ed., McGraw-Hill 2001).
75. X.E. Xu & A.L. Loviscek, *The Performances of MBS Hedge Funds and Mutual Funds: A Puzzle*, 6 J. Inv. Mgt. 59 (2008). Whether hedge funds that traded mortgage-backed securities during the US 2007–2008 sub-prime mortgage crisis also outperformed mutual funds for MBS is unclear as this has not (yet) been investigated. But, see n. 80, *infra*.
76. *Ibid.*, 85. *See also* F.R. Edwards & M.O. Caglayan, *Hedge Fund Performance and Manager Skill*, 21 J. Futures Mkt. 1021 (2001).
77. C. Cao, B.A. Goldie & B. Liang, *What Is the Nature of Hedge Fund Manager Skills? Evidence from the Risk Arbitrage Strategy*, 32 (22 Jul. 2014) ('[H]edge fund managers appear to be more skillful at managing the downside risk associated with deal withdrawals than non-hedge fund managers are. It is this ability of hedge fund managers to limit downside risk that explains hedge funds' superior performance in risk arbitrage'). Available at SSRN. *See* also X. Li and H.A. Shawky, *The Market Timing Skills of Long/Short Equity Hedge Fund Managers*, 30 Research in Finance 51

or that other factors may also contribute to this. So has research also shown that positive hedge fund returns within a particular strategy are largely driven by external market factors (such as changes in credit spreads or market volatility).[78]

In addition, there is some evidence that various fund specific characteristics (such as costs, fees, fund size, the ability of investor to redeem their shares, and liquidity) may also affect fund performance in general.[79] This is also illustrated by the financial crisis of 2007–2009, during which many hedge funds have shown to be underperforming the overall market while being confronted with severe liquidity problems due to large redemption requests of investors.[80] Thus, one can say that a high level of performance cannot be assumed to be solely the result of management skill, nor can it be concluded that lower performance results can be directly linked to incapable managers.[81] Other factors, such as general (profitable or difficult) market conditions, fund size and ability to afford less favourable liquidity conditions, fees and costs and of course (a portion of) pure luck (or misfortune) may play an equally important role in the level of return achieved by a particular fund.

From a regulatory perspective, a fund manager can be defined as legal or natural person that qualify as either a management company under the UCITS Directive, alternative fund manager under the AIFM Directive or investment firm under the MiFID 2 in the EU or an investment adviser under the Advisers Act.[82] As such, it will usually have to register with the relevant securities authority and become subject to or, in case

(2014) ('Our empirical results show that there are at least 21.32% of the Long/Short [hedge] funds that exhibit good nonlinear market timing skills').

78. W. Fung & D.A. Hsieh, *Asset-Based Style Factors for Hedge Funds*, 58 Fin. Analysts J. 16–27 (2002).
79. *See*, e.g., M. Amman & P. Moerth, *Impact of Fund Size on Hedge Fund Performance*, 6 J. Asset Mgt. 219–238 (2005), M.J. Howell, *Fund Age and Performance*, 4 J. Alt. Inv. 57–60 (2001), C. Ackermann, R. McEnally & D. Ravenscraft, *The Performance of Hedge Funds: Risk, Return and Incentives*, 54 J. Fin. 833–874 (1999).
80. For example, in October 2008, The Economist reported that the 30 core US equity holdings of the biggest hedge funds, tracked by analysts at Merrill Lynch, had underperformed the stock market since the end of August 2008. The Economist, Hedge funds in trouble: The incredible shrinking funds, 23 Oct. 2008. In addition to the underperformance of certain funds, some funds (nearly) collapsed due to the financial crisis, under which the closing of a multibillion-dollar high-yield fund of Bank of America (see The New York Times, Mortgage Crisis Forces the Closing of a Fund, 11 Dec. 2007) and the famous near-collapse of two hedge funds of investment bank Bear Stearns. *See Bear Stearns Staves Off Collapse of 2 Hedge Funds,* The New York Times (21 Jun. 2007). *See* for more on redeemable shares, section 2.6.2[B].
81. *See also* T. Schneeweis, H.B Kazemi & G.A. Martin, *Understanding Hedge Fund Performance: Research Issues Revisited – Part I*, 5 J. Alt. Inv. 7 (2002).
82. *See* Articles 2(1)(b) of the UCITS Directive (defining a UCITS management company as 'a company, the regular business of which is the management of UCITS (…)'), 3(1)(c) of the AIFM Directive (alternative investment fund managers (AIFMs) are 'legal persons whose regular business is managing one or more alternative investment funds'), 4(1)(1) of the MiFID 2 ('Investment firm means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis' and 'Member States may include in the definition of investment firms undertakings which are not legal persons, provided that [certain conditions are met]'), and Article 202(a)(11) od the Advisers Act (an investment adviser means 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities (…)').

this is not required, comply with certain anti-fraud rules and regulations and fiduciary obligations under the applicable (national) law. A fund manager may be directly responsible for managing an EU fund's portfolio as it is designated to act as a fund manager and is authorized as such under either the UCITS or AIFM Directive, or is a delegated manager to perform portfolio management services to the fund.In the first case, the manager would be considered to be either a UCITS management company or an AIFM explicitly appointed to manage a fund under either the UCITS or AIFM Directive.[83] In the latter case, the manager can be an authorized UCITS management company, AIFM, a MiFID licensed firm, or a US investment adviser, depending on the nature and legal structure of the fund and the country or countries in which the fund's shares or other participation rights are being offered (see below). In case the fund is internally managed, an individual board member or multiple board members function as the fund's manager (see section 2.3.2). In such a case, the fund itself is considered to register with the relevant security authority.

[B] Delegated Management

Fund managers are permitted by law to delegate some of their activities, including investment management functions, to an external third party investment management company, i.e., the delegated manager (or submanager). The delegated manager may, on its turn, subdelegate any of its delegation management powers or other functions to another party. In case of a UCITS or AIF, however, the UCITS and AIFM Directive have placed some restrictions on the delegation of carrying out key functions to a third party, including: the Member State in which the UCITS/AIF has its registered office must allow the functions to be delegated, the function of investment management may not be delegated to the depositary of the fund,[84] nor to any other entity whose interests may conflict with those of the management company or the fund's investors, and, when the delegation concern the management of self-managed corporate UCITS/AIF, the mandate may only be provided to asset managers that are authorized or registered for the purpose of asset management subject to prudential supervision by EU Member States or, if cooperation between supervisory authorities is ensured, by non-EU Member States.[85]

An important note in this respect is the fact that a UCITS management company or AIFM may not delegate so much of its responsibilities that it becomes, in essence, a so-called letter-box entity. For UCITS management companies, the precise meaning of the term letterbox entity set out in Article 13(2) of the UCITS Directive has not clarified in either the UCITS Directive nor by the Committee of European Securities Regulators (CESR) (the former ESMA), but it can be argued that in, any case, a UCITS management

83. Article 5(2) of the UCITS Directive and 5(1) of the AIFM Directive.
84. *See* for the definition and duties of the EU depositary, section 2.3.3[A].
85. Article 13(1)(c)(d) and (e) of the UCITS Directive and Articles 5(1)(b) and 20 of the AIFM Directive. For AIFMs, ESMA has clarified that when an AIF depositary has sub-delegated custody of the AIF's assets to either an EU or third-country central securities depositary, the delegate must comply with the depositary rules under Article 21(11) of the AIFM Directive. See ESMA, Questions & Answers, Application of the AIFMD, ESMA/2015/1490, 1 Oct. 2015, 23 (Question 8).

company that has no physical presence in another country other than a mailing address is a letter-box entity. For AIFMs, ESMA has identified two circumstances under which an AIFM would become a letter-box entity as set out in Article 20(3) of the AIFM Directive: (1) where the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation or (2) where the AIFM no longer has the power: (i) to take decisions in key areas which fall under the responsibility of the senior management or (ii) to perform senior management functions (e.g., the implementation of the general investment policy and investment strategies).[86] Since Article 20 is based on Article 13 of the UCITS Directive, it can be assumed that the clarification of the term 'letter box entity' is in line with the current practice of this term under the UCITS Directive.[87]

Under EU law, a fund manager's core business must be the management of investment funds, except when the manager is a MiFID licensed manager that is appointed as delegated manager. The delegated fund manager can thus be a branch or subsidiary of a bank, broker-dealer or an insurance company, or a financial services firm that specializes in fund management. However, it can be noted that, similar to a US investment adviser or MiFID licensed manager, UCITS managers and AIFMs may also perform certain non-core services, provided that it complies with certain provisions set out in the MiFID 2.[88] With respect to delegated fund managers, it is furthermore worth noting that UCITS management companies and AIFMs cannot be a branch of a bank or other financial institution, considering that they must be separate legal entities.[89] US and MiFID fund managers can also be natural persons, although they will generally have legal personality due to liability risks.

[C] Regulatory Management Options

The above shows a fund manager can be either internal or external and can be either designated or delegated. Table 2.1 gives an overview of the possible options related to the investment management of funds offered to investors in the EU.[90] One aspect to note in relation to this table is that where it is referred to an (additional) AIFM license, it is assumed that the AIFM in question is not exempt from application of (most of) the AIFM Directive and that thus the mentioned provisions under that directive apply.[91] In

86. ESMA, Final Report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, Nov. 2011, 135.
87. *Ibid.,* 126.
88. Articles 6(3) and (4) of the UCITS Directive and 6(4), (5), and (6) of the AIFM Directive.
89. Articles 2(1)(b) of the UCITS Directive and 3(1)(c) of the AIFM Directive. However, they can manage funds established in other EU Member States than their home Member State under the EU passport via a branch.
90. This book focuses on the protection of EU investors. It will therefore only be assessed which types of fund managers can manage EU or non-EU (i.e., US) funds available to EU investors. However, in case of a US manager or fund, the fund may also be offered to US investors. In Ch. 4, US law applying to US funds protecting investors, both living in the EU and the US, will be discussed.
91. *See* for these exemptions, section 3.3.2.

addition, where it is referred to a UCITS management company to which AIFM investment management functions are delegated, it is assumed that the particular UCITS management company is allowed to perform portfolio investment management services outside their UCITS range.[92] The same applies to an AIFM to which non-AIF management services are delegated.[93] Lastly, as mentioned, when a UCITS or AIF is internally managed, the fund itself is considered as UCITS management company or AIFM for purposes of the license requirement. In Table 2.1, no distinction is being made between a designated UCITS management company or AIFM (in case of an externally managed fund) or UCITS or AIF (in case of an internally managed fund).

Table 2.1 Fund Investment Management Options of Funds Offered in the EU

	MiFID Firm	*UCITS Management Company*	*AIFM*	*US Investment Adviser*
Designated UCITS manager	No	Yes	Yes, subject to additional UCITS management company license.[94]	No[95]
Designated AIFM for an EU AIF	No	Yes, subject to an additional AIFM license.[96]	Yes	Yes, subject to an AIFM license or a qualified national private placement regime (until abolished).[97]

92. The UCITS Directive allows a EU Member State to authorize a UCITS to provide the following investment services to a third party: portfolio investment management and non-core services comprising: (1) investment advice and (2) safe-keeping and administration in relation to shares or units of collective investment undertakings. Article 6(3) of the UCITS Directive. Please note that no extension is available to self-managed UCITS investment company (UCITS can only be self-managed in case they are established as an investment company, i.e., a fund created by statute) as such a collective investment scheme cannot be authorized to do anything more than internally manage that UCITS.
93. Article 6(4) of the AIFM Directive. The conditions laid down in the AIFM Directive concerning additional services performed by AIFMs are similar to those set out in the UCITS Directive. *See ibid*. However, in addition to the services also described in the UCITS Directive, AIFMs may also be allowed to be delegated the and/or reception and transmission of orders in relation to financial instruments.
94. Recital 21 to the AIFM Directive ('Pursuant to authorisation under Directive 2009/65/EC, an external AIFM should be allowed to manage UCITS') and Article 6(2) of the AIFM Directive (providing that an AIFM may also act as a management company for UCITS provided that the AIFM is authorized in accordance with UCITS Directive for that activity).
95. Article 6(1) of the UCITS Directive ('Access to the business of management companies shall be subject to prior authorization to be granted by the competent authorities of the management company's home [EU] Member State').
96. Recital 3 to the AIFM Directive ('AIFMs should not be entitled to manage UCITS within the meaning of Directive 2009/65/EC [the UCITS Directive] on the basis of an authorisation under this Directive', thus, they need both an AIFM and a UCITS authorization).
97. Articles 37–39 and 42 of the AIFM Directive. *See also* n. 49 and accompanying text, *supra*.

	MiFID Firm	*UCITS Management Company*	*AIFM*	*US Investment Adviser*
Designated AIFM for a US fund	No	Yes, subject to an additional AIFM license or a qualified national private placement regime (until abolished).[98]	Yes, subject to an AIFM license or a qualified national private placement regime (until abolished).	Yes, subject to an AIFM or a qualified national private placement regime (until abolished).[99]
Delegated manager for a UCITS	Yes, unless prohibited by the competent EU Member State and provided that certain conditions related to the delegation are met.	Yes, unless prohibited by the competent EU Member State and provided that certain conditions related to the delegation are met.	Yes, unless prohibited by the competent EU Member State and provided that certain conditions related to the delegation are met.	Yes, unless prohibited by the competent EU Member State and provided that certain conditions related to the delegation are met.[100]
Delegated manager for an AIF	Yes, provided that certain conditions related to the delegation are met.	Yes, provided that certain conditions related to the delegation are met.	Yes, provided that certain conditions related to the delegation are met.	Yes, provided that certain conditions related to the delegation are met.

98. Articles 35–36 and 67–68 of the AIFM Directive.
99. Articles 40 and 42 of the AIFM Directive.
100. *See* in particular Article 13(1)(d) of the UCITS Directive (cooperation between the supervisory authorities of a third-country delegated manager and the UCITS home Member State must be ensured).

	MiFID Firm	*UCITS Management Company*	*AIFM*	*US Investment Adviser*
Delegated manager for a US fund	Yes, provided that certain conditions related to the delegation *and* the marketing of non-EU AIFs in the EU or a qualified national private placement regime (until abolished) are met.[101]	Yes, provided that certain conditions related to the delegation *and* the marketing of non-EU AIFs in the EU) or a qualified national private placement regime (until abolished) are met.	Yes, provided that certain conditions related to the delegation *and* the marketing of non-EU AIFs in the EU or a qualified national private placement regime (until abolished) are met.	Yes, provided that certain conditions related to the delegation *and* the marketing of non-EU AIFs in the EU or a qualified national private placement regime (until abolished) are met.[102]

It follows from Table 2.1 that there are many possible ways to manage and/or market a fund in the EU. The EU regulatory framework for funds, consisting of the UCITS and AIFM Directive and, when concerning a delegated MiFID investment firm, the MiFID 2, however requires a fund manager to comply with several rules and requirements before it may market the shares or other participation rights of the fund in the EU (unless an exemption applies A designated fund manager is required to obtain a license for the management of the fund and/or the marketing of the fund's shares or other participation rights, as a result of which it is subject to ongoing supervision by the national securities authority in which it is established.[103] In the US, fund managers marketing fund participation rights are subject to a registration requirements (unless exempted) and various other provisions set out in the Advisers Act.

101. *Ibid* and Articles 35 and 36 (in case of a EU AIFM) or 37–41 and 42 (in case of a non-EU AIFM). A US fund is considered a non-EU AIF under the AIFM Directive. When offered to EU investors, the AIFM must thus comply with the conditions and procedures laid down in the AIFM Directive regarding the delegation of AIFM functions and the marketing of non-EU AIFs in the EU.
102. *Ibid*. *See* with respect to the delegation of AIFM functions in particular Article 20(1)(d) of the AIFM Directive concerning the delegation to a third-country undertaking.
103. Article 12(3)(c) of Commission Regulation (EU) No. 584/2010 of 1 Jul. 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities, OJ L 176, 16 and Article 1 of the AIFM Directive.

A fund manager that markets shares or other participation rights of a fund in the EU may thus have to comply with the provisions of the UCITS and/or the AIFM Directive. In addition, if the manager has its registered office in the US, it may also fall under US regulations for fund managers and subsequent rules. These rules include several investor protection rules applying to managers managing funds, including rules on internal control, transparency and disclosure, and conduct of business (fiduciary) rules. As this research deals with the protection of EU investors in funds with respect to the activities of fund managers, these rules and regulation altogether are of considerable importance. Therefore, they will be assessed in the following two chapters (see with respect to the specific investor protection issues identified in this chapter, section 2.8).

2.3.2 Fund Board

In general, the board of directors of an investment fund, in particular in case of a EU or US corporate fund (see section 2.7.4), is responsible for overseeing the activities of the manager, including the manager's compliance with the applicable law and the fund's guidelines.[104] As noted above, the fund board generally does not manage the portfolio of the fund since this is generally conducted by an external fund manager. However, in some instances, the board may comprise of only one director, which is also the fund manager. In case of a fund organized as trust or Limited Partnership (LP), the fund board is legally referred to as the board of trustees or trustee respectively the general partner (see also sections 2.7.2 & 2.7.3). In these cases, the manager may functions as both the sole trustee or general partner and the manager all in one. Thus, whether or not the fund board is a separate entity from the fund manager highly depends the legal structure of the fund.

In this context, it can be noted that in the UK, a corporate fund regulated as a UK ICVC is even required to have a sole director, referred to as the 'Authorized Corporate Director' (ACD). The ACD may fulfil both the role of fund manager and director of the fund. The ACD can be the only director of the fund or one of the members of the board of directors, although most UK ICVC's have only one director: the ACD.[105] The ACD must be a separate corporate entity and specially authorized by the UK Financial

104. *See* Technical Committee of the IOSCO, *Report on the Examination of Governance for Collective Investment Schemes: Part I* 7 (June 2006) ('The Board of Directors is responsible for overseeing at a first level the CIS's operations and the CIS Operator and other service providers, such as CIS Distributors, as well as for monitoring conflicts of interest'), A. Almazan et al., *Why Constrain Your Mutual Fund Manager?* 73 J. Fin. Econ. 301–302 (2004) and E.D. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 Duke L. J. 152 (2009). The IOSCO report can be found at IOSCO's website: http://www.iosco.org/.
105. Article 6.5.3 of the COLL. A UK ICVC, whether a UCITS fund or not, is not required to have a board of individual directors as long as it has one ACD. Although more than one directors is thus allowed, no ICVC has apparently appointed more than one director as it is unclear what their role would be next to the ACD and depositary. *See* J.K. Thompson and S. Choi, *Governance Systems for Collective Investment Schemes in OECD Countries, OECD,* Financial Affairs Division, Occasional Paper, No. 1, 42 (2001), The paper can be found at OECD's website: http://www.oecd.org/.

Service Authority (FSA) to act as an ACD.[106] It has the primary responsibility to perform the day-to-day management of the fund, but it may also delegate this function to an external manager, provided that the provisions regarding the delegation of portfolio management based on the UCITS/AIFM Directive are met.

US registered funds are required to appoint multiple directors, of which at least 40% are independent directors,[107] although in practice this percentage exceeds 50% on most US-registered fund boards.[108] Persons that are considered to be not independent include, among others, employees (and their immediate family members) of the fund or the manager, the manager itself, and the underwriter of the fund.[109] By contrast, a US unregistered fund will generally, similar to the EU model, have the fund manager to function as the fund's board. In case of multiple directors, the monitoring role of the board however will be very limited in practice as the fund manager has considerable influence on the way in which this role is being exercised. As noted, the fund manager is often the creator/sponsor of a new fund. In this capacity, the fund manager gives the fund its name, which is generally the same brand name used in the fund family accompanied with a fund-specific index number or name. While the investors in a fund generally have the power to appoint and remove incumbent fund directors, the fund manager, in its capacity of fund sponsor and originator, is however the one who appoints the initial fund board. The fund board in turn generally has the duty to appoint the fund manager.[110] As a result of these mutual appointments, there is a close nexus between the fund's initial board and the manager.

This connected relationship between the fund manager and fund board in the case of both EU and US funds creates an inherent conflict of interest between the manager and board on the one hand and the fund investors on the other (see also section 2.2.1). As mentioned, the fund's board has the duty to monitor the manager. However, board members receive compensation for each board on which they serve, which can add up to a substantial amount in case of multiple board appointments

106. Article 6.5.3 of the COLL.
107. Articles 10(a) and 2(a)(19) of the 1940 Act. Please note that the terms 'unaffiliated director' and 'disinterested director' are also used to denote an independent director, often in line with the term used in the law applying to the fund. The three terms can be used interchangeably as they all mean the same thing: a director who has no material relationship with the fund in which he or she serves as director or with the fund's manager. Which relationships are 'material' depends on the particular law (or code of conduct) that applies to the fund. In general, material relationships include all business or professional relationships that can be reasonably perceived to interfere with the exercise of a director's independent judgment. A person is not dependent, however, solely by reason of being a director or shareholder of a fund, or a relative of such person. *See* Schonfeld & Kerwin, *Organization of a Mutual Fund*, 121.
108. OECD, *Insurance and Private Pensions Compendium for Emerging Economies: Book 2, Part 1:4)a: Corporate Governance and Collective Investment Instrument* 12 (2001) and ICI and Independent Directors Council (IDC), *Overview of Fund Governance Practices:* 1994–2008 (2009) (showing that independent directors hold 75% or more of the board seats in nearly 90% of the fund complexes examined by the ICI and IDC). The OECD compendium can be found at OECD's website: http://www.oecd.org/. The ICI/IDC document can be found at ICI's website: http://www.ici.org/.
109. Articles 2(a)(3) and (19) of the 1940 Act.
110. J.B. Warner & J.S. Wu, *Why Do Mutual Fund Advisory Contracts Change? Performance, Growth, and Spillover Effects*, 46 J. Fin. 274 (2011).

under the US multiple director model. In such a case, the fund manager usually appoints the board members and is also generally one of the directors itself. As mentioned, many fund managers manage multiple funds. As a result, fund board members will often favour the fund manager who is also the sponsor of the fund and has offered them the board seats, regardless of the reputation of this manager and the fees charged, and may do so again in future.[111]

The height of the manager's fee is negotiated by the fund's board and the manager in the management contract. However, since one of the directors is the fund manager and many of the other directors also serve on the boards of other funds in the manager's fund family, they have little incentive to negotiate a lower price for the services in the interests of investors.[112] As noted by Kuhnen, most fund boards generally do not renegotiate the management fee and only a handful of boards fire the primary advisor.[113] On this matter, Johnson further states that:

> [f]iring an investment advisor [i.e., manager] would fundamentally alter the fund. Investors do not choose to invest in a fund because of the composition of the board; instead they invest with a particular investment advisor. After all, it is the advisor's name on the fund and not the board's.[114]

In case of a fund board consisting of only one director that is also the fund manager, as may be the case for EU funds and in the case of US unregistered funds, the risk of conflict of interests is even more apparent. The fund manager/director directly profits from and can determine his own compensation contract with the fund.[115] In both the single and multiple director system, the manager has de facto authority to determine and approve (either directly or through its influence on the assignment of board seats) its own compensation arrangements paid by the fund and subsequently the investors, although they may be subject to remuneration (see section 2.5) and conduct of business rules (see sections 3.8 & 4.9).

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111. W.P. Rogers & J. N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?* 1072–1073.
112. *Ibid.*, and Technical Committee of the IOSCO, *Conflicts of Interests of CIS Operators* 153 (referring to the Fidelity complex of funds, in which nine individuals served as independent directors for all 237 investment companies in the complex). The IOSCO report can be found at IOSCO's website: http://www.iosco.org/. *See also* P. Tufano & M. Sevick, *Board Structure and Fee-Setting in the US Mutual Fund Industry*, 46 J. Fin. Econ. 334 (1997) (stating that the 10,162 independent board seats in the sample are filled by only 635 individuals) and S.P. Ferris & X.(S.) Yan, *Do Independent Directors and Chairman Matter? The Role of Board of Directors in Mutual Fund Governance*, 13 Journal of Corporate Finance 399–340 (2007) (finding that in the sample of fund families, independent directors oversee an average of 18.54 funds and that directors of scandal funds families oversee even, on average, sixty-two funds).
113. C.M. Kuhnen, *Business Networks, Corporate Governance, and Contracting in the Mutual Fund Industry*, 64 J. Fin. 2186 (2009) ('On average, only about 10% of all U.S. mutual funds renegotiate the management fee or change a subadvisor in any given year between 1993 and 2002, and there are only a handful of cases where the primary advisor was fired by the board'). *See also* P. Tufano & M. Sevick, *Board Structure and Fee-Setting in the US Mutual Fund Industry*, 325 ('We are aware of only three instances in the past three decades where boards have terminated the contract and replaced a fund sponsor against the sponsor's wishes').
114. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 154.
115. L. Johnson, *A Fresh Look at Director 'Independence': Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vanderbilt Law Review 505 (2008).

Considering these evident conflicts of interest, it can be concluded that fund boards often may not evaluate the factors relevant to the fund manager's compensation as intensively as may be expected from their monitoring role. Furthermore, the conflicting nature of this relationship may also result in self-dealing behaviour by the fund manager and/or excessive asset management/poor investment performance. The way in which regulators have responded to these potential conflicts of interests is of particular relevance to investor protection. Therefore, these issues will be discussed in more detail in the subsequent chapters.

2.3.3 Depositary and Custodian

A depositary is an entity, usually a bank, that is responsible for safekeeping the fund's assets and thus exercising certain supervisory responsibilities. Instead of or in addition to a depositary, a fund may have appointed a custodian. A custodian only has safekeeping duties and is therefore, from a governance perspective, less relevant than the depositary.[116]

Whether or not a separate depositary or custodian is required and which standards such an entity will have to comply with depends on the law under which the fund operates. For example, US law only requires that a US mutual fund places its assets with a qualified custodian.[117] Fund managers of EU funds are required to appoint a depositary for the funds they manage that is independent from their funds' manager on the basis of either the UCITS or the AIFM Directive.[118] In essence, the EU depositary not only acts as custodian but it also as has a monitoring function towards the fund. The EU depositary may delegate its custody function to a separate subcustodian, but it is not required to do so under EU law and certain conditions must be met (see below). In this respect, it can however be noted that US funds that are offered to EU investors may be subject to the depositary (and other) rules of the AIFM Directive. See Table 2.1. The duties of the EU depositary and US custodian are discussed in more detail below.

[A] EU Depositary

The EU rules require a depositary to be entrusted with the safekeeping of the fund's assets and to be provided with certain monitoring duties to ensure that the management company is operating the fund in compliance with regulation and fund rules.[119] The depositary must be a credit institution or a firm regulated in accordance with the standard applied to MiFID investment firms.[120] In case of a non-EU AIF, the depositary may also be a credit institution or other entity of the same nature of a MiFID firm

116. St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 22.
117. Article 17(f) of the 1940 Act.
118. Articles 22(1) of the UCITS Directive and 21(1) of the AIFM Directive.
119. Articles 22(3) and (4) of the UCITS Directive and 21(7) and (9) of the AIFM Directive.
120. Articles 23(2) of the UCITS Directive and 21(3) of the AIFM Directive.

provided that such entities are subject to effective prudential regulation and supervision which have the same effect as EU law and are effectively enforced.[121] As noted, fund managers of UCITS and AIFs cannot themselves act as depositaries and the depositary should act in the sole interests of investors and independently from the manager.[122]

The safekeeping function of the EU depositary includes the duties to hold (as intermediary) the fund's assets, arrange settlement of transactions and administer income, proxy voting and corporate actions. The UCITS and AIFM Directive describe the safekeeping function as either custody- or recordkeeping, depending on the type of assets of the fund. Assets are held in custody only where this is required as a condition of dealing and settlement - most commonly in relation to securities such as listed securities.[123] Furthermore, the custody function includes a requirement that the fund's assets be segregated from the assets of the depositary (and its delegates), so that any assets on the depositary's books held for a UCITS or AIF can be distinguished from the depositary's own assets (and those of its delegates), and can at all times be identified as belonging to that UCITS or AIF.[124] The record-keeping function covers those assets which cannot be held in custody, in which case the depositary's obligation is to maintain up-to-date records and verify ownership.[125] Verification is based on information to be provided by the UCITS, management company or AIFM or, if available, external evidence.[126] In this context, it can be noted the depositary may also be the legal owner of the assets of the EU fund, although this does not follow from the UCITS or AIFM Directive.[127] In such a case, the depositary not only has a safekeeping role, but also functions as the 'title holder' or 'nominee' of the fund's assets.[128]

With respect to the monitoring role of depositaries of EU funds, the following general duties can be distinguished: (1) monitoring the fund's cash flows and (2) carrying out a number of oversight tasks. The duty of the depositary to monitor the cash flows includes ensuring that payments made by investors for subscriptions to fund shares or other participation rights are received and that all cash of the fund has

121. Article 21(3)(c) and (6)(b) of the AIFM Directive. The European Commission has adopted a delegated act containing implementing measures under the AIFM Directive which elaborates on the criteria to be applied in assessing third country prudential and supervisory regimes. *See* Article 84 of the Commission Delegated Regulation on AIFMs.
122. Articles 25(1) of the UCITS Directive and 21(4)(a) of the AIFM Directive.
123. Articles 22(5)(a)(i) of the UCITS Directive and 21(8)(a)(i) of the AIFM Directive.
124. Articles 22(5)(a)(ii) of the UCITS Directive and 21(8)(a)(ii) and 11(d)(iii) of the AIFM Directive and article 99 of the Commission Delegated Regulation on AIFMs.
125. Articles 22(5)(b)(i) and (ii) of the UCITS Directive and 21(8)(b)(i) and (iii) of the AIFM Directive.
126. Articles 22(5)(b)(i) of the UCITS Directive and 21(8)(b)(ii) of the AIFM Directive. The Commission Delegated Regulation on AIFMs sets out the conditions that should be met by AIFs in order to enable the depositary to satisfy itself as to ownership and to ensure such assets cannot be transferred without the depositary or its delegate being informed). There is no such guidance in UCITS Directive but depositaries of UCITS are likely to implement procedures that are similar to those set out in the AIFM regulation.
127. In the Netherlands, the depositary of a Dutch fund was even legally required to owe the assets of the fund, but this provision was amended with the implementation of the AIFM Directive in 2013 (for both Dutch ICBE's and AIF's). *See* notes 352 & 353, *infra*.
128. *See* also section 2.7.2.

been booked in one or more cash accounts. In case the cash account is opened in the name of the depositary acting on behalf of the fund, the depositary's own account may not also be booked on that account.[129] The oversight tasks of the depositary are described in the UCITS and AIFM Directive as ensuring that the applicable law and the UCITS/AIF constitutional document are respected in the following operations: transactions on fund participation rights (i.e., sale, issue, repurchase, redemption or cancellations), the calculation of the value of the fund shares or other types of participation rights, and the calculation of the fund's income.[130] In addition, the depositary must ensure that the transactions performed by the fund manager involving the assets of the fund are remitted to the fund within the usual time limits and that the instructions it receives from the fund manager do not conflict with applicable law and the fund's rules or instruments of incorporation.[131]

The depositary may not delegate any monitoring duties to a third party, but may delegate its custodian duties to a separate entity, not being the fund manager, provided that certain conditions relating to, among other things, prudential requirements, the segregation of fund assets and the disclosure of the delegation to investors, are met.[132] The depositary is liable for losses at sub-custodian level.[133] So the fund manager cannot be custodian and manager at the same time. Adversely, the duty of portfolio or risk management may also not be delegated to the depositary or any other third party whose interests may conflict with those of the manager or the investors.[134] In this context, it can be noted that US AIFs that are being marketed in the EU should, in case of the marketing without a passport, appoint one or more entities (e.g., the custodian) to carry out the monitoring tasks of the depositary or, in case of the marketing with a passport, comply with the rules or provide for at least equivalent rules (e.g., requiring the custodian the perform similar duties).[135]

So do these two core EU functions of the depositary, i.e., safekeeping (custody- and recordkeeping) and monitoring duties, contribute to the protection of investors in

129. Articles 22(4) of the UCITS Directive and 21(7) of the AIFM Directive.
130. Articles 22(3) of the UCITS Directive and 21(9) of the AIFM Directive.
131. *Ibid*.
132. Article 22(7) of the UCITS Directive and 21(11) of the AIFM Directive. The rules for UCITS and AIFs are mostly the same, although a major difference is that with respect to UCITS, in the case of the insolvency of a safekeeping delegate, securities held by them will not be available for distribution to their creditors. *Ibid*. In addition: (1) the tasks are not delegated with the intention to avoid the requirements of the AIFM or UCITS Directive, (2) there must be an objective reason for the delegation, and (3) the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it intends to delegate parts of its tasks and continues to do so in the periodic review and monitoring of the third party. *See* Articles 22a(2) of the UCITS Directive and 21(11)(a)-(c) of the AIFM Directive.
133. Articles 24(1) and (2) of the UCITS Directive and 21(12) and (13) of the AIFM Directive.
134. Articles 13(1)(e) of the UCITS Directive and 20(2)(a) of the AIFM Directive. In case of an AIF, entities other than the depositary or a delegate of the depositary that perform potentially conflicting tasks, such as the fund administrator or underwriter, may be delegated with the portfolio or risk management of the fund in case such an entity has functionally and hierarchically separated the performance of its portfolio or risk management tasks from its other potentially conflicting tasks, and the conflicting tasks are properly identified, managed, monitored and disclosed to investors. *See* Article 20(2)(b) of the AIFM Directive.
135. Articles 36(1)(a) and 37(2) of the AIFM Directive.

relation to the management (or mismanagement) activities of the fund manager? The safekeeping function of the EU depositary has a clear function in the protection of investors: it aims to protect against the risk of bankruptcy or insolvency of the fund or any other fund managed by the same fund manager. However, as stated in section 1.1, it does not protect investors against fraud, misdealing or other operational activities of the fund manager.[136] Since this research focuses on these aspects of investor protection (i.e., mitigating micro-prudential risks), and not on the protection against bankruptcy risk, the rules applying to EU depositaries related to the safekeeping of assets will not be discussed in more detail in the next two chapters.

With respect to the EU depositary's monitoring role, it can be noted that many of the aforementioned requirements related to cash monitoring are relatively new; they were adopted in 2011 in the AIFM Directive and in 2014 in the UCITS Directive. The oversight duties imposed on depositaries of UCITS remain substantially the same as those imposed before the UCITS amendments of 2014, whereas the AIF depositary duties are newly introduced by the adoption of the AIFM Directive. Reason for the rules was the different ways in which national regulators interpreted former UCITS provisions governing depositaries, which became particularly apparent during the financial crises and, according to the European Commission, in the Madoff affair.[137] While the funds managed by Madoff were AIFs, not UCITS, and the AIFM Directive was not yet effective at that time, EU Member States had adopted similar regulations regarding the independence of depositaries of non-UCITS funds as currently set out in the AIFM directive. For example, in the Netherlands, the depositary of both UCITS and non-UCITS should have been personally and financially independent of the fund's manager, which was interpreted by the Authority for the Financial Markets (AFM) as excluding the possibility of directors serving on the board of both the depositary and the manager and of both entities to participate in each other.[138] In the UK, the regulations applying to corporate funds even went further by requiring the depositary of an open-end

136. *See* also European Asset Management Association, *The Role of Custody in European Asset Management, A Report by Oxford Economic Research Associates* 6 & 59 (November 2002) ('Custody provides no effective protection against misdealing, fraud or other operational failures, such as failures (…) to obtain best execution', 'the main protection provided by custody relates to the risk of theft of securities', and that custody 'tends to protect against settlement errors and failures to collect all client entitlements').
137. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 3 Jul. 2012, COM(2012) 350, 5 ('What the UCITS directive does not specify is that the separation between portfolio management and custody should also prevail in case the depositary function is delegated to a third party who, in turn, cannot be portfolio manager and custodian at the same time. This latter conflict of interest was presented in the Madoff scenario').
138. Articles 4:42 and 4:56 of the Dutch Financial Supervision Act, Kamerstukken II (1988/1989), 21 127, 3, Bepalingen inzake het toezicht op beleggingsinstellingen (Wet toezicht beleggingsinstellingen), Memorie van Toelichting, 17 and J.W.P.M. van der Velden, *Beleggingsfondsen naar burgerlijk recht* 199 (Onderneming en Recht Series, vol. 47, Kluwer 2008). It is however not prohibited that the depositary and manager are subsidiaries of the same parent company as long as the functions of both parties are effectively separated from each other. *Ibid*.

corporate fund, regulated as an ICVC, to be independent all the directors of the fund, including the ACD (although usually the sole director).[139]

The EU depositary rules for UCITS and AIF depositaries however introduce a new depositary duty relating to cash flows and imposes an EU requirement on AIFMs to appoint a depositary with they manage that has both oversight tasks and cash monitoring duties. As mentioned in UCITS V, 'detailed provisions should be adopted on cash flow monitoring so as to ensure effective and consistent levels of investor protection'.[140] With respect to the general oversight duties of the depositary, it was stated by the Commission that different approaches among Member States with regard to these rules has, '[a]s evidenced by the Madoff case, (…) led to different levels of investor protection depending on where the UCITS fund is domiciled'.[141] In addition, the Commission noted that since '[t]he Directive requires that the depositary be domiciled in the same country as the management company (and by extension of the fund)', 'there is a need for close proximity between the depositary and fund to allow the depositary to perform effective real-time monitoring in respect of the activities of the fund' and that '[g]iven the increased complexity and heterogeneity of funds, the role of the depositary becomes even more important control on the way in which the fund manager conducts its business'.[142] These clear references to investor protection in relation to the activities of fund manager have made the monitoring and cash flow rules applying to EU depositaries relevant to this research. As a result, they will be discussed in more detail in Chapter 3 regarding EU law.

[B] US Custodian

The US custodian only fulfils a custody function in relation to the fund's assets. Under US law, the custodian must be 'qualified', which is defined in rule 206(4)(2) of the Advisers Act as to include a bank, a registered broker-dealer and a registered futures commission merchant to the extent that they are 'holding the client assets in customer accounts' or a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory client' assets in customer accounts segregated from its proprietary assets.[143] In this context 'custody' means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them, including arrangements in which a related

139. Article 6.9.2(1) of the COLL. A UK ICVC, also known as an Open-Ended Investment Company (OEIC)), is an open-end investment fund formed as a corporation under the Open-Ended Investment Companies Regulations 2001, as amended. UK ICVC's are however not companies in the meaning of the UK Companies Act, but make up a whole new form of corporate vehicle subject to specific FSA regulations. *See* Viitala, *Taxation of Investment Funds in the European Union*, 35. The Open-Ended Investment Companies Regulations 2001 can be found at http://www.legislation.gov.uk/.
140. Recital 15 to the UCITS V Directive.
141. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V, 5–6.
142. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 54.
143. Rule 206(4)-2(d)(6) of the Advisers Act.

person holds client funds or securities, or has authority to obtain possession of them.[144] Under the 1940 Act, US registered investment funds are required to maintain strict custody of their assets, separate from the assets of the fund manager.[145] Although the 1940 Act permits other arrangements, most registered funds use a bank for the custody of domestic securities.[146] Foreign securities are required to be held in the custody of a foreign bank or securities depository.[147]

Other than EU depositaries, US law does not require the custodian to be independent.[148] However, in response of, again, the Madoff fraud case, the SEC amended the rule 206(4)(2) of the Advisers Act in 2009 requiring a US registered fund manager to, among other things: (1) undergo an annual surprise examination to verify client assets, (2) have the qualified custodian send account statements directly to its clients, or investors in case of investment funds, and (3) unless client assets are maintained by a custodian that is not a related person of the manager, to obtain a report of the internal controls relating to the custody of those assets from an independent public accountant.[149] Fund managers of US registered funds are exempt from application of this rule and US unregistered funds that are subject to an annual financial statement audit by an independent public accountant/auditor, and that distribute the audited account statements to each investor, are exempt from the provisions regarding the sending of account statements to investors and the notification of custodian information and are deemed to have satisfied the annual surprise examination requirement.[150] It follows from the above rule that a fund manager of a US fund can also be the custodian of the fund, although it may have to comply with additional requirements, whereas a fund manager of an EU fund cannot perform custodian services, irrespective of whether the fund is a UCITS or AIF.

For the purpose of this research, the (US) custodian has little relevance as it is only held to facilitate asset protection through appropriate segregation of assets. This has the effect of ring-fencing the fund's assets from the manager's own accounts and from other fund's assets managed by the manager. It however does not protect investors against losses caused by mismanagement, complex fee structures and inadequate disclosure. Since this research focuses on these aspects of investor protection, the duties of the US custodian will not be further assessed in this book.

144. Rule 206(4)-2(d)(2) of the Advisers Act.
145. Article 17(f)(1) of the 1940 Act.
146. The 1940 Act contains six separate custody rules for the possible types of custody arrangements for US funds. *See ibid* and rule 17f-1-7 of the 1940 Act.
147. Rule 17f-5 and 7 of the 1940 Act.
148. Article 17(f)(1) of the 1940 Act and rule 206(4)-2(d)(6) of the Advisers Act. Furthermore, an investment adviser under the Advisers Act can 'have custody' in certain circumstances under the very broad definition in the Advisers Act (and be subject to additional regulation for the protection of investors). This 'self-custody' is however is not permissible for US fund managers or funds that intend to use the EU-passport under the AIFM Directive. *See* ESMA, Advice – ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, 19.
149. Rule 206(4)-2(a)(2), (3) and (4) of the Advisers Act. *See* SEC, Final Rule – Custody of Funds or Securities of Clients by Release No. IA-2968, 30 Dec. 2009.
150. Rule 206(4)-2(b)(4) and (5) of the Advisers Act.

2.3.4 Auditor

Next to the depositary, custodian and other third party services providers performing a wide range of duties, such as administration duties, it should be noted that most funds are often required by (EU or US) law to have an independent auditor.[151] An independent auditor has the duty to review the fund's financial statements included in the annual report of the fund. A financial report audited by an auditor must contain the auditor's opinion as to whether the financial statements present fairly, in all material respects, the fund's financial position and operating results, in accordance with the applicable accounting standards.

In the US, the General Accepted Accounting Principles (GAAP) apply to registered funds.[152] In the EU, either the International Financial Reporting Standards (IFRS) (in case of listed funds) or national accounting principles (often based on either GAAP or IFRS) apply.[153] The auditor is mostly concerned with examining the process with which the fund keeps its records and the controls in place to ensure that those processes are performed correctly. In addition, the auditor reviews the fund's compliance with several regulatory requirements and verifies matters related to its financial integrity, including the valuation of the fund's assets and the Net Asset Value (NAV) of the fund (i.e., the price per share/participation right calculated by dividing the fund's total assets minus its total liabilities by the number of total shares or participation rights outstanding),[154] the correct recording of portfolio sale transactions and the calculation and classification of capital gains, the management fees and other fees charged to investors in the annual report of the fund, and the compliance of the fund with tax laws.[155]

The external auditor of an EU fund may also be entrusted with certain oversight responsibilities. Other than in the US, the auditor of an EU fund generally has more duties than just the duty to audit the fund's financial statements. For example, the EU fund auditor may be engaged to perform specific agreed-upon-procedures in order to assess the compliance of the board of directors of the fund with certain laws and regulations, in particular relating to the correct valuation and pricing of fund participation rights and the validation of the fund's income and costs, including management fees, and the dividends paid to investors after taxes in a particular year.[156] According to

151. Articles 73 of the UCITS Directive, 22(3) of the AIFM Directive and 30(g) of the 1940 Act.
152. L.L. Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals* 146 (John Wiley & Sons 2005).
153. Articles 19(3) of the UCITS Directive and 22(3) of the AIFM Directive. Since 2005, all companies in the EU that are publicly traded are required to present their consolidated financial statements under IFRS. *See* for the IFRS standards: http://www.ifrs.org/.
154. Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals*, 146–147.
155. *Ibid*. Some auditors also perform additional services, such as taxation advice, general consulting, or compliance services. However, the ability of an independent auditor to provide non-audit services is limited by certain (EU Member State) laws and regulations.
156. An engagement to perform agreed-upon procedures may involve the auditor in performing certain procedures concerning individual items of financial data (e.g., accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity), a financial statement (e.g., a balance sheet) or even a complete set of financial

IOSCO's Technical Committee, however, the depositary is best fit to perform these and other duties, but 'the CIS [Collective Investment Scheme] Auditor can be a key element for complementing or double checking the controls that are carried out by the Depositary'.[157] While US fund auditor's duties are generally more limited, most (regulated) US funds have put an audit committee into place with similar oversight duties.

The external auditor plays an important role in a fund's compliance with its accounting disclosure obligations. The auditor tests whether the financial statements in the fund's annual report comply with the applicable accounting rules. It does provide ex-post protection against the reporting of incorrect information by the fund manager. However, it does not monitor the activities of the fund manager nor does it protect investors against conflict of interest issues, high costs, and other forms of investor expropriation. Therefore, in this book, the role of the auditor will not be further discussed.

2.4 FUND SHARES OR PARTICIPATION RIGHTS

An important (and defining) feature of funds by which they, among other things, distinguish themselves from other collective investment vehicles is the fact that they issue securities or other financial instruments to investors. Financial instruments and securities are defined in multiple laws and typically include the commonly known documents traded for speculations or investment, such as company shares, options, bonds, futures, convertibles, and certificates or units of interest.[158] In general, the participation rights issued by funds are referred to as shares or units, although the

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statements. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The report is restricted to those parties that have agreed to the procedures to be performed. *See* International Federation of Accountants (IFAC), *International Standard on Related Services (ISRS) 4400*, *Engagements to Perform Agreed-Upon Procedures regarding Financial Information* 2 (November 2010). The standard can be found at IFAC's website: http://www.ifac.org/. In addition, EU law also has some provisions in place providing auditors with some extra oversight duties. *See* Articles 42 (in case of UCITS mergers) of the UCITS Directive and 18(9) of the AIFM Directive (requiring the AIFM to have its valuation procedures performed or verified by an auditor in case this is not performed by an external valuer).

157. Technical Committee of the IOSCO, *Report on the Examination of Governance for Collective Investment Schemes: Part II* 3 (February 2007). The report can be found at IOSCO's website: http://www.iosco.org/.

158. *See*, e.g., section C of Annex 1 to the MiFID 2 (providing a list of instruments which are considered to be 'financial instruments', including transferable securities as defined in Article 4(1)(17) of the MiFID 2, money market instruments, units in collective investment schemes, options, futures, swaps, forwards, and other derivative instruments) and Article 2(a)(1) of the 1933 Act (defining 'securities' as including, among other things, 'any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate' and various derivative instruments or 'or, in general, any interest or instrument commonly known as a security' (quotation marks omitted)).

terms certificates of interest or participation may also be used.[159] For the purpose of this research, from now on, the term 'shares' will be predominantly used, referring to shares, units and other types participation rights issued by funds to investors.

With respect to fund shares, it is worth noting that some instruments may appear to be financial instruments or securities at first, but in fact, are not. For example, a US entity that issues participation instruments in equity, bonds or property that are referred to as 'investment contracts' may not be issuing securities. Under US law, an investment contract is only then a security if the investors: (1) expect profits from (2) a common enterprise that (3) depends upon the efforts of others.[160] Consequently, an entity that merely sells such instruments and does not perform any further efforts that will affect the outcome of the investment, i.e., the entity does not perform any managerial or entrepreneurial functions or have a third party perform such activities, will not be considered to issue securities under US law and is thus not an investment fund. Under EU law, similar so-called asset backed securities, even if relating to underlying equity, are qualified as non-equity securities. Although such instruments thus qualify as securities, they are treated differently from equity securities since less detailed information requirements apply to them on the basis of the Prospectus Directive that those applying to equity securities.[161]

An example of a case in the US in which the issuing of investment contract was not considered to be the issuing of securities includes the case with the issuance of interests in life insurance policies from terminally ill AIDS patients ('viatical settlements'). In this case, entrepreneurs did not perform any other activities than selling the policies and transferring the policies to a trustee who serviced the policies (i.e., paid the premiums and collected and paid the proceeds), as a result which viatical settlements were not securities.[162] By contrast, a number of other instruments that might not

159. Legally, in case an investment fund has taken a corporate form which operates on the basis of company law in the country where is has been created, it issues shares as are those issued by other companies. The holdings in investment funds that are structured as partnerships or other contractual forms are generally defined as 'units' in EU jurisdictions. *See* Moloney, *EC Securities Regulation*, 232. In the US, registered investment funds are required to issue 'redeemable securities', which can include shares (in case of a corporate fund), trust units (in case of a trust fund), or partnership interests (in case of a LP fund).

160. *SEC v. Howey Co.*, 328 U.S. 293, at. 298–299 (US Supr. 1946). In the Howey case, the instruments issued were considered 'investment contracts' as '[t]he respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents' *Ibid.*, at 299.

161. *See*, e.g., Articles 2(1)(c), (m), 7(2)(b), 10(3) and 19(4) of the Prospectus Directive and Commission Regulation (EC) of 29 Apr. 2004 No. 809/2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, OJ L 149, 1.

162. *SEC v. Life Partners, Inc.*, 87 F.3d 536, at 548 (D.C. Cir. 1996). The court held that 'pre-purchase services cannot by themselves suffice to make the profits of an investment arise predominately from the efforts of others' and 'ministerial functions should receive a good deal less weight than entrepreneurial activities.' The court further emphasizes that '[t]he SEC (…) has identified no post-purchase service provided by LPI [Life Partners, Inc.] (…) that could fairly be characterized as entrepreneurial'. *Ibid.*

appear to be securities at first sight, such as fractionalized interest in pools of mortgages or car loans, interests in earthworm farms and chinchilla ranches, and various forms of pyramid schemes, have been classified as such under the above-mentioned investment contract test.[163]

In the EU, funds are generally required to issue either 'shares or units', which means any security issued by the fund that represents the rights of the investors in the fund's assets.[164] As such, they can be both equity and debt in nature (or a combination of both) as both instruments represent the investor's rights in the fund's assets, namely a certain portion, whether based on a fixed (in case of debt securities) or proportional (in case of equity securities) interest rate, of the fund's assets. This is similar in the US, as the definition of 'securities' also includes a broad range of instruments, including regular shares or units, convertibles, options (both of the equity and debt type) and other equity or debt-like instruments.[165] Most funds will, however, issue 'traditional' instruments of the equity type, such as ownership shares/units.[166]

Fund shares of the equity type represent the pro rata (proportional) interest of an investor in the total assets of the fund.[167] For example, in case someone invests EUR 10,000 in a particular investment fund which has EUR 500,000 assets in total under management, the value of the shares or units he holds represent a one-fiftieth part of the total assets of the fund. This means that if the fund makes a return of 10% on its assets in a particular year and that return is fully paid out to investors, he will receive a gross return of EUR 1,000 (one-fiftieth of EUR 50,000).[168] However, in case someone enters into a pension or insurance scheme, he only has a right to receive payments either upon retirement or upon a specific event occurring.[169] Such a person is not

163. M.R. Albert, *The Howey Test Turns 64: Are the Courts Grading this Test on a Curve?*, 2 Wm & Mary Bus. L. Rev. 7 and note 24 (2011) (citing a number of US cases in which these interests have been characterized as 'investment contracts,' and thus securities). Of course, the three elements from the Howey case must be met before an instrument can be classified as investment contract.
164. Article 2(1)(o)(ii) of the Prospectus Directive ('units of a collective investment undertaking mean securities issued by a collective investment undertaking as representing the rights of the participants in such an undertaking over its assets' (quotation marks omitted).
165. *See* n. 163*, supra*.
166. However, an increasing number of funds issue debt securities, such as bonds, to finance long-term investments, particularly (exotic) real-estate, shipping and teak wood plantation projects.
167. Unless any special agreement as regard to the share in the fund's net proceeds of a specific type of investor states otherwise. An entity that issues ownership interests that represent a direct ownership in property or underlying assets is not a fund, but an entity that offers ownership rights.
168. The fund may also decide to reinvest the profits earned on its assets in a particular year. Furthermore, investors may also not wish to receive payments from the fund for tax reasons. Instead, they might be more interested in selling their fund shares at a higher price than the original purchase price. At that moment, they will have to pay taxes on their profit earned, but, other than yearly contributions from the fund, these taxes are better foreseeable and therefore manageable. Positive developments in the exchange rate of the fund shares are often tax-free.
169. However, in the last years forms of pension (known as 'money purchase' or 'defined contribution') and life insurance products (or 'unit-linked products') have developed funds that work similar to investment funds: the investor buys shares/units in the fund and the amount of money that the investor can take out upon retirement or at the end of a period of saving equals the current value of the units owned. *See* St Giles, Alexeeva & Buxton, *Managing*

entitled to any share in the profits made by the pension and insurance company respectively. In other words, investors in an investment fund are entitled to a share in the investment return of the fund represented by their interest in the fund, whereas beneficiaries of a pension fund or insurance company are entitled to a certain retirement pension or amount of insurance that is covered by the insurance policy.[170]

In addition to a portion of the fund's investment return, investors in funds are usually provided by law with investor rights similar to those of stock owners in companies. These rights may include the right to vote for the election or removal of directors, to place items on the agenda of the investor meeting, and to ask questions and express their views at the meeting. In addition, large fund investors may use their influence by participating in the fund's supervisory board or board committee. Next to the use of their investor rights and/or the exercise of influence within the fund structure, investors, of course, always have the possibility to 'vote with their feet' (sell or redeem their shares) in order to express their dissatisfaction with the fund's management. In any case, the way in which investor rights in investor meetings are protected by EU and US law might be of relevance for an investor's decision to buy, sell, or hold the fund share and will therefore be assessed in Chapters 3 and 4.

2.5 FEE STRUCTURE

Without restrictions, funds can use whatever fee structure to compensate their managers. As pointed out in section 2.2.1, compensation of the fund manager creates an inherent conflict of interest between the fund manager and the fund investors. It can lead to excessive payments and may create an incentive conflict that may contribute to mismanagement or misappropriation of the fund manager. Therefore, when determining which features of investment funds have the most impact on the protection of retail investors, the fee structure of funds is worth discussing in more detail.

In general, there are two basic kinds of fees charged by investment funds: (1) fees that are paid only by the investors entering or leaving the fund (but do not affect the return of the fund) and (2) fees that are levied on the fund level (and do affect the return of the fund).[171] Fees that fall within the first category (those that are paid only by investors entering or leaving the fund) typically contain initial sales costs and dilution costs. Fees that can be placed in the second category (those that are paid on the fund

Collective Investment Funds, xviii. Because these contribution pensions and unit-linked funds in essence work the same as investment funds, they are considered to be investment funds for the purpose of this study (as distinguished from 'traditional' pension funds and insurance companies).

170. The amount of a retirement pension generally depends on the person's discontinuation of his professional activity and his previously earned income. In general, only the earnings having induced the payment of contributions will be taken into account. *See* D. Pieters, *Social Security: An Introduction to the Basic Principles* 57 (2d ed., Kluwer L. Intl. 2006).

171. St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 145.

level and then charged to each investors' capital account) include, among others, fees paid to the fund manager.[172]

2.5.1 Initial Sales Costs

Initial sales costs include charges investors pay when entering a fund (also called 'entry fee' or 'front-end load') and charges paid when they redeem their shares (i.e., sell their shares back) to the fund (also called 'back-end load', 'deferred load' or 'exit fee').[173] An initial front-end or back-end load typically ranges from zero up to 8.5% of the investment.[174] These charges are most frequently used by funds to compensate outside brokers who distribute fund shares, although there are also funds that make no use of outside brokers and still charge a front-end or a back-end load, or both.[175] Therefore, these charges are also referred to as distribution fees. Sometimes these distribution fees are paid indirectly to brokers under so-called soft dollar arrangements. Under these arrangements, fund managers use a part of the brokerage commission to obtain research or other services, in exchange for the manager directing brokerage transactions.[176] Funds that charge no fee to buy or redeem shares in the fund are called 'no-load funds', as opposed to 'load funds'. Such funds are particularly popular among retail investors because of their absence of initial costs.[177]

172. In addition to management and incentive fees, other costs that reduce the return of the fund include transaction costs in fund's assets, custodian/depositary costs, fees paid to directors, legal costs, audit costs, taxes, regulatory costs and any other cost paid at the fund level. *See* for an overview of all fund fees and costs, St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 146.
173. The main difference between a front-end load and a back-end load is that a front-end load is deducted from the amount that is invested in the funds. So, if someone for example invest EUR 10,000 in a certain fund that charges 5% front-end load, only EUR 9,500 is left to invest in the fund. If the fund however charges a 5% back-end sales load, and there are no other 'purchase fees', the entire EUR 10,000 will be used to purchase fund shares, and the 5% sales load is not deducted (postponed or deferred) until the investor redeems his or her shares, at which point the fee is deducted from the redemption proceeds (generally based on the lesser of the value of the shareholder's initial investment or the value of the shareholder's investment at redemption). The most common back-end load is the 'contingent deferred sales charge', which is a back-end load that gradually declines on withdrawal based on how long the shares are held. *See* E. Faerber, *All about Bonds and Bond Mutual Funds: The Easy Way to Get Started* 274 (2d ed., McGraw-Hill Companies 1999) and A.J. Fredman & R. Wiles, *How Mutual Funds Work* 25–26 (New York Institute of Finance 1993).
174. St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 148. The 8.5% limit stems from the National Association of Securities Dealers (NASD), which were given rulemaking authority regarding the 1940 Act by the US Congress in 1970. The NASD adopted a rule placing a ceiling of 8.5% on the front-end sales load that a US registered fund distributed by NASD members could charge. Today, few funds impose sales loads that approach the maximum limit. *See* Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers,* 27.03. For EU funds, there is no ceiling on costs imposed by EU regulators. These funds are required to clearly disclose the fees that are directly or indirectly borne by investors. *See* Article 90 of the UCITS Directive and Article 20(1)(i) of the AIFM Directive.
175. SEC website: http://www.sec.gov/, under Fast answers, Mutual Fund Fees and Expenses.
176. Robertson, *Fund Governance: Legal Duties of Investment Company Directors,* 10.03[1].
177. D. Bergstresser, J.M.R. Chalmers & P. Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 Rev. Fin. Stud. 4132 (2009).

However, no-load funds may compensate for the marketing and distribution costs they make by charging annual sales charges or higher management fees or, in the case of US registered funds, by imposing a special annual distribution fee known as the '12b-1' fee.[178] Such funds are also called level load funds as the charge is assessed at the same percentage each year. A 12b-1 fee may not exceed 1% of the fund's net assets in a particular year, of which a maximum of 0.25% may be used to pay commissions to brokers or any other person that sell fund shares and 0.75% may be asset-based.[179] Most no-load funds will incur some form of sales charge, especially when they aim at retail investors since those investors are more sensitive to marketing activities than sophisticated investors.[180]

2.5.2 Dilution Costs

Dilution costs can be described as the costs charged on the purchase of disposal of shares to compensate the remaining investors in the fund for the costs that arise as a result of large inflows/outflows resulting from investors subscribing or redeeming shares.[181] An anti-dilution fee can, for example, be charged if the volume of share purchases outweighs the volume of sales in a particular trading period. In that case, the fund manager will have to go to the open market to buy more of the assets underlying the fund, incurring a brokerage fee (and taxes) in the process which has an adverse effect on the fund as a whole ('diluting' the fund). The same is the case with large redeem orders, but in that case the fund manager will have to sell assets. When to apply, or not to apply, such a fee is generally at the discretion of the fund management. However, some funds may be subject to certain rules that specify the conditions under which an anti-dilution fee may be charged and the maximum rate of the fee.[182] Typically, the prospectus of the fund will set out the terms and conditions under which an anti-dilution fee is charged. Both the initial charges and dilution costs are based on a percentage of the fund's NAV.

178. US funds that charge a 12b-1 fee operate under rule 12b-1 of the 1940 Act, which allows US registered funds to compensate portfolio managers or other third-party service providers for providing marketing and distribution services to the fund.
179. *Ibid* and NASD Conduct Rule 2830(d)(3)(C)(5), available at http://finra.complinet.com/. The maximum asset-based fee for any year may not exceed 0.75% of the fund's annual net assets. *See* NASD Conduct Rule 2830(d)(2)(E)(i).
180. It is generally assumed that the less sophisticated investors are, the more affected they are by advertising and advice. In other words, sophisticated require less marketing costs, thereby effecting lower sales costs. *See*, e.g., V. Nanda, M.P. Narayanan & V.A. Warther, *Liquidity, Investment Ability, and Mutual Fund Structure*, 57 J. Fin. Econ. 437 (2000) and M. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. Fin. 807 (1996) (defining unsophisticated investors as 'a group that directs its money to funds based at least in part on other influences such as advertising and advice from brokers').
181. Turner, *International Funds: A Practical Guide to Their Establishments and Operations*, 127.
182. For example, US mutual funds are subject to regulations that requires the board of directors of a mutual fund to consider to adopt a redemption fee, which fee may not exceed two percent and must be retained by the fund, or affirmatively decide that one is unnecessary. In addition, the funds must enter into written agreements with 'financial intermediaries', obligating those intermediaries to provide information needed to identify short-term traders and to follow the fund's instructions to restrict their trades. *See* Rule 22c-2 of the 1940 Act.

While the price of one fund share is technically the same as the fund's NAV (see also section 2.6.2), the offering price may be higher as it is thus adjusted to the initial entry costs that an investor must pay. The offering price is calculated as the NAV divided by one minus the entry costs rounded to the nearest penny.[183] For example, in case a fund has a 5% front-end load and the fund's NAV is EUR 10 on a particular day, the fund's offering price of that day[184] is EUR 10.50 (EUR 10/1-0.05). It can however be noted that many funds provide for a discount on the front-end charges in case of large purchases.[185]

2.5.3 Fees Paid to the Fund Manager

The fund manager is typically paid by a management fee and an incentive fee. A management fee is a fee paid to the fund manager that is typically based on a fixed percentage of the average annual asset size of the fund. Management fees are normally calculated and paid quarterly or monthly and are used to cover certain operating expenses, salaries for the portfolio managers and staff, and other general costs of running an investment fund. In general, management fees range between 0.25% and 2% of the fund's assets under management.[186] An incentive fee is a fee paid to the fund management that is usually based on the amount of increase, if any, in the net return of the fund. They can be divided into performance-based fees and carried interest. Performance-based fees are fees calculated as a percentage of the profits earned by the fund during a particular period. Carried interest is the right to receive a share of the profits of the fund (allocation of profits) that is paid to the manager in excess of a certain level. It can include an allocation of capital gain realized when the fund sells certain investments or an allocation of fund shares without an obligation to contribute to the capital of the fund. Generally, it is calculated quarterly and paid to the fund manager annually.[187]

Especially private equity and hedge funds are widely known for using incentive fees. These funds typically charge investors an incentive fee ranging from 20% to 50% of the fund's return for a given period.[188] In addition, private equity and hedge funds usually employ a high water mark, sometimes by itself, and sometimes in combination

183. L.L. Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals* 173 (John Wiley & Sons 2005).
184. The NAV is calculated once a day after the stock market closes.
185. St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 149 ('This [discount] may take the form of a tapering charge, where only small investments attract the full charge and larger investments are subject to a reducing level of charge, which will sometimes reach zero for very large investments').
186. J.R. Kapoor, L.R. Dlabay & R.J. Hughes, Personal finance 529 (7th ed., Mcgraw-Hill 2003).
187. D.A. Strachman, *The Fundamentals of Hedge Fund Management: How to Successfully Launch and Operate a Hedge Fund* 40 (John Wiley & Sons 2007).
188. *See*, e.g., B. Litterman, *Modern Investment Manager; An Equilibrium Approach* 503 (John Wiley & Sons 2003), D.L. Hammer et al., *U.S. Regulation of Hedge Funds* 328 (American Bar Association 2005) and P. Athanassiou, *Hedge Fund Regulation in the European Union: Current Trends and Future Prospects* vol. 9, 22 (International Banking and Finance Series, Kluwer L. Intl. 2009).

with a hurdle rate. A high-water mark refers to the provision in the fund agreement which requires that the fund manager may only charge an incentive fee above the previous highest value of each account and only until previous losses are fully recouped.[189] A hurdle rate is a provision in the fund agreement that sets out the required rate of return, benchmark or index that the fund must exceed before the incentive fee is calculated.[190]

2.5.4 Fee Restrictions

Because of the potential conflict of interest related to fees paid to the fund manager, both EU and US regulators have placed some restrictions on the use of fees by fund manager. For example, UCITS rules on the establishment of remuneration require, among other things, that: (1) the fixed and variable components of the total remuneration, including both asset-based and performance-based fees[191] be 'appropriately balanced', (2) at least 50% of the variable remuneration consist of managed fund shares, and (3) at least 40% of the variable remuneration is deferred for at least three years (or 60% for 'particularly high' bonuses).[192]

Furthermore, the variable remuneration should correspond to the fund's performance so as to reflect reduced bonus levels when the fund has 'subdued or negative financial performance', considering current compensation and reductions in pay-outs of amounts previously earned, including through malus or claw-back arrangements.[193] In addition, guaranteed variable remuneration can only be granted in exceptional

189. For example, if an investor contributes EUR 400,000 in year 1, which decreases to EUR 300,000 in the first quarter and increases to EUR 450,000 in the second quarter, the fund can only assess an incentive fee in the second quarter on the EUR 50,000 of overall-profit above the high-water mark. The value of the account at the end of year 1 will be the new high-water mark for year 2. *See also* C. Brooks, A.D. Clare & N.E. Motson, *The Gross Truth about Hedge Fund Performance and Risk: The Impact of Incentive Fees*, 24 J. Fin. Transformation 34 (2008) and Hammer et al., *U.S. Regulation of Hedge Funds*, 329–331.
190. For example, in case a fund with a 10% incentive fee and a 5% hurdle has a 10% rate of return in a particular year, the first 5% return would go to the investors and of the next 5% return, 4.5% (10% incentive fee of 5% return) would go to the investors and 0.5% to the fund. *See* J.G. Nicholas, *Hedge Fund of Funds Investing: An Investor's Guide* 56 (Bloomberg Press 2004). If a fund applies both a high-water mark and a hurdle rate, the incentive fee would be based on the amount of return above the high-water mark exceeding the hurdle.
191. Fixed remuneration are defined by ESMA as payments or benefits without consideration of any performance criteria, whereas variable remuneration include additional payments or benefits depending on performance or, in certain cases, other contractual criteria. *See* ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, ESMA/2013/201, 11 Feb. 2013, 49.
192. Article 14(b)(1)(j), (m), and (n) of the UCITS Directive.
193. Article 14(b)(1)(0) of the UCITS Directive. Malus arrangements are arrangements that adjust an award of variable remuneration, such as a performance-linked bonus or share award, before it has vested. Claw-back arrangements are arrangements that include the recovery of variable remuneration which has already been paid. *See* ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 47.

circumstances, and should be limited to the first year of engagement.[194] The remuneration rules for AIFMs are to a large extent equivalent to the rules applying to UCITS.[195] In this context, it can be noted that remuneration should include any amount paid by the AIFM itself, including carried interest.[196] US law requires that incentive fees for US mutual funds must be centred around a certain index and exhibit a symmetrical design of extra payments for results above the index and of penalty payments for a performance below the index. In case a fund performs equal to the index, its managers will only receive a certain base fee, referred to as the 'fulcrum fee'.[197]

The above shows that fee structure of funds is an important issue that regulators face in protecting investors. However, besides regulating the use of certain fees, and thereby the remuneration of the fund manager, the high impact of fees on investor returns justifies that they receive adequate and readable information about the fee structure of a fund. In addition, funds should implement adequate control systems to ensure this disclosure and compliance to the applicable remuneration rules. These issues will therefore also be discussed in this book in the context of EU and US law (Chapters 3 and 4).

2.6 OPERATIONAL STRUCTURES AND INVESTMENT STRATEGIES

2.6.1 Introduction

For the purpose of this research, a fund's operational structure refers to the way that it has arranged its structures and policies related to the sale of its shares and its investment activities. With respect to the first issue, i.e., the sale of fund shares, funds can be distinguished between open- and closed-end funds. When referring to the investment activities of a fund, a number of organizational structures may be used in organizing the fund's portfolio investments and trading activities. These structures include the master-feeder structure, umbrella structure and Fund of Funds (FoF) structure. In addition, there are many different investment strategies used by funds. However, in this respect, two fund types can be generally characterized by the investment activities they perform: hedge funds and private equity funds. Although these funds are technically organized as either closed- or semi-open end and may use the umbrella, master-feeder or FoF structure or a combination of these structures,[198]

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194. Article 14(b)(1)(i) of the UCITS Directive.
195. Annex II, under 1(f), (j), (m), (n), and (o) to the AIFM Directive.
196. ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 49 (under 10). In its guidelines, EMSA however takes the position that excluded from the definition of variable remuneration should be payments that represent a pro-rata return on employees' co-investment in the AIF. *Ibid.*, 49–50 (under 12 & 13).
197. This form of incentive fee is therefore also referred to as a fulcrum fee arrangement. F.S. Thomas & J.C. Jaye, *Compensating Mutual Fund Advisers: A Return to the Basics of Properly Structured Performance Fees*, 7 J. Inv. Compl. 28–37 (2006) and Robertson, *Fund Governance: Legal Duties of Investment Company Directors,* 6.02[2][c]. *See* on the fulcrum fee for US fund managers also section 4.4.
198. *See* J.C. Stein, *Why Are Most Funds Open-End? Competition and the Limits of Arbitrage*, 120 Q. J. Econ. 252 (2005) ('Virtually all hedge funds allow investors to liquidate their positions at

they use some specific investment strategies or a combination of strategies, often considered to be more risky than other, more 'traditional' fund strategies. By describing the strategies used by private equity and hedge funds, it will also become clear which strategies are used by traditional funds. In the following subparagraphs, these different fund operational structures and investment strategies of hedge funds and private equity funds will be discussed.

2.6.2 Open- and Closed-End Structure

Funds that have adopted an open-end structure are funds that continuously, or at regular intervals, sell new shares and redeem shares from investors who want to sell them back to the fund, at the price dependent on the NAV of the fund.[199] Redemption on demand protects investors against liquidity risks as it allows them to redeem their shares in a crisis before illiquid instruments have to be sold. In addition, it provides investors with a means to express their dissatisfaction with the management of the fund or, at least, exit a fund in case of underperformance.

Closed-end funds are funds that, as a general rule, do not sell and redeem their shares to investors on a regular basis. Instead, they raise money for investment by selling a fixed number of their shares through an Initial Public Offering (IPO), after which the shares are traded on the secondary market like regularly stock.[200] Thus, if an investor wants to sell its shares or buy shares after the IPO, it must sell them to other investors as the fund itself does not sell or redeem them. The price of closed-end fund shares is subject to market demand, so shares can either trade below NAV ('at a discount') or above it ('at a premium'). Of course, the market will look at the fund's

some horizon; in this sense, they are all quasi-open-end'), S.N. Kaplan & P. Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. Econ. Persps. 123 (2009) ('Most private equity funds are "closed end" vehicles'), A. Achleitner & C. Kaserer, *Private Equity and Hedge Funds: A Primer*, CEFS Working Paper No. 2005-03, 4 (2005), available at SSRN ('[S]ome hedge-fund-of-funds also invest in private equity' and 'some institutions offer hedge funds and private equity funds under one umbrella') and D.P. Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm* 265 (Academic Press 2010) ('Both onshore and offshore [hedge] funds usually invest in a master feeder fund, which then co-invest in a master fund').

199. Thompson & Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, 4, note 1 ('An open-ended CIS is one in which in which net asset value (NAV) is calculated periodically and investors may buy or redeem shares at NAV, net of certain charges, at regular intervals').

200. *See*, e.g., E. Dimson & C. Minio-Kozerski, *Closed-End Funds: A Survey*, 8 Fin. Mkts Inst. & Instruments 1 (1999) ('Closed-end funds are so-called because their capitalization is fixed, or "closed", which implies that the supply of closed-end fund shares is inelastic. Thus, the price is a function of the supply and demand for the shares trading on the market'), D.N. Deli & R. Varma, *Closed-End versus Open-End: The Choice of Organizational Form*, 8 J. Corp. Fin. 4 (2002) ('Closed-end funds traded in the secondary market at prices potentially different from the NAV') and W.D. Allen, *Essays on Closed-End Funds: Internal versus External Management and Insider Trading*, 1 ('A closed-end fund (…) is a pooled investment corporation whose equity shares are listed on an exchange or traded OTC'). The term 'secondary market' refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the stock exchange. This includes the Over-The-Counter (OTC) market and the stock exchange market.

NAV when buying or selling the fund's shares and changes in the fund's NAV will affect investors' perception of its appeal and therefore their demand for the shares.[201]

US open-end registered funds are held to calculate and publish their NAV once a day at the close of the NYSE at 4 PM Eastern Standard Time.[202] The value of shares of closed-end funds are, as mentioned, determined by the valuation of the market, although it can be noted that registered closed-end funds that periodically redeem their shares in reliance of rule 23c-3 of the 1940 Act must calculate the NAVs of such shares no less frequently than weekly and daily on the five business days preceding a repurchase request deadline.[203] Furthermore, under the forward pricing rule required by rule 22c-1(a) of the 1940 Act, orders received before 4 PM should be priced at the NAV calculated on the day of the trade while trades received after 4 PM should be priced at the next-day NAV. This rule aims at preventing illegal market timing and late trading practices as discovered in 2003 in a number of mutual fund groups, including Canary Capital, Janus, Bank One's One Group, and Strong Capital.[204]

UCITS must value their shares at least twice a month, although Member States may permit a UCITS to reduce the frequency to once a month on condition that such derogation does not prejudice the interests of the investors.[205] Like US open-end funds, the pricing of UCITS shares is generally conducted on a forward-pricing basis rather than on an historic basis (i.e., at the next valuation point rather than at the last valuation point). Other than US law, however, EU law does not provide rules to prevent illegal market timing and late trading. Rather, this is left to the national Member States.

With respect to share valuation, it can furthermore be noted that MMFs seek to maintain a stable NAV at EUR 1 (in case of an EU MMF) or USD 1 (in case of a US MMF) per share when investors redeem or purchase shares. To avoid a fluctuating share value, a MMF has been traditionally allowed to use the amortized costs method to value its assets. Under this method, the fund values its portfolio securities at the funds' acquisition cost as adjusted for amortization of premium, or accretion of discount, rather than at their value based on current market factors. However, as a result of the financial crisis of 2007 which caused a number of MMF NAVs to drop below the EUR 1 or USD 1, US and EU regulators proposed changes to the MMF regulation, including

201. Turner, *International Funds: A Practical Guide to Their Establishment and Operation*, 43.
202. Rule 2a-4(a)(2) of the 1940 Act. A fund is not required to calculate its NAV on days on which changes in value will not materially affect the current NAV, days on which no redemption, purchase or sell orders for the fund's shares are received and on holidays. Rule 2a-4(a) and (a)(3) of the 1940 Act. *See* with respect to closed-end funds rule 23c-3(7)(iii) of the 1940 Act.
203. Rule 23c-3(b)(1) and (7)(i) and (ii) of the 1940 Act.
204. Canary Capital was accused of conducting both illegal market timing and late trading of shares of funds managed by Bank of America. *See* Complaint, *State of New York v. Canary Capital Partners*, LLC et al. (N.Y. Sup. Ct., 3 Sep. 2003). The complaint was settled for USD 40 million. After this scandal, Janus, Bank One's One Group, and Strong Capital were charged with illegal market timing/late trading practices. Following these complaints, the SEC launched its own investigation on the matter and filed its own securities fraud charges against mutual fund managers and affiliated companies for mutual fund trading abuses, among which were Prudential Securities, Putman Investment Management, and Securities Brokerage. *See* for an overview of the market timing/late trading cases Fein, *Banking and Financial Services: A Regulatory Guide to the Convergence of Banking, Securities, and Insurance in the United States*, 13.12.
205. Article 76 of the UCITS Directive.

restrictions on the use of the amortized costs method for the valuation of MMF assets.[206] Under the US MMF final rule, institutional MMFs (i.e., non-governmental/ non-retail MMFs) are only able to use amortized cost valuation if the fund's board of directors determines, in good faith, that the fair value of debt securities with remaining maturities of sixty days or less is its amortized cost, unless the particular circumstances warrant otherwise.[207] The EU MMF Proposal will, if adopted, only allow MMFs to use the amortized costs if they comply with specific authorization requirements and maintain at all times a buffer amounting to at least 3% of the total value of their assets, which can only be used to compensate the difference between the constant NAV per share and the 'real' value of a share.[208]

[A] Share Distribution

Other than closed-end funds, open-end funds usually do not trade on stock-exchanges, but sell and redeem their shares through a variety of distribution channels. In this respect, it can be noted that ETFs typically legally typically qualify as open-end funds, despite the fact that they have both open-end and closed-end features.[209] Open-end funds that are not ETFs usually do not list on a stock exchange, simply because there is no need to as the shares can be marketed directly to investors. The most commonly used way to sell open-end fund shares is to enter into a distribution agreement with the principal underwriter of the fund, who in turn generally enters into agreements with broker-dealer(s) who then sell the shares to investors.[210] However, there are other ways to sell open-end shares. The fund can appoint a principal underwriter who sells the shares directly to the public or, which is less common due to liability risks, the fund itself can enter into distribution arrangements with broker-dealers. As mentioned before, the principal underwriter is usually the fund manager or a broker-dealer

206. *See* MMF Proposal and SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616, IA-3879, IC-31166, 23 Jul. 2014, 1.
207. SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, 277. In addition, the SEC air valuation must be conducted each time that the security is priced. To this end, the SEC suggests that a fund's policies and procedures could be designed to ensure that the adviser is actively monitoring issuer- and market-specific developments to determine whether using amortized cost is appropriate. *Ibid.*, 280–281.
208. Explanatory Memorandum to the MMF Proposal, 8 and Article 29–34 of the MMF Proposal. These articles also contains rules on when the NAV buffer must be debited and when it can be credited and contain the obligation to replenish the buffer and the consequences of a failure to replenish the NAV buffer.
209. Under US law, a new ETF must receive an order from the SEC giving it relief from provisions of the 1940 Act that would not otherwise allow the specific structure of the ETF. In 2008, however, the SEC proposed a new rule under the 1940 Act (rule 6c-11) that would qualify an ETF that complies with the rule's conditions as an open-end investment company without the need for exemptive orders, but this rule has not yet entered into force. *See* SEC, Proposed Rule – Exchange-Traded Funds, Release Nos 33–8901; IC–2819, 18 Mar. 2008. The vast majority of assets in ETFs are registered with the SEC under the 1940 Act and are thereby subject to the same regulations as mutual funds. *See* ICI, *2009 Investment Company Fact Book*, 49th ed., 41. The fact book can be found at ICI's website: http://www.ici.org/. In the EU, many ETFs are set up as UCITS. In this context, it must be noted that ETFs set up under the UCITS Directive would have to comply with UCITS provisions relating to index replication.
210. *See* for the definition of principal underwriter, section 2.3.

affiliated with the manager. In case fund shares are sold through the manager, it can act either as a principal underwriter (that purchases and resells the shares) or an agent (arranging the sell). In either case, the fund manager has the exclusive right to distribute the shares.[211]

It follows from the above that, in general, the underwriter/manager often contracts with separate brokerage firms who sell the shares to the public. However, an increased number of open-end fund managers appear to also be part of a growing trend of distributing shares within their fund family themselves or through a transfer agent,[212] without using a broker-dealer or other intermediary. Many fund managers maintain websites that facilitate the purchasing of fund shares, but the sale may also be achieved through other communication means.[213] This way of selling fund shares is also referred to as 'direct marketing' as it establishes a direct relationship between the investor and the manager of the fund. However, some observers of the fund industry also define direct marketing of fund shares to include the marketing though so-called fund supermarkets or platforms, independent advisers (not being the underwriter or manager of the fund), and wrap accounts.[214] Wrap accounts are managed fund accounts 'wrapped' in a services package providing investors with advice and assistance on the mix of managed fund accounts.[215] In this broader meaning, 'direct marketing' means the marketing of fund shares that does not include the interference of a third party broker appointed by the fund or fund manager or any other intermediary not including providers of fund supermarkets/platforms or wrap accounts and independent advisers. Examples of such intermediaries are banks, insurance companies and pension funds.

When buying or redeeming shares of open-end funds through direct marketing, investors may not be charged with initial (front-end or back-end) loads. Since, in the case of direct marketing, external brokers are not involved in the sales process, or at least not by means of a distribution contract with the fund, there is no need for charging

211. Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals*, 167.
212. *See* for the definition of transfer agent, section 2.3.
213. *Ibid.*, 13–114 (describing the direct distribution channel as a channel through which investors purchase and redeem fund shares with the fund or its transfer agent by mail, telephone, the Internet, or at customer service centres). Fund supermarkets are financial institutions (often brokers) that offer investors, through a single Internet-based client account, a large number of open-end funds from different fund families. *See* St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 220. Fund platforms only offer fund shares on an online basis to other institutions such as banks. *See* ICI/IDC, *Navigating Intermediary Relationships* 17 (2009). The ICI/IDC paper can be found at: http://www.ici.org/. Fund wrap accounts are online brokerage accounts which offer investors a package ('wrap') of advice and funds under only one asset based fee. The wrap provider, most often a brokerage firm, engages an independent adviser to allocate the amount invested among a portfolio of funds according to the adviser's analysis of the investor's situation. The account of the investor may be changed periodically. *See* J. Downes & J.E. Goodman, *Dictionary of Finance and Investment Terms* 831 (Barron's Financial Guide 2010).
214. Gremillion, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals*, 189.
215. F.J. Fabozzi (ed.), *Handbook of Finance, Financial Markets and Instruments* 630 (John Wiley & Sons 2008).

an initial sales load. In general, it appears that open-end no-loads funds have emerged as a popular investment option over the years.[216] For small, retail investors with high liquidity needs (i.e., short-term investors), no-load funds are particularly interesting since the shares of these funds cost nothing to trade.[217] It is because of this increased popularity of no-load funds among these investors that direct marketing of open-end fund shares has emerged over the past years.[218]

[B] Redemption

As mentioned, most open-end funds redeem and sell their shares regularly to investors. However, it can be noted that they are not required by law to do so. Whether or not a fund redeems its shares depends on whether or not the internal fund instrument or statute allows this. Closed-end funds are exempt from the UCITS Directive and most national jurisdictions have, before the implementation of the AIFM Directive, excluded closed-end funds from the application of many national securities laws and regulations that would otherwise subject them to various investment restrictions, minimum capital requirements and disclosure requirements. Furthermore, closed-end funds are often exempt from the requirement to issue a prospectus under the Prospectus Directive or, in case of a US fund, under the 1933 Act,[219] and, in US closed-end will often not have to register with the SEC, provided that they are not promoted to the public.[220]

However, since the adoption of the AIFM Directive, several disclosure requirements have been placed on both open- and closed-end (EU and non-EU) AIF funds offered in the EU, aiming at providing investors with a minimum level of information about the fund's investment strategies, the types of investments, the risks and costs, leverage and other aspect of the fund operations. At the EU level, thus, both fund types

216. ICI, *2011 Investment Company Fact Book*, 51st ed., 76 (showing a significant growth of investors' assets in long-term no-load share classes, from USD 72 billion at the end of 2011 to USD 253 billion at the end of 2010, compared an outflow of USD 33 billion for load share classes in 2010). The fact book can be found at ICI's website: http://www.ici.org/.
217. M.J. Anson, F.J. Fabozzi & F.J. Jones, *The Handbook of Traditional and Alternative Investment Vehicles: Investment Characteristics and Strategies* 272 (John Wiley & Sons 2010) (referring to the increased use of no-load funds in employment retirement plans which are offered through monthly payroll deductions).
218. ICI, *2011 Investment Company Fact Book*, 77 (stating that in 2010, a total amount of USD 2,987 billion was invested in no-load funds by retail investors as opposed to USD 1,492 billion in 2005. Institutional investors account for USD 2,109 billion of investments in no-load funds in 2010).
219. The Prospectus Directive contains an exemption from the obligation to publish a prospectus for offers addressed solely to 'qualified investors', which is defined as those persons that are classified as professional clients or eligible counterparties in accordance with Annex II of the MiFID 2. *See* Article 2(1)(e) of the Prospectus Directive. Under US law, funds that offer their shares to 'qualified purchasers' are exempt from registration with the SEC (and several transparency requirements and other rules and restrictions applying to US registered fund). *See* Article 2(a)(51) of the 1940 Act. In addition, US funds that offer and sell their shares to 'accredited investors' exclusively, are exempt from the requirement to publish a prospectus. *See* Rule 506(b)(2) of the 1933 Act. *See also* section 4.3.
220. *Ibid*.

are currently regulated. Still, the regulatory frameworks applying to open- and closed-end funds differ from each other so the decision whether or not to establish an open- or closed-end fund might be induced by the differences in regulatory compliance levels.

So when is a fund considered to be open-end? Under US law, funds are deemed to be open-end in nature in case they redeem their fund shares at their NAV on a regular basis. They are thus not required to also sell them regularly.[221] The term 'redeemable securities' is defined in Article 2(a)(32) of the 1940 Act as:

> any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

What is meant with redeeming on a 'regular basis', is that the fund must repurchase its shares at the demand of investors at regular intervals and without having placed substantial restrictions upon the right of redemption or the proportional amount received for the shares redeemed.[222]

There is no uniform rule on how often the fund must enable investors to redeem their shares, but SEC has issued a number of no-action letters discussing whether certain types of securities are considered redeemable securities under Article 2(a)(32) of the 1940 Act. In these no-action letters, SEC considers various factors to be important in this respect, among which: whether the investor's withdrawal right is conditional or absolute, whether the amount of securities an investor can withdraw at one time is limited or unlimited, whether or not there is a holding (lock-up) period, how often an investor can withdraw and the minimum amount needed to withdraw.[223] In general, SEC appears to be of the opinion that any restriction or condition significantly limiting the possibility to execute the right to redeem shares on a regular basis or the amount an investor will receive when redeeming his shares in relation to his proportional share in

221. Article 5(a)(1) of the 1940 Act ('Open-end company means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer' (quotation marks omitted)).
222. R.H. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions* 406–407 (American Bar Association 2003).
223. Generally, these factors are all considered in conjunction with each other. An example of a case where the SEC did not qualify shares to be redeemable concerns the situations where, among other things (1) investors could not redeem shares during the first twelve months after purchase and thereafter only on a quarterly basis and only with a ninety days' notice period, (2) the amount of quarterly redemptions was limited, (3) the fund would use no more than 20% of its assets for the redemptions, and (4) redemptions would only be made to the extent cash was available. SEC No-Action Letter, California Dentists' Guild Real Estate Mortgage Fund II, 4 Jan. 1990. In the United States Property Investment N.V (SEC No-Action Letter, 1 May 1989), the SEC determined that shares were not redeemable if they could not be redeemed for two years, (2) thereafter, could only be redeemed once a year, and (3) there was no obligation to honour redemption requests. *See* for an examination of the SEC's No-Action letters R.H. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions* 404–409 (American Bar Association 2003). The no-action letters can be found at SEC's website: http://www.sec.gov/.

the fund's assets, makes the security not redeemable (and the fund closed-end).[224] However, with respect to the latter, it can be noted that SEC has also found that a particular share may be redeemable when a portion of the issuer's income is excluded from the redemption right.[225] In practice, however, mutual funds allow investors to redeem their shares every day.[226]

The UCITS Directive provides that UCITS redeem their shares on request of investors against the NAV or, in case of listed UCITS, a price that does not significantly vary from their NAV.[227] UCITS thus also, similar to US funds, do not have to continuously or even regularly sell their shares to investors. It follows from the UCITS Directive that funds should allow investors to redeem their shares at least twice a month in order for it to qualify as being open-end for purposes of the directive.[228] Additionally, a UCITS may provide in its organizational document, if allowed under the applicable national law, that it only redeems its shares once a month.[229] Moreover, some national regulators have, similar to the SEC in case of US funds, provided guidance or adopted rules on the frequency of redemption of shares for UCITS established in their jurisdiction.[230] However, similar to mutual funds, most UCITS allow investors to redeem their shares on a daily basis.

An open-end AIF is defined by the Commission as an AIF which repurchases or redeems its shares with its investors, at the request of any of its investors, prior to the commencement of its liquidation phase or wind-down out of the assets of the AIF and does so according to the procedures and frequency set out in its rules or instruments of

224. *Ibid* (as indicated by notes 18–20). It must however be noted that there is not one general rule available in determining whether or not a share is redeemable or not.
225. SEC No-Action Letter, Georgia International Corp., 10 May 1972 (LP interests were redeemable securities when, among other things, the partnership would offer to purchase the LP interests at 90% of their value). The no-action letter can be found at SEC's website: http://www.sec.gov/.
226. J. Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 Yale L. J. 1234 (2014) and Y. Amihud, *Open-end Mutual Funds in the United States of America*, in *Funds and Portfolio Management Institutions, An International Survey* 171–172 (S. Preda (ed.), Elsevier science 1991).
227. Article 1(2)(b) of the UCITS Directive. With respect to listed UCITS, the directive provides that any action taken by the UCITS to ensure that the stock exchange value of its units does not significantly vary from their NAV shall be regarded as equivalent to such repurchase or redemption (second sentence). UCITS which are corporations that market at least 80% of their shares through one or more stock exchanges must intervene on the market to prevent their stock exchange value from deviating by more than 5% of their NAV. *See* Article 32(5) of the UCITS Directive.
228. Articles 1(2)(b) and 76 of the UCITS Directive.
229. Article 76 of the UCITS Directive.
230. For example, in the Netherlands, the supervisory authority (AFM) determined that in order for a fund to be qualified as open-end under Dutch law (and therefore also eligible to qualify as a UCITS), it must allow investors to redeem their shares at regular intervals, for example, daily, weekly, or monthly. The AFM requires that an open-end fund must redeem its shares at least once a year. Funds that are free to decide whether or not to grant a repurchase request or to limit the maximum number or percentage of shares that can be redeemed per year without a relation to the maximum number of outstanding shares and/or the applicable liquidity rules are considered to be closed-end. *See* H.E. Wegman, *Toezicht op (frauduleuze) beleggingsfondsen: systeem van uitzonderingen en vrijstellingen* 1 Onderneming & Financiering 7–8 & note 15–16 (2009).

incorporation, prospectus or offering documents.[231] The Commission expressed the view that imposing any criterion as to the frequency of redemptions conflicts with the words of Articles 16(1) (liquidity management) and 19(3) (valuation) of the AIFM Directive.[232] Furthermore, any restrictive powers in the AIF's rules or instruments of incorporation (e.g., suspensions, lock-up periods) are not taken into account in determining whether the AIF is open- or closed-end.[233] So, an AIF with an initial lock-up period can still be considered to be open-end if it allows investors to redeem shares prior to the commencement of its liquidation phase or wind-down. Closed-end AIFs are subject to less liquidity (management) requirements (in case they are also considered 'unleveraged', see section 3.3.2[B]) and less frequent valuations than open-end AIFs.[234]

Should a redemption request of an investor always be granted? A UCITS' organizational document may provide for a provision, allowing the UCITS management to, in exceptional circumstances in the interests of the investors or the public (e.g., temporary liquidity shortage), arrange for a delay in settlement of repurchase requests for a specific time or for a proportional reduction of all repurchase requests provided that the requests are dealt with in priority to new requests for redemption of shares until the deferred requests have been fully satisfied.[235] In case the repurchased requests received on a single day exceeds 10% of the value of the fund's assets, UCITS are even required to suspend the redemption requests in order to meet with the directive's rules on investment requirements.[236] EU Member States may also require

231. Article 1(2) of the Commission Delegated Regulation (EU) No. 694/2014 of 17 Dec. 2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers, OJ L 183, 18.
232. Letter from the European Commission to the European Securities and Markets Authority concerning draft RTS to determine types of alternative investment fund managers, 4 Jul. 2013, http://www.esma.europa.eu/system/files/ec_letter_to_esma_re_draft_rts_on_types_of_aifmd_4_july_2013.pdf (accessed 6 Oct. 2014) (stating that it follows from the words of Articles 16(1) and 19(3) of the AIFM Directive that a closed AIF 'valuation and calculation frequency is (…) linked solely to increases or decreases of its capital' and that 'the main distinction between open and closed-ended AIF rests on the fact that open-ended AIF are confronted with "underlying obligations" beyond those resulting from leverage, i.e., to redeem investors' instead of the frequency of redemptions).
233. ESMA, Final report-Draft regulatory technical standards on types of AIFMs, ESMA/2013/413, 2 Apr. 2013, 9 ('ESMA saw merit in modifying the draft RTS in order to recognize that events such as side pockets, gates and suspensions or other similar arrangements arise from the illiquidity of assets, while lock-up periods do not necessarily arise from the illiquid nature of the AIF's assets'). A lock-up period is a minimum holding period during which investors may not exercise their redemption rights. *See* ESMA, Consultation paper-Draft regulatory technical standards on types of AIFMs, ESMA/2012/844, 19 Dec. 2012, 7.
234. For example, Article 16(1) AIFMD requires that all AIFMs shall, for each AIF that they manage which is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and Article 19(3) provides that an open-ended AIF shall carry out valuations of its assets and the calculation of its NAV 'at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency'. If the AIF is closed-end, such valuations should only be carried out in case of an increase of decrease of the capital by the relevant AIF. *See ibid*.
235. Article 84(1) of the UCITS Directive.
236. Article 55(1) of the UCITS Directive ('A UCITS may acquire the units of a UCITS (…), provided that no more than 10% of its assets are invested in units of a single UCITS or other collective

UCITS to suspend, in certain circumstances, the redemption of shares in the interests of investors or the public or provide additional rules on the redemption of UCITS shares or the (maximum period of) suspension of redemptions.[237] US mutual funds may suspend the right of redemption or postpone the date of settlement for no more than seven days after the share has been tendered for redemption.[238]

[C] Semi-open Funds

In addition to open- and closed-end funds, it can be noted that some funds might have adopted the so-called semi-open structure. These funds combine features of both open and closed funds as they offer investors the possibility to redeem their shares, but only upon certain conditions. Investors in such funds may, for example, be allowed to redeem their shares at limited, fixed intervals, usually only once a year, or only in case they give prior notice of their intention or to the extent that the fund has cash available.[239] For example, most hedge funds require a period of notice for redemption of shares, normally in the thirty to ninety day range.[240] Such funds are also often referred to as interval funds, as they enable investors to purchase new shares from the fund and redeem their shares periodically at the NAV, but not as regularly as typical open-end funds.

While semi-open funds thus may not be as 'open' as regular open-end funds, they may also not be qualified as 'closed-end' under the applicable laws of the country or countries in which they wish to offer their shares. Depending on how often they allow investors to redeem their shares (see above), the fund will be qualified as either open- or closed-end and will become subject to the subsequent regulations. Most semi-open funds will however prefer to be qualified as closed-end funds in order to avoid the application of more stringent rules specifically designed for open-end funds (such as the UCITS Directive). In addition, they may choose to meet other requirements that exempt them from publishing a prospectus and/or to register with the national securities authority.

Overall, it can be concluded that no regulatory requirement exists requiring funds to be either open- or closed-end in nature. Rather, it is left up to decide by the originator (manager) of the fund whether, and if so, how often investors can redeem their shares

investment undertaking'). The 10% limit may be raised by EU Member States to 20%. *See* Article 55(1) of the UCITS Directive, second sentence.

237. Articles 19(3)(b) and 84(2) of the UCITS Directive. For example, in the UK, UCITS (regulated as AUTs or ICVCs) are required to pay the investor the appropriate proceeds for all shares redeemed on the fourth business day following: (a) the valuation point immediately after the fund manager received the request to redeem or (b) the time when the fund manager has all duly executed instruments and authorizations to effect (or enable the fund manager to effect) transfer of title to the shares. UK UCITS funds that suspend the redemption of their shares are not allowed to issue new shares or redeem other shares than those deferred for redemption during the suspension period. They must also inform the FSA of the suspension and the reasons for the suspension and the redemption request must be satisfied within twenty-eight days after the request has been made. *See* Articles 6.2.16(5), 7.2.1(1), (2) and (4A) of the COLL.
238. Article 22(e) of the 1940 Act.
239. St Giles, Alexeeva & Buxton, *Managing Collective Investment Funds*, 176–177.
240. M.J.P. Anson, *Handbook of Alternative Assets* 125 (John Wiley & Sons 2008).

with the fund. When a fund is considered to be open-end under the UCITS Directive or the 1940 Act (and other eligibility requirements apply), these regulations apply. In case of an AIF, either the open-end or the closed-end AIF regime applies, depending on whether or not the AIF meets the definition of open-end AIF or not. In any case, the protection of investors in EU and US funds is not determined by virtue of the open- or closed-end structure of funds, but by the consequential regulations applying to such funds. The level of investor protection can thus be viewed a consequence of, among other things, the internal fund policy on share redeemability. In the following chapters, therefore, the difference between open- and closed-end funds will only be referred to when appropriate to the purpose of determining the way in which investors are protected.

2.6.3 Master-Feeder Structure

A common operational structure used by funds is the master-feeder structure. The master-feeder structure is a structure where one or more ‘feeder funds’ invest in a single ‘master fund’. The feeder funds are marketed to investors, while the master fund pools the investments of all the feeders. Consequently, it is said that this structure may allow for greater economies of scale than a single fund structure because it allows only one fund (the master) to combine the assets of two or more other funds (the feeders) into a pool of money and invest this pool collectively. The feeder funds invest most or all of their assets in the master fund. The performance of the feeders will therefore be primarily based on the performance of the master fund. This will reduce administrative and marketing costs since all funds will have merely identical performances.[241] Furthermore, the management of the funds may be performed more efficiently as only one fund manager is necessary to manage the master fund and decide on the investment strategy to use for various funds. By trading larger blocks of securities, the funds as a group will also save transactions costs. However, it can be noted that, in practice, the complexity of this structure often results in high legal, accounting, and administrative costs, aside from possible extra fees for investors.[242] In addition, the allocation of profits and losses among the different feeder funds might be complex and often creates certain administrative issues, such as accounting adjustments relating to new issues and redemptions of the feeder funds (for each subscription or redemption there must be a corresponding transaction between the master and feeder fund).[243]

The master-feeder structure is particularly popular among private equity and hedge fund managers that wish to pool money from both domestic and investors from abroad while ensuring preferable tax treatment for each of these groups. Under the structure, the feeders are usually set up as local LP or other contractual funds for domestic investors and as corporate funds, usually established in low-tax, offshore

241. Hammer et al., *U.S. Regulation of Hedge Funds*, 369.
242. R.C. Pozen, *The Mutual Fund Business* 545 (Houghton Mifflin Company 2002).
243. Hammer et al., *U.S. Regulation of Hedge Funds*, 109–110.

jurisdictions,[244] for investors from abroad.[245] These corporations are typically tax-exempt in their country of establishment.[246] It can be noted that under US law, feeder funds may also be structured as LP funds under non-US law that elect to be treated as a corporation for US tax purposes, which makes them more attractive for certain US tax-exempt (sophisticated) investors.[247]

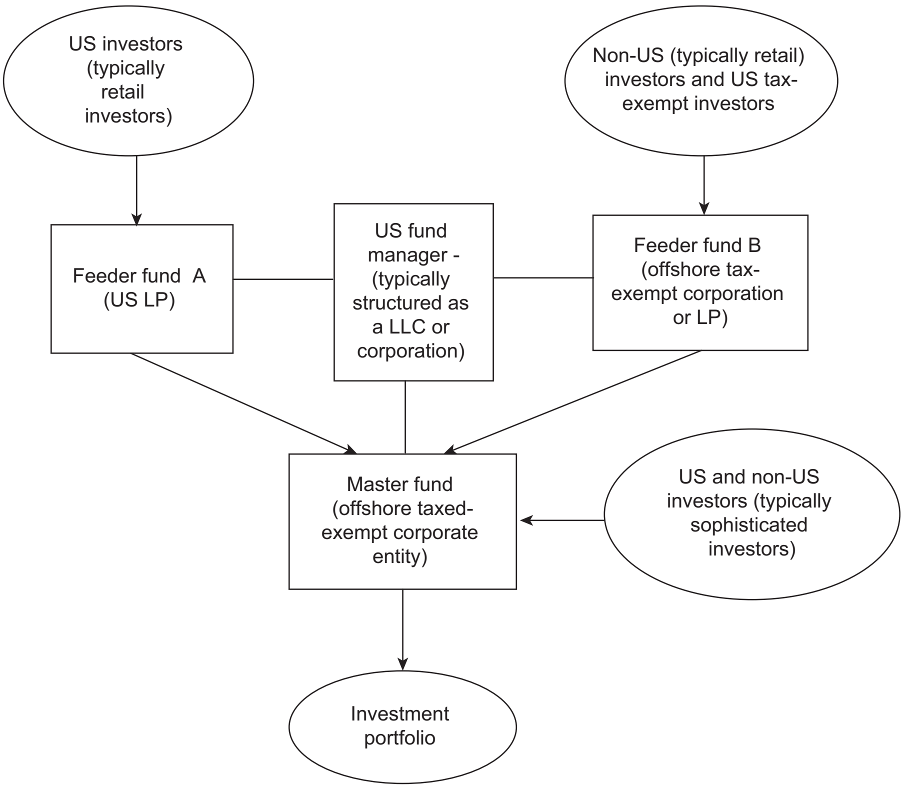
The master fund is generally structured as an offshore tax-exempt corporate entity that is treated as a tax transparent entity in order to ensure that both domestic and non-domestic investors profit from pass-through taxation at the master level.[248] Non-domestic investors that invest through a feeder fund will be only subject to (income or dividend) taxes in their home country. The fund manager is generally organized as a corporation or, in case of a US manager, a Limited Liability Company (LLC) or in order to avoid liability.[249]

The principle of setting up a master fund creates a number of possibilities for funds that wish to reach both institutional and retail investors in different countries. While most private equity and hedge funds are only directly offered to institutional and high-net worth investors (see section 2.6.6), and thus typically have a high minimum initial subscription per investor, they can reach small retail investors by adding a feeder fund specifically for these investors (and certain tax-exempt investors). As a consequence, small investors are provided with an entry possibility into private equity and hedge funds, which would normally not be available to them. In addition, it may provide for a mechanism for different pricing, with the institutional investors paying only the charges levied on the fund level and the entry and exit costs, whereas the retail investors pay an extra fee for the additional fund layer.[250] However, fund managers of

244. An offshore jurisdiction is a low-tax, lightly regulated jurisdiction which specializes in providing the corporate and commercial infrastructure to facilitate the use of that jurisdiction for the formation of offshore companies and funds. Offshore jurisdictions include, among others, the Cayman Islands, British Virgin Islands, the Bahamas, Panama, the Netherlands Antilles and Bermuda. *See* SEC, *Staff Report to the United States Securities and Exchange Commission: Implications of the Growth of Hedge Funds*, 10 (September 2003). The SEC report can be found at SEC's website: http://www.sec.gov/.
245. In the US, the fund manager may also achieve similar tax benefits by establishing a US master fund organized as a US LP in which non-US investors invest directly. However, non-US investors may be reluctant to invest in funds established abroad and will thus prefer to invest in local funds. Therefore, most of these structures have set up a non-US master. *See* Hammer et al., *U.S. Regulation of Hedge Funds*, 99 and 107 (note 70).
246. J.M. Schell, *Private Equity Funds: Business Structure and Operations* 7–17 & note 8 (Law Journal Press 2007).
247. *Ibid*. Reason for this is the fact that in case US tax-exempt investors, such as certain pension funds and charitable organizations, invest in a non-US tax-exempt fund, they might incur tax liability on income from 'debt-financed property' (e.g., gains from the sale of stock purchased on margin). For non-US LP funds that elect to be taxed as corporations for US tax purposes, no such tax would be required, provided that the fund's income is allocated to these investors. *See* Hammer et al., U*.S. Regulation of Hedge Funds*, 368.
248. Pass-through taxation is a type of taxation in which the investors in the entity pay income tax on the entity's income, and not the entity itself. In general, this means that investors will have to pay a lower tax rate than would have been the case if the entity was subject to local taxes as they avoid double taxation at both the entity and the investor level. Such entities are also referred to as fiscally transparent or flow-through entities.
249. Hammer et al., *U.S. Regulation of Hedge Funds,* 92.
250. Turner, *International Funds: A Practical Guide to Their Establishment and Operation*, 31.

master-feeder structures may decide not to deduct charges at both underlying and feeder fund level as they might see it as a worthwhile cost to attract the additional business.[251] At any rate, it can be concluded that this structure could imply a double layer of fees for investors, which may be particularly cumbersome for small retail investors investing in feeder funds.

Figure 2.3 Master-Feeder Structure US Private Equity or Hedge Fund



Besides the master-feeder structure commonly used by US and EU private equity and hedge funds (see Figure 2.3 for the US structure), US regulated funds and EU funds may also adopt this structure, although they are subject to certain regulatory limitations and constrains. With respect to UCITS, it can be noted that it is required that both the master and feeder funds are subject to the UCITS Directive. Furthermore, in order for a UCITS to be qualified as a feeder UCITS, it must invest at least 85% of its assets in the master UCITS.[252] The remaining 15% has to be invested into liquid assets,

251. *Ibid.*, 53.
252. Article 58(1) of the UCITS Directive.

financial derivatives for hedging purposes, and, if it is a company, movable and immovable property essential for the direct pursuit of the business.[253]

While the feeder UCITS may derogate from the diversification limits set out in the UCITS Directive in order to invest 85% or more of its assets in only one master fund, the master UCITS must comply with the diversification standards set out in the directive. The UCITS Directive also states that the master may not be a feeder itself or invest in a feeder UCITS.[254] With respect to the UCITS feeder, it has been determined that its initial investment into the master UCITS is subject to prior approval by the competent authorities of the feeder UCITS home Member State in order to protect the feeder UCITS' investors.[255] Furthermore, the feeder UCITS must, among other things, publish its own prospectus and 'Key Investor Information' document (KII).[256] Feeder AIFs are AIFs that invest, or have an equivalent exposure, at least 85% of their assets in one master AIFM or invest in more than one AIFM master with identical investment strategies.[257]

With respect to US regulated funds, it should be noted that registered funds that are classified as diversified funds cannot be feeder funds as they are not allowed to invest more than 5% of its assets in only one type of security, which includes other fund shares, and may not contain more than 10% of the outstanding shares of another issuer, including another fund.[258] Non-diversified registered funds may act as feeders, but it must be noted that for the purpose of determining whether the master fund needs to be registered with the SEC, all the investors in the US feeders will be deemed to be investors of the master fund.[259]

When looking at above key features of the master-feeder structure, it can be concluded that investor protection issues may arise with respect to transparency about the costs, risks and performance of the master fund in which the feeders invest. The structure by itself does not raise issues regarding to the protection of investors, as those issues are a consequence of the structure used. Consequently, in this book, the specific transparency and disclosure rules applying to master-feeder funds will be assessed in case relevant to the research question.

253. Article 58(2) of the UCITS Directive.
254. Article 58(3) of the UCITS Directive.
255. Article 59(1) of the UCITS Directive.
256. Article 59(3)(b) and 63(1)(f) of the UCITS Directive.
257. Article 4(1)(m) of the AIFM Directive.
258. Article 5(b)(1) of the 1940 Act.
259. Under Article 3(c)(1)(A) of the 1940 Act, each investor in the feeder fund is counted as a beneficial owner of outstanding securities of a master fund for the purpose of the 100-investor (or 100-owner) limit and the subsequent registration requirement of the master, if the fund owns 10% or more of the master fund's outstanding voting securities. This provision is known as the 'Ten Percent Look-Through Test'. It aims to limit the use of multi-tiered pooled investment vehicles to avoid the 100-investor limit. Hammer et al., *U.S. Regulation of Hedge Funds*, 62–63.

2.6.4 Umbrella Structure

An umbrella fund structure is a fund structure that refers to a family of subfunds each of which has shares offered to investors.[260] From a legal perspective, the structure consists of only one fund which employs multiple investment strategies. This is accomplished by designating different investment compartments ('subfunds'). Each compartment is devoted to a specific investment strategy and one or more share classes can exist within each compartment. For example, subfund A shares might be equity long-short, subfund B shares fixed income, and subfund C hybrid load shares. In essence, this capital structure is nothing more than a collection of different shares offering investors a range of investment possibilities within the fund. However, as each 'subfund' has its own portfolio of underlying assets, they may qualify as a contractual fund under national law.[261] In some cases, however, the structure will constitute a master-feeder structure instead of an umbrella structure, depending on whether or not the 'subfunds' in that structure are considered to be separate legal entities qualifying as feeders under national law.

While the umbrella structure could benefit the fund manager as it encourages investors to stay within the fund family when their investor goal changes, it is also subject to certain legal limits. For example, in the case of umbrella UCITS, a separate KII must be produced for each investment compartment or share class thereof, except where a share class can be selected to represent other share classes and certain additional conditions are met.[262] Furthermore, if an umbrella UCITS wishes to market its shares in other Member States than its home Member State, it is required to submit a notification letter to the competent authorities of its home Member State including information regarding arrangements made with respect to the marketing of the shares in the host Member States, including with respect to share classes.[263] For an umbrella AIF, no conditions or constrains apply as it is only provided that the definition of a single AIF includes investment compartments of that AIF, although the AIFM must provide the Member State in which the shares are marketed with a description of, or information on, the AIF marketed.[264] This will include information on the investment compartments offered to investors.

In principle, for each compartment of an umbrella fund, separate accounts should be maintained, which means that profits, losses and general liabilities of the subfund are segregated and the losses of one subfund cannot be recouped from the assets of

260. Viitala, *Taxation of Investment Funds in the European Union*, 24.
261. That is, if they have no legal status, other than a tax-related one, and are thus not separate legal entities, such as the Dutch FGR.
262. Articles 25(1) and 26(1) and (2) of Commission Regulation No. 583/2010 of 1 Jul. 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website, OJ 176, 1. ('Commission Regulation No. 583/2010').
263. Article 93(1) of the UCITS Directive.
264. Article 4(1)(a) and Annex II and IV of the AIFM Directive.

another.[265] While they are technically not separate legal entities, in practice, they operate as separate funds, although it can be noted that the law in some jurisdictions is not entirely clear as to whether this separation is sufficient to prevent the insolvency of one subfund from influencing the assets of other subfunds.[266] It does depends on the applicable national law whether or not investors are sufficiently protected against bankruptcy and insolvency risks of subfunds in an umbrella structure. Umbrella UCITS are required to provide details in its KII of whether the assets and liabilities of each subfund are segregated by law and how the absence of segregation might affect the investor.[267] In any case, the treatment of compartments as separate funds under national law does not extend to separate oversight as the subfunds require no separate license under securities law. Only the KII is separate for each subfund (not the full prospectus). The main advantage of investing in an umbrella fund is the fact that it is easy for investors to switch from one subfund to another. Normally, an investor will have to pay initial sales and dilution costs when selling fund shares and buying new ones. This will not be the case when switching between subfunds in an umbrella structure.

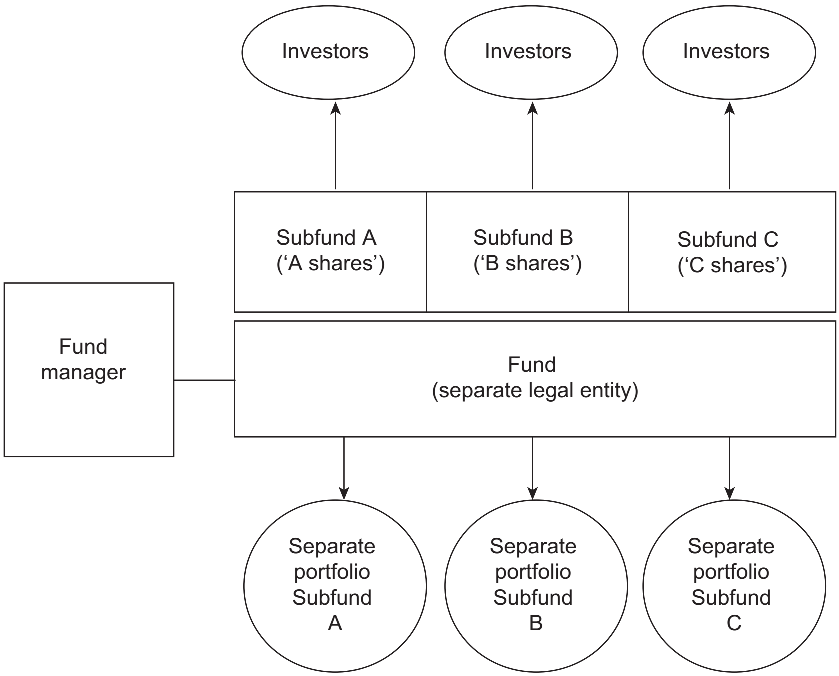
While an umbrella structure can be singly employed, it can also be combined with the master-feeder structure and/or the fund of funds structure. This may be useful when a fund family wishes to offer multiple investment strategies to investors and also wants to profit from the tax benefits offered by the master-feeder structure and/or the diversifications benefits of the fund of funds structure (see below). Similar to the master-feeder structure, this structure may be of relevance in the context of investor protection with respect to the (specific) disclosure requirements applying to such funds. Where appropriate, these requirements will be taken into account when determining the protection of investors in funds offered in the EU. In Figure 2.4, the single umbrella structure is given.

265. *See* ESMA, Final Report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 101 ('If an AIF has different investment compartments, separate accounts shall be maintained for those investment compartments'), G. Altman et al., A Practical Guide to the Investment Company Act, 2–3, 1996, p. 2–3 ('Each portfolio of a series [US mutual fund] company has distinct objectives and policies, and interests in each portfolio are represented by a separate class or series of shares. Shareholders of each series participate solely in the investment results of that series'), and Article 25(2)(b) Commission Regulation (EU) No. 583/2010 ('Each key investor information document (…) shall indicate (…) whether or not the assets and liabilities of each compartment are segregated by law and how this might affect the investor').

266. Therefore, most fund managers establish a so-called Protected Cell Company (PCC), which is an entity that has legislative protection for the segregation of its assets. Assets in a PCC are either 'cellular' (in that they are attributable to a specific cell) or 'non-cellular' (in which case they are considered 'core assets'). In general, the assets of one cell are not available to investors or creditors of another cell or to investors or creditors of the 'core'. Guernsey was the first jurisdiction to introduce the PCC, but other jurisdictions, such as the Cayman Islands and Jersey, followed. *See* on the PCC in general N. Feetham & G. Jones, *Protected Cell Companies: A Guide to Their Implementation and Use* (Spiramus Press 2008).

267. Article 25(b) of Commission Regulation No. 583/2010.

Figure 2.4 Umbrella Fund Structure



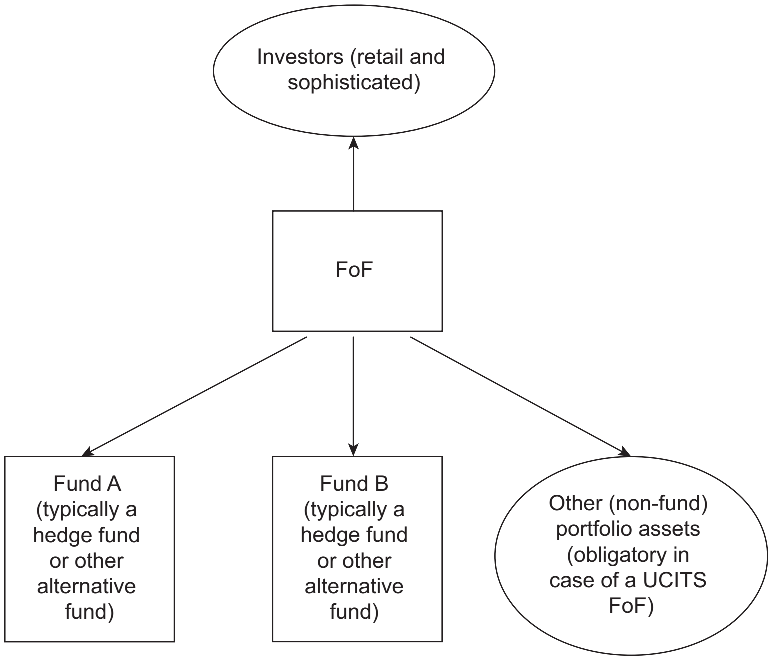
2.6.5 Fund of Funds Structure

The FoF structure is actually not a legal organizational structure, but it is a way of investing, i.e., an investment strategy.[268] However, since FoFs are often confused with feeder and umbrella funds, it is discussed here as separate structure. FoFs are funds that invest exclusively or a substantial part of their assets into other funds (Figure 2.5).[269] Funds that invest in other funds generally invest in a pool of funds with similar or higher return goals in order to generate a similar level of return for their investors. A fund that is a FoF thus actually employs the investment strategy of investing in other investment funds.[270] This strategy is often linked to hedge funds, private equity funds and other 'alternative funds' since those funds are often objects of investments by

268. Turner, *International Funds: A Practical Guide to Their Establishment and Operation*, 55.
269. The question rises what constitutes a 'substantial part' of a fund's assets. Generally, a fund will be classified as a FoF in case it invests at least 10% of its assets into other funds, but no more than 85% as in that case it will be considered a feeder fund under EU law. However, both EU and US law does not prescribe a minimal percentage of fund assets to be invested in other funds in order to be qualified a FoF.
270. Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm*, 217.

FoFs, although they can be themselves also FoFs, depending on their investment strategy.

Figure 2.5 Fund of Funds Structure



Investing in a FoF enables retail investors that are otherwise not qualified to invest in alternative funds because they have insufficient capital or are not recognized as qualified investors, to invest indirectly in such funds. In addition, while a fund may offer investors a certain level of diversification, a fund that invests in a number of other funds provides an even greater deal of diversification that would not be achieved by individual investors themselves due to limited capital amounts.

For high net worth and sophisticated investors, investing in a FoF may also be beneficial because the manager of the FoF will usually perform a due diligence research before investing into a particular fund, which may provide for a certain quality label for investors and will save them money and time as they would not have to perform this research themselves. However, it can be noted such a research may not always provide for an adequate analysis of the underlying FoFs. In this context, the Madoff fraud case is often mentioned as an example of insufficient due diligence performed by institutional investors. Although technically not involving FoFs (or feeder funds), various investment funds (sub)managed by Madoff's investment management company relied upon the experience of Madoff and his high returns based on the system developed by Madoff and his 'investment strategy'.[271]

Even though the Madoff case concerned managed accounts instead of FoF investments, the collapse of the scheme led to an increased focus on due diligence and risk assessments on the part of FoFs and feeder funds.[272] This evidentially led to several regulatory reforms in both the EU and US affecting (the management of) these funds. Examples include the adoption of due diligence requirements in the UCITS and AIFM Directives and amendments to the US Advisers Act, which have broadened the scope of fund managers that will have to register with the SEC and extended the information that managers have to provide to investors about the funds they manage.[273] Some regulators, including UK's FSA, have adopted additional due diligence rules for FoFs investing in alternative funds in addition to or overlapping existing EU rules.[274] These rules also apply to feeder funds investing a hedge fund master or other alternative master funds. While these rules enhance investor protection, it can however be questioned whether the Madoff case forms sufficient justification for the reforms. After all, is someone provides sufficient information about his investment strategy, but that information is false, how can be possible argued that the due diligence process was insufficient?

At any rate, despite the diversification, professional management and due diligence benefits, investing in a FoF comes at the cost of a multiplication of fees. In addition to the fees of the funds themselves, the fees charged to them by the underlying

271. Madoff told investors who invested money in his funds that he used a so-called split-strike conversion strategy, but in fact, he was operating a Ponzi scheme. In a Ponzi scheme, returns are paid to investors out of the money paid in by subsequent investors instead of from profits. Ponzi schemes usually have to attract new investments at an exponentially growing rate to sustain payments to existing investors, and inevitably collapse when the new investment needed exceeds the size of the target market. *See* A. Carvajal et al., *Ponzi Schemes in the Caribbean*, IMF Working Paper 09/95, 4 (2009). The working paper can be found at: https://www.imf.org/external/pubs/ft/wp/2009/wp0995.pdf (accessed 15 Aug. 2014).
272. *See*, e.g., P. Clauss, T. Roncalli & G. Weisang, *Risk Management Lessons from Madoff Fraud*, in *Credit, Currency or Derivatives: Instruments of Global Financial Stability or Crisis?* vol. 10, 505–543 (J. J. Choi & M. Papaioannou eds, International Finance Review Series, Emerald 2009) (pleading for a more quantitative due diligence process performed by fund of hedge funds managers with strict eligibility criteria of which violation would require the manager to explain in details the reasons on a regular basis) and C.P. Sullivan & L.A. Furnals, *Madoff One Year Later: A Litigation Tsunami?* 2 Fin. Fraud Rpt. 214 (2010) (stating that plaintiffs 'claim that Madoff's fraud was obvious and that the feeder funds performed almost no due diligence' and that '[t]he feeder funds may have a hard time convincing […] that their due diligence of Madoff was adequate').
273. SEC, Final Rule – Amendments to Form ADV, Release No. IA-3060, 28 Jul. 2010 and the Private Fund Registration Act of 2010, Ch. 17 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ('Dodd-Frank Act', Pub.L. 111–203, 124 Stat. 1376, H.R. 4173, enacted 21 Jun. 2010).
274. FSA, Policy Statement 10/3, Funds of Alternative Investment Funds (FAIFs), Including feedback on CP08/4, February 2010, 12 & 18 (stating that FSA's 2008 proposals to strengthen due diligence requirements for FAIFs are, in light of recent events in the international fund industry, including the Madoff case, necessary and relevant to investing in underlying unregulated schemes and that the proposal on the AIFM directive 'should not deter us from putting the proposed FAIFs arrangements in place'). The details of the due diligence are set out in Articles 5.7.9 and 5.7.10 of the COLL.

funds are usually passed on to investors. As most FoFs report their return after all the fees are paid, investors may not be aware of this. The issue of double fees, although also present in the master-feeder structure discussed above, is the most critical in the FoF structure. Master funds do not always charge management fees to their feeders and even if they do, the feeders will have to, as mentioned above, inform investors of these costs. FoFs on the other hand generally have no influence on the fees charged by the funds in which they invest, although they can of course decide to not invest in a fund with high fees. In addition, they typically invest in multiple different funds with different fee structures, which makes it more difficult for them to calculate the fees charged by the underlying funds than for a feeder with respect to the master's fees.[275] In this context, it can be noted that sometimes, the FoF structure may even be used to compensate for losses in fees. For example, in the Netherlands, large banks have set up new so-called 'rebate free' FoF fund structures after Dutch law introduced a ban on distribution fees paid to banks in 2013.[276] As a result of this new rule, Dutch banks no longer receive these fees from funds that are marketed by them to investors. By setting up a FoF rebate free structure, consisting of a own fund that invests in other underlying funds, banks have however found a way to earn back their fee losses since they can charge investors with higher costs at the level of the bank-owned fund.[277]

UCITS FoFs may invest only up to a maximum of 10% of their assets in a single other funds.[278] They are required to include a description of the fees paid to the underlying funds and reflect those fees in the calculation of their ongoing charges figure set out in the KII.[279] AIF FoFs have no investment restrictions and have to disclose information on the investment strategies of the underlying funds to investors.[280] With respect to US registered FoFs, it can be noted that they must be 'undiversified' in nature (as US registered feeders) and are required to include a separate line in their prospectus showing the fees charged to them by the underlying funds.[281]

Since the additional layer of costs in the FoF structure raises various investor protection concerns, the rules concerning cost disclosures applying to FoFs are of particular importance to this research. In addition, other rules related to the underlying funds in which FoFs invest, such as risks and performance, should also be taken into account as they may be key factors in investors' decision-making process.[282] In the

275. ESMA has therefore set out the calculation method for the ongoing charges attributable to underlying funds. *See* Annex 2 to CESR's technical advice to the European Commission on the level 2 measures related to the format and content of the Key Information Document disclosures for UCITS (Ref. CESR/09-949), CESR/09-1028, December 2009, under 15.
276. Article 86c of the Decree on the Supervision of the Conduct of Financial Enterprises pursuant to the Dutch Financial Supervision Act.
277. *See* J. Dobber & R. Cohen, *Provisieverbod leidt tot intransparantie*, Het Financieel Dagblad (31 Jul. 2014).
278. Article 55(1) of the UCITS Directive. Member States may raise this limit to a maximum of 20%.
279. Article 30 of Commission Regulation (EU) No. 583/2010.
280. Article 7(3)(a) of the AIFM Directive.
281. *See* section 4.8.1.
282. *See* on these key factors influencing investor decision making, also section 5.5.2.

following chapters, these factors within the context of investor protection regulation will therefore, where relevant to the issue at consideration, be discussed.

2.6.6 Hedge Funds and Private Equity Funds

Hedge funds and private equity funds are special types of funds that operate within the EU under the AIFM Directive (whether regulated by it or expressly exempt from it). As such, they can be classified as AIFs. There is no regulatory or other uniform definition of a private equity or a hedge fund. Rather, they can be characterized by their investment strategies and objectives.[283] In general, both fund types are known for employing multiple alternative investment strategies, although they may also perform only one strategy.[284] They use a number of structures as vehicles for their business. Most common is the US LP form, although other contractual (EU) structures may also be used.[285] With regard to the operational structure of private equity and hedge funds, it can be noted that they are typically closed- or semi-open end in nature and may use the umbrella, master-feeder or FoF structure or a combination of these structures.[286] Furthermore, both fund types are considered to be 'private funds', which means that they generally aim at high net worth and institutional investors. Due to this, it is often claimed that it is difficult to obtain adequate information about the risks and operations

283. *See*, e.g., K. Steck, *Legal Aspects of German Hedge Fund Structures* in *Hedge Funds, Risks and Regulation* 137 (T. Baums & A. Cahn eds, Institute for Law and Finance Series, De Gruyter 2004) ('The term "hedge" rather describes different investment strategies aiming at a rapid asset growth irrespective of a certain market trend (absolute return)'), A. Engert, *Transnational Hedge Fund Regulation*, 11 Eur. Bus. Org. L. Rev. 334 (2010) ('Hedge funds should thus be defined as investment funds that aim primarily at "alpha" returns from actively exploiting mispricings') and C. Diller & C. Kaserer, *What Drives Private Equity Returns? – Fund Inflows, Skilled GPs, and/or Risk?*, 15 Eur. Fin. Mgt. 649 (2009) ('It should be noted that TVE uses the term "private equity" to cover all venture investing, buyout investing, and mezzanine investing'). A fund may also be considered to be a 'hedge fund' if it calls itself as such for marketing purposes. *See* AFM, *Hedge Funds: An Exploratory Study of Conduct-Related Issues*, 22.

284. For example, a private equity fund may be primarily engaged in leveraged buy-out investing and a hedge fund may only invest in other funds (hedge fund of funds). However, in particular hedge fund managers change investment strategies depending on market conditions, or allocate capital across different strategies simultaneously.

285. A. Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1735 (2008) ('The typical hedge fund is a partnership entity managed by a general partner; the investors are limited partners who are passive and have little or no say in the hedge fund's business'), Kaplan & Strömberg, *Leveraged Buyouts and Private Equity* 123 (2009) ('Legally, private equity funds are organized as LPs in which the general partners manage the fund and the limited partners provide most of the capital'). *See* for the US LP structure, section 2.7.2.

286. Stein, *Why Are Most Funds Open-End? Competition and the Limits of Arbitrage*, 252 ('Virtually all hedge funds allow investors to liquidate their positions at some horizon; in this sense, they are all quasi-open-end'), Kaplan & Strömberg, *Leveraged Buyouts and Private Equity*, 123 ('Most private equity funds are "closed end" vehicles'), A. Achleitner & C. Kaserer, *Private Equity and Hedge Funds: A Primer*, CEFS Working Paper No. 2005-03, 4 (2005), available at SSRN ('[S]ome hedge-fund-of-funds also invest in private equity' and 'some institutions offer hedge funds and private equity funds under one umbrella') and Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm*, 265 ('Both onshore and offshore [hedge] funds usually invest in a master feeder fund, which then co-invest in a master fund').

of individual hedge funds and private equity funds and reliable summary statistics about the industry as a whole.[287] Finally, they are known for their performance fee structure. In general, they are often said to have a '2 and 20' fee structure, meaning that they charge their investors a 2% management fee and a 20% incentive fee, although some funds may charge even up to 50% incentive fee.[288]

Another visible feature of private equity and hedge funds is their increasing active involvement in the corporate governance of the companies in which they invest. Although it were traditionally private equity funds that aimed to create value by making changes in the corporate governance rules of their 'investee' companies, hedge funds have also increasingly embodied this strategy.[289] This so-called activist behaviour tend to attract substantial media attention as well as sharp criticism and has increased court rulings in some jurisdictions related to the attempts of these funds to reorganize and/or split up the company.[290]

Although there are many similarities between private equity and hedge funds, there are still some typical differences between the strategies used by both fund types. Below, these strategies are discussed in more detail.

287. W. Fung & D.A. Hsieh, *The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers*, 14 Rev. Fin. Stud. 313–314 (2001) ('Because hedge funds are typically organized as private investment vehicles for wealthy individuals and institutional investors, they do not disclose their activities publicly. Hence, little is known about the risk in hedge fund strategies' (citations omitted)) and S.N. Kaplan & A. Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. Fin. 1791, 1793 (2005) ('The [private equity] LPs consist largely of institutional investors and wealthy individuals who provide the bulk of the capital' and 'Private equity, as the name suggests, is largely exempt from public disclosure requirements', consequently 'we have only a limited understanding of private equity returns, capital flows, and their interrelation').

288. Achleitner & Kaserer, *Private Equity and Hedge Funds*: *A Primer*, 10 and n. 191, *supra*.

289. H.B. Shadab, *Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds*, 29 Nw. J. Intl. L. & Bus. 603 (2009). *See also* J. Bevilacqua, *Convergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity Funds*, 54 Buff. L. Rev. 251 et seq. (2006).

290. During 2005 and 2008, hedge funds pressured McDonald's Company to spin-off major assets in a IPO, pushed Time-Warner, Inc. to change its business strategy, threatened or held proxy contests over H.J. Heinz Company, Massey Energy Company, InfoUSA, Inc., and GenCorp, Inc., pushed for a merger between Euronext N.V. and Deutsche Börse Commodities GmbH, urged ABN Amro N.V. and ASMI to split up, and tried to reorganize Stork N.V. Private equity funds bought out, among others, VNU N.V., BSN Medical GmbH & Co, Vendex KBB N.V, and, in 2012, Four Seasons Health Care Ltd. *See*, e.g., Report of The Conference Board Research Working Group on Hedge Fund Activism, *Findings and Recommendations for Corporations and Investors* 57 (September 2008) (providing a table of examples of activist hedge Fund tactics and outcomes during the period 2005–2008) and J.M. Tannon & R. Johnson, *Transatlantic Private Equity: Beyond a Trillion Dollar Force*, 8 J. Priv. Equity 78 & 80 (2005) ('Perhaps the highest profile of any segment of the private equity fund marketplace in the U.S. would be the leveraged buyout or LBO funds' and 'Significant activity occurred in each of these sectors, including transactions such as Safety Clean, Odeon, Saga, and Four Seasons Healthcare'). The report of the Conference Board Research Working Group on Hedge Fund Activism can be found at: http://www.conferenceboard.ca/.

[A] Hedge Fund Strategies

Hedge fund strategies can be generally divided into four broad groups: (1) event driven strategies, (2) arbitrage strategies, (3) global macro strategies, and (4) long and short sale strategies. Event driven strategies include investing in companies in order to seek to profit from price changes subsequent to companies that go bankrupt, undergo restructuring or merge, and also include (generally short-term) investing in companies to influence company management and operations (distressed securities).[291] The latter also includes activist behaviour of hedge funds after obtaining a minority (or sometimes majority) stake in a company. In its impact assessment to the AIFM Directive, the Commission considered alternative funds, including hedge funds, to pose a risk on the market for corporate control when they acquire shares of a company in order to play an active role in the governance of the company. As such, there may be a risk that the acquisition of shares by the fund have not been sufficiently transparent to the company's management and may be detrimental to the interests of other stakeholders.[292]

Arbitrage strategies are strategies that aim at exploiting price differentials that exist as a result of market inefficiencies. Examples of such strategies include the taking long and short positions in similar portfolios within a certain country (equity market arbitrage), exploiting price differences between related interest products (fixed income arbitrage), and purchasing convertible securities and the corresponding share in order to profit from the price difference between the two securities (convertible arbitrage).[293] The global macro strategy is the strategy of investing in a variety of financial instruments to profit from broad worldwide changes in economic factors such as currency rates, national income, and demographics.[294]

Long and short sale strategies comprise of the following subcategories: short selling, long-only, and long/short equity. Short selling is the sale of a security that the seller does not own, with the intention of buying back an identical security at a later point in time to be able to deliver the security.[295] Long-only is a strategy which employs a 'growth' or a 'value' approach to investing in equities with no short selling or hedging to minimize the risks.[296] Long-only funds typically invest in emerging markets where there are restrictions on short selling.[297] It is generally assumed that traditional funds in principle take long positions only, as a consequence of which a fund that has

291. A.A. Al-Sharkas, *The Return in Hedge-Fund Strategies*, 10 Intl. J. Bus. 221 (2005).
292. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 21.
293. AFM, *Hedge Funds: An Exploratory Study of Conduct-Related Issues*, 23.
294. Shadab, *Coming Together after the Crisis: Global Convergence of Private Equity and Hedge Funds*, 605.
295. T. Garbaravicius & F. Dierick, *Hedge Funds and Their Implications for Financial Stability,* ECB Occasional Paper Series No. 34, 70 (2005) and n. 322, *infra*. This paper can be found at http://userpage.fu-berlin.de/~ballou/economics/texte/marketstabilityhfundsecb01.pdf (accessed 15 Aug. 2014).
296. Al-Sharkas, *The Return in Hedge-Fund Strategies*, 221.
297. R. Gupta & J. Jithendranathan, *Short-Sales Restrictions and Efficiency of Emerging Option Market: A Study of Indian Stock Index* Options, 46 Intl. Res. J. Fin. & Econ. 99–100 (2010) ('In many of the emerging equity markets short-sales is not allowed', but 'when these emerging

employs only this strategy will generally not be a hedge fund.[298] Hedge funds usually combine this strategy with short positions, i.e., the long/short equity strategy.[299] In this respect, it can be noted that the proposed ELTIF framework intends to provide for an EU passport for funds that only want to invest in qualifying long-term assets, such as infrastructure, transport and sustainable energy projects.[300] If the regulations come into force, such funds are available to all types of investor, including retail investors, across the EU subject to the investor protection regulations of the AIFM Directive and certain additional requirements.[301]

A hedge fund that uses the long/short equity strategy typically buys long equities that are expected to increase in value and sells short equities that are expected to decrease in value.[302] By taking short positions in the same market, the fund manager 'hedges' the risk that the long investments would not increase in value. Although this 'market-neutral' behaviour formed the basis of the first hedge fund, most hedge funds nowadays intentionally seek market risk in order to gain as much profit as possible.[303]

[B] Private Equity Fund Strategies

Private equity strategies generally comprise of the following four types: (1) venture capital, (2) leveraged buy-outs, (3) mezzanine debt investing, and (4) distressed strategies. Venture capital financing is widely known as taking large blocks of shares of new companies and then take on an active approach into the decision-making process of the company in order to help the company grow and generate a positive return on the investment.[304] Venture capital funds make investments into companies that are not

markets introduce derivative markets such as options and futures contracts on the underlying stocks, investors can use these derivatives to overcome many of the short-sales restrictions').

298. AFM, *Hedge Funds: An Exploratory Study of Conduct-Related Issues,* 16.
299. *Ibid*.
300. An ELTIF should invest at least 70% of its capital in qualifying long term investments, of which not more than 10% is invested in instrument issued or by or loans grated to a single qualifying portfolio undertaking, directly or indirectly in a real estate and any single ELTIF, EuVCF or EuSEF, and 5% should be invested in eligible assets for UCITS where those assets have been issued by any single body. In addition, the aggregate value of shares of ELTIFs, EuvECAs and EuSEFs in an ELTIF portfolio shall not exceed 20% of the value of its capital and the aggregate risk exposure to a counterparty of the ELTIF stemming from OTC derivative transactions or reverse repurchase agreements shall not exceed 5% of its capital. *See* Article 12(1)-(4) of the ELTIF Proposal.
301. For example, the fund manager of any such ELTIF must obtain all necessary information regarding a retail investor's knowledge and experience, financial situation, risk appetite, investment objectives and time horizon in order to assess whether the ELTIF is suitable for direct marketing to that retail investor, taking into account, *inter alia*, the lifecycle and the intended investment strategy of the ELTIF. *See* Article 23a and 23b of the ELTIF Proposal.
302. Consequently, the fund manager wishes to profit from both investments. *See* F. l'Habitant, *Handbook of Hedge Funds* 7 (John Wiley & Sons 2011).
303. Engert, *Transnational Hedge Fund Regulation,* 334.
304. M. Wright & K. Robbie, *Venture Capital and Private Equity: A Review and Synthesis*, 25 J. Bus. Fin. & Acctg 521 (1998) ('Venture capital is typically defined as the investment by professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is an eventual capital gain, supplemented by dividend yield').

listed on the stock exchanges.[305] At the EU level, an EU venture capital fund framework, the EuVCF Regulation, has been adopted to allow certain small fund managers to market qualifying venture capital funds across the EU under a voluntary EU passport, without having to comply to all the requirements AIFM that are deemed to be unsuitable for this industry.[306] These requirements include the minimum capital requirements, the requirement to appoint a depositary, regular valuation of assets, liquidity management, leverage calculation and delegation rules of the AIFM Directive.[307]

Similar to venture capital funds, leveraged buy-out funds take large positions, sometimes majority positions, into companies with the aim of restructuring them and making a profit. The main difference between leveraged buy-out funds and venture capital funds is that leveraged buy-out funds usually invest in public companies. Leveraged buy-out funds can be broadly defined as funds that borrow capital to take a public company private or to place control in the hands of company managers, and then seek to increase the company's value by improving its operations or structure.[308] Most leveraged buy-out funds require the management of the company to take on a significant investment in the company, so that they have 'skin in the game', although research shows that the management's interest in the company is not always high enough to be considered to be a 'significant' stake.[309] In a leveraged buy-out, a controlling part of the sharers of another company is acquired by using a significant amount of borrowed money to meet the cost of acquisition.[310] According to the Commission, there is a risk that the company may not be able to pay down that debt or to meet the interests payments.[311]

305. *Ibid.*
306. A qualifying venture capital fund is a fund that: (i) intends 70% of the capital received from investors is spent in supporting young and innovative companies, and (ii) does not use more than 30% of its aggregate capital contributions and uncalled committed capital for the acquisition of assets other than young and innovative companies. *See* Article 3(a) of the EuVCF Regulation. The regulation only applies to managers of EuVCF's falling below the de minimis thresholds of the AIFM Directive. *See* on these thresholds section 3.3.2[B].
307. European Commission, Impact Assessment to the Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds, COM(2011) 860 final, 2011, 57 ('Full compliance with these requirements, tailor-made for systemically relevant investment strategies that involve a high level of leverage do not appear suitable for venture capital funds').
308. Shadab, *Coming Together after the Crisis: Global Convergence of Private Equity and Hedge Funds,* 604.
309. Kaplan & Strömberg, *Leveraged Buyouts and Private Equity*, 131 (stating that '[i]t remains the case that management teams obtain significant equity stakes in portfolio companies' and noting that of the forty-three leveraged buy-outs in the US from 1996 to 2004 that were object of research, the median chief executive officer received 5.4%of the equity upside (stock and options) and the management team as a whole got 16%).
310. Kaplan & Strömberg, *Leveraged Buyouts and Private Equity*, 121 ('In a leveraged buyout, a company is acquired by a specialized investment firm using a relatively small portion of equity and a relatively large portion of outside debt financing').
311. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 22, n. 30 ('In autumn 2008 there were about 75% of portfolio companies behind schedule in their earnings plans to decrease the debt burden, which clearly reflects the difficulty of accessing credit to re-finance the debt, as was common practice prior to the financial crisis').

Mezzanine debt strategies involves the buying of securities that have the features of both debt and equity, such as debt securities that are convertible to equity, because such securities may enable the private equity fund to both generate a profit when equity markets rise, while the debt provides a constant level of cash payments.[312] Private equity funds often use this strategy to help finance their leveraged buy-outs. Finally, distressed strategies involves purchase a large stake in the debt and/or equity of companies near or in bankruptcy at a fraction of their face value with the aim of actively turning around the company, taking part in the restructuring or bankruptcy process, or otherwise generating long-term value from the securities by actively engaging in the corporate governance of the company.[313] As mentioned, hedge funds also increasingly use this strategy, although they generally take only a small stake of the shares or other securities of a company.[314]

[C] Specific Legislative Initiatives Targeted at Hedge Funds and Private Equity Funds

Traditionally, the European Commission was opposed to regulating hedge funds and private equity funds as they were considered to have a positive effect on the market since 'they have given greater liquidity, they have added shareholder value and they have helped the rationalization and innovation of companies'.[315] However, the Commission changed its view on these and other alternative funds (such as real-estate funds) as a result of the financial crisis of 2007 as 'the financial crisis indicate[d] that a number of the risks posed by AIFM have been underestimated and are not sufficiently addressed by the current combination of national financial and company law regulation, general EU provisions and self-regulation'.[316] Consequently, the AIFM Directive was adopted in 2009.

While the AIFM Directive applies to all types of alternative funds, hedge funds and private equity funds, are often assumed to have a higher risk profile than other alternative funds. According to the impact assessment to the directive, hedge funds appear to be the most risky funds of the alternative type, whereas private equity funds have the highest risk exposure in a particular segment, namely risks related to leveraged buy-outs and the market for corporate control.[317] Furthermore, considering the activities of these funds, they stand out the most among alternative funds. Both

312. Anson, *Handbook of Alternative Assets*, 456. Most private equity funds demand an equity 'kicker' to be attached to the mezzanine debt, which is usually in the form of equity warrants to purchase stock at a discounted strike price. *Ibid.*, 457.
313. *Ibid.*, 477–478 (however speaking only of distressed debt investing) and J. Madura, *Financial Markets and Institutions (with Stock Trak Coupon)*, 603 (Cengage Learning 2009).
314. *See* n. 289, *supra*.
315. *Hedge Funds, Private Equity 'Good for Market'*, Financial Times (19 Feb. 2007) (interview former Internal Market Commissioner McCreevy).
316. Commission of the European Communities, Impact Assessment on the proposed AIFM Directive, 18.
317. *Ibid.*, 7–8.

types of funds generally seek to generate absolute return.[318] Absolute return funds are funds that aim to deliver positive returns in all market conditions, as opposed to traditional funds, which merely focus on beating an index benchmark.[319] In general, they employ a high level of leverage.[320]

Leverage is a method to gain a large exposure to a financial market. It can be achieved by increasing the investment through either borrowing or via short selling, the use of derivative instruments and/or structured products.[321] When a fund borrows money, its losses, as well as its gains, is magnified. Short selling is the practice of selling securities that are borrowed.[322] Derivatives, such as options, swaps and futures, magnify the exposure to a certain asset class, and structured products, such as collateralized debit obligations, also provide implicit leverage. Leverage not only magnifies the impact of risks for investors, but also can mean that leveraged fund have a much stronger influence on markets than otherwise expected, that can lead to systemic risk.[323] As a result, the AIFM Directive imposes several transparency rules related to an AIF's leverage exposure (see sections 3.7.3 & 3.7.4). In addition, the use of short selling by several market parties drew much attention from regulators and supervisory authorities, which led to the adoption of a notification duty by the EU regulator.[324]

318. It can be noted that private equity funds, other than hedge funds, are not always expressly typified as funds that generate absolute return. However, most private equity funds invest in private companies or buy-out public companies that are in their view undervalued with the aim of making that company more profitable and later making a return on the investment even if the equity market or the market in which the company operates declines. In many cases, they will thus employ an absolute return strategy depending on the development of their portfolio companies. *See also* A. Achleitner & C. Kaserer, *Private Equity and Hedge Funds*: *A Primer*, 9.
319. *See* for the difference between absolute return and traditional return funds also, e.g., AFM, *Hedge Funds: An Exploratory Study of Conduct-Related Issues* 16 (2005). The AFM study can be found at AFM's website: http://www.afm.nl/.
320. Although traditional funds may also employ (some amount of) leverage.
321. Stowell, *Investment Banks, Hedge Funds, and Private Equity,* 221.
322. There are two types of short selling: 'covered' short selling where the seller has made arrangements to borrow the securities before the sale and 'uncovered' or 'naked' short selling where the seller has not borrowed the securities when the short sale occurs. *See* European Commission, Impact Assessment to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps, SEC(2010) 1055, 2010, 5. Although most definitions of short selling refer to the borrowing of securities, in both forms of short selling, full legal ownership is transferred to the borrower under the agreement of delivering the securities back at a later point in time. In addition, both seller and buyer will generally negotiate a fee for this loan arrangement. *See* G.T.M.J. Raaijmakers, *Synthetische aandelenbelangen in beursvennootschappen. Empty voting, vote stripping, hidden ownership en vote trading*, in *Preadvies 2007 van de Vereniging Handelsrecht: Achter de schermen van beursaandeelhouder* 16–17 (G.T.M.J. Raaijmakers & R. Abda, Kluwer 2007).
323. Commission of the European Communities, Impact Assessment on the proposed AIFM Directive, 10.
324. Commission Regulation (EU) No. 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps, OJ L 86, 1 (effective as of 1 Nov. 2012). The Regulation entails a notification requirement of all market participants to the competent authorities for a net short position in listed shares at a threshold of 0.2%. If the net short position reaches a threshold of 0.5% of the issued share capital of the listed company public disclosure of the position is required. Uncovered short positions are only allowed under certain circumstances set out in the Regulation.

Systemic risk can be described as the risk that an event will trigger a loss of economic value or confidence in a substantial portion of the financial system that is serious enough to have adverse consequences for the real economy.[325] Although many, including the Commission,[326] believe that hedge funds and private equity funds did not cause the financial crisis, they are generally considered to have the potential to pose systemic risk to financial stability if they are individually very large or highly leveraged.[327] Risk factors of AIFs that influence the financial system as a whole are highly leveraged portfolios and direct exposure to systematically important banks.[328]

Since, as a result of the adoption of AIFM Directive, both hedge funds and private equity funds are covered by this directive when they offer their shares in the EU (unless exempted), they are also subject to the rules following from this directive, including rules on their leverage use. In the next chapter, it will therefore be referred to the investor protection regulations governing all types of alternative funds, including private equity and hedge funds. In case the AIFM Directive contains specific investor protection rules that are primarily aimed at hedge funds and/or private equity funds, reference will however be made of that fact. Rules that do not affect the protection of fund investors, such as restrictions on asset stripping, will not be discussed as they fall outside the scope of this research.[329] For venture capital funds, the EuVCF Regulation may be used to offer shares in the EU, but this is a voluntary regime and it aimed is at a specific AIF sector that, according to the Commission, does not employ 'systemically relevant investment strategies'.[330] From an investor protection perspective, these different regulatory treatments may be relevant as they may lead to different levels of protection. For the purpose of this research, however, the AIFM Directive (and the UCITS Directive) will form the basis of the discussion of EU law. Other EU law,

325. S. Gerlach, Note prepared for the European Parliament's Committee on Economic and Monetary Affairs, *Defining and Measuring Systemic Risk* 2–3 (November 2009). The note can be found at: http://www.europarl.europa.eu/.
326. C. McCreevy, *Opening Speech EC Conference on Private Equity & Hedge Funds* (26 February 2009) (stating that, while referring to the De Larosière Report, 'hedge funds and private equity have not been central to the crisis'). The speech can be found at: http://europa.eu/.
327. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 8 ('AIFM – in particular those managing large, leveraged AIF – may also have contributed to asset price inflation in many markets, where they were active momentum traders in the period to mid-2007').
328. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 64 (stating that systemic risk of AIFs may crystallize through two broad channels: the credit channel (exposures to funds are an important source of counterparty risk for the providers of leverage, namely the prime brokers) and the market channel (as large players in markets for many financial assets, leveraged funds have the potential to move markets)).
329. Article 30 of the AIFM Directive imposes restrictions on distributions (which includes dividends and interest on shares), capital reductions, share redemptions or purchases of own shares by 'controlled' portfolio companies during the first two years of ownership by an AIF managed by an EU AIFM or a non-EU AIFM marketing such AIF in the EU pursuant to the passport. *See* on this provision, e.g., Zetsche, *The Alternative Investment Fund Manager Directive* vol. 20, 589–590 (International Banking and Finance Law Series, Kluwer Law International 2012).
330. *See* n. 306 and accompanying text, *supra*.

including the EuVCF Regulation, will be mentioned in case it is of relevance to the particular issue under consideration.

2.7 LEGAL STRUCTURES

The legal structure of a fund forms the basis of the governance framework under which the fund operates.[331] Investment funds are organized in a legal structure under national EU Member State law, in case of an EU-based fund, or state law in case of a US-based fund. As these laws may provide for certain (minimum) level of protection to investors, it is interesting to assess the main legal structures used by funds and the subsequent national/state regulations applying to these fund structures. As the other features discussed in this Chapter, the question intended to be answered in this paragraph is related to the first research question ('Which key features of investment funds are relevant in relation to the activities of fund managers to the issue of the retail investor protection?'). More specifically: can the legal structure be qualified as key feature of funds that helps protect EU retail investors?

2.7.1 Two Types of Legal Models

There are two basic legal models in which investment funds are organized: (1) the contractual model and (2) the corporate model.[332] In this classification, the contractual model consists of all fund structures created by contract and the corporate model consists of corporations set up as such under statutory law. A type of fund that falls in the contractual model include, among others, the UK/US LP, the French/Luxembourg FCP and the Dutch Commanditaire Vennootschap (CV). In general, these structures can be classified as partnership structures, which include all contractual structures that are not separate legal entities under which each investor is a co-owner of the assets funds can be organized. Another contractual fund structure is the trust. A trust fund is essentially created by contract (i.e., the trust agreement).[333] It can however be noted that some refer to the trust form as a separate category, next to the partnership

331. The Financial Affairs Commission of the OECD describes the relationship between fund governance and investor protection as follows: 'In its broadest sense, the task of governance of CIS can be conceived as a set of arrangements, including a well-defined legal and regulatory framework for investor protection, through which a CIS operator offers the public a vehicle embodying a specified investment mandate, communicates essential facts about the CIS to investors and implements the investment strategy on an ongoing basis'. Thompson & Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, 9. The legal structure of a fund is not the only factor in the governance regime. Other factors, such as industry standards of best practice ('codes of conduct'), and market competition may also play an important role in the governance of funds and thus, the way in which fund investors are protected. In this book, these aspects will however only be dealt with indirectly, where appropriate.
332. Technical Committee of the IOSCO, *Examination of Governance for Collective Investment Schemes, Consultation Report Prepared by the Committee's Standing Committee on Investment Management (SC5)*, 5 (identifying two main fund structural models: the corporate and the contractual model).
333. *Ibid.*, 8 (referring however to 'trust deed' instead of trust agreement).

structures in the contractual model.[334] This is mainly because, while a trust can technically be classified as a contractual form, investors (also referred to as 'the beneficiaries') do not, as opposed to other contractual funds, have the legal title to the fund property. This is vested in the hands of the trustee. Instead, investors have an equitable property interest in the fund.[335]

This difference in legal status of investors may justify the separate status of the trust. However, the trust is also very similar to most other contractual funds as it can only be operated when established under the specific laws of the home jurisdiction related to this structure. Where, for example, Dutch CVs are required to be created under Dutch law applying to CVs and must operate in accordance with the provisions of that law, trust funds must comply with the laws and regulations relating to trusts in their country of establishment, often the US or UK. Under these laws, the principle of the freedom of contract is impeded by some mandatory provisions, which are provisions that parties cannot change by contractual agreement. For example, investors in a Dutch CV are prohibited from performing management activities or to work in the CV's business, on the penalty of liability for the fund's debts.[336] In a UK trust fund, the trustee has an obligatory monitoring function on the fund's manager.[337] However, rules and restrictions limiting the party autonomy and the freedom to determine (parts of) the content of the contract are applicable to all contractual funds that have a legal basis. Therefore, for the purpose of this research, all the above-mentioned contractual fund structures, including the trust form, will be considered to fall under the contractual model.

In the following subparagraphs, the two general structures within the contractual model (i.e., the partnership and trust structure) and the corporate model will be discussed. After this, it will be assessed which (features of the) legal structures discussed are relevant in the context of investor protection and will, therefore, be further discussed in the following chapters. With respect to the contractual model, it can be noted that there are some contractual funds that are not subject to any organizational or operational laws and regulations. They do not have any legal status and are only created for tax-related purposes. These funds can be established by contract without having to comply with legal obligations regarding the form of the fund or the rights and duties of the parties in the fund. An example of such a fund is the

334. Thompson & Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, 14 (characterizing the remainder category however as 'the contractual form', which includes all funds created by contract that are not trusts (or corporations)).
335. J.H. Sears, *Trust Estates as Business Companies* 1 (2nd ed., The Lawbook Exchange 1998) (stating that a trust 'implies two interests: one legal and the other equitable; the trustee holding the legal title or interest and the cestui qui trust or beneficiary holding the equitable title or interest') and C.E. Rounds, *Loring a Trustees Handbook* 236 (Aspen Publishers 2009) (noting, while citing work of Ascher & Scott, that the trust is a form of double ownership with the trustee holding the legal title, but the beneficiary having equity ownership). Rounds however mentions that the beneficiary may also has some proprietary interest in the underlying property, along with the equitable interest.
336. *See* n. 347, *infra*.
337. *See* n. 412, *infra*.

Dutch Fonds voor Gemene Rekening (FGR).[338] FGRs are held to comply with Dutch securities laws that are highly derived from the UCITS Directive or the AIFM Directive. Although most Dutch funds are structured as FGR's, there are no specific statutory regulations applying to them. As a result, this fund structure, as well as other purely contractual EU funds that are not subject to specific national securities law, will not be assessed separately below.

2.7.2 Partnership Structure

[A] General Structure

Partnerships are essentially associations of two or more persons to carry on a business as co-owner for profit. An important advantage of the partnership is the fact that they are generally tax transparent, which means that the income and capital gains of such funds will be taxed at the investor level, based on the proportional share of the investor in the fund's assets.[339] However, it can be noted that non-residential investors may be faced with burdensome administrative procedures in attempting to claim this transparency.[340] In any case, because the tax treatment of investment funds is not harmonized across the EU, it will depend on the national applicable tax rules how a fund, and subsequently its investors, is taxed and how much tax there is withhold by the national tax authorities or must be paid on realization of the investment income and distribution of that income to investors.[341]

While in EU continental countries there are a variety of partnership forms available, in the US, essentially only one form is used to organize contractual funds in:

338. *See* on the tax status of the Dutch FGR, D.F.M.M. Zaman & M.S. Koppert-van Beek, *De kwalificatie van het fonds voor gemene rekening*, 109 Ondernemingsrecht 379 (2008) ('Van een besloten fonds voor gemene rekening [FGR], dat anders dan het open fonds fiscaal transparant is voor vennootschapsbelasting en dividendbelastingdoeleinden is sprake wanneer het een fonds betreft, waarbij de vervreemding van de bewijzen van deelgerechtigdheid kan plaatsvinden, mits daarvoor de toestemming van alle participanten is verkregen. In het hierboven genoemde Besluit uit 2007 is dat toestemmingsvereiste enigszins versoepeld').
339. *See*, e.g., S. Jaffer (ed.), *Multi-Manager Funds: Long-Only Strategies for Managers and Investors* 294 (Euromoney Books 2006) (noting that '[t]he Irish common collective fund (CCF), introduced in 2003, has been used as an effective route to secure the zero per cent rate available on direct holdings of US equities by UK pension schemes under the US/UK double taxation agreement' and that 'the FCP (…) can be used to enable flow-through of the benefits (and tax entitlements) accruing from the underlying investment to the end-investor via the medium of the intermediate transparent pooling arrangement').
340. *See* Viitala, *Taxation of Investment Funds in the European Union*, 153 (stating that '[i]n the case of the FCP, the principle of transparency is also applicable to non-residential investors', however 'it is up to the individual investor to claim any benefit provided by the tax treaty between the state of residence and France' and 'tax credits – in respect of foreign-source income provided by tax treaties between France and the source states of income – are not available to non-resident investors'. 'In practice, individual claims by non-resident investors are precluded by disproportionately burdensome administrative procedures').
341. *See* on the taxation of investment funds, more specifically UCITS, and the tax advantages and disadvantages that occur in cross border trading, R.P.C. Adema, *UCITS and Taxation: Towards Harmonization of the Taxation of UCITS* (Kluwer Law International 2009).

the LP structure.[342] In both the EU partnerships forms used by funds and the LP structure, the fund is established by a single contract, also referred to as the partnership agreement. There are two types of partners in partnership structures used by funds: general and limited partners. Limited partners have limited liability, i.e., their exposure to the fund's debts is generally limited to their investments in the fund. By contrast, general partners are jointly and severally liable for all obligations of the fund, although they are typically organized as corporations in order to avoid liability. General partners manage the fund, while the limited partners only invest in the fund.

EU Structures

The most commonly used partnership funds established in continental Europe include the French/Luxembourg FCP, the Dutch Commanditaire Vennootschap (CV), the Irish Common Contractual Fund (CCF), and the German Miteigentumslösung. In the French and the Luxembourg FCP (the latter of which is highly based on the French model), the fund manager must be a separate management company (société de gestion) that is registered (has obtained a license) with the Autorité des marchés financiers (France) (AMF) or Commission of Surveillance of the Financial sector (Luxembourg) and the fund must have a separate independent depositary in accordance with EU law.[343] The investors in the FCP have, being in fact the limited partners of the fund, no personal liability beyond their investment in the FCP.[344]

The Dutch CV form is a contractual legal form used by many funds established in the Netherlands in which at least one or more sleeping (commanditaire) and at least one or more active or general (beherende) partners exists.[345] Sleeping partners are partners who only contribute capital or other resources to the partnership and are generally only liable up to the amount of their contribution.[346] Consequently, these partners are also referred to as limited partners. A sleeping partner is prohibited from performing an act of management (daad van beheer) or to work in the CV's business. Furthermore, the name of a sleeping partner may not be used in the name of the CV. In case these restrictions are violated, the sleeping partner concerned becomes fully

342. Although US contractual funds can also be organized as general partnerships, LLCs or limited liability partnerships (LLPs). These forms are however less popular among fund originators than the LP form for different reasons. In a general partnership, each partner is fully personally liable for the debts of the partnership, while investors in a LP are only liable up to the amount they have invested in the partnership. The LLC and LLP also structures offer limited liability to investors, but require enhanced disclosure to investors based on company law (in case of an LLC) or may be only available to professional practices (in case of a LLP).
343. *See* Articles 7 and 17(1) of the Luxembourg UCI law and Article 214-8-1 of the French Ordinance 2011-915 (providing that the custody of the assets of a FCP must be entrusted to a depositary and that the FCP must be managed by a management company).
344. Article 5 of the of the Luxembourg UCI law and Article 214-8-5 of the French Ordinance 2011-915.
345. Article 19(1) of the Dutch Commercial Code, The Netherlands Bulletin of Acts (Staatsblad) 1826, 18, lastly amended in 2009.
346. Article 20(3) of the Dutch Commercial Code.

personally liable for the debts of the CV.[347] Active partners have the duty to manage the CV and can be held personally liable for the debts of the CV if the CV fails to meet its obligations.[348] They are therefore also referred to as general partners. With respect to a Dutch CV fund that is required to register with the AFM,[349] a separate entity (beheerder) that is authorized to manage the fund is required.[350] Furthermore, Dutch law requires that the legal ownership of a fund that has no legal personality, including CV funds (and FGR's), as well as all Dutch UCITS, is in the hands of an independent separate entity.[351] Before the implementation of the AIFM Directive into Dutch law in 2013, the depositary was held to also be the legal owner of the fund's assets.[352] The newly introduced 'separate entity' that functions as title holder or owner of the fund's assets may also be the depositary, but this is no longer required (for both Dutch UCITS and AIFs). With respect to the old rule, there was discussion among academics on the question whether the text of the particular provision should been understood as requiring to depositary to be also the legal owner of the fund's debts or not, since the provision and its legislative history are not conclusive on this matter.[353] The same

347. *See* Articles 20(1), (2) and 21 of the Dutch Commercial Code and the Dutch Supreme Court, 24 Apr. 1970, NJ 1970, 406 (Romano Import) (determining that de sleeping partner can be held liable for both existing and future debts of the CV in case of violation of Article 20 of the Dutch Commerce Code).
348. Article 19(1) of the Dutch Commercial Code.
349. A Dutch CV fund that wishes to offer its shares in the Netherlands is required to register with the AFM, unless (1) its shares are offered to fewer than 150 people who are not qualified investors and/or exclusively qualified investors (the definition of qualified investors is aligned with the definition of qualified investors and professional investors used in respectively the Prospectus Directive and the MiFID 2), (2) its shares can only be acquired at a counter value of at least EUR 100,000 per participant or per unit and/or are offered to directors, supervisory directors or employees of the fund or an entity affiliated to the fund, (3) its manager has a portfolio of assets under management that does not exceed a threshold of EUR 100 million or EUR 500 million in case of an unleveraged portfolio, (4) it is a foreign UCITS or AIF the manager of which has obtained a license in another EU Member or EEA Member State and has submit a notification letter, or (5) it is a 'Properly Supervised Investment Undertaking' (Adequaat Toezicht Beleggingsinstelling) under Article 2 of the Designated States Degree (Besluit aangewezen staten Wft), published in the Netherlands Government Gazette (Staatscourant) 2006, 228, as amended) (national regime that is applicable next to the AIFM regime until spring 2018). *See* Articles 2:65, 2:66(1), (3) and (4) and 2:66a(1) and (2) of the Dutch Financial Supervision Act.
350. Article 2:65(a) of the Dutch Financial Supervision Act. Funds that are structured as corporations may be self-managed and are thus not required to have a separate manager. *See* Article 2:65(b) of the Dutch Financial Supervision Act.
351. Article 4:37(f)(1) and (j), 4:44 and 4:45 of the Dutch Financial Supervision Act.
352. *See* Memorie van Toelichting of Wijziging van de Wet op het financieel toezicht, het Burgerlijk Wetboek, de Wet op de economische delicten en enige fiscale wetten ter implementatie van richtlijn nr. 2011/61/EU van het Europees Parlement en de Raad van de Europese Unie van 8 juni 2011 inzake beheerders van alternatieve beleggingsinstellingen en tot wijziging van de Richtlijnen 2003/41/EG en 2009/65/EG en van de Verordeningen (EG) Nr. 1060/2009 en (EU) Nr. 1095/2010 (PbEU 2011, L 174), Kamerstukken II (2011/201) 33 235, No. 2, 14.
353. *See* W.A.K. Rank & B. Bierman, *Aangaan van verplichtingen voor rekening van een FGR: aansprakelijkheid en verhaal*, 9 Tijdschrift voor Financieel Recht 301–302 (2008) (arguing that the relevant provision should be read as not including the depositary to be the legal owner of the fund's debts), D. Busch & J.W.P.M. van der Velden, *Aansprakelijkheid en verhaal bij Fondsen voor Gemene Rekening, Reactie op prof. mr. W.A.K. Rank en mr. B. Bierman, Aangaan van verplichtingen voor rekening van een FGR: aansprakelijkheid en verhaal, FR 2008, nr. 9, p. 299-310*, 4 Tijdschrift voor Financieel Recht 161–162 (2009) (arguing the opposite), Van der

discussion can however be taking place with respect to the new provision. However, since this difference in reading is relevant in the context of insolvency issues, as it influences the possibilities of investors to recover funds from the fund's assets, I will not further elaborate on this[354] In case a Dutch fund is not required to register with the AFM, either the depositary or other entity, not being the depositary, or the investors jointly own the legal title of the fund's assets, depending on the (interpretation of the) particular provision in the fund agreement relating to this issue.[355]

An Irish CCF is a contractual fund structure established under Irish law by a management company.[356] A CCF is constituted by a so-called deed of constitution which provides for, among other things, the safekeeping of the CCF's assets by a separate depositary and sets out the monitoring duties of the depositary.[357] Investors in a CCF are co-owners of the fund's assets and only liable up to the amount contributed by them for the shares of the CFF.[358] CCF's can be established as UCITS or non-UCITS funds and must be authorized by the Irish Central Bank and Financial Services Authority before allowed to market their shares in Ireland.[359] The CCF is considered a

Velden, *Beleggingsfondsen naar burgerlijk recht*, 130–134, and C.J. Groffen, *Nieuwe Wtb en Btb 2005; de implementatie*, 12 Tijdschrift voor Financieel Recht 369 (2005) (arguing in a similar way as Busch & Van der Velden).

354. J.W.P.M. van der Velden, *Civielrechtelijke aspecten van fondsen voor gemene rekening*, 16 Vastgoed 6 (2011) (stating that the separation of the fund's assets prevents creditors from other, insolvent funds managed by the same manager from attempting to recover money from the fund and that, in view of this, the legal ownership of the depositary would be meaningless in case the ownership of the depositary would only include the fund's assets (and not also the fund's debts)). *See* on the exclusion of bankruptcy and insolvency issues from the scope of this book, section 1.1.

355. Van der Velden, *Beleggingsfondsen naar burgerlijk recht*, 64–66 (describing four different interpretations of a provision in the Dutch fund agreement relating to the ownership of the fund's assets under the old rule that is not in itself definite on the issue of ownership: (1) the depositary holds the fund's assets in name of investors in the fund who are the co-owners of the assets, (2) the depositary holds the fund's assets in its own name for the benefit of the investors who are the co-owners of the assets, (3) the depositary is the legal owner of the fund's assets, or (4) the depositary is the legal owner of the fund's assets, which assets are separated from the assets of the depositary's own assets (this is the case for Dutch registered contractual funds)).

356. *See* the definition of 'common contractual fund' set out in the preliminary to the Irish European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (Irish UCITS Regulations 2011), Statutory Instruments no. 352 of 2011 ('common contractual fund' means a collective investment undertaking, being an unincorporated body established by a management company under which the participants by contractual arrangement participate and share in the property of the undertaking as co-owners).

357. *See* Articles 33 and 34 of the Irish UCITS Regulations 2011 and Ch. 6 of the Irish AIF Rulebook (Central Bank of Ireland, AIF Rulebook, May 2013). The rulebook can be found at the Irish Central Bank's website: http://www.centralbank.ie/. These supervisory duties are in line with the duties of de depositary set out in the UCITS Directive and the AIFM Directive.

358. Articles 37(4) of the Irish UCITS Regulations 2011 and 16(3) of the Irish Investment Funds, Companies and Miscellaneous Provisions Act 2005, Statutory Instruments no. 12 of 2005.

359. Articles 3(1) and 7(1) of the Irish UCITS Regulations 2011, 6(1) and 8(1) of the Irish Investment Funds, Companies and Miscellaneous Provisions Act 2005 and Irish AIF Rulebook, 35 and 104. A CCF can be organized as a retail UCITS fund, a Retail Investor AIF or a Qualifying Investor AIF. In the first case, it will be a UCITS, in the latter two, a non-UCITS.

tax transparent entity under Irish tax law, provided that the shareholders are exclusively institutional investors.[360]

In Germany, two subcategories of contractual forms are regulated by law: the Treuhandlösung and the Miteigentumslösung.[361] The German Treuhandlösung is a public contractual fund form that has trust-like features (see below). In this form, the title to the fund's assets (Sondervermögen) is in the hands of the external manager of the fund (Kapitalverwaltungsgesellschaft, or KVG, an investment management company under German law).[362] In a German Miteigentumslösung, the investors collectively have the legal title to the fund's assets. The Miteigentumslösung is managed by the Kapitalverwaltungsgesellschaft, or KVG, an investment management company under German law. The KVG is by the fund statute authorized to act on behalf of the investors with respect to the fund account.[363] Each KVG is required to have a two-tier board structure, which means that it must have a supervisory board that oversees the management board of the KVG.[364] A KVG must obtain a banking license from the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, or BAFin) in order to set up and manage a fund.[365] As a result, the KVG is subject to permanent supervision of the BAFin and must comply with the rules and regulations set out in the German Investment Act with respect to the funds managed by it. Following EU law, the German Miteigentumslösung is required to have an independent depositary for safekeeping the fund's assets and to monitor certain activities of the

360. Article 44 of the Irish Finance Act 2005, SI No. 5 of 2005. Until 2005, only pension funds and trustees or custodians of pension funds could invest in CCF's. The CCF's investor base was expanded by the Irish Finance Act 2005 to include all institutional investors and corporate entities.
361. C.E. Rounds & A. Dehio, *Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal* Structures, 3 N.Y.U J. L. & Bus. 496 (2007). These terms or not formal legal terms, but are commonly used in practice to describe the two types of German contractual funds found in the German Investment Act. *See also*, e.g., F. Haase & K. Brändel, *Investmentsteuerrecht: Einführung* 34 (Wiesbaden 2011) and S. Teichert, *Die Besteuerung in- und ausländischer Investmentfonds nach dem Investmentsteuergesetz* 43–44 (Schriften zum Wirtschafts- und Medienrecht, Steuerrecht und Zivilprozeßrecht, vol. 34, Peter Lang International Academic Publishers 2009).
362. *See* Articles 1(10) and 92(1) and of the German Capital Investment Act, Kapitalanlagegesetzbuch, Gesetz zur Umsetzung der Richtlinie 2011/61/EU über die Verwalter alternativer Investmentfonds (AIFM-Umsetzungsgesetz, 4 Jul. 2013, BGBl. 2013 Teil I Nr. 35, 10 Jul. 2013, 1981–2164) (providing that in case of a Treuhandlösung, title to the underlying assets is in the KAG). *See* for the definition of KVG Article 17(1) of the German Capital Investment Act. A KVG must be structured in the form of a public limited company (Aktiengesellschaft) or a private limited company (GmbH) (most common). *See* Article 17(2)(1) of the German Capital Investment Act.
363. Articles 1(10) and 92(1) of the German Capital Investment Act.
364. Similar to a regular German public limited company (Aktiengesellschaft). *See* Article 18(2) of the German Capital Investment Act (stating that also in case the KVG is structured as a GmbH, it must, in contradiction to the general law applying to GmbHs, have a supervisory board). The supervisory board must contain at least three members and that at least one of the members of this board must be independent of the management board. *See* Article 95 German Stock Corporation Act. The latter requirement (at least one independent board member) however does not apply to KAGs managing the Miteigentumslösung. *See* Article 18(3) of the German Capital Investment Act.
365. Article 20(1) of the German Capital Investment Act.

KVG.[366] Furthermore, the investors in a German Miteigentumslösung have limited liability, as the KVG is held liable for the debts of the fund.[367]

US Structure

Similar to the EU partnership structures, the US LP structure offers investors liability protection up to the amount invested in the fund. However, as a limited partner in a Dutch CV, investors have a risk of losing their limited liability if they participate in the management or control of the LP. This so-called control rule was first set out in the Uniform Limited Partnership Act (ULPA), drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1916,[368] and adopted in the early 1970s by all US states except for Louisiana.[369] In 1976, a revised version of the ULPA was adopted, the Revised Uniform Limited Partnership Act (RULPA),[370] which was amended in 1985. The RULPA added a list of safe harbour activities that do not constitute control. These activities include consultation with general partners about the LP's business, being a contractor, agent, employee or surety for the LP, attending partnership meetings, and proposing -and voting on- various fundamental and structural changes to the LP (e.g., dissolution, sale of all the LP's assets and admitting and removing partners).[371] In addition to these safe harbour provisions, the RULPA limited the control rule liability to persons who conduct business with the LP reasonably believing that the limited partner is a general partner.[372]

366. Articles 68–90 of the German Capital Investment Act (providing that the KVG has to appoint a an authorized credit institution acting as depositary (Verwahrstelle) that has the duty of safekeeping of the fund's assets and, among other things, ensure that the issue and redemption of units as well as the calculation of the value of units are always carried out in accordance with the Act and the fund rules, supervise the investment fund's transactions and approve specific transfers. These supervisory duties are in line with the duties of de depositary set out in the UCITS and AIFM Directive. The KVG and depositary can be of the same group, but the law requires that the directors of the depositary and its shareholders may not be employees of the KVG and vice versa. *See* Article 70(4) of the German Capital Investment Act.
367. Article 93(2) of the German Capital Investment Act (stating that the fund is not liable for obligations of the KVG and for transactions that the KVG has committed for the joint account of investors in the fund).
368. Article 7 of the ULPA of 1916 (declaring that the limited partner loses his or hers limited liability if 'in addition to the exercise of his rights and powers (…) he takes part in the control of the business'). The ULPA can be found at: http://www.uniformlaws.org/.
369. J.D. Donnell, *An Analysis of the Revised Uniform Limited Partnership Act*, 18 Am. Bus. L. J. 399–400 (1980) and R.A. Kessler, *The New Uniform Limited Partnership Act: A Critique*, 48 Ford. L. Rev. 159 (1979).
370. The RULPA of 1976 can be found at: http://www.uniformlaws.org/.
371. Article 303(b) of the RULPA of 1985. The RULPA of 1985 can be found at: http://www.uniformlaws.org/. A list of safe harbour activities also exist in the 1976 RULPA version, but the 1985 amendments extended the list by including, among other things, being an officer, director, or shareholder of a general partner that is a corporation, guaranteeing or assuming one or more specific obligations of the LP and taking any action required or permitted by law to bring or pursue a derivative action in the right of the LP.
372. Article 303(a) of the RULPA of 1985. Under the 1976 RULPA version, the control rule is limited to persons who conduct business with the LP 'with actual knowledge of his participation in control'.

As a result of the control rule set out in the RULPA, which has been adopted in more than forty states, including Delaware, limited partners in US LP's essentially are only held liable if the third party detrimentally relied on the exercise of control, and then only if the control does not fall within the long list of acts that the RULPA provides that do not constitute control.[373] Additionally, a number of states, in line with the ULPA 2001,[374] have even completely eliminated the rule. Thus, it can be concluded that limited partner liability in US LP's does not exist in reality. In general, US limited partners are either waived from liability or only liable in very exceptional cases (i.e., when they mislead a third party or perform activities outside the lengthy list of safe harbour activities).

[B] Management Structure

In all common partnership structures used by funds, the manager is usually a separate legal entity that also serves as the general partner of the fund. Contractual funds that fall under the UCITS Directive are even required to appoint a separate manager.[375] In case of a US LP fund that is registered with the SEC, however, the manager cannot be the only general partner of the fund as the law requires US registered funds to have at least 40% independent directors on their 'boards'.[376] EU contractual funds generally require less independence of fund directors, but may require a supervisory board on the level of the manager.[377] However, the latter is not a commonly used model in EU countries as EU law requires the adoption of an independent depositary with oversight duties in accordance with the UCITS or AIFM Directive.

The manager of a partnership fund operates on the basis of the partnership agreement, which is the main contract between the manager and the original (first) investors of the fund. This agreement usually (i) grants exclusive authority to the

373. *See also* L.E. Ribstein, *Limited Partnerships Revisited*, 67 U. Cin. L. Rev. 979 (1999) (stating that that the control rule essentially duplicates purported general partner liability).
374. Article 303 of the ULPA of 2001. The ULPA can be found at: http://www.uniformlaws.org/. The main reason for eliminating the rule in the ULPA 2001 is the fact that firms can easily avoid the rule by forming a LLC or other unincorporated legal structure. *See* ULPA 2001, Prefatory Note (stating that '[a]lthough th[e] "control rule" is subject to a lengthy list of safe harbors (…), in a world with LLPs, LLCs and, most importantly, LLLPs, the rule is an anachronism'). At 2012, about twenty states adopted the ULPA 2001, including Alabama, California, and Utah. Delaware, however, did not adopt the Act. *See* http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act%20(2001)%20(Last%20Amended%202013) (last amended 2013, accessed 26 Sep. 2015)).
375. *See* n. 410, *supra*.
376. *See* n. 107, *infra*.
377. For example, in Germany, the KVG is required to have a supervisory board that oversees the management board of the KVG. *See* n. 364, *supra*. In the Netherlands, such a board in not required by law, but the Dutch Fund and Asset Management Association (DUFAS) has set out rules relating to this issue in its 'Principles of Fund Governance' (adopted in 2008 and approved by the Dutch Ministry of Finance), which serve as a guidance for many internal Dutch fund codes. According to the DUFAS Principles, funds that do not opt for a supervisory board at the management company need to shape the oversight function in another way, where the oversight entity must be able to operate independently from the fund manager and associated parties. In the annex to the principles a number of options are described regarding how a fund manager can shape this within his own organization. *See* DUFAS *Fund Governance Principles*.

manager to manage the fund, (ii) establishes the compensation rules for the fund (including the special profit allocation rules for the manager), (ii) provides for the management fees and payment terms, (iii) specifies the costs of the fund and those that will be borne by the investors, (iv) establishes the investor's redemption rights and manager's rights to expel investors, (v) contains provisions relating to the delivery of records and accounts to the investors, and (vi) establishes other investor rights, including voting rights, and rules. In case the depositary is the legal owner of the fund's assets, as is the case for EU funds,[378] the agreement also typically includes a provision requiring that all legal actions performed by the manager are done in name of the depositary.[379] The manager generally has the right to amend the agreement. Investors can either decide to redeem their shares (if possible) or sell their shares in case they do not agree with any changes made to fund agreement by the adviser. In case of trust or corporate funds, a similar fund agreement is set up, although the denomination of the agreements vary among the different fund types (corporate fund charter or articles of incorporation, trust agreement or certificate of trust and the LP, CV, FCP agreement (i.e., partnership agreement), etc.).

The fund manager furthermore operates on the basis of an investment management contract. An investment management contract is a contract between the manager and the fund, in which the fund board (in the case of a partnership consisting of the general partner(s)) delegates to the manager the authority to manage the fund's portfolio. A third contract found in fund structures is the subscription agreement. This is the contract between the fund and new investors which provides the terms on which the investor may buy fund shares. It also includes certain representations and warranties. In case the fund shares are sold through a broker-dealer, the investor simply fills out an application or a subscription agreement that the broker-dealer forwards to the fund.[380] Finally, the fund manager contracts with various service providers providing services to the fund, including the depositary and/or custodian.

2.7.3 Trust Structure

[A] General Structure

A trust can be generally described as a contractual relationship, in which the trustee is held to deal with the trust property for the benefit of the beneficial owners of the trust.[381] The trust originally stems from the English medieval law and is nowadays

378. Articles 22 of the UCITS Directive and 21 of the AIFM Directive.
379. Busch & Van der Velden, *Aansprakelijkheid en verhaal bij Fondsen voor Gemene Rekening, Reactie op prof. mr. W.A.K. Rank en mr. B. Bierman, Aangaan van verplichtingen voor rekening van een FGR: aansprakelijkheid en verhaal, FR 2008, nr. 9, p. 299-310, 164*.
380. *See*, e.g., SEC, Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934, Securities Exchange Act Release No. 34-44992, 26 Oct. 2001, n. 14 and accompanying text.
381. *See also* Rounds, *Loring a Trustees Handbook* 17 (comparing the classic US and English definitions of the trust).

predominantly found in common law jurisdictions, most notably the US and the UK.[382] Similar to partnership funds, trusts are generally fiscally transparent which makes them popular investment choices for investors. With respect to the US trust form, it is even argued that their popularity is mainly related to their beneficial tax treatment.[383] In this context, it can be noted that US trust funds that qualify as Real Estate Investment Trusts (REITs) under Subchapter M of the Internal Revenue Code (IRC),[384] are classified as corporations for federal tax purposes. However, a REIT is permitted to deduct dividends paid to its investors from its corporate taxable income. REITs are required to distribute at least 90% of their taxable income to their investors annually.[385] As a result, REITs that distribute 100% of their taxable income to their investors owe no federal corporate tax and are thus, in essence, tax-exempt at the US federal level.[386] In addition, corporate funds qualifying as Regulated Investment Companies (RICs), are subject to similar provisions.[387]

UK and US Structure

While both systems allow the trust structure to be used as business structure, UK and US law relating to this structure differ from each other in a number of ways. So does UK law[388] governing open-end unit trusts (AUTs) require that the manager and the trustee be completely independent of each other, whereas the trustee of a US trust fund, structured as a business trust under the laws of a particular state, particularly Delaware or Massachusetts, can also be the manager of the fund?[389] Furthermore, there are a

382. Although trust-like structures do exist in non-common law systems, including civil law and mixed jurisdictions. *See* C. Howard, *Trust Funds in Common Law and Civil Law Systems: A Comparative Analysis*, 13 U. Miami Intl. & Comp. L. Rev. 356–357 (2006).
383. *See*, among others, W. Fenton & E.A. Mazie, *Delaware Business Trust* in *Delaware Law of Corporations & Business Organizations* 19-1 (J.A. Finkelstein & R. Franklin Bacotti, 3rd ed., sup. 2001, Wolters Kluwer Law & Business 1997), Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107, Jones, Moret & Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 456 and Schonfeld & Kerwin, *Organization of a Mutual Fund*, 115.
384. Codified in articles 856–859 of the IRC of 1986 (codified in Title 26 of the US Code (U.S.C.), § 1 et seq.).
385. Article 857(a)(1) IRC.
386. In addition to the 90% distribution requirement, REITs must meet several other requirements in order to make use of the conduit tax treatment of Subchapter M. For example, REITs must invest at least 75% of their assets in real estate investments and 95% of their income must derive from dividends, interest, rents, gains and refunds from real-estate investment income. *See* Article 856(c)(2) and (3) IRC.
387. *See* Articles 851–855 IRC. By contrast, however, at least 90% of a RIC's income must come from its investments as capital gains, dividends and interest. Also, it must have at least a 50% of its assets invested in cash or cash items, other RICs, US government securities, or other securities to an amount not greater in value than 5% of its NAV and to no more than 10% of the outstanding voting securities of such an issuer. *See* Article 851(ab) and (b) IRC.
388. Applying in England, Scotland, Wales and North-Ireland.
389. Article 6.9.2(1) of the COLL. US securities law only requires a certain percentage (40%) of the persons comprising the trust fund board (i.e., board of trustees) to be independent of the manager. *See* n. 107, *supra*. Note that in case the fund can be qualified as a US Unit Investment Trust under Article 4(2) of the 1940 Act, it has no board of directors. In that case, it has a depositary which is considered to be dependent under the Act. *See* Article 2(3)(F) of the 1940

number of strict provisions that are derived from the UCITS Directive and must be contained in the trust instrument of a UK Unit Trust, which are not, or not to the same extent, required in case of a US trust fund.[390] More generally, the securities and trust law systems in place in the US and UK have significant variations. Finally, while both the UK and US legislator have adopted the REIT model with tax benefits for investors, the two structures may be structurally different from each other as only the US REIT is required to be structured as a trust.[391]

However, despite these differences in US and UK trust structures, there are also some similarities between the two structures. So are investors in both structures not responsible for liabilities incurred by a trustee acting in behalf of a trust. However, they may become liable in case they, similar as to limited partners in the partnership, interfere in the business of the trust.[392] Another feature of the trust is that in the trust, title to the assets of the fund is held by the trustee or the board of trustees in case the fund has multiple trustees.[393] By contrast, in a corporate fund, the corporate entity itself is usually the titleholder, although this may also be the depositary of the fund in case of an EU corporate (or partnership) fund.[394] In a trust fund, the investors are the beneficiaries of the fund's assets and are therefore also referred to as the equitable owners of the fund's property, as opposed to the legal owner trustee.

Legal versus Equitable Ownership

The division of ownership between 'legal' and 'equitable' is a fundamental notion of the trust which stems from the traditional English court system, in which separate courts of equity (i.e., courts of chancery) and law existed.[395] An equitable ownership interest is in essence an interest right in property which has been developed by courts of chancery and which are usually governed by the terms of the trust agreement. Equitable ownership interest rights are also referred to as units, which represent a portion of the amount of money invested in the trust.[396] A bank, trust company, or

Act. Since most US trust funds are regulated under the 1940 Act as mutual funds, the Unit Investment Trust structure will not be discussed here.

390. Article 3.2.6 of the COLL sets out a number of requirements that must be implemented in a UK Unit Trust agreement. In case of a US trust fund, similar requirements only apply in case the fund is required to register with the SEC.
391. Rounds & Dehio, *Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal* Structures, 479 (stating that '[a] UK REIT (…) is not really a REIT in that it is neither a trust nor a mutual fund. Rather, it is similar in form and function to a U.S. Subchapter S Corporation').
392. *See* with respect to the US trust, J.A. Shafran, *Limited Liability of Shareholders in Real Estate Investment Trusts and the Conflict of Laws*, 50 Cal. L. Rev. 697–698 (1962).
393. *See* n. 335, *supra*.
394. *Ibid* and, e.g., Rounds & Dehio, *Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal Structures*, 490 (stating that the depositary of a UK OEIC (ICVC) holds legal title to the assets in the OEIC) and J.W.P.M. van der Velden, *Beleggingsfondsen naar burgerlijk recht*, 64 (noting that Dutch law prescribes that the depositary of a contractual Dutch registered fund is the legal owner of the fund's assets).
395. Rounds, *Loring a Trustees Handbook*, 1, note 5 ('Equity is essentially a collection of principles that were first enunciated in decisions of the chancery courts').
396. *See* on the term 'units' also n. 159, *supra*.

safe-deposit company (the 'lessor') is usually the custodian of the trust's assets.[397] However, a trustee that is a separate legal entity may also act as custodian.[398] Next to being the legal owner, the trustee of a UK Unit Trust fund performs the role as the depositary of the Unit Trust for the purposes of the UCITS or AIFM Directive.[399]

Legal Status

As mentioned, the trustee may consist of multiple natural or legal persons (together comprising the board of trustees of the fund) or be a separate legal entity. In the case the trustee is a separate legal entity, the persons serving on its board enjoy limited liability. This may be beneficial as the trust itself is often not recognized as a separate legal person. In general, the trust is considered to be a contractual relationship between the trustee and the beneficiaries, which is constituted by the trust agreement.[400] The legal status of the trust has also been described as an 'aggregation of property', where the rights and duties are divided among the trustee and the beneficiaries in the trust.[401] In this meaning, the trust can be viewed as a collection of relationships, such as a property relationship, liability relationship, and fiduciary relationship.

Despite this traditional view, however, courts have increasingly recognized the trust structure as being a separate legal entity or quasi-legal entity, providing the trustee limited liability for the acts of its agents or in tort cases.[402] More specifically, with respect to the US Massachusetts business trust, US courts have recognized that the trustee's liability may be limited in the trust agreement and that the beneficiaries of a Massachusetts business trust may bring a derivate action and vote by proxy.[403] However, neither Massachusetts law nor US courts recognize the business trust as a legal entity for all purposes.[404] In case of a Delaware business trust, however, the applicable statutory law states that this entity organized under the Delaware Business Trust Act (DBTA) is a legal entity, separate from their trustee(s), and may therefore carry on any lawful business or activity.[405] By contrast, a UK Units Trust is not considered to be a legal entity in itself, but will often have a trustee that is a separate

397. Rounds, *Loring a Trustees Handbook,* 772 (noting that the lessor may risk liability if the trustee is committing a breach of trust in permitting an agent access to the safe-deposit box).
398. Thompson & Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, 17.
399. Although there may be differences between the oversight responsibilities of the depositary in the COLL and those of the trustee under trust law. *See* Article 6.1.3(3) COLL ('The oversight responsibilities for a trustee of an AUT are similar to, but not the same as, the oversight responsibilities of the depositary of an ICVC or ACS. These differences result from the different legal structure of the authorised funds and the trustee's obligations under trust law'). *See* on the duties of the EU depositary also sections 2.3.3[A] & 3.9.
400. *See* n. 333, *supra*.
401. Rounds, *Loring a Trustees Handbook,* 109.
402. *Ibid.,* 110.
403. Jones, Moret & Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 433 & 443–444.
404. *Ibid.,* 430 & 440–441 (noting that 'the potential for shareholder liability continues to be an issue which must be addressed by lawyers representing Massachusetts business trusts').
405. Article 3801(g) of the DBTA, Del. Code Ann. tit. 12, § 3801 et seq.

(usually corporate) legal entity shielding the persons sitting on the trustee's board from any personal liability. Furthermore, the investors in the Unit Trust are not liable for the debts of the trust other than the payment they have made to purchase the units.[406] Thus, in the case of a UK Unit Trust, limited liability is de facto achieved. With respect to UK trust funds that do not qualify as Unit Trusts, i.e., Investment Trust Companies, including UK REITs, it must be noted that these trusts are legally constituted as public liability companies.[407] Consequently, other than what their name may suggest, they are technically separate legal entities with limited liability for their management and shareholders. Their governance structure is similar to that of a regular corporate fund (see below). In addition, ITCs that are listed on the London stock exchange are subject to a variety of regulations laid down by the FSA relating to listing, disclosure and transparency.[408]

[B] Management Structure

In the trust structure, the trustee has, as discussed above, a number of important duties. But can this figure also be the manager of the trust fund? In the case of a UK Unit Trust, the law requires that the trustee is independent of, and thus separate from, the manager of the fund.[409] This goes further than EU law, as only trust funds that are UCITS are required to appoint a manager that is a separate legal entity, being either the trustee or an external party.[410] As mentioned, the trustee of a UK Unit Trust functions as the depositary and can thus not also be the manager of the fund. In US trust funds, on the other hand, the trustee can be the fund's manager, provided that the fund is not required to register with the SEC. In addition, problems discussed above relating to the potential conflicts of interest of trustees when selecting and monitoring the external manager are addressed in the requirement of appointing one or multiple independent trustees.

As noted, in a UK Unit Trust structure, the trustee must be independent of the fund manager. The trustee thus in fact serves as the board of directors of the fund. This 'trust board' comprises a sole director that is a separate legal entity (trustee) or multiple

406. *See* Article 3.2.6 of the COLL (stating that the trust agreement of a UK Unit Trust must contain 'a provision that a unitholder in an AUT 'is not liable to make any further payment after he has paid the price of his units and that no further liability can be imposed on him in respect of the units which he holds').
407. A UK public liability company is a type of LLC that sells shares to the public. It is a flexible form of organizing a company that has elements of both the corporation and the partnership structure in it. The characteristic it has in common with the corporations is that it provides limited liability to the directors and shareholders of the company. It is similar to the partnership in that is has the availability of pass-through taxation. *See* Articles 3, 4 and 756–757 of the UK Company Act 2006, Article111 of the UK Income and Corporation Taxes Act 1988 and Article 848 of the UK Income Tax (Trading and Other Income) Act, 2005. The UK Income(Trading and Other Income) Act can be found at: http://www.legislation.gov.uk/.
408. *See*, e.g., the UK Company Act, the FSA's Listing Rules, http://fsahandbook.info/FSA/html/handbook/LR (accessed 30 Jul. 2014) and Financial Reporting Council, The UK Corporate Governance Code (September 2012). The UK code can be found at: http://www.frc.org.uk/.
409. *See* n. 389, *supra*.
410. Article 5(2) of the UCITS Directive.

directors, in which case the board is referred to as the board of trustees. In addition, the trustee also de facto operates as the depositary of the fund. In general, the trustee/depositary is independent of the external fund manager and has several oversight duties next to its key duty of safekeeping the fund's assets.[411] In case of a US public trust fund, however, a different regulatory approach will apply. Such a fund will generally fall under the definition of 'investment adviser' under the 1940 Act as a result of which it is required to register with the SEC.[412] Consequently, it will be required by law have a board of directors (called 'board of trustees'), which must meet the same criteria as the board of a corporate registered fund.

One of the most significant criterion for the board of a US registered fund is the requirement that the board must be composed of at least 40% of independent directors.[413] As the fund manager is not considered to be independent, the manager cannot also be the sole trustee of a US registered (trust) fund. He can only be one of the trustees sitting on the board of trustees, comprising of both dependent directors, including the manager, and independent directors. However, as is also the case with respect to a corporate fund (see below), persons with a strong personal or business relationship (not being an employee) with the fund or the manager, are not considered to be 'dependent' under US law and may thus qualify as independent directors. This is also the case for trustee members of a UK Unit Trust's board.[414] As many fund directors sit on multiple board seats within a fund family, they have a personal interest in electing and maintaining the manager, as well as in determining the height of the manager's remuneration. It can therefore be noted that it is questionable whether such directors would likely discipline ill-performing managers and thus be a potential obstacle for the manager.

With respect to UK Unit Trusts, it can be noted that the depository role of the trustee poses similar problems. While the trustee of a UK Unit Trust must be independent of the fund manager, it will generally serve as a trustee for multiple trust funds. In addition, depositary-like duties of the trustee may also be exercised in a way which impairs the independence of the trustee. This also relates to the fact that the trustee may have personal incentives, i.e., conflicts of interests, due to (generally present) multiple trustee appointments.

411. These duties are derived from the UCITS or the AIFM Directive. They are generally similar for both the depositary of a corporate (UCITS or non-UCITS) fund and the trustee of a (UCITS or non-UCITS) trust fund. *See* for the relevant provisions of the EU directives n. 120, *supra*. UK law implementing these provisions for trustees of Units Trusts can be found in the COLL (Article 6.6).
412. Article 2(20) of the 1940 Act.
413. *See* n. 107 and accompanying text, *supra*.
414. *See* n. 389, *supra*. It is a generally accepted regulatory view that the independence of the trustee is lost if by legal or operational means the manager can control the action of the trustee or the other way around. This is for instance the case when the parties have directors in common, cross shareholdings or contractual commitments. *See* Technical Committee of the IOSCO, *Report on the Examination of Governance for Collective Investment Schemes: Part I*, 35, note 37. However, this does not include the situation where trustee directors serve on multiple trust board within the manager's fund family. *See also* Article 6.9.3(2) of the COLL.

2.7.4 Corporate Structure

[A] General Structure

Under the corporate structure, investors are the shareholders of the fund that is set up under the corporate law of a particular jurisdiction. A corporation can be generally described as a legal entity that is created as such under the authority of the laws of a country or state. Corporations, including those functioning as investment funds, are managed by a board of directors. The board of directors of an investment fund, however, may, as mentioned, comprise of only one director that is also the manager of the fund. The fund may also be internally managed or self-managed, in which case the board may hire a professional management staff and/or delegate its management duties to one of its board committees, often referred to as the investment committee.[415] Board committees may also be implemented in partnership or trust structures. However, in practice, most funds are managed by an external fund manager.[416]

The investment committee, if appointed, is usually provided with the responsibility to supervise and monitor the manager(s) of the fund. In general, the investment committee has two key duties: (1) determining the fund's investment strategies and (2) overseeing that the manager acts in accordance with these strategies. With respect to this second duty, the investment committee has the right of veto over key issues in an investment fund, including changes to business activities or investment strategy, redevelopment of facilities and development of assets over a certain value. Consequently, such a committee is also referred to as a 'green lighting committee' due to its ability to accept or decline certain important changes related to the fund. Furthermore, the investment committee generally evaluates the investment performance of the fund and may also be responsible for the hiring/selection and termination of the fund manager[417] and the selection of and contracting with other service providers to the fund.

In general, institutional investors have acquired a seat on this committee in return of large investments in the fund. Other committee members include the fund's incumbent board members, consisting of both independent directors (i.e., directors who have no material relationship with the fund, fund manager or principal underwriter) and one or multiple dependent directors, such as directors or employees of the

415. Robertson identifies two categories of board committees: (1) 'standing' committees, which are maintained on an ongoing basis, and (2) 'special' or 'ad hoc' committees, which are established for a discrete assignment. Standing committees generally maintained by funds include audit, investment and pricing committees. *See* Robertson, *Fund Governance: Legal Duties of Investment Company Directors*, 4–16 & 4–17.
416. Bogle notes that in 1945, the major US mutual funds were mostly managed by investment committees, but that the portfolio manager model gradually became the new standard due to economic developments and the search for a more aggressive investment approach. J.C. Bogle, *The Mutual Fund Industry 60 Years Later: For Better or Worse?*, 61 Fin. Analysts J. 17 (2005) (stating that 3,387 of the 4,194 sample of stock funds listed in Morningstar in 2004 adopted 'the portfolio manager system').
417. Although the contract with the fund manager is generally subject to approval of the full board of the fund. *See* Technical Committee of the IOSCO, *Report on the Examination of Governance for Collective Investment Schemes: Part I* 6-7.

fund principal underwriter or manager or the manager itself.[418] In addition to an investment committee, funds often also establish several other committees, most notably the audit, nominating, pricing and governance committee.[419] The members of these committees consist of solely board members, which may or may not be independent directors.[420] While board committees are generally not mandatory for funds, they may be implemented by self-managed funds for the reason that they offer the board of directors the opportunity to delegate certain tasks and responsibilities and ensure the efficient use of an individual board members' expertise.

[B] Management Structure

As mentioned, the fund manager of a corporate fund is responsible for, alone or together with one or more submanagers, the management of the fund's assets. As also mentioned with respect to the partnership structure (see section 2.7.2[B]), the fund manager of a corporate fund operates on the basis of the corporate charter or articles of incorporation and the investment management contract. Under the Anglo-saxon one-tier board model (i.e., a single or multiple directors, both executive directors and non-executive directors, form one board), the fund's board of directors is responsible for overseeing the daily operations of the fund and the activities of the manager, unless the investment committee has taken over this latter responsibility (see above). In the case of the (generally voluntary) continental European two-tier model, two separate bodies operate independently: the board of directors and the supervisory board. In this model, the supervisory board is responsible for monitoring the management of the fund.[421] The one-tier board and the supervisory board are supposed to fulfil oversight and monitoring functions, which includes monitoring the manager's compliance with the applicable law and the fund's guidelines. In line with this role, the board of directors or supervisory board is required to look after the interests of investors.

418. In general, the law does not impose requirements on the composition of a board committee. With respect to the board of directors, it depends on the particular country in which the fund is established whether or not the composition of the board is subject to certain requirements.
419. Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 4–17 (citing a 2000 survey conducted by Managed Practice Inc., which found that 95% of the sample (US) funds had an audit committee, 36% a nominating committee, 32% an investment committee, and 18% a governance committee). The audit committee is charged with oversight of the financial reporting, the system of internal controls, and the audit process of the fund. The nominating committee generally has the purpose of considering and recommending to the board candidates for seats on the fund's board and/or board committees. The governance committee is responsible for monitoring the board's activities, including the compliance with the fund's governance code. The pricing committee sets the policies ensuring accurate and timely pricing the pricing of the fund's shares. Other committees commonly found in fund structures include the contract committee, executive committee, and compensation committee. *See* Robertson, just cited.
420. *See* n. 418, *supra*.
421. G.F. Maassen, *An International Comparison of Corporate Governance Models* 15 (Spencer Stuart 1999).

Fund directors have therefore also been described as serving a 'watchdog' function on behalf of the fund and the investors.[422]

In general, independent directors are given explicit duties with respect to approval of the fund's management and underwriting contract and the selection of the independent auditor and are held to oversee transactions involving potential conflicts of interest between the fund and its manager or the manager's affiliates.[423] Whether or not a director can be considered to be independent depends on the particular law of the country in which the fund is established. For example, in the US, a very broad definition of a director that is not an independent director applies to directors of funds that are registered with the SEC. Such a director is considered dependent in case, among other things, he holds 5% or more of the outstanding voting shares of the fund, is the manager of the fund or a member of the advisory board of the manager or is an interested person of the manager or the principal underwriter of the fund.[424]

In most EU countries, the formation of a supervisory board is not mandatory. Exemptions include the Netherlands and Germany. Under the Dutch 'structural' regime, large corporate funds are required to have a separate supervisory board in place comprising of independent directors.[425] In Germany, a corporate Investmentaktiengesellschaft is required to have a two-tier board structure, which supervisory board is responsible to oversee the management board.[426] However, while some countries require a supervisory board for certain types of corporate funds, European systems in general require less independence of fund directors than the US fund system.[427] By contrast, the directors of the fund manager may be subject to certain (securities) rules relating to their activities. For example, in the Netherlands, (executive) directors of regulated funds need not be independent, but are required to be 'knowledgeable and reliable' in the view of the AFM.[428] Nevertheless, Dutch regulated funds must put appropriate procedures and policies into place to ensure the integrity of the directors

422. ICI, *Understanding the Role of Mutual Fund Directors,* ICI Investor Awareness Series, 3 (1999) ('Unlike the directors of other corporations, mutual fund directors are responsible for protecting consumers, in this case, the fund's investors. This unique "watchdog" role (…) provides investors with the confidence of knowing that directors oversee the advisers who manage and service their investments'). This document can be found at ICI's website: http://www.ici.org/. *See also Burks v. Laskar*, 441 U.S. 471, at 484 (2nd Cir. 1979), in which case the US Supreme Court has called independent directors the 'watchdogs' of the mutual fund industry, entrusted with safeguarding the interests of the investors.
423. *See*, e.g., Articles 15, 32(a) and rules 10f-3, 17a-7, 17a-8, and 17e-1 (17 CFR 270.10f-3, 270.17a-7, 270.17a-8, and 270.17e-1) of the 1940 Act.
424. Articles 2(a)(3) and (19) of the 1940 Act.
425. Articles 2:153, 2:158, 2:263, 2:268 of the Dutch Civil Code.
426. *See* Article 95 of the German Stock Corporation Act (Aktiengesetz), German Federal Law Gazette 1965, Part I, 1089, as amended, and Article106a of the German Investment Act (Investmentgesetz), German Federal Law Gazette 2003, Part I, 2676, 15 Dec. 2003, as amended (defining the supervisory board ('Aufsichtsrat') of the Investmentaktiengesellschaft). Article 95 of the German Stock Corporation Act requires that the supervisory board must contain at least three members and that at least one of the members of this board must be independent of the management board.
427. OECD, *Insurance and Private Pensions Compendium for Emerging Economies: Book 2, Part 1:4)a: Corporate Governance and Collective Investment Instrument* 13–14.
428. *See* Article 4:9 and 4:10 of the Dutch Financial Supervision Act (Wet op het financieel toezicht), The Netherlands Bulletin of Acts (Staatsblad) 2006, 475, 28 Sep. 2006, as amended.

and the manager must ensure that these procedures are tested systematically subject to independent oversight.[429]

As previously mentioned, fund directors, both dependent and independent or executive and supervisory, generally sit on many fund boards of the manager's fund family. The law in both the US and EU countries does not prohibit this; it generally only requires independent or supervisory directors to be structurally independent of the fund's manager (and sometimes also the fund's underwriter and depositary). Consequently, most directors, whether deemed to be independent or not, will have a personal financial interest in appointing and keeping the same manager that has also established the fund, even though this may not be in the interest of investors.[430] Moreover, as mentioned, in practice, the fund manager of most corporate EU funds and US unregistered funds acts as sole director of the fund. In such cases, no independent or supervisory directors exist. This creates an inherent conflict of interest between as both fund board and management are vested in the hands of a single entity.

In the EU, the problem is intended to be 'solved' by the requirement of funds to appoint an independent depositary monitoring the manager. However, the depositary does not have a function in actually evaluating the performance of the manager nor does it have the power to select or replace the manager as it may only assess whether the fees are calculated correctly and the information to investors is provided in a correct way (see section 3.9). These duties are restricted to the board of directors of the fund.

2.7.5 The Relevance of Legal Structures to Investor Protection

In this paragraph, it will be assessed whether the above discussed key features of the different legal structures in which funds are established are relevant in the context of investor protection with respect to the activities of fund managers.

Firstly, with respect to the partnership structure, it has been shown that investors are provided with tax-benefits, limited liability benefits, and, in most cases, co-ownership of the fund's assets. While these features are important to investors, they are not key aspects of investor protection for the purposes of this research (considering the limited meaning of the term 'investor protection' used in this book – see section 1.1). since they do not aim to protect investors against losses due to mismanagement

429. Article 4:11 of the Dutch Financial Supervision Act and Article 17 of the Decree on the Supervision of the Conduct of Financial Enterprises pursuant to the Dutch Financial Supervision Act. *See also* Annex to the DUFAS *Fund Governance Principles* (noting that independent oversight can be designed in various ways, including a separate advisory board, an external auditor or an independent depositary).

430. In the US, the SEC has acknowledged this problem and adopted a new rule in 2004. SEC, Final Rule: Investment Company Governance, Release No. IC-26520, Federal Register, Vol. 69, No. 147, RIN 3235-AJ05, 2 Aug. 2004, 46378–46393. The rule effectively requires US registered funds to have a minimum of 75% independent directors on their boards (or, if the fund has only three directors, all but one to be independent directors) and the directors of such funds to evaluate at least once annually the performance of the board and its committees. However, the rule was set aside by the District Court of Columbia Court of Appeals in 2005 and again in 2006 for the reason that the SEC has failed to adequately consider the costs for the US fund industry or available alternatives. *See Chamber of Commerce v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005) and *Chamber of Commerce v. SEC*, 443 F.3d 890, 902 (D.C. Cir. 2006).

or misconduct by the fund manager. Therefore, these features will not be further assessed later on in this book.

Secondly, similar to the partnership structure, the trust provides investors with tax transparency and limited liability. The most important difference between the trust and the partnership structure is the fact that in the trust, the investors are not owners of the trust's assets, whereas in most partnership structures, they are co-owners of the fund's assets. In addition, in case the trust fund is a US registered fund, the board of trustees should consist of sufficient independent directors monitoring the fund manager. However, these features also do not significantly contribute to the level of protection provided to investors against misleading of misconduct by the fund manager. The first two features only provide investors (potential) tax benefits and protection from personal liability of the fund's debts. With respect to the independent directors' requirement, this requirement has little practical relevance since most directors, whether independent or not, have a personal (financial) interest in keeping the same fund manager. Consequently, these features will not be discussed in more detail in the following chapters.

Thirdly and lastly, with respect to corporate funds, a similar conclusion can be drawn with respect to the independent director requirement under US law for registered corporate funds. The national laws of EU Member States may provide for a provision on supervisory directors who, in theory, should monitor the fund manager. This is however often not a mandatory provision and, as for US funds, these directors may not function their 'watchdog' function in such a way that it protects investors from losses related to mismanagement or misconduct of the fund manager. As a result, the features of corporate funds will also not be further discussed in this book.

2.8 CONCLUSION

This chapter provides an answer to the first question of this research: 'Which key features of investment funds are relevant in relation to the activities of fund managers to the issue of the retail investors protection?'. In this chapter, the term 'investment fund' has been defined as 'an investment fund is a professionally managed entity that pools money from investors who, in return, receive fund shares or other participation rights representing a pro rate interest in the fund, and invests that money in one or multiple assets in accordance with its investment policy'. The key features of investment funds that have been discussed are categorized in: (1) fund parties associated with investment funds, including the fund manager, board, depositary, custodian and auditor, (2) fund shares issued by funds, (3) fee structure of funds, (4) commonly used fund operational structures, including the open- and closed-end, master-feeder, FoF and umbrella structure, (5) (hedge funds and private equity) investment strategies, and (6) legal structures used by funds.

Of the key fund parties, the fund manager appears to be the most important party. In general, not the fund board (of directors or trustees) or general partner manages the fund, but an external fund manager operates as single director or partner of the fund. Even if a separate board or multiple directors or trustees exist, their monitoring role is limited in practice due to potential personal interests. Considering the important role of the fund manager, the following chapters will focus on the (EU and US) investor protection rules and regulations applying to fund managers when offering fund shares to EU investors. These rules include, among other things, internal control policy, transparency, and conduct of business requirements. Furthermore, funds regulated by EU law are required to appoint a depositary with a number of oversight duties and the duty to monitor the fund's cash flows. As these duties primarily focus on the protection of investors, they will also be discussed in more detail. This will only be done in Chapter 3 relating to EU law, since US law does not require funds to appoint a depositary. Custodians and auditor have no monitoring role as regards investor protection issues relating to the activities of the fund manager. The rules applying to these entities will therefore not be further discussed in this book.

With respect to fund shares, it has been concluded in section 2.4 that rules related to the exercise of certain rights of investors that owe fund shares may be of importance to this research. In case investors can adequately use these rights, they can express their dissatisfaction with how the fund is managed. In particular, it can be referred to requirements safeguarding the exercise of investor rights in investor meetings. Adequate regulations regarding the fee structure of a fund is also of relevance to investors for a number of reasons: preventing excessive fee payments, informing investors about the fees that must be paid, and ensuring adequate controls to monitor these two aspects.

The assessment of the operational fund structures and investment strategies shows that the protection of investors in EU and US funds is not determined by the operational structure or strategy a fund uses. An operational structure by itself does not raise issues regarding the protection of investors, but certain investor protection issues may become more apparent as a result of the particular structure chosen. For example, in the master-feeder and FoF structure, it is of relevance that investors gain insight into the underlying fees paid by the fund ('double fees'). Thus, when discussing, among other things, (fee) disclosure and internal remuneration policies, the operational structure of funds should be taken into account. With respect to 'risky' investment strategies used by private equity and hedge funds (and also increasingly by more 'traditional' funds), it can be noted that investors will generally benefit from adequate risk disclosure and management policies relating to the strategies used. In addition, the use of leverage can also be mentioned here. From an investor perspective, it can be noted that leverage not only magnifies potential returns, but also the potential risks involved in an investment. When a fund is thus highly leveraged, investors should be aware of the risks associated with the fund. The risks associated with leveraged investments may also be reason for regulators to restrict the use of leverage by certain types of funds, especially those available to retail investors. Thus, when developing investor protection regulations, the EU regulator should keep in mind the different strategies used by funds, including private equity and hedge funds.

Finally, as regards legal structures, it has been concluded in section 2.7.5 that the legal form in which a fund is established does not contribute significantly to the protection of investors against misdealing, fraud or other operational failures of the fund manager. The main reason for this is the fact that EU and US securities law makes no distinction between legal forms in which can be structured when applying (investor protection) regulations on fund managers and funds. However, with respect to the right to vote in investor meetings, it should be looked at the company laws in place in the particular EU Member State or US state. These laws may differentiate in levels of protection between the different fund structures. Thus, with respect to these issues, the laws applying to specific fund structures in the EU and US will be referred to.

It follows from the above that there are a number of fund features relevant to the issue of investor protection in relation to the activities of fund managers. By contrast, some features, most notably the way in which a fund is legally structured, have been considered to be of less relevance to the issue at consideration. In addition, a number of rules have been identified that are directly or indirectly related to these features. So are the rules concerning the way in which investors can exercise their rights in investor meetings relevant in the context of the feature 'fund shares' and do rules concerning internal remuneration policies relate to the fund's fee structure. In conclusion, the assessment provided above shows that the following categories of rules are most relevant to investors and the way in which they are protected against potential investment losses that occur due to misconduct by fund managers and should therefore be further assessed in this book: (1) rules related to the fund's internal control systems, (2) leverage restrictions, (3) rules aimed to secure investor rights in investor meetings, (4) transparency and disclosure rules, (5) conduct of business rules, and (6) monitoring rules applying to depositaries.

Systems of internal control encompass the policies and procedures that aim to ensure compliance with the laws and regulations of fund managers. These systems generally consist of risk management systems, procedures on preventing or managing conflicts of interest, liquidity management policies, procedures for the valuation of the assets of the fund and remuneration policies. Leverage restrictions relate to the use of leverage, including both borrowing money and investing in derivatives, by the fund manager. As to rules relating to investors rights in investment meetings, the regulations concerning requirements for conducting an annual (or special) meeting of investors and the exercise of voting rights by investors at those meetings will be discussed. Transparency and disclosure rules can be divided into pre-contractual and ongoing reporting requirements. The first category of disclosure includes the fund's prospectus and other pre-sale information documents. The second category concerns the annual reports and other ongoing disclosures of funds to (potential) investors. Furthermore, fund managers have to comply with certain (statutory or non-statutory) rules that relate to their business conduct, which generally includes acting honestly, fairly and with due skill, care and diligence in conducting its activities.[431] Finally, depositary

431. *See* e.g., T. Spangler (ed.), *Investment Management – Law and Practice* 68–69 & 75 (Oxford U. Press 2010) (summarizing the specific common law fiduciary duties in an investment management relationship under UK and US law) and L. van Setten, *The Law of Institutional Investment Management* 84 (Oxford U. Press 2009) ('In the context of supply of investment management services (…) the benchmark is the skill, care, and diligence that may be expected of a hypothetical investment manager who possesses an ordinary level of professional competence (…)').

monitoring rules include, as discussed, the oversight and cash monitoring duties of the depositary under the UCITS or AIFM Directive.

In the next two chapters, these categories of investor protection regulations will be discussed in more detail with respect to EU and US law. Since the depositary monitoring rules are only included in EU law, they will only be discussed in Chapter 3.

CHAPTER 3
EU Investor Protection Law

3.1 INTRODUCTION

This chapter deals with the second research question of this book: 'How are EU and US funds available to EU retail investors currently regulated relating to the protection of investors?'. However, where the research question concerns the regulations applying to both EU and US funds, this chapter only considers the *EU* investor protection law applying to funds that offer their shares to EU investors or that could be indirectly of relevance to them. It will firstly set out the scope of the (passport) activities of the two categories of funds regulated under EU law, UCITS and AIFs, and the general criteria assessing whether or not a particular fund qualifies as either a UCITS or AIF (sections 3.2 & 3.3). The chapter will then turn to a thematic analysis of the different types of investor protection regulations applying to EU funds excerpted from Chapter 2, including: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, (5) conduct of business rules, and (6) depositary monitoring duties (sections 3.4–3.9). Finally, the chapter will close with a conclusion (section 3.10).

3.2 UCITS

In Europe, about 70% of the assets under management of EU investment funds is invested by UCITS.[1] The UCITS form is a widely used form for funds since the adoption of the UCITS Directive in 1985.[2] The objective of the UCITS Directive is to be an

1. EFAMA, *Trends in the European Investment Fund Industry in the Fourth Quarter of 2014 and Results for the Full-Year 2014: Quarterly Statistical Release*, 3 (showing that, by the end of 2012, UCITS net assets comprised of EUR 7,979 billion of the in total EUR 11,341 billion net assets under management).
2. *See*, e.g., C.D. Christian, K.S. Cohen & J.L. Wendell, *Offering UCITS to US Institutional Investors: A Post Dodd-Frank Overview-Part 1 of 2*, 19 Inv. Law. 3 (2012), C. Szylar, *Risk Management under*

optional framework to enhance the cross-border marketing and managing of funds within Europe while ensuring a minimum standard of investor protection.[3] It is thus aimed at enabling fund managers to profit from its principal advantage, the EU passport. This passport makes it possible for fund managers to sell UCITS to investors throughout the European Economic Area (EEA),[4] without further authorization in each Member State in which they wish to offer their shares.

The passport is provided to the UCITS management company and so-called self-managed UCITS.[5] It allows a UCITS management company or self-managed UCITS to pursue in other Member States the activities for which it has been authorized in its home Member State subject to a notification procedure ('home country control principle').[6] In order to prevent national Member States from imposing additional notification rules, a practice that occurred on a wide scale among Member States,[7] some improvements to the principle of home country control were made in 2009 by the

UCITS III / IV: New Challenges for the Fund Industry 3 (John Wiley & Sons 2010), and K.R. Johannsen, *Jumping the Gun, Hedge Funds in Search of Capital under UCITS IV*, 5:2 Brook. J. Corp. Fin. & Comm. L. 473 & 475 (2011).

3. *See* the recitals of the original UCITS Directive (85/611/EEC, OJ L 375, 1985, 3), which make clear that the objective of the directive is to take away regulatory differences that distort the competition between funds and to ensure investor protection, rather than providing for a mandatory framework to regulate funds ('national laws governing collective investment undertakings should be coordinated with a view to approximating the conditions of competition between those undertakings at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders').
4. The EEA includes the EU Member States and the three EEA countries: Iceland, Liechtenstein and Norway. Switzerland, has not joined the EEA, but has a similar agreement with the EU. *See* http://www.efta.int/eea/eea-agreement.aspx, last accessed on 21 Aug. 2013. In this book, when referring to the EU in the context of the EU passport, it will be meant the EU Member States and countries that are party to the EEA agreement.
5. The management company passport was introduced in 2001 by the UCITS III Management Company Directive. Directive 2001/107/EC of the European Parliament and of the Council of 21 Jan. 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, OJ L 41, 20–34 ('the UCITS III Management Company Directive').
6. Recital 8 of the preamble to the UCITS III Management Company Directive ('[A] management company should be authorised in the Member State in which it has its registered office. In accordance with the principle of the home country control, only the Member State in which the management company has its registered office can be considered competent to approve the fund rules of unit trusts/common funds set up by such a company and the choice of the depositary. In order to prevent supervisory arbitrage (…), a requirement for authorisation of a UCITS should be that it should not be prevented in any legal way from being marketed in its home Member State').
7. A research performed by the Fédération Européenne des Fonds et Sociétés d'Investissement (FEFSI) and PwC in 2001 showed that Member States impose several regulatory constraints on UCITS, varying from additional registration and information requirements to national marketing, distribution, delegation and taxation requirements that must be met in order to maintain the UCITS authorization. For example, at 2001, in Belgium, all the registration documents must be translated into at least one of the three national languages (French, Dutch, German) and French law required all documents to be translated into French and sometimes additional information is required a few days before the expiry date which extends the time taken to receive a notification. *See* FESI & PwC, *Cross-Border Marketing of 'Harmonised' UCITS in Europe, Current Situation, Constraints and Ways Forward* (November 2001). The research report can be found at FEFSI's website: http://www.fefsi.org/.

UCITS IV Directive.[8] Under UCITS IV, host Member States are prohibited from imposing any additional notification requirements other than those provided in the directive. Furthermore, UCITS IV permits the marketing of UCITS shares in another Member State immediately after the transmission of the notification letter accompanied by complete documentation in the home Member State, which effectively reduced the notification period from two months to ten days.[9] UCITS IV also replaced the simplified prospectus with a new document: the Key Investor Information document (KII).[10]

In order for a fund to qualify as an UCITS, an investment fund must meet certain requirements. According to Article 1(2)(a) and (b) of the current UCITS Directive, UCITS are undertakings 'with the sole object of collective investment in transferable securities or in other liquid financial assets (…) of capital raised from the public and which operate on the principle of risk-spreading' and the shares of 'which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets'. It follows from this description that UCITS: (1) must be open-ended in nature, (2) must invest capital raised from investors by promoting the fund to the public, and (3) have the single objective to invest solely in a limited list of eligible assets and on the basis of risk-spreading. For the first two requirements, it can be referred to sections 2.2.1 & 2.6.2 relating to the features of funds in general. Below, only the UCITS-specific features, including the eligible assets in which UCITS are allowed to invest and the rules on risk-spreading applying to them will be discussed (sections 3.2.1 & 3.2.2.).

Furthermore, in order for a UCITS management company or self-managed UCITS to pursue activities in the EU, it must be authorized by the competent authorities of its home Member State. The competent authorities may not authorize a UCITS management company/self-managed UCITS if the investment fund does not comply with a number of preconditions set out in the directive. As UCITS shares can only be marketed in the EU with prior authorization of the competent Member State, the qualification of

8. Recital 8 of the preamble to the UCITS Directive ('The approach adopted in this Directive is to ensure the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems, making possible the grant of a single authorisation valid throughout the Community and the application of the principle of home Member State supervision'). This approach follows an advice by the CESR on issues arising in connection with the management company passport requested by the Commission. *See* CESR's advice to the European Commission on the UCITS Management Company Passport, CESR/08-867, October 2008, 6 ('The management company's home Member States should be the Member State in which the management company's registered office is situated or, if the management company has, under its national law, no registered office, the Member State in which the head office is situated').
9. Article 19(1) and (3) and 18(2) of the UCITS Directive. The home Member State has no later than ten working days after the date of the initial request to transmit the filing, effectively reducing the notification period from two months to ten days. Article 93(3) of the UCITS Directive.
10. Recital 59 of the preamble to the UCITS Directive. Other changes introduced by the UCITS Directive are a framework for cross-border mergers between UCITS, the establishment of cross-border master-feeder UCITS structures, and measures to improve. cooperation between supervisors. *See* recitals 21, 28, and 51 of the preamble to the UCITS Directive and the corresponding provisions. *See* on the KII, section with respect to the de minimis rents 3.7.1[B].

being a UCITS is meaningless without this authorization. Therefore, these authorization requirements will also be briefly discussed below (section 3.2.3).

3.2.1 Eligible Assets

UCTS may only invest in 'liquid financial assets'.[11] They include, among others, transferable securities, deposits, money market instruments, other UCITS shares and financial derivatives.[12] Originally, UCITS were only allowed to invest in transferable securities. However, revision of the UCITS Directive in 2001 by the UCITS III Product Directive has expanded this list to include other liquid assets as well, including financial derivatives.[13] The idea behind requiring UCITS to invest in exclusively liquid assets stems from the fact that they have an open-end structure and must therefore be able to re-purchase their shares at any time at the request of investors, as required by Article 84 of the current UCITS Directive.[14] In order to meet sudden redemption requests, UCITS may need to sell (part of) their underlying portfolio assets. The risk that investors could not redeem their shares due to a cash problem at the UCITS was considered minimal in case the UCITS' portfolio is sufficiently liquid.

Under the current UCITS Directive, financial assets must meet certain criteria in order to be qualified as eligible *liquid* financial assets under the directive. So may UCITS invest part of their assets in other funds, provided that certain risk-spreading rules are met (see section 3.2.2). This practice is used by many UCITS.[15] Short selling is not allowed under the directive, whether it includes 'covered' or 'uncovered' short selling.[16] See on short selling in general, section 2.6.6[A]. With respect to financial derivatives, the directive requires that UCITS may invest in such instruments provided that the underlying of the derivative consists of eligible instruments covered by the directive, financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS may invest according to its investment objectives.[17] OTC derivatives

11. Articles 1(2)(a) and 50 of the UCITS Directive.
12. Article 50(1) of the UCITS Directive.
13. Directive 2001/108/EC of the European Parliament and of the Council of 21 Jan. 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS, OJ L 41, 35 ('the UCITS III Product Directive').
14. CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS Consultation Paper, CESR/05-064b, March 2005, 9.
15. In 2011, more than 80% of the newly launched UCITS funds of hedge funds used the FoF structure. *See* G.N. Gregoriou (ed.), *Reconsidering Funds of Hedge Funds: The Financial Crisis and Best Practices in UCITS, Tail Risk, Performance, and Due Diligence*, 97.
16. *See* Article 89 of the UCITS Directive (prohibiting uncovered short selling) and European Commission, Letter of the DG Internal Market and Services: Psychical short-selling in the context of the UCITS Directive – March 2007 CESR guidelines on eligible assets, MARKT/G4/dm/D(2008) 4056, 11 Apr. 2008, 2 (considering that physical short selling of borrowed securities is inconsistent with important provisions of the UCITS Directive since '[t]he mere fact of borrowing the security to cover potential obligation to settle the short sale does not mitigate the exposure of the UCITS to potentially unlimited risk' and 'the prohibition on borrowing laid down in (…) [a]rticle 36 [of the UCITS Directive] – except on limited and temporary basis – is not confined to borrowing money but also extends to securities').
17. Article 50(1)(g)(i) of the UCITS Directive.

are allowed in case the counterparties to the transactions are subject to prudential supervision and that the derivatives are subject to 'reliable and verifiable' valuation and can be sold at any time at their fair value.[18]

The UCITS Directive contains a number of definitions related to the eligible financial instruments or their underlying components. However, since the adoption of the directive, the variety of financial instruments traded on financial markets has increased considerably. Therefore, in 2007, the European Commission adopted an implementing directive on the clarification of certain definitions in the UCITS Directive ('the UCITS Eligible Assets Directive').[19] In addition, CESR has published separate guidance concerning eligible assets for investment by UCITS.[20] In this respect, the definition of 'financial indices' is particularly interesting. An increasing amount of UCITS are nowadays investing in index-based financial derivatives.[21] The UCITS directive does not state when an index is eligible for covering derivatives. In the UCITS Eligible Assets Directive, this is further defined. According to this directive, financial indices must be 'sufficiently diversified, which represent an adequate benchmark to the market to which they refer and (…) [be] subject to appropriate information regarding the index composition and calculation' in order to qualify as financial indices on which derivatives may be based.[22] The directive also sets out more detailed criteria, including the requirement that the index must be revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers, that its underlying assets are sufficiently liquid, and that material information about the index, such as index calculation, rebalancing methodologies, index changes or any operational difficulties in providing timely or accurate information, is to be provided to investors.[23]

Although the UCITS Eligible Assets Directive gives some clarity as to the interpretation of financial indices for investments by UCITS, it still leaves the door open for Member States to interpret certain criteria in a different way. For example, it does not define the frequency of 'periodically' and when something is 'sufficient'. On the basis of the directive, CESR stated that indices based on financial derivatives on commodities or indices on property may be eligible in case they comply with the criteria set down in the UCITS Eligible Assets Directive.[24] Regarding derivatives on

18. Article 50(1)(g)(ii) and (iii) of the UCITS Directive.
19. Commission Directive 2007/16/EC of 19 Mar. 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions, OJ L 79, 11 ('UCITS Eligible Assets Directive'). The power to clarify definition in the UCITS Directive is provided by the Commission in Article 53a of the original UCITS Directive of 1985 'in order to ensure uniform application of [the] Directive throughout the Community'.
20. CESR's guidelines concerning eligible assets for investment by UCITS, CESR/07-044, March 2007.
21. G.N. Gregoriou (ed.), *Reconsidering Funds of Hedge Funds: The Financial Crisis and Best Practices in UCITS, Tail Risk, Performance, and Due Diligence* 99 (Elsevier 2013) (stating that, at the first quarter of 2012, 24.5% of the total number of UCITS funds of hedge funds are index funds or ETFs, comprising 26.1% of the total UCITS funds of hedge funds' assets under management).
22. Recital 11 of the preamble to the UCITS Eligible Assets Directive.
23. Article 9 of the UCITS Eligible Assets Directive.
24. CESR's guidelines concerning eligible assets for investment by UCITS, 10.

hedge fund indices, CESR issued specific guidelines in July 2007.[25] In these guidelines, CESR stated that, in addition to the requirements applicable to financial indices and derivatives, hedge fund indices are eligible in case the UCITS meets additional requirements relating to the 'adequate benchmark requirement' and appropriate due diligence on the quality of the index.[26]

The CESR guidelines were reaffirmed and expanded in 2012 by ESMA.[27] Furthermore, the ESMA guidelines require, among other things, that an index should be transparent and replicable. Rebalancing more frequently than weekly is no longer allowed, with an exception for technical adjustments.[28] This effectively restricts the investments of UCITS in derivatives on indices that are based on highly active strategies, such as most hedge fund strategies, as these indices may be rebalanced on an intra-day or daily basis. Another requirement following from the ESMA guidelines is the requirement that the index methodology must be published in a way that enables investors to replicate the index should they wish to do so. This includes describing all the underlying components of the index.[29] This may rule out indices of which the components or the weighting of a component within a subindex change over time due to frequent rebalancing. Lastly, ESMA considers, in determining whether or not the index is sufficiently diversified, sub-categories of a commodity as the same commodity. Therefore, a commodity index that invests heavily in a part of the commodity market, will not meet the diversification requirements. UCITS that invest in derivatives based on commodity strategies are known as Commodity Trading Advisor (CTA) UCITS. CTA UCITS use indexes to replicate the performance of funds investing in commodities because of the restriction of the UCITS Directive of investing directly in commodities, including commodity futures.[30]

25. CESR's guidelines concerning eligible assets for investment by UCITS, The classification of hedge fund indices as financial indices, CESR/07-434, July 2007.
26. *Ibid.,* 6–8.
27. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, ESMA/2012/474, 25 Jul. 2012.
28. *Ibid.*, 51. The Q&A provides further guidance as to what is meant by 'technical adjustments', stating such adjustments include adjustments which are based solely on algorithmic non-subjective frameworks, are generally published on an ex-ante basis, draw on publicly available criteria (or data), and do not rely on the judgment of the index-provider, for example, indices which follow mechanical rebalancing formulae. *See* ESMA, Questions and Answers, ESMA's guidelines on ETFs and other UCITS issues, ESMA/2014/295, 24 Mar. 2014, 10.
29. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 51.
30. CTA UCITS increased in popularity over the past years. *See* UCITS Alternative Index, *Impact of the Recent Regulatory Changes on the UCITS CTA Market* 3 (10 Dec. 2012) (stating that the number of CTA UCITS funds has grown from nine to fifty-five funds from January 2008 to September 2012 and the assets managed by these funds have grown from EUR 1.57 billion to EUR 6.09 billion over the same period). The document can be found at http://www.ucits-alternative.com/files/presse//UAIUCITSCTAMarket20121211.pdf (last accessed on 16 Apr. 2014). It can be questioned whether the number and assets under management of this fund type, as a result of the new ESMA guidelines, will continue to grow.

3.2.2 Risk Spreading

The principle of risk spreading means that restrictions apply to UCITS which limit their spread of exposure, investments, and leverage. The restrictions build in certain levels of diversification with the aim of reducing the vulnerability of UCITS to the performance of a small number of assets. Central to this principle is the so-called 5/10/40 Rule. The 5/10/40 Rule is codified in Article 52(1) of the UCITS Directive. It concerns the risk exposure for UCITS and provides that no more than 5% of an UCITS' assets may be invested in transferable securities or money market investments of a single issuer. Member States may however raise the 5% limit to a maximum of 10% provided that, the exposure to these issuers, when added together, does not exceed 40% of the UCITS' assets.[31]

Furthermore, UCITS are allowed to invest 20% of their assets in deposits made within the same body.[32] In case of transferable securities and money market instruments issued or guaranteed by public authorities, Member States may raise the 5% limit up to 35% and in case of bonds issued by a credit institution up to 25%.[33] The limits may not be combined, as a result of which the total investments in transferable securities, money market instruments or bonds issued by the same body can under no circumstances exceed in total 35% of the UCITS' assets.[34] Another UCITS' risk exposure rule includes the rule UCITS may not combine investments in transferable securities, money market investments, deposits or exposures arising from OTC transactions that would lead to an investment of more than 20% in one single body. Companies included in the same group for purposes of consolidation are regarded as one single body.[35] With respect to OTC transactions, it can be noted that the risk exposure to a counterparty of a UCITS in an OTC transaction may not exceed 10% when the counterparty is a credit institution or, in all other cases, 5% of the UCITS' assets.[36] Furthermore, Member States are recommended to ensure that the global exposure relating to financial derivative instruments may not exceed 100% of the UCITS' NAV, and hence that the UCITS' overall risk exposure may not exceed 200% of the NAV on a permanent basis.[37]

In addition to the aforementioned and other risk exposure rules, a UCITS must comply with certain investment limits. For example, there are limits as regards the investments a UCITS can make into other funds. The UCITS Directive allows UCITS to

31. Article 52(2) of the UCITS Directive.
32. Article 52(1)(b) of the UCITS Directive.
33. Provided that certain conditions are met. *See* Article 52(2) and (3) of the UCITS Directive.
34. Article 52(5) of the UCITS Directive.
35. Article 52(2) and 52(5) of the UCITS Directive. Member States may however allow cumulative investment in transferable securities or money market investments within the same group up to a limit of 20%. *Ibid*.
36. Article 52(1) of the UCITS Directive. ESMA's Guidelines require that the risk exposures arising from both OTC derivative transactions and Efficient portfolio management (EPM) techniques, such as securities lending, should be combined when calculating counterparty risk limits. ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 48.
37. Commission Recommendation 2004/383/EC on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS), 25.

invest in other funds, provided that: (1) the investments in one single (UCITS or non-UCITS) fund does not exceed 10% (or maximum 20% in case a Member State has raised this limit) of its assets, (2) the investments in a non-UCITS fund does not exceed 30% of the total assets of the UCITS and the non-UCITS is considered by the competent authorities of the UCITS home Member State to be subject to equivalent supervision and investor protection as an UCITS fund and that cooperation between authorities is sufficiently ensured, (3) the underlying fund has not invested more than 10% of its assets in the shares of any other fund.[38] It follows from these restrictions that UCITS are allowed to invest 100% of their assets in other UCITS and a maximum of 30% in non-UCITS that are subject to equivalent supervision and investor protection. It will depend on the particular non-UCITS and the home Member States whether or not a non-UCITS will be eligible for UCITS to invest. Article 50(1)(e)(ii) of the UCITS Directive only provides that the level of investor protection should in particular be equivalent to the UCITS rules related to asset-segregation, borrowing, lending, and uncovered sales of transferable securities and money market instruments.[39]

Furthermore, as a general rule, UCITS are not allowed to invest more than 10% of their assets in transferable securities or money market instruments other than those referred to in Article 50(1) of the UCITS Directive ('trash bucket').[40] Another investment restriction worth noting is the restriction for UCITS to invest in psychical commodities or real estate. UCITS may not acquire precious metals or certificates representing them and may only acquire movable or immovable property which is essential for the direct pursuit of their business, i.e., only for own use (not investment purposes).[41] They can thus not directly invest in real estate. Such investments would however also be not suitable for UCITS due to their open-end nature, which requires a liquid portfolio. It is very difficult to provide timely liquidity from investments in real estate.

Lastly, the principle of risk spreading encompasses borrowing controls. Under the UCITS Directive, UCITS may borrow to 10% of their total net assets (including the borrowed amount) provided that the borrowing is: (a) on a temporary basis (i.e., within a specific time limit) or (b) in case it concerns the acquisition of immovable property that is essential for the direct pursuit of its business and the home Member States allows the UCITS to do so.[42] Since the Commission recommends that the overall risk exposure related to the use of derivatives may not exceed 100% of the UCITS' NAV (see above), the total risk exposure of a UCITS (including both leverage through

38. Articles 50(1)(e) and 55(1) and (2) of the UCITS Directive. According to ESMA, non-UCITS that do not fulfil all of the conditions listed in the foregoing Article 50(1)(e) of the UCIT Directive do not constitute UCITS eligible investments under Article 50(2)(a) of the UCITS Directive, which requires UCITS to invest no more than 10% of their assets in other transferable assets or money market instruments that those referred to in Article (1)(e). Thus, UCITS may only invest in shares of other funds as defined in Article 50(1)(e) of the UCITS Directive. *See* ESMA's Opinion on Article 50(2)(a) of Directive 2009/65/EC, 2012/721, 20 Nov. 2012.
39. The non-UCITS in which the UCITS invests must also publish a half-yearly and annual report. *See* Article 50(1)(e)(iii) of the UCITS Directive.
40. Including unlisted securities and money market instruments.
41. Article 50(2)(b) and (3) of the UCITS Directive.
42. Article 83(2) of the UCITS Directive.

derivatives and borrowing by temporary means), should consequently not exceed 210% of the NAV on a permanent basis.[43] However, when a Member State has authorized UCITS to borrow money under both options, the total amount borrowed should not exceed 15% of the total assets of the UCITS.[44]

3.2.3 Authorization Requirements

The UCITS Directive establishes common authorization requirements which UCITS must comply with before they receive authorization from their home Member State to be allowed to pursue activities in the EU. These requirements are reflected in Article 5(4) of the UCITS Directive. This article firstly refers to number of standards set out in the directive applying to the business of the UCITS in case it is structured in the corporate form (i.e., an investment company with variable or fixed capital). Secondly, it refers to standards applying to UCITS that are structured in the contractual form (i.e., trusts or other contractual funds). In such a case, it requires the home Member State to approve the management company of the UCITS in case it complies with several operational and capital requirements of the UCITS Directive.

With respect to self-managed UCITS, it is referred to Article 29(1) of the UCITS Directive requiring that the UCITS must have at least EUR 300,000 initial capital. In addition, the self-managed UCITS must submit a programme of activity to its home Member State which sets out, at least, the organizational structure of the fund. The programme of activity furthermore generally requires the UCITS to submit a number of documents to satisfy its home Member State that, on an ongoing basis, it will be able to comply with the operational and governance requirements of the UCITS Directive. This typically includes the legal form of the UCITs, its draft articles of association, a description of outsourcing arrangements, policies on conflicts of interest and code of conduct, name of external auditor, investment policy and strategies, and a description of the risk management and remuneration policies in place.

Furthermore, the UCITS' directors must be of sufficiently good repute and be sufficiently experienced in relation to the type of business carried out by the UCITS. At least two directors must decide on matters related to the conduct of the UCITS' business and in case a 'close link' exists between the UCITS and other natural or legal persons, including directors, authorization may be granted only if this link does not prevent effective supervision.[45] Lastly, rules on management delegation and the depositary must be complied with.[46]

In case the UCITS does not meet these requirements, its authorization will be refused by its home Member State. Member States must furthermore draw up prudential rules that such a UCITS, once authorized, must comply with, including rules on

43. Commission Recommendation 2004/383/EC on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS), 26.
44. Article 83(2)(b) of the UCITS Directive.
45. Article 29(1)(a), (b) and (c) of the UCITS Directive.
46. Articles 13, 29, 30, and 32–36 of the UCITS Directive. *See* on these rules also sections 2.3.1[B] & 2.3.3[A].

record-keeping, accounting procedures and that the assets of the UCITS are invested in accordance with the instrument of incorporation and the laws currently in force.[47] In this respect, Article 14 of the UCITS Directive gives a list of principles which should serve as the measure for rules of conduct for UCITS. Special emphasis is put on the idea of the UCITS acting honestly, fairly, and with due skill, care and diligence. See on these conduct of business rules section 3.8.

The authorization requirements for UCITS management companies are laid down in Article 7 of the UCITS Directive. It provides that the initial capital of a management company must be a minimum of EUR 125,000. Other than self-managed UCITS, UCITS management companies must maintain an additional amount of own funds equal to 0.02% of the value in excess of EUR 250 million. However, there is a maximum limit of 'own funds set'[48] at EUR 10 million and the minimum additional own funds must never be lower than one quarter of the management company's preceding year fixed overheads.[49] UCITS management companies may be exempted from providing up to 50% of the additional amount of own funds if they have a guarantee from a credit institution or insurance undertaking.[50]

Similar to the authorization rules for self-managed UCITS, the conduct of the business of a UCITS management company must be decided by at least two persons who are considered by the competent home Member State of the management company to be experienced and to possess sufficient good repute.[51] Also, similar provisions apply related to other business aspects, including the programme of activity, the possibility to refuse authorization in case of connections to a natural or legal third party which are deemed to prevent effective supervision, rules related to the depositary, the delegation of management activities, and the obligation of Member States to draw up rules addressing prudential issues and the conduct of business rules set out in the directive.[52] Other requirements relate to the head and registered office of the management company, the approval of qualifying shareholders, and investments in UCITS that are managed by the management company.[53]

47. Article 31 of the UCITS Directive.
48. 'Own funds' includes the notion of 'initial capital' and adds in particular (1) 'revaluation reserves', (2) 'value adjustments', (3) 'other items' within the meaning of Article 63 of Directive 2006/48/EC, and (4) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 64(3) of Directive 2006/48/EC. *See* Article 2(1)(l) of the UCITS Directive (referring to Articles 56–67 of Directive 2006/48/EC).
49. Article 7(1)(a)(i) and (iii) of the UCITS Directive and Article 21 of Directive 2006/49/EC of the European Parliament and of the Council of 14 Jun. 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ L 177, 201.
50. Article 7(1)(d) of the UCITS Directive.
51. Article 7(1)(b) of the UCITS Directive.
52. *Ibid.* and Articles 7(1)(c), (2), 12(1), 13, 14 and 22–26 of the UCITS Directive. *See* on the rules related to the delegation of management functions and the depositary also sections 2.3.1[B] & 2.3.3[B].
53. Articles 7(1)(d), 8 and 12(2) of the UCITS Directive.

3.3 AIF

Before the adoption of the AIFM Directive, AIFs, or non-UCITS, were not subject to specific EU legislation. AIFs were only regulated by national law. Furthermore, many managers of AIFs, in particular managers of private equity and hedge funds, were not required to license for portfolio management and/or investment advice under the MiFID due to the fact that they were generally domiciled in non-EU jurisdictions.[54] Additionally, the offering and sale of the shares of the AIFs were often exempt from the requirements of the Prospectus Directive as offers of AIF shares are generally addressed to only qualified investors and/or a limited number of investors.

With the adoption of the AIFM Directive, a harmonized framework for regulating AIFs is provided. Other than the UCITS Directive, which is intended to be an optional framework, the objective of the AIFM Directive is to impose mandatory rules on AIFMs that operate within the EU.[55] EU AIFMs will benefit from a 'passport' enabling them to market EU AIFs in the EU. Non-EU AIFMs can market AIF shares in the EU with a passport from November 2015 at the latest, in case of non-EU AIFMs or AIFs established in Guernsey, Jersey or Switzerland, or within three months after a positive advice from ESMA.[56] Before that date, such AIFMs will have to use the national private placement regimes of each Member State in which they wish to market these shares, provided that these regimes comply with Article 36 or 42 of the AIFM Directive. However, as stated before, for the purpose of this research, it is assumed that the provisions of the AIFM Directive related to the EU passport for non-EU AIFs and AIFMs have come into effect.

Pursuant to Article 31(1) of the directive, an authorized EU AIFM may market shares of an EU AIF to professional investors as defined in Annex II to the MIFID 2 in its home Member State, either by providing cross-border marketing services or by means of a branch, provided that the notification requirements for such AIFMs are met (see section 2.2.3[A]). The notification requirements are set out in Article 31(2) and Annex III, which requires the AIFM to provide the competent authorities in its home Member State with several details of each EU AIF that it intends to market.[57] Non-EU AIFMs that wish to market EU AIFs under an EU passport must comply with the rules

54. The original MiFID did not provide a harmonized approach non-EU firms providing investment services to or for EU clients but left it to Member States to impose limits on such services, subject to the general requirement under EU law not to grant a non-EU firm more favourable treatment than an EU firm. Under the MiFID 2, however, non-EU AIFM that wish to provide MiFID investment services, which include portfolio management and investment advice, are covered by the directive. *See* Article 39 of MiFID 2.
55. Recital 2 of the preamble to the AIFM Directive ('This Directive (…) aims at establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the Union') and Zetsche, *The Alternative Investment Fund Manager Directive,* 85–86.
56. *See* section 2.2.3[A]. Thus far, ESMA has delivered a positive advice to extent the AIFM passport to Guernsey, Jersey and Switzerland. *Ibid.*
57. Article 32 of the AIFM Directive and Annex IV to the AIFM Directive. This information includes the rules or instrument of incorporation of the AIF, a description of, or any information on, the AIF, and any additional disclosures to investors. In case the EU AIFM wishes to market EU AIF shares in other Member States than its home Member State, it must meet similar requirements.

set out in Articles 37 and 39 of the AIFM Directive. Since such AIFMs are established in a non-EU Member State, Article 37(1) of the directive requires that they must receive authorization to market their shares under the passport by their 'Member State of reference'.[58] Similar to authorized EU AIFMs, it must submit a notification file (to its Member State of reference), which includes relevant information on each AIF and the information provided to investors.[59] In addition, the competent authorities of the Member State of reference are required to inform ESMA and the competent authorities of the AIF that the AIFM may start marketing.[60]

In case of an EU AIFM marketing non-EU AIFs in the EU, Article 35(2) of the directive provides that they may only do so if they comply with all the requirements of the AIFM Directive, except for the rules applying to the marketing of EU AIFs by EU AIFMs, if certain additional conditions are met.[61] The notification procedure of the AIFM is similar to the procedure applicable to EU AIFMs marketing EU AIFs.[62] Additionally, as is also the case for the Member State of reference of the non-EU AIFM marketing EU AIFs via a passport, the home Member State of the AIFM must inform ESMA in case the AIFM may start marketing the non-AIFs shares.[63]

Lastly, non-EU AIFMs marketing EU AIFs must request authorization and file notification with their Member States of reference.[64] These AIFMs are not subject to a provision of the AIFM Directive in case this provision is incompatible with national law the AIFM or AIF has to comply with.[65] They are furthermore subject to equivalent conditions on these matters applying to EU AIFMs described above, provided that with instead of the AIFM's home Member State, it is referred to the AIFM's Member State of reference.[66] The notification procedure is in line with the notification procedure that

58. In general, the Member State of reference will be the Member State in which the largest part of the AIFM's activities subject to the directive takes place, although the AIFM may often also choose for the Member State in which the AIF it intends to market is registered (if such is the case). *See* Article 37(4) of the AIFM Directive.
59. Article 39(2) and (4) of the AIFM Directive and Annex III and IV to the AIFM Directive.
60. Article 39(3) and (6) of the AIFM Directive.
61. These conditions are: (1) there must be satisfactory cooperation agreements in place between the competent authorities of the AIFM's home Member State and the supervisory authorities of the country of establishment of the non-EU AIF, (2) the country of establishment of the non-EU AIF is not on the list of Non-Cooperative Countries and Territories by the Financial Action Task Force on anti-money laundering and terrorist financing, and (3) the country of establishment of the non-EU AIF has signed a OECD compliant tax treaty with the relevant AIFM's home Member State and with any other Member State in which it is intended that the non-EU AIF will be marketed. *See* Article 35(2)(a)-(c) of the AIFM Directive.
62. Article 35(4) of the AIFM Directive.
63. Article 35(7) of the AIFM Directive.
64. Article 37(1) of the AIFM Directive.
65. Article 37(2) of the AIFM Directive. Non-EU AIFM must provide additional information regarding its assessment as to which Member State it considers to be its Member State of reference, the name of the legal representative of the AIFM and the place where it is established, and the provisions of the directive that the AIFM cannot comply with due to incompatibility of national law. In case of the latter, the AIFM must also provide written evidence based on ESMA standards that its national law provides for rules equivalent to the rules of the directive for which compliance is impossible, offering the same level of investor protection. Article 37(8)(a) of the AIFM Directive.
66. Article 40(2) of the AIFM Directive.

applies to EU AIFMs.[67] Furthermore, similar to non-EU AIFMs marketing EU AIFs, the competent authorities of the Member State of reference of the AIFM is required to inform ESMA on the marketing approval of the AIF shares.[68]

AIFs are defined in Article 4(1) of the AIFM Directive as 'collective investment undertakings (…), which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC [the UCITS Directive]'. Article 4(2) of the directive gives the definition of AIFMs, which are 'legal persons whose regular business is managing one or more AIFs'. In sum, there are three requirements that a fund has to meet in order to fall under the definition of an AIF and for the directive to apply to its AIFM: (1) it must raise capital from a number of investors, (2) in accordance with a pre-defined investment policy, and (3) does not require authorization under the UCITS Directive. With respect to the first two criteria, it can be referred to section 2.2.1 about funds in general. With respect to the last criterion, it can be referred to what is described above about UCITS.

Similar to UCITS management companies and self-managed UCITS, AIFMs must receive prior authorization of their home Member State (or Member State of reference in case of a non-EU AIFM) in order to manage and/or market AIF shares in the EU via a passport.[69] The qualification of being an AIF is thus worthless without the actual authorization to provide management service or the cross-border marketing of AIF shares in the EU. Therefore, although they are technically not criteria to fall under the scope of the directive, the authorization requirements for AIFMs will be discussed below (section 3.3.1). In addition, as mentioned, the AIFM Directive is intended to be a mandatory framework for all non-UCITS. Therefore, other than is the case under the UCITS Directive, there are a number of exemptions to the directive to prevent application. These key exemptions to the scope of the AIFM Directive will also be set out below (section 3.3.2).

3.3.1 Authorization Requirements

An AIFM that cannot make use of an exemption from the AIFM Directive will need to obtain authorization from its home Member State, or in case of a non-EU AIFM, its Member State of reference. Article 8(1) of the AIFM Directive requires that the competent authorities of the home Member State of the AIFM may only grant authorization in case: (1) they are satisfied that the AIFM will meet the conditions of the directive, (2) the AIFM complies with Article 9 of the directive, (3) there are at least two persons that conduct the business of the AIFM and they are of sufficiently good repute and sufficiently experienced considering the investment strategies pursued by the AIFM, (4) the investors of the AIFM that have qualifying holdings are suitably taking into account the sound and prudent management of the AIFM, and (5) the head office and registered office of the AIFM are located in the same Member State. With

67. Article 40(4) of the AIFM Directive.
68. Article 40(7) of the AIFM Directive.
69. Articles 6(1), 31(1), 32(1), 33(1) 35(1), 37(1), 39(1) and 40(1) of the AIFM Directive.

respect to non-EU AIFMs, the latter requirement logically does not apply as well as the requirements in the directive related to the marketing of EU AIF shares in the EU by EU AIFMs and rules that are 'incompatible with compliance with the law to which the non-EU AIFM and/or the non-EU AIF marketed in the Union is subject'.[70]

Similar to UCITS management companies, authorization must be refused in case close links exist between the AIFM and other natural or legal persons which prevent the effective supervision of the AIFM.[71] Additionally, it can be noted that Member States may restrict the scope of the authorization, in particular as regards the investment strategies of AIFs the AIFM is allowed to manage.[72] Since most AIFMs focus on one or a limited number of investment strategies, the license granted by the competent authority of the home Member State will generally be restricted to those strategies for which the AIFM has skilled and experienced personnel.[73] Other restrictions that may be imposed include restrictions on the services that an AIFM may perform, such as administration services and asset-related services, in case it does not have adequate resources for these services.[74]

The authorization rules of EU AIFMs are to a large extent similar to those applying to UCITS management companies. So AIFMs must provide information about their programme of activity setting. In addition, similar provisions apply related to the four eyes principle on business decisions, the possibility to refuse authorization in case of connections to a natural or legal third party which are deemed to prevent effective supervision, the head and registered office the AIFM, depositary arrangements, and the delegation of management functions.[75] The AIFM must also disclose its remuneration policies and practices and comply with the restrictions on remuneration.[76] In addition, they must provide information on their investment strategies, the AIFM's policy on leverage, provision of the rules or instruments of incorporation of each AIF, the identity of the master AIF, if any of the AIFs are feeder funds, risk profile and other characteristics of the AIFs, including whether they are or will be established in the EU or a third country, and various other disclosures to investors referred to in the AIFM Directive.[77] Given that the AIFM Directive does not regulate AIFs, but only AIFMs, this information provides the competent authority with the information needed to assess the risks and the risk-adjusted return profiles of the AIFs. While UCITS are not required by the UCITS Directive to provide this information to obtain an authorization, they will generally be required to provide similar information in their 'programme of activity' by national law as part of the application forms of their home Member States.

In addition to these information requirements, AIFMs are required to meet the capital requirements set out in Article 9 of the AIFM Directive in order to be granted a

70. Article 37(2)(a) and (8)(d) of the AIFM Directive.
71. Article 8(3)(a) of the AIFM Directive.
72. Article 8(4) of the AIFM Directive.
73. Zetsche, *The Alternative Investment Fund Manager Directive*, 178.
74. *Ibid.*, 178–179. Zetsche notes that in such cases, the AIFM may delegate these functions to a third party, although it would still be required to supervise the third party via its depositary.
75. Article 7(2)(a), (b), (c), (e) and 8(1)(c), (d), (e) and (3) of the AIFM Directive.
76. Article 7(2)(d) of the AIFM Directive. UCITS are also subject to remuneration restrictions. *See* section 2.5.4.
77. Article 7(3) of the AIFM Directive.

license.[78] The capital requirements that an AIFM must hold differ depending on whether the AIFM is appointed as an external manager of AIFs or is an internally managed AIF. If the AIFM is an external manager of AIFs, it is required to have an initial capital of at least EUR 125,000. Similar to UCITS management companies, if the value of the portfolios managed by the AIFM exceeds EUR 250 million, the AIFM must provide an additional amount of own funds equal to 0.02% of the value in excess of EUR 250 million, with a limit of EUR 10 million. These own funds must be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.[79] The minimum additional own funds must never be lower than one quarter of the AIFM's preceding year fixed overheads.[80] Member States may authorize AIFM to not provide up to 50% of the additional amount of own funds in case they have a guarantee from a credit institution or insurance undertaking.[81] Internally managed AIFs are required to have an initial capital of at least EUR 300,000.[82]

Other than UCITS, AIFMs must either have professional indemnity insurance or have additional own funds appropriate to cover risks arising from professional negligence.[83] The liability of the AIFM should not be affected by delegation or sub-delegation and the AIFM should provide adequate coverage for professional risks related to such third parties for whom it is legally liable.[84] The professional liability risks envisaged by the Commission that should be covered include, but are not limited to, risks of losses arising from negligence in relation to business disruption, system failures and process management, and those in relation to investors, products and business practices. This would include the loss of title documents evidencing ownership, misrepresentations made by the AIFM or its staff resulting in a breach of the conduct of business rules, failures to prevent fraudulent or malicious acts by the AIFM's staff or third parties for whom the AIFM has vicarious liability, and the improper valuation of assets and calculation of share prices.[85]

If the AIFM chooses to cover professional liability risk through additional funds, it must hold at least 0.01% of the value of its assets under management. A Member State may however set a lower standard if the AIFM can demonstrate that liability risk is adequately covered or a higher standard if the competent authority believes the existing own funds held by the AIFM are not sufficient to cover the risks.[86] In addition to these quantitative requirements, the AIFM must also implement effective internal operational risk management policies and procedures in order to identify, measure,

78. This article does not apply when the AIFM is authorized as a management company under the UCITS Directive. *See* Article 9(10) of the AIFM Directive.
79. Article 9(8) of the AIFM Directive. In its Q&A on the AIFM Directive, the Commission stated that Member States may develop principle based criteria to specify what should be considered as liquid or readily convertible to cash, but urges ESMA to develop a common approach among Member States on this issue. *See* Q&A on the AIFM Directive, ID 1153, Own Funds.
80. Article 9(5) of the AIFM Directive and Article 21 of Directive 2006/49/EC.
81. Article 9(6) of the AIFM Directive.
82. Article 9(1) of the AIFM Directive.
83. Article 9(7) of the AIFM Directive.
84. Article 75(a) of the Commission Delegated Regulation on AIFMs.
85. Article 12 of the Commission Delegated Regulation on AIFMs.
86. Article 14(2), (4) and (5) of the Commission Delegated Regulation on AIFMs.

manage and monitor appropriately operational risks including professional liability risks.[87] Operational risk exposures and loss experience must be monitored by the AIFM on an ongoing basis, with operational risk management policies and procedures and measurement systems to be subject to regular review, at least on an annual basis.[88]

3.3.2 Exemptions and Exclusions

The AIFM Directive provides for a number of exemptions and exclusions. The most commonly used exemptions include the exemption for non-EU AIFs and AIFMs, the intragroup exemption, the 'de minimis exemption', and the exclusions for holding companies,family offices, joint ventures and insurance contracts, and other entities that cannot be considered to be AIFs. Firstly, as mentioned (see section 3.3), non-EU AIFMs marketing AIFs and EU/non-EU AIFMs marketing non-EU AIFs in the EU are currently not subject to the full directive. Asa result, they will not have access to the EU passport, although certain non-EU AIFs (established in Guernsey, Jersey and Switzerland), will be able to use the passport from November 2015 at the latest. However, since it is likely that the passport will be extended to the marketing of AIFs by non-EU AIFMs and non-EU AIFs by EU AIFMs (see section 2.2.3[A]), this exclusion will not be discussed separately below. Secondly, in addition to these exemptions, it can be noted that the AIFM Directive includes two grandfathering provisions for AIFMs managing existing AIFs of the closed-end type that have been offered pursuant to a private placement. If such AIFs: (1) do not make any additional investments after 22 July 2013, or (2) closed their subscription period for investors prior to 21 July 2011 and if their term expires at the latest by 22 July 2016, the relevant AIFM may, however, continue to manage such AIFs without needing an authorization under the AIFM Directive.[89] Thirdly, AIFMs that market shares of AIFs under a prospectus set up in accordance with the Prospectus Directive are not subject to Articles 31, 32 and 33 of the AIFM Directive and thus may continue to be marketed to the public on the basis of that prospectus, as long as the prospectus is valid.[90] These grandfathering and transitional provisions are in no need for further explanation. Therefore, below, the following key exemptions to the directive are discussed in more detail: [A] the intragroup exemption, [B] the de minimis exemption, and [C] exclusions (including, among others, holding companies and family offices).

[A] Intragroup Exemption

Pursuant to Article 3(1) of the AIFM Directive, the directive does not apply to AIFMs that manage AIFs whose only investors are the AIFM or the parent undertakings, subsidiaries or other subsidiaries of the parent undertakings of the AIFM, provided that none of those investors itself is an AIF. This exemption is also referred to as the

87. Article 13 of the Commission Delegated Regulation on AIFMs.
88. Article 13(4) of the Commission Delegated Regulation on AIFMs.
89. Article 61(3) and (4) of the AIFM Directive.
90. Article 61(2) of the AIFM Directive.

'intragroup exemption' as it aims at excluding group companies with no external investors. The definition of 'parent undertaking' and 'subsidiary' follows those used for the purposes of consolidating accounts on a group basis.[91] Where a financial transaction or (delegation) arrangement falls within the intragroup exemption, that transaction or arrangement will be a full derogation in the sense that none of the requirements of the AIFM Directive will apply to the relevant entity.

The effect of this exemption that the relevant AIFM will be out of the scope of the AIFM Directive with respect to these activities. In cases where the AIFM is a member of a group and subject to the AIFM Directive due to its other activities, its conflict of interest policy must also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.[92] The policy must include reference to the activities carried out by or on behalf of the AIFM, including activities carried out by a delegate, subdelegate, external valuer or counterparty, identifying the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the AIF or its investors, and must specify any procedures to be followed and measures to be adopted in order to prevent, manage and monitor such conflicts.[93]

[B] De Minimis Exemption

As stated in Article 3(2) of the AIFM Directive, an exemption applies to certain small AIFMs. This exception refers to the business volume of AIFMs and is also known as the 'de minimis exemption'. It is included in the directive to prevent unnecessary administrative burden is imposed on AIFM that the Commission assumes to not pose relevant risks to financial stability and market efficiency.[94] The de minimis exemption, although referred to as such, it not a real exemption as it does not fully exclude AIFMs from the scope of the directive, but provides a lighter ('minimis') regime for AIFMs. It applies to AIFMs that manage portfolios of AIFs which in aggregate do not exceed: (a) EUR 100 million, or (b) EUR 500 when the AIFs are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. In cases where the portfolio of AIFs of an AIFM combines both (a) and (b), the AIFM must aggregate the portfolios of all AIFs and the threshold of EUR 100 million should be applied in determining whether the AIFM is fully within scope.[95]

When the 'exemption' applies, the AIFM is not subject to a license requirement but only to an obligation to register and thereby only 'limited' reporting obligations apply. Such AIFMs must provide information on its identity, the AIFs managed and their investment strategies to the competent authorities. The AIFM will furthermore

91. Article 3(ae) and (ak) of the AIFM Directive.
92. Article 31(1) of the Commission Delegated Regulation on AIFMs.
93. Article 31(2) of the Commission Delegated Regulation on AIFMs.
94. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 48 and 55.
95. Article 2(1)(c) of the Commission Delegated Regulation on AIFMs.

need to report on a regular basis on the main instruments traded, the principal exposures and most important concentrations of AIFs managed.[96] The rationale behind these rules is, although the activities of the AIFM concerned are unlikely to have individually significant consequences for financial stability, it could be possible that in aggregate their activities give rise to systemic risk. In case the exempted AIFM no longer falls under the de minimis exemption, it must notify its competent authority and apply for a full authorization.[97]

AIFMs that use the de minimis exemption cannot market their shares in the EU via the AIFM passport, unless they opt-in to the AIFM Directive. This possibility is set out in Article 3(4) of the AIFM Directive, which provides that the particular AIFM may voluntarily choose to apply to the stricter rules requiring a license as a result of which it may benefit from the passport rights provided under the directive and becomes subject to all the provisions of the directive. In addition, venture funds and social entrepreneurship funds that fall under the EuVCF or EuSEF Regulation are provided with an EU passport under this regulation in case their assets under management fall below the EUR 500 million threshold, subject to some reducing requirements for their AIFMs.[98] See on the EuVCF Regulation also section 2.6.6[B].

In order to qualify for the de minimis exemption, the total value of assets under management of the AIFM must be calculated. The Commissions has adopted rules on how this should be done in its Delegated Regulation on AIFMs. These rules determine, among other things, that AIFMs must calculate their assets under managements on at least an annual basis (except for closed-ended AIFs) using the latest available asset values, on a threshold calculation date determined by the AIFM and applied in a consistent manner.[99] Exempted from the calculation are all UCITS portfolios, investments of AIFs in other AIFs that are managed by the same AIFM, and investments of AIFs in compartments of that AIF.[100] In cases where the (exempted) AIFM has substantial leveraged portfolios, it must disclose this exposure to the competent authorities of its home Member State.[101] Registered AIFMs must also disclose their total amount of leverage calculated in accordance with these two methods as part of the AIF's periodic reporting to investors.[102]

96. Article 3(3)(a)-(d) of the AIFM Directive. Member States may however impose stricter provisions to these AIFMs. *See* Article 3(3) of the AIFM Directive.
97. Article 3(3)(e) of the AIFM Directive. However, breaches of the threshold that are of a temporary nature are allowed. A situation is no longer considered to be temporarily in case it is likely to continue for a period in excess of three months. *See* Article 4(4) of the Commission Delegated Regulation on AIFMs.
98. *See* for the definitions of venture capital and social entrepreneurship funds that are subject to these regulations, Article 3(b) of the EuVCF Regulation and Article 3(b) of the EuSEF Regulation.
99. Article 2(6) of the Commission Delegated Regulation on AIFMs.
100. Article 2(2), (4), and (5) of the Commission Delegated Regulation on AIFMs.
101. Articles 24(4) of the AIFM Directive and 110(5) of the Commission Delegated Regulation on AIFMs. An AIFM is considered to be employing substantial leverage when the exposure of an AIF as calculated by the commitment method exceeds three times its NAV. *See* Article 111(1) of the Commission Delegated Regulation on AIFMs.
102. Articles 23(5) of the AIFM Directive and 109(2)(a) and (3) of the Commission Delegated Regulation on AIFMs.

It is difficult to define or quantify the exact impact of the de minimis exemption. In the case of hedge funds, the Commission stated that de minimis rule of EUR 100 million would exempt 80% of the hedge fund managers, but would still cover about 70% of the total net assets under management of the market. The EUR 500 million however would cover about half of the total hedge fund industry's net assets, but only less than 10% of the managers'.[103] Since most hedge funds will be considered to be leveraged, the EUR 100-threshold will most likely apply, as a result of which most hedge fund managers will fall under the full scope of the directive. The Commission has noted that the use of a threshold may give rise to abuse in order to circumvent the full directive from applying.[104]

Such abuse could for example be done through the use of an FoF structure in which a non-EU AIF offering shares to EU investors invests solely in other, leveraged AIFs and all funds have the same manager. The non-EU AIF may exempt from its assets calculation the investments in the other AIFs, as a result of which it will be considered unleveraged for the purpose of the de minimis exemption. The other AIFs are exempt from application of the AIFM directive if they have only issued shares to the non-EU AIF. Since the non-EU AIF does not qualify as an EU investor, these funds fall outside the scope of the directive. As a result, the AIFM of the non-EU AIF would not be required to comply with the AIFM Directive. However, it can be questioned whether such a structure will be allowed by Member States as recital 9 of the AIFM Directive provides that 'Member States should (…) ensure that investment firms established in a third country that, pursuant to the relevant national law, can provide investment services in respect of AIFs also fall within the scope of [the AIFM Directive]' and that national law implementing the directive 'should never amount to a de facto circumvention of this Directive by means of turning the AIFM into a letter-box entity, irrespective of whether the AIFM is established in the Union or in a third country'.[105]

In any case, it is not expected that a large part of the AIFM industry in terms of assets under management will be able to take advantage of the threshold amounts considering the small de minimis limits set out within the AIFM Directive.[106] However,

103. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 48. Furthermore, the de minimis rule would exempt only between 5% and 25% of the 80% of hedge funds domiciled outside the EU, and just over 20% of the estimated 66% of private equity firms outside the EU. *See* European Parliament's Committee on Economic and Monetary Affairs, Ex-ante evaluation of the proposed Alternative Investment Managers Directive, IP/A/ECON/NT/2009_03, Feb. 2011, 11.

104. *Ibid.*, 51. The Commission however states that 'this has to be weighed against the burden imposed on the AIFM covered'. *Ibid*.

105. It will thus depend on the applicable national law and the supervision exercised by the national financial supervisory authorities whether or not the AIFM will need to comply with the AIFM Directive. However, Article 82 of the Commission Delegated Regulation on AIFMs provided for a number of circumstances under which the AIFM is considered to be a 'letter-box entity' and therefore is no longer considered to be the manager of the AIF, including the situation when the AIFM no longer has the power to take key decisions and has delegated the performance of investment management functions to an extent that exceeds by a substantial margin the management functions performed by the AIFM itself. This article does not include the situation in which the FoF structure is used to circumvent application of the AIFM Directive.

106. PwC, *The AIFM: Getting Authorised – AIFMD Newsbrief* 6 (February 2013). The news brief can be found at http://www.pwc.lu/.

many managers with a small asset portfolio will however fall under the exemption. AIFMs that are exempt on the basis of the de minimis exemption must nonetheless register with the relevant competent authorities of their home Member State and provide for certain initial information on, among other things, their investment strategies, and ongoing information (at least annually) on the main instruments in which they are trading, the principal exposures and the most important concentrations of the AIFs they manage in order to enable the authorities to effectively monitor systemic risk.[107] Since these 'exempted' AIFMs do not benefit from the EU AIFM passport, the question can be raised whether the advantages outweigh the costs of using the de minimis exemption.[108] It may therefore be more beneficial for some of these AIFMs to opt-in to the full directive. Furthermore, Member States may impose additional (stricter) requirements and use different and complex registration forms for the registration of these AIFMs, which may further increase the costs and reduce the advantage of this exemption.

[C] Exclusions

Besides the exemptions described above, the AIFM directive excludes a number of entities. These entities are not considered AIFs and therefore fall outside the scope of the directive. To this end, in the first place, Article 2(3) of the AIFM Directive sums up the following entities that the directive does not apply to:

(a) holding companies;
(b) institutions covered by the Directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORP Directive), or pension funds;[109]
(c) supranational institutions, such as the World Bank, IMF, ECB, and other supranational institutions and similar international organizations;[110]

107. In the Commission Delegated Regulation on AIFMs, these information requirements are further specified. So are exempted AIFMs required to provide, among other things, a break-down of financial instruments and other assets in which it is trading, including the AIF's investment strategies and their geographical and sectoral investment focus. *See* Article 110(1)(a) of the Commission Delegated Regulation on AIFMs.
108. *See also* Zetsche, *The Alternative Investment Fund Manager Directive*, 67 (stating that '[t]his heavy handed approach takes a lot from the proportionality principle to which the legislature often referred when discussing the AIFM (Level 1) Directive').
109. Directive 2003/41/EC of the European Parliament and of the Council of 3 Jun. 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235, 10 (IORP Directive). The IORP Directive defines an Institution for Occupational Retirement (IORP) as 'an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity. *See* Article 6(a) of the IORP Directive. The IORP thus regulates occupational pension funds.
110. This exemption applies in so far the AIFs act in the public interest, which may, for example, include the temporarily adoption of AIF management in order to stabilize the financial markets. *See* Zetsche, *The Alternative Investment Fund Manager Directive*, 57.

(d) national central banks;[111]
(e) national, regional and local governments and bodies or other institutions which manage funds supporting social security and pensions systems;[112]
(f) employee participation or saving schemes;[113]
(g) Securitization Special Purpose Entities (SSPEs).[114]

Holding Companies

With respect to the above-mentioned list of exclusions, the exclusion for holding companies needs some further explanation. Holding companies are defined in the directive as companies which carry out a business strategy or strategies through its affiliates in order to contribute to its long-term value and, where a holding company is not listed on an EU stock exchange and operating for its own account, are not established for the main purpose of generating returns for its investors by means of divestment of its affiliates.[115] When looking at this definition, four criteria can be identified: (1) the holding of participations in affiliates, (2) the pursuit of one or more business strategies, (3) aimed at creating long-term value, and (4) being listed on an EU stock exchange and operating for its own account *or* not established for the primary purpose of obtaining return for investors by the disposal of its affiliates.

111. *Ibid*.
112. The AIFM Directive is thus not applicable on social security and pension funds managed by government institutions. Sovereign wealth funds (i.e., a state-owned pool of money that invests in various financial assets) may fall under this exemption, but will often also be exempt from the AIFM Directive due to the fact that they do not raise capital from investors as they generally invest government budgetary surplus. *See also* Zetsche, *The Alternative Investment Fund Manager Directive*, 65.
113. This exclusion covers schemes in which an employee invests in securities of the employer or in a company in the employee's group (or derivatives in relation to them such as options) or other schemes (such as an employee carried interest or co-investment vehicles).
114. SPPEs are defined in the AIFM Directive entities which sole purpose is to carry on a securitization or securitizations within the meaning of Article 1(2) of Regulation 24/2009 of the ECB. The ECB defines 'securitization' as 'a transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitization'. It can be noted that structured issues which are not credit-linked (e.g., debt securities linked to indices, commodities or equities), or structured issues where the transfer of credit risk could be viewed as accessory to the principal activity of the entity, or structured issues where there is no separation of the originator and issuer (possibly loan participation notes), may not fall within this definition. *See* Joint Associations Committee on Retail Structured Products (JAC), *Response to ESMA Consultation Paper – Guidelines on Key Concepts of the AIFMD (ESMA/2012/845) (the AIFMD Key Concepts Consultation)* 6 (29 Jun. 2104). The Commission notes that the securitization special purpose entities exemption should be interpreted narrowly and should not be used in order to circumvent the application of the AIFM Directive, but that further guidelines of ESMA may be feasible. *See* Q&A on the AIFM Directive, ID 1157, Scopes and exemptions. The JAC response can be found at ESMA's website: http://www.esma.europa.eu/.
115. Article 4(1)(o) of the AIFM Directive.

With respect to the first criterion, i.e., the holding of participations in affiliates, it is not clear if these participations should only include controlling stakes or whether non-controlling stakes, without exercising control, may also be considered. It should be considered that this could lead to different interpretations among Member States. The second criterion, i.e., the pursuit of one or more business strategies, refers to the difference between pursuing an investment strategy and a business strategy.[116] The third criterion provides that this business strategy must be intended at generating long-term value. The term 'long-term value' is not further defined and thus also leaves space for different interpretations by Member States. Private equity and venture capital funds may claim that they do just that. However, in addition to the aforementioned criterion, the fourth criterion relevant to these funds, i.e., self-governed listed funds, should also be met.[117]

In its Q&A, the Commission considers that the holding company exemption must be read in conjunction with recital 8 of the AIFM Directive which specifically mentions that managers of private equity whose shares are admitted to trading should not be excluded by definition as the criterion of being listed is not in itself sufficient. According to the Commission, a holding company is a separate legal entity that carries out the business of owning and holding equity shares of other companies without the intent to dispose of such shares. Such business is done on the own account of the holding company and not on behalf of a third party. All other operations apart from those related to the ownership of shares and assets are done via its subsidiaries, associated companies or participations. The Commission concludes that the exclusion of a holding company in Article 2(3)(a) was meant to exclude from the AIFMD large corporates such as Siemens or Shell.[118] Since private equity and venture capital funds generally intend to dispose of their shares after a certain holding period in order to gain a profit for their investors, they will not be able to use this exclusion based on the Commission's interpretation.

Family Offices

In addition to the list of entities that are expressly excluded from the AIFM Directive in Article 2(3), other entities may be excluded from the directive on the basis of the preamble or another provision included in the AIFM Directive, including family offices. The 'family offices' exemption is also reflected in preamble to the directive, which states that 'family office vehicles which invest the private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with this Directive'.[119] In this context, it can be noted that the directive may seem to be making

116. *See* section 2.2.1.
117. Considering that these funds will generate return for their investors from the sales of shares, the second restriction of this criterion, i.e., not being established for the primary purpose of obtaining return for investors by the disposal of its affiliates, will not be available to them.
118. Q&A on the AIFM Directive, ID 1146, Scopes and exemptions.
119. *Ibid.*, 9-10, recital 7 of the preamble to the AIFM Directive and ESMA, Final report – Guidelines on key concepts of the AIFMD, 32 ('[W]hen capital is invested in an undertaking by a member

a distinction between internal and external capital, as it considers the absence of external capital indicative for whether or not a family office is an AIF.

In a similar way, in its 2012 discussion paper on key concepts of the AIFM Directive and types of AIFM, ESMA stated that a fund whose only investors are the manager and its 'employees' should not be an AIF as such investors are not 'external investors'.[120] However, ESMA deleted this part from the text of its final Guidelines on key concepts of the AIFMD as 'the exemption would have been against the Level 1 provisions, since the relationship of the investor with an undertaking should not define the existence of a fund'.[121]

Joint Ventures and Insurance Contracts

According to recital 8 of the AIFM Directive, joint ventures and insurance contracts are also not subject to the AIFM Directive. While the directive thus clearly intends to exclude such structures from its scope, they are not included in the list of exclusions set out in Article 2(3). The Commission's Q&A considers in this respect that recital 8 is a 'floating' recital with no legal effect. Therefore, joint ventures are not excluded per se but only to the extent they do not have the characteristics of an AIF or fall within the scope of an express exemption.[122] Joint ventures will generally not be AIFs because they cannot be considered to be collective investments undertakings under Article 4(1)(a) of the AIFM Directive due to the fact that the participating companies typically have day-to-day discretion or control over the activities of the joint venture.[123] However, as mentioned, this should be determined on a case-by-case basis by the Member States. With respect to insurance contracts, including life insurance funds, the same rule can, in my view, be applied. According to the Commission's Q&A, 'each situation should be assessed on its own merits in order to determine whether the criteria listed in Article 4(1)(a) are fulfilled or not, whereby substance should prevail over the formal denomination of the specific structure'.[124]

of a pre-existing group, for the investment of whose private wealth the undertaking has been exclusively established, this is not likely to be within the scope of raising capital').

120. ESMA, Discussion paper – Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM, 52 (under 13(a) and (b)) ('[W]hen capital is invested in an undertaking by a natural or legal person or body of persons who is (...): (a) a member of the governing body of that undertaking or the legal person managing that undertaking; [or] (b) an employee of the undertaking or of the legal person managing the undertaking whose professional activities have a material impact on the risk profiles of the undertakings they manage and into which he or she invests; (...) this is not likely to be within the scope of raising capital').
121. ESMA, Final report – Guidelines on key concepts of the AIFMD, 13.
122. Q&A on the AIFM Directive, ID 1160, Scopes and exemptions.
123. Joint ventures can be defined as 'a number of contractual relations formed to carry out one project and generally define a business agreement in which parties agree to develop a new entity and new assets by contributing equity. The parties exercise control over the enterprise and consequently share revenues, expenses and assets'. *Ibid.*
124. *Ibid.*

Other Non-collective Investment Undertakings

Next to holding companies, family offices and joint ventures and insurance contracts, there is a 'catch all' provision for all other entities that cannot be qualified as undertakings for collective investments under Article 4(1)(a) of the AIFM Directive and are therefore not considered to be AIFs (and thus excluded from the AIFM Directive). ESMA's Guidelines on key concepts of the AIFMD explains when an entity is a 'collective investment undertaking' for the purpose of the AIFM Directive.[125] It provides for three cumulative criteria.

Firstly, an entity should not be carried on for a general commercial or industrial purpose, i.e., the purpose of pursuing a business strategy which includes running a predominantly commercial or industrial activity.[126] This criterion again intends to exclude ordinary companies from the AIFM Directive. In this context, it can be noted that real-estate funds may claim that they fall outside the scope of the AIFM Directive on the basis that they have a 'general commercial or industrial purpose', namely property development or property rental. However, in its Q&A, the Commission states that such companies 'cannot be excluded as such a priori' and that 'each situation needs to be valued on its own merits, based on substance, not on form'.[127]

Secondly, the entity must pool capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors. The necessity of asset pooling is used in many definitions of 'collective investment undertakings' or 'investment funds', including the one used in this book, and aims at excluding individual portfolio management.

Thirdly, ESMA has included a definition of 'day-to-day discretion or control', defined as a form of direct and ongoing power of decision over operational matters which extends further than the ordinary exercise of decision through voting at shareholder meetings. The guidelines provide that the investors have no day-to-day control over the AIF, as the AIFM must have the responsibility for the management of the AIF's assets.[128] This criterion refers to the 'professional management' criterion which excludes from the scope of the AIFM Directive investors self-managing a fund and investment clubs whose investors participate in the making of investment decisions.[129] Consequently, a private equity or real estate structure that is in fact a co-management arrangement for a particular asset where each of the investors directly co-owns the underlying asset under management, may be excluded from the scope of the directive. However, such arrangements should be fully co-owned, as ESMA states that even if one of more of the investors have day-to-day control, the fact that others do

125. ESMA, Final report – Guidelines on key concepts of the AIFMD, 31 (under 12).
126. ESMA, Final report – Guidelines on key concepts of the AIFMD, 29.
127. Q&A on the AIFM Directive, ID 1164, Scopes and exemptions.
128. ESMA, Discussion paper – Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM, 11 ('The AIFM or internally-managed AIF must have responsibility for the management of the AIF's assets. Investors have day-to-day no discretion or control over these assets').
129. Zetsche, *The Alternative Investment Fund Manager Directive*, 42.

not have this control implies that the undertaking may still be a collective investment undertaking.[130]

3.4 INTERNAL CONTROL SYSTEMS

Internal control systems consist of a set of internal rules, policies, and procedures an organization implements to ensure that, through a process of identifying, measuring, managing and monitoring the main risks, its operations are in line with the applicable laws and regulations. Rules related to internal control systems of investment funds typically aim at the monitoring and management of prudential risk by securities authorities and the protection of investors. This also follows from the impact assessment on the AIFM Directive, which states that the AIFM framework aims, among other things, the management of micro-prudential risks through 'the imposition of strict risk management controls on market, liquidity, counterparty (credit and settlement, especially in case of short selling) and operational risks' and the improvements in investor disclosures and effective due diligence by 'ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions'.[131] The UCITS Directive focuses mainly on the protection of investors, as its preamble provides that it is 'necessary, for the protection of investors, to guarantee the internal overview of every management company in particular by means of a two-person management system and by adequate internal control mechanisms'.[132]

In general, EU rules related to internal control systems for funds encompass a set of mandatory policies and procedures that must be implemented by the fund under EU law, which includes: (1) procedures on preventing or managing conflicts of interest, (2) risk management procedures, (3) liquidity management policies, (4) procedures for the valuation of assets, and (5) remuneration policies. The five types of internal control systems are discussed below.

3.4.1 Conflicts of Interest Policies

Controlling conflict of interest situations is an important aspect of investor protection. As mentioned, an inherent conflict of interest exist between fund managers and investment funds.[133] With the level of management fee representing the fund manager's revenue, the manager may have an incentive to increase investment risk, especially in case a performance-based fee is granted to the manager. In addition, there is also a risk that the manager favours accounts of funds that earn performance-based fees over those that do not or that it carries out transaction on behalf of the fund with

130. ESMA, Final report – Guidelines on key concepts of the AIFMD, 31 (under 12(c)).
131. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed AIFM Directive, 29.
132. Recital 10 of the preamble to the UCITS Directive.
133. *See* section 2.2.1.

affiliated parties (such as a broker-dealer or bank). To mitigate such conflicts and possible adverse consequences to investors, the EU regulator requires funds to adopt so-called conflicts of interest policies.

In this respect, the UCITS and AIFM Directive and corresponding regulations appear to be nearly the same. Both directives require the fund manager (or, in case of a self-managed UCITS, the UCITS itself),[134] to maintain an effective conflicts of interest policy designed to identify, prevent, manage and monitor conflicts of interests in order to circumvent them from damaging the interests of investors.[135] The Commission has adopted additional legislation regarding, among others, the internal control systems of UCITS and AIFs which provide insight into the types of conflicts that the manager should take into account and the organizational and administrative procedures that should be followed to manage these conflicts.[136]

The types of conflicts concern situations where the UCITS management company or AIFM (or a relevant person or a person directly or indirectly linked by way of control to the manager):[137] (1) is likely to make a financial gain at the expense of the UCITS/AIF or its investors, (2) has an interest in an outcome that is distinct from the UCITS' or AIF's interest in that outcome, (3) has an incentive to favour the interests of AIFs, UCITS, another client or group of clients over another, or one investor over another, (4) carries out the same activities for the AIF or UCITS and for another AIF, UCITS or client, or (5) receives or will receive from a person other than the UCITS or AIF an inducement in relation to collective portfolio management activities provided to the UCITS or AIF, other than the standard commission or fee for that service.[138]

Examples of conflict of interest situations mentioned by the EU regulator for UCITS and AIFs, include, among others: the delegation of activities (e.g., property and facility management of a real estate fund) to a member of the group to the detriment of the fund or its investors (for instance when the delegate is a poor provider), assets held by the fund have been purchased from or sold to relevant persons or persons directly or indirectly linked by control to the AIFM or UCITS management company, an AIFM manages both an AIF and a UCITS while the AIF has a long position and the UCITS a

134. Hereafter, it will be referred to UCITS management companies which also includes UCITS self-managed funds.
135. Article 14(2)(c) of the UCITS Directive and Article 14(1) of the AIFM Directive.
136. Commission Directive 2010/43/EU of 1 Jul. 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, OJ L 176, 42 (Directive 2010/43/EU) and the Commission Delegated Regulation on AIFMs.
137. The term 'relevant person' means a director, partner or equivalent, or manager of the UCITS management company or AIFM, an employee of the UCITS management company or AIFM, as well as any other natural person whose services are placed at the disposal and under the control of the UCITS management company or AIFM and who is involved in the provision by the UCITS management company or AIFM of collective portfolio management, or a natural person who is directly involved in the provision of services to the UCITS management company or AIFM under a delegation arrangements to third parties for the purpose of the provision by the UCITS management company or AIFM of collective portfolio management. *See* Article 1(2) of the Commission Delegated Regulation on AIFMs.
138. Article 17(1) of Directive 2010/43/EU and Article 30 of the Commission Delegated Regulation on AIFMs.

short one in the same asset, cross trades between two AIFs or between an AIF and a UCITS on terms that put one of the parties at a disadvantage, and soft commission agreements with brokers, target AIFs/UCITS or target companies.[139] The fund manager is required to create a conflict of interest policy that identifies such situations and assesses the potential risks of damage to the fund's interests or its investors. For this identification, the manager should not only take into account its own activities, but also the activities carried out by a delegate, sub-delegate, external valuer and/or counterparty.[140]

In order to prevent damaging the investors, the fund manager should furthermore adopt procedures and measures to ensure that relevant persons engaged in different business activities that could involve conflicts of interest carry out these activities on an appropriately independent level. Such measures may include, where necessary, the adoption of appropriate 'Chinese walls' and segregation of duties. When the measures could not prevent the risk of damage to the interest of investors, the senior manager or other internal competent body of the manager must be immediately informed and provided with the task to ensure that the manager acts in the best interest of the fund and/or its investors.[141] Investors must be informed about such situations 'by any appropriate durable medium' and should be given reasons for any decision made in this respect.[142]

3.4.2 Risk Management Policies

Under Article 51(1) of the UCITS Directive, UCITS management companies must employ a risk management process which enables it to monitor and measure on an ongoing basis the risk of the positions and their contribution to the overall risk profile of the fund. Article 15(2) of the AIFM Directive provides for a similar rule. The risk management process of the fund manager covers three general areas: risk measurement, risk control, and risk monitoring.[143]

139. *See* on these and other examples ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, 16 Nov. 2011, 53–55.
140. Article 18(2)(a) of Directive 2010/43/EU (referring to 'collective portfolio management activities carried out by or on behalf of the management company', which include, among others, investment management and valuation and pricing, but however not the activities of a counterparty) and Article 31(2)(a) of the Commission Delegated Regulation on AIFMs.
141. Articles 19(2) and 20(2) of Directive 2010/43/EU and Articles 32(2) and 34 of the Commission Delegated Regulation on AIFMs. In the case of UCITS, the obligation is to act in the best interest of both the UCITS and its investors, whereas in the case of AIFs, the manager must act in the best interest of the AIF *or* its investors. As a consequence, the AIFM may decide that a conflicting situation is allowed because it is in the interest of the AIF, even if investor interests are damaged. This could for example occur when an AIFM extends the statutory life of an AIF in order to gain ongoing charges.
142. Article 20(3) of Directive 2010/43/EU and Article 36(1) of the Commission Delegated Regulation on AIFMs. If the UCITS management company or AIFM chooses to publish conflict of interest situations via its website, certain additional criteria apply. *See* for UCITS, Article 38 of Commission Regulation No. 583/2010 (if the information is disclosed in the KII or prospectus) and for AIFMs, Article 36(2) of the Commission Delegated Regulation on AIFMs.
143. Szylar, *Risk Management under UCITS III / IV: New Challenges for the Fund Industry,* 108–109.

[A] Risk Measurement

Risk measurement refers to the identification and calculation of all risk exposures of the fund. The procedure should contain measures that enable the manager to assess the exposure for each fund it manages to market, liquidity, counterparty risk, and all other risks that may be material to investors, such as operational risk. It should include the techniques, and tools that are deemed suitable to measure the risk factors attached to an investment strategy and the management styles adopted for the fund that are relevant to investors.[144] Such techniques should include both quantitative measures, as regards quantifiable risks, and qualitative methods.[145] With respect to UCITS, it is determined that Member States may require UCITS to apply the commitment approach, the Value at Risk (VaR) relative or absolute method, or other advanced risk measurement methodologies that are appropriate to measure risk 'taking into account the investment strategy pursued by the UCITS and the types and complexities of the financial derivative instruments used, and the proportion of the UCITS portfolio which comprises financial derivative instruments'.[146] Each of these methods may produce differing results.[147] The CESR has adopted guidelines with respect to the use of the commitment or VaR method for UCITS and stated that 'a UCITS may consider appropriate for the calculation of global exposure only those methodologies on which CESR has published level 3 Guidelines'.[148]

The CESR guidelines include rules on the way to convert financial derivatives into equivalent positions, the calculation of exposure when using efficient portfolio management techniques, and the methodology for the computation of the global exposure when using relative and absolute VaR. When a UCITS uses the VaR method, it should disclose the expected level of leverage employed and the possibility of higher leverage levels during the relevant period.[149] Furthermore, when using the relative VaR approach, information on the reference portfolio should be disclosed in the prospectus. In addition, the UCITS should disclose in its annual report the risk methodology used and, in case the VaR method is used, the VaR measure, the level of leverage employed during the relevant period, and, when using the relative VaR approach, information on the reference portfolio.[150] Furthermore, ESMA adopted guidelines for certain structured UCITS which allows them to use an alternative application of the commitment

144. Article 38(1) of Directive 2010/43/EU and Article 40(2) of the Commission Delegated Regulation on AIFMs.
145. CESR, Risk management principles for UCITS, CESR/09-178, February 2009, 16 and ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 67.
146. Article 41(3) of Directive 2010/43/EU. The VaR method measures the maximum loss of a portfolio value that will occur over some period at some specific confidence level due to normal market factors. *See* P. Penza & V.K. Bansal, *Measuring Market Risk with Value at Risk* 62 (John Wiley & Sons 2001). *See* for the commitment method, n. 211 and accompanying text, *infra*.
147. R.W. Helm, D.P. Dick & G.S. Schneberger, *Investments in Derivatives by U.S. and European Mutual Funds*, 44 Rev. Sec. & Commodities Reg. 135 (2011).
148. CESR, CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788, 28 Jul. 2010, 5.
149. *Ibid.*, 35.
150. *Ibid.*, 35–36.

approach.[151] It follows from the CESR and ESMA guidelines that non-structured UCITS may only use the VaR or commitment method and that structured UCITS may use these methods or an alternative application of the commitment method as long as they comply with the applicable set of guidelines.

AIFMs are not required to use a specific method, but are only held to adopt measures that are 'proportionate to the nature, scale and complexity of the business of the AIFM and of each AIF it manages'.[152] The rationale behind this is the fact that the AIFM sector is considered to be more heterogeneous than the UCITS sector, which would make it more appropriate to impose adequate controls that ensure that there are sufficient controls and that the risk profile disclosed to investors is aligned with the actual risk profile of the AIF (i.e., risk control).[153] However, although the risk profile has to be measured based on reliable data,[154] the underlying calculation method used to measure an AIF's risk exposure may be inadequate. For example, it is generally argued that the 'snapshot' style of the VaR method does nog take into account the dynamics of active strategies.[155] Furthermore, the standard deviation or variance method concentrates on past returns and the downside and upside risk of a particular security, but does not consider risks when distributions are not symmetrical which is the case for mostly dynamic strategies and options with asymmetric payoff profiles.[156] In general, there appears to be no single method that is appropriate for the AIFM industry as a whole. It therefore depends on the particular AIF and the strategies used by the AIFM which method or combinations of methods are most appropriate. In any case, the AIFM Directive raises a risk for investor protection on this issue. In absence of a uniform standard used at EU level, it is up to the individual Member States and codes of conduct to make sure that adequate methods are being used.[157] In addition, appropriate stress testing should enable the AIFM to review the methods use and address its key risks (see below).

151. ESMA, Final Report – Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS, ESMA/2011/112, 14 Apr. 2011.
152. Article 45(2) of the Commission Delegated Regulation on AIFMs.
153. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 61 ('ESMA has not provided advice on the specific construction of the portfolio stress tests that AIFMs may perform. ESMA considers it is more appropriate to focus on and to enhance the governance structures envisioned under the UCITS Directive to ensure that there are robust controls that ensure the risk profile disclosed to investors is aligned with the actual risk profile of the AIF').
154. Article 43(1)(a) of the Commission Delegated Regulation on AIFMs. However, when data is aggregated, it must be noted that some assumptions regarding this data (e.g., valuation and external analysis), may result in misrepresentation that the AIFM must be aware of. Zetsche, *The Alternative Investment Fund Manager Directive*, 316.
155. W.V. Bud Haslett, *Risk Management: Foundations for a Changing Financial World* 200 (John Wiley & Sons 2010).
156. *Ibid.*, 198.
157. In current codes of conduct adopted by the AIFM industry, such as the European Private Equity and Venture Capital Association (EVCA), *Handbook on the Professional Standards for Private Equity and Venture Capital* (July 2011), however, do not provide for such rules. The EVCA Handbook can be found at EVCA's website: http://www.evca.eu/.

[B] Risk Control

Risk control refers to the control of the risk measures implemented by the fund. It requires the fund manager to review the risk management system on an ongoing basis, including the risk measurement methods used to determine the risk profile of each fund it manages. To make sure that the risk measurement framework remain accurate and viable, AIFMs should conduct periodic 'back- and stress testing' to verify that the model-based forecasts and estimates correspond to the actual values of the relevant risk measures ('back testing') and to address risks arising from potential changes in market conditions ('stress testing').[158]

UCITS are only required to perform these tests in case appropriate, i.e., for UCITS with a complex risk profile.[159] When such testing would result in a revision of the methods used, this must be notified to their home Member State of the AIFM/UCITS.[160] In addition, they must establish and implement a quantitative or qualitative risk limits, approved by the fund's board, taking into account all relevant risks. This includes establishing procedures that, in the event of a breach of those limits, result in timely remedial actions in the best interest of investors.[161] Furthermore, another control mechanism can be found in the fact that the risk management policy as a whole should be approved by the fund board.[162] Finally, UCITS management companies and AIFMs are required to establish a hierarchically and functionally independent 'permanent risk management function'. The primary role of the risk management function is the implementation of the fund's risk management policies, ensuring compliance with risk limits, advising on the risk profile of funds and, with respect to UCITS, reviewing the valuation of assets.[163] Despite complaints by the AIFM industry, this requirement also applies to AIFMs, although it is subject to a principle of proportionality. Member States may thus choose to not apply this requirement if it would be disproportionate (e.g., for a small AIFM), provided that the relevant AIFM can demonstrate that there are adequate safeguards against conflicts of interest so that the risk management is 'consistently effective'.[164]

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158. Article 45(3)(b) and (c) of the Commission Delegated Regulation on AIFMs. Back-testing involves comparing observed with expected outcomes. Ideality it should be based on a comparison of the portfolio's end-of-day value and, assuming unchanged positions, its value at the end of the following day. Stress-testing is a method to determine the effect on the value of a portfolio in stress situations. *See*, e.g., C. Muller & A. Ruttiens, *A Practical Guide to UCITS Funds and Their Risk Management* 125 & 128 (Edipro 2013).
159. Article 40(2)(b) and (c) of Directive 2010/43/EU.
160. Articles 39(2) of Directive 2010/43/EU and 41(4) of the Commission Delegated Regulation on AIFMs.
161. Articles 40(2)(d) of Directive 2010/43/EU and (f) and 44 and 45 (1)(b) of the Commission Delegated Regulation on AIFMs.
162. This is because the policy is part of the instruments of corporation or trust/LP agreement of the fund.
163. Articles 12 of Directive 2010/43/EU and 39 of the Commission Delegated Regulation on AIFMs.
164. Article 40(4)(d) of the Commission Delegated Regulation on AIFMs.

[C] Risk Monitoring

Risk monitoring includes the supervision and oversight of the risk management function. More specifically, it places a requirement on the manager to report to the risk management function on the effectiveness of the risk management process and remedial actions taken against defences in the process. The board of directors of the UCITS management company or AIFM should provide the risk management function with all the information needed to perform its reviewing duties.[165] Furthermore, the risk management policies employed by the fund manager and any material changes thereof must be disclosed to the home Member State and investors.[166]

3.4.3 Liquidity Management Policies

Although liquidity management is part of an entity's overall risk management system, it is generally mentioned as a separate category due to its importance for the fund industry, especially for open-end funds.[167] Liquidity management aims to monitor liquidity risk and to ensure an adequate corresponding balance between cash inflows and cash outflows. In essence, it ensures that an entity is able to pay off its short term debt by selling its liquid assets. Directive 2010/43/EU requires that UCITS management companies employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with the redemption rules set out in Article 84(1) of the UCITS Directive.[168] CESR guidelines regarding risk management principles for UCITS also emphasize the importance of managing liquidity risk by UCITS, as they mention it as one of the key risks that should be covered by the ongoing risk management operations of the fund.[169]

Directive 2010/43/EU provides for two requirements regarding the liquidity management policy of UCITS: (1) UCITS management companies should, where appropriate, conduct stress tests to assess the liquidity risk of the UCITS under exceptional circumstances, and (2) the liquidity profile of the UCITS should be appropriate to the redemption policy of the fund.[170] In 2013, the IOSCO published a report containing principles on liquidity risk management for investment funds which

165. Articles 12(4) of Directive 2010/43/EU and 39(2) of the Commission Delegated Regulation on AIFMs.
166. Articles 39(3) of Directive 2010/43/EU, 70(4) of the UCITS Directive and 41(4) and 108(5), 110(2)(c) of the Commission Delegated Regulation on AIFMs. For UCITS, the risk management policies are subject to review by their home Member States on an ongoing basis and when granting authorization, whereas AIFMs must only report periodically on the main features if their risk management policies to investors. UCITS must provide, on request, information about their risk management policy to investors and AIFMs are required to include this information in the periodic disclosure documents to investors.
167. Open-end funds are required to meet investors' redemptions requests, which may cause for liquidity problems.
168. Article 40(3) of Directive 2010/43/EU.
169. CESR, Risk management principles for UCITS, 16.
170. Article 40(3) and (4) of Directive 2010/43/EU.

provides some further guidance on this issue.[171] The principles provide, among other things, that a fund manager should make best efforts to manage future cash flows (e.g., negotiating a pre-notice period with brokers before changes in margin call formulas become effective) and should consider risk factors to assess the liquidity of the underlying securities of the fund and ensure compliance with defined liquidity limits and redemption policies.[172] The principles also mention the importance of stress tests (in both normal and exceptional situations, such as atypical redemptions) and the disclosure of liquidity risk in the fund's annual report and in other manners to investors.[173] A stress test may include, for example, an analysis of the number of days that it takes to sell assets and meet liabilities in stressed situations, taking into account expected behaviour of other market participants and liquidity management actions taken by the fund manager.[174]

With respect to AIFMs, Article 16(1) of the AIFM Directive requires that AIFMs, for each unleveraged closed-end AIF they manage, should employ an appropriate liquidity management system, adopt procedures to monitor the liquidity risk of the AIF and ensure that the liquidity profile of the AIF complies with its underlying obligations. Furthermore, Article 16(2) of the AIFM Directive provides that for each AIF an AIFM manages, whether unleveraged closed-end in nature or not, it should be ensured that the investment strategy, liquidity profile and redemption policy are consistent with each other. The Commission Delegated Regulation on AIFMs sets out further rules on liquidity management for AIFMs which are very much alike to the IOSCO principles.[175] Unleveraged closed-end AIFs are required to implement 'liquidity management tools' which can be used to manage liquidity risk.[176] The liquidity management process of AIFMs, including the liquidity management tools and any material changes in the process, should be disclosed to investors in the pre-contractual disclosure document or promptly in the case of a material change and periodically in the case of new policies.[177]

3.4.4 Valuation Policies

In light of the risk of inaccurate valuation of the fund's shares, UCITS management companies should adopt appropriate procedures for the independent valuation of the assets of the funds they manage.[178] In this context, Directive 2010/43/EU states that

171. IOSCO, *Final Report – Principles of Liquidity Risk Management for Collective Investment Schemes*, FR 03/13 (March 2013).
172. *Ibid.*, 9–10.
173. *Ibid.*, 10.
174. *Ibid.*
175. *See* Article 47(1)(a)-(c) (regarding the management of cash flows), 47(1)(d) (regarding the assessment of risk factors), 48 (regarding stress tests) of the Commission Delegated Regulation on AIFMs.
176. These tools may include, among others, partial redemptions, temporary borrowings, notice periods, and suspensions. Article 47(1)(e) of the Commission Delegated Regulation on AIFMs and Zetsche, *The Alternative Investment Fund Manager Directive*, 328.
177. Articles 23(1)(h) and (4)(b) of the AIFM Directive and 47(1)(e) and 108(3) of the Commission Delegated Regulation on AIFMs.
178. Article 8(3), 22(3) of Directive 2010/43/EU.

Member States should ensure that UCITS management companies 'establish appropriate procedures to ensure the proper and accurate valuation of the assets and liabilities of the UCITS'. However, what constitutes an 'accurate valuation' is not further specified. This is left to the Member States. This also follows from Article 85 of the UCITS Directive, which stipulates that the valuation of assets of UCITS must be laid down in national law, fund rules or in the instruments of corporation of the UCITS.

In general, the latest official market closing prices are used to value publicly-traded securities or at a price considered to be an appropriate, fair market price. According to CESR, 'pricing in the instrument should ideally be readily available, regular and independent of the issuer. The UCITS's overall valuation must be fairly and accurately reflect the value of its underlying assets'.[179] In case of securities traded on a regulated market, the price can be determined by the closing market price. For other financial assets, CESR provides for a number of factors which may be considered by the UCITS in determining whether or not an asset can be assumed to be 'liquid', which may also be helpful in this respect, including the volume and turnover in the instrument, the bid and offer prices over a period of time, the quality of secondary market activity, and the number of intermediaries and market makers dealing in the instrument concerned.[180] With respect to OTC derivatives that are not listed or traded on regulated markets, there are prescribed rules.[181]

For AIFMs, a number of rules have been imposed relating to the valuation of the assets of the AIFs they manage. However, similar to the regulations applying to UCITS, the rules do not get into the methods of valuation used, although some disclosure and control procedures apply on them,[182] but merely provide rules regarding the valuation policy that must be implemented and the frequency of valuation. Article 19(3) of the AIFM Directive provides that assets must be valued and the NAV per share calculated on the occasion of each issue or subscription or redemption or cancellation of shares or – in the case of a closed-end AIF – in the event of an increase or decrease of the capital of the relevant AIF. However, for closed-AIFs, calculation should occur at least once a year.

AIFMs must ensure that there is a consistent application of valuation policies across all of the AIFs it manages, taking into account the investment strategies and types of assets held by the AIF, and, if applicable, whether the AIFs use different

179. CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS Consultation Paper, 10.
180. CESR's guidelines concerning eligible assets for investment by UCITS, 6.
181. Article 44 of Directive 2010/43/EU. So must the UCITS management company put in place valuation procedures for derivatives that are appropriate to their level of complexity, and details of the valuation process must be disclosed to investors. Article 44(1) of Directive 2010/43/EU. These rules also apply to other, less liquid or complex transferable securities or money market instruments. *See* recital 28 to Directive 2010/45/EU.
182. Article 68 of the Commission Delegated Regulation on AIFMs (providing, among other things, that for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them, and the limitations of the model-based valuation shall be appropriately documented, should be explained in the valuation process and that the model is validated by a person with sufficient expertise who has not been involved in the process of building that model).

external valuers.[183] AIFMs that perform in-house valuations must, according to the Commission Delegated Regulation on AIFMs, take into account a number of factors, including the competence and independence of the personnel conducting the valuation, the specific strategies and assets of the AIF, the control over the valuation method, and the appropriate time for closing the books for valuation purposes.[184] The valuation policy must be reviewed by the AIFM periodically, and at least once a year or before an AIF engages with a new investment strategy or type of asset.[185] The policy must be disclosed to investors prior to the investment.[186]

3.4.5 Remuneration Policies

In light of the financial crisis of 2007, the issue of remuneration in the financial sectors, especially performance-based fees, drew the attention of both EU and US securities regulators. It was generally perceived that the financial crisis 'revealed that the remuneration and incentive schemes commonly applied within financial institutions were themselves exacerbating the impact and scale of the crisis' and that these schemes created 'incentives for taking excessive risk', which increases systemic risk.[187] At the EU level, this has resulted in the adoption of a set of rules related to the remuneration of fund managers in UCITS V (which amended the original UCITS Directive)[188] and the AIFM Directive.

For the most part, UCITS V aligns with the AIFM Directive on remuneration requirements.[189] Both directives provide restrictions on the use of variable remuneration (although still allowed), rules on remuneration policies for UCITS and AIFs, and disclosure rules relating to the remuneration paid by the management company and the carried interest paid by the UCITS or AIF. With respect to the remuneration restrictions, fixed and variable components (including carried interest) must be appropriately balanced, and the fixed component must represent a sufficiently high portion. Furthermore, for the variable components of remuneration, additional requirements apply, including the requirement that guaranteed variable remuneration may only occur when hiring new staff, and only for the first year. See for these and other remuneration rules, section 2.5.

183. Article 69 of the Commission Delegated Regulation on AIFMs.
184. Article 67(2) of the Commission Delegated Regulation on AIFMs.
185. Article 70(1) of the Commission Delegated Regulation on AIFMs.
186. Article 23(1)(g) of the AIFM Directive.
187. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 7.
188. Directive 2014/91/EU of the European Parliament and of the Council of 23 Jul. 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, OJ L 257, 186 (UCITS V).
189. The Commission has pointed out three reasons for this: (1) the growing use of complex strategies among UCITS and 'exotic' products coupled with an increase in performance fees, (2) creating a level playing field with the banking and AIFM sector, (3) providing harmonized rules for group-wide asset managers. European Commission, DG Internal Market and Services Working Document, Consultation Paper on the UCITS Depositary Function and of the UCITS Managers' Remuneration, MARKT/G4 D (2010) 950800, 14 Dec. 2010, 26–27.

With respect to remuneration disclosure, UCITS are required to 'appropriately balance' the remuneration paid and disclose it to investors in their annual report.[190] To limit circumvention of the remuneration rules by outsourcing the asset management to third countries, ESMA has launched a public consultation on its draft guidelines on the scope of staff that shall be covered by these remuneration principles.[191] The proposed guidelines provide guidance on issues such as proportionality, governance of remuneration, requirements on risk alignment and disclosure and are, in line with the general intend of the Commission to provide for convergence relating to this issue between UCITS and AIFMs, to a large extent, similar to those applying to AIFM's. In the ESMA guidelines applying to AIFMs and the proposed guidelines for UCITS, ESMA determines that AIFMs and UCITS management companies 'should consider the additional disclosure on remuneration required under paragraph (8) of the Recommendation', which information can be disclosed 'through an independent remuneration policy statement, a periodic disclosure in the annual report or any other form' as long as the disclosure 'is clear and easily understandable and accessible'.[192] This disclosure obligation comes in addition to the KII cost disclosure requirements for UCITS and the requirement to disclose all fees, charges and expenses which are directly or indirectly borne to investor to potential investors under Article 23(1)(i) of the AIFM Directive and the remuneration disclosure in annual reports under Articles 69(3) of the UCITS Directive and 22(2)(e) and (f) of the AIFM Directive.

190. *See* section 2.5.4 and Article 69(3) of the UCITS Directive.

191. ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 2015/ESMA/1172, 25 Jul. 2015. The Consultation Paper also proposes a revision of the AIFM Remuneration Guidelines by clarifying that in a group context, non-AIFM sectoral prudential supervisors of group entities may deem certain staff of an AIFM in that group to be identified staff for the purpose of their sectoral remuneration rules. The different use of criteria used to identify staff subject to the rules has also been highlighted by the Committee of European Banking Supervisors (CEBS) with respect to banking remunerations. *See* CEBS, *Report on National Implementation of CEBS High-Level Principles for Remuneration Policies* 4 (June 2010) ('The scope of the [High-level Principles for Remuneration Policies], within a given institution, raises more interpretation problems, especially as to how remuneration of certain categories of staff (senior management, risk takers and control functions) should be subject to specific measures'). The CEBS report can be found at: https://www.eba.europa.eu/.

192. *See* ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 90 (under 163) and ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 74 (under 160). This information includes, among other things, information concerning the decision-making process used for determining the remuneration policy, information on linkage between pay and performance, information on the performance criteria, and the main parameters and rationale for any annual bonus scheme and any other non-cash benefits. However, ESMA states that small or non-complex AIFMs/AIFs or UCITS management companies/UCITS will only be expected to provide some qualitative information and very basic quantitative information where appropriate under consideration of the proportionality principle. *See* ESMA – Consultation Paper, Guidelines on sound remuneration policies under the UCITS Directive and AIFMD, 91 (under 165) and ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 75 (under 162).

[A] UCITS Policies

With respect to the remuneration policies for UCITS, UCITS V requires UCITS management companies to establish, oversee and review remuneration policies that promote sound risk management and to disclose aggregate information on remuneration in the UCITS annual report.[193] The remuneration policies rules are based on the same principle as the requirements on other internal control systems: they do not specify the remuneration policies for all UCITS management companies. The Commission explains this point of view in its impact assessment on UCITS V, stating that this would be 'very intrusive and disproportionate as it would not take into account differences in the business models of UCITS management companies, their sizes and managerial practices'.[194]

The scope of the application of the remuneration policies is set very broad as they should cover all staff that can impact the UCITS' risk profile, including 'senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers and whose professional activities have a material impact on the risk profiles of the management companies or of UCITS they manage'.[195] This may also include delegates that impact on the risk profile of the UCITS, e.g., a delegated (portfolio) manager. The remuneration policies should be in line with the business strategy, objectives, values and interests of the management company, the UCITS it manages and its investors.[196] At least once a year, compliance with the remuneration policies must be reviewed by a central and independent internal auditor.[197] Larger UCITS management companies are required to establish a remuneration committee, which is responsible for the preparation of decisions regarding remuneration and to directly oversee remuneration of the senior officers in risk management.[198]

[B] AIF Policies

AIFMs, as mentioned, must establish remuneration policies for staff members whose activities impact the risk profile of the AIFM or the AIF it manages. The policies must be consistent with and promote sound risk management and must not encourage risk-taking which is beyond the AIF's risk profile.[199] As with UCITS, the policies apply to 'identified staff', which includes non-executive (as well as executive) members of the AIFM's governing body. In its guidelines on remuneration policies for AIFMs, ESMA provided a definition of this term that is equal to the list of identified staff to which the UCITS remuneration rules apply. However, ESMA explicitly adds to the

193. Article 14(a)(1) and 69(3) of the UCITS Directive.
194. Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 42.
195. Article 14(a)(3) of the UCITS Directive.
196. Article 14(b)(1)(b) of the UCITS Directive.
197. Article 14(b)(1)(d) of the UCITS Directive.
198. Article 14(b)(1)(f) and (3) of the UCITS Directive.
199. Article 13(1) of the AIFM Directive.

definition staff of the AIFM or AIF to which portfolio or risk management have been delegated and whose professional activities have a material impact on the risk profiles.[200] Furthermore, ESMA clarifies the term 'risk takers' as including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the AIFM or of an AIF it manages, such as sales persons, individual traders and specific trading desks.[201]

The examples given by ESMA are not exhaustive. External service providers which do not have the power to take any decisions are not covered. For example, advisers that only provide advisory services per definition do not have a material impact on the AIFM's risk profile or on an AIF it manages and should therefore not be qualified as identified staff. Staff responsible for heading the portfolio management, administration, marketing, and human resources is however included in ESMA's definition of identified staff.[202]

The guidelines also provide that, in exceptional cases, based on size, internal organization, scope and complexity of activities, some of the remuneration provisions can be disapplied entirely, including establishing a remuneration committee, delivering at least 50% of variable remuneration in the form of units or shares in the AIF, and the deferral, retention and performance adjustment mechanisms (i.e., malus or clawback).[203] ESMA refers in this respect to the Commission Recommendation on remuneration policies in the financial sector, which mentions that when taking measures to implement remuneration principles, Member States should take account of the size nature and scope of financial undertakings' activities.[204] An AIFM should make its own assessment for each remuneration requirement to determine whether proportionality allows it to not apply the requirement, subject to review by the competent authorities of its Member State.[205] This opens up possibilities for, for example, small-AIFMs – depending on whether or not the AIFs they manage are systemically important or use complex investment strategies – to discard some of the stringent remuneration rules.[206] This may pose a risk of circumvention of the rules. As the Commission Recommendation concerns the financial sector of a whole, similar guidelines are likely to be adopted for UCITS, although the focus on a high level of

200. ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 47.
201. *Ibid.*, 51.
202. *Ibid.*, 52 (under 20).
203. *Ibid.*, 52–53 (under 26).
204. *Ibid.*, 52 (under 23). *See* for the Commission Recommendation: Commission Recommendation of 30 Apr. 2009 on remuneration policies in the financial sector, OJ L 120, 22.
205. ESMA, Final Report – Guidelines on sound remuneration policies under the AIFMD, 53 (under 28).
206. ESMA identified a number of criteria that are relevant to justify a proportionate implementation of the remuneration principles, among which, the value of the AIFM capital and the assets under management, the potentially systemically importance (e.g., in terms of total assets under management) of the AIFs or complex investment management activities, the complexity of the internal governance structure of the AIFM, and, with respect to different categories of staff, the size of the obligations into which a risk taker may enter on behalf of the AIFM and the structure of the remuneration. *Ibid.*, 53–54.

investor protection in the UCITS framework may also result in a more limited application of the proportionality principle.[207]

Another interesting aspect of the ESMA's guidelines, which deviates from the UCITS remuneration framework, is the introduction of a so-called supervisory function, which includes non-executive members. Where appropriate considering the size of the AIFM, its internal organization and the nature, scope and complexity of its activities, the management body should not determine its own remuneration, but the supervisory function, which should also oversee the remuneration of the management body.[208] Rationale for this requirement is to avoid apparent conflicts of interests on the part of executive staff members when determining their own remuneration.[209]

3.5 LEVERAGE RESTRICTIONS

Leverage has been defined in this book (see section 2.6.6[C]) as including both the borrowing of money and the use of derivatives by fund managers. While highly leveraged funds might create systemic risk, they also form a risk to investors as it increases the risk level of their investment (as well as their potential return). The question can therefore be raised whether funds that use leverage are suitable to retail investors. With respect to the retail-orientated UCITS, the UCITS Directive requires that UCITS cannot have a global exposure greater than its NAV. Thus, there is a hard limit to a UCITS' leverage of 100% of the NAV. In addition, the risk exposure of a UCITS may not be increased by more than 10% by means of temporarily borrowing. Consequently, the overall risk exposure of a UCITS may not exceed 210% of the NAV under any circumstances. See with respect to the risk exposure of UCITS also section 3.2.2.

Furthermore, the use of derivatives by UCITS is limited by the UCITS Directive. As discussed in section 3.2.1, UCITS may also invest in derivatives in case the underlying instrument of the derivative consists of eligible instruments covered by the directive, financial indices, interest rates, foreign exchange rates or currencies. OTC derivatives may be invested in case the counterparties to the transactions are subject to prudential supervision and valuation of the derivative is reliable and verifiable and can be sold at any time at their fair value. Short-selling is not allowed under the directive. An UCITS must provide specific disclosures in the prospectus in relation to the use of

207. For example, only for non-complex ('traditional') UCITS. At any case, Article 14(a)(4) of the UCITS Directive provides that guidelines issued by ESMA shall take into account 'the principles on sound remuneration policies set out in Commission Recommendation 2009/384/EC, the size of the management company and the size of UCITS they manage, their internal organisation and the nature, the scope and the complexity of their activities'.

208. However, for AIFMs which are required to have a remuneration committee, the remuneration of the senior staff responsible for heading the control functions should not be solely left to the supervisory function, but should, as is also the case with UCITS, be directly overseen by the remuneration committee. *Ibid.*, 61 (under 73).

209. *See* ESMA, Consultation paper – Guidelines on sound remuneration policies under the AIFMD, ESMA/2012/406, 28 Jun. 2012, 24 (under 64) (referring to the conflicts of interest policies that AIFMs should adopt, which includes 'where necessary, the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities' (quotation marks omitted)).

derivatives, to clarify the outset of the purpose behind the use of the derivatives and to set out the extent to which the UCITS becomes leveraged as a result.[210]

AIFMs are not subject to restrictions regarding the amount of leverage they may employ, but their leverage exposure of an AIFM is relevant for determining whether or not the AIFM falls under the de minimis exemption provided in the directive (see section 3.3.2[B]). In addition, AIFMs are subject to a number of ongoing disclosure requirements related to their leverage exposure (see section 3.7.4).

Leveraged AIFMs must calculate leverage as a ratio of exposure to the NAV, using the gross and the commitment method. The gross method is the sum of the absolute value of all positions plus the market value of the equivalent underlying position for derivatives. The commitment method is similar to the gross method but allows for, under certain conditions, netting and hedging arrangements that aim at reducing the exposure to be excluded from the calculation.[211] Netting arrangements include derivatives or securities positions that refer to the same underlying asset, irrespective, in the case of derivatives, they have different maturity dates, that aim at eliminating risks linked to the positions. Hedging arrangements include derivatives or securities positions that do not need to refer to the same underlying asset that aim at offsetting risks linked to the positions. This method is based on the UCITS method.[212] The combination of both methods aims to provide investors (in the case of registered AIFMs) and competent authorities (in the case of registered and exempted AIFMs) with sufficient information on the leverage employed by the AIF: the gross method gives insight into the overall exposure of the AIFM and the commitment method provides insight into the hedging and netting techniques of the AIFM. In 2015, the Commission will review both methods in order to decide whether they are sufficient for all types of AIF.

3.6 INVESTOR MEETINGS

As with regular companies, the board of an investment fund may be required to hold an annual meeting of investors in accordance with the applicable national law. In addition, at the EU level, the Shareholder Rights Directive establishes requirements in relation to the exercise of certain shareholder rights attaching to voting shares in relation to annual meetings of 'companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State', i.e., EU-listed companies.[213] The directive allows

210. Article 70(1) of the UCITS Directive.
211. Articles 6(5), 7 and 8 of the Commission Delegated Regulation on AIFMs. The motivation behind this is that while these instruments in principle increase the exposure of an AIF, effective hedging or netting arrangements leads to a decrease in the overall risk in the fund. *See* Commission of the European Communities, Commission Staff Working Document, Impact assessment on the Commission Delegated Regulation on AIFMs, 19 Dec. 2012, SWD(2012) 386 final, 22. Both arrangements are combinations of trades on derivatives or securities which are concluded with the sole aim of offsetting the exposure linked to other positions, thereby allowing AIFMs to reduce overall exposure of their AIFs. *Ibid*.
212. *See* on this method, CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788, 28 Jul. 2010.
213. Article 1(1) of the Shareholder Rights Directive.

Member States to exclude from the scope of the directive UCITS and other public funds subject to national law and supervision that operate on the principles of risk-spreading and do not seek to take legal or management control over any of the issuers of their underlying investments.[214] EU-listed UCITS management companies, AIFMs and AIFs are however included in the scope of the directive.

With respect to the national laws of Member States regarding investor meetings of funds, it can be noted that investors are faced with a number of restrictions, among which restrictions relating to the right to place of items on the agenda, (super)majority vote restrictions, and the right to participate in meetings.

3.6.1 Right to Place Items on the Agenda

For corporate funds, although meetings are generally required or may be requested by investors under EU Member State law,[215] the provisions governing investor access to place items on the agenda or submit proposals included or to be included on the agenda are stringent. For example, in the Netherlands, investors in corporate funds must own at least 3% (in case of a large, public company, i.e., Naamloze Vennootschap, 'NV') or 1% (in case of a private limit liability company, i.e., Besloten Vennootschap, 'BV') of the issued share capital to submit proposals to be voted upon at an annual meeting.[216] With respect to a BV fund, the board can even decide not to place proposals on the agenda in case severe interests of the fund conflict with the proposal.[217] In the UK, investors in closed-end corporate funds must own at least 10% of the fund's issued share capital in order to submit proposals to be voted upon at the annual meeting. Alternatively, a group of at least 100 investors, each with no less than GBP 100 invested, may also put forward a proposal.[218]

The Shareholder Rights Directive recognizes that in order to protect their interests, '[s]hareholders should, in principle, have the possibility to put items on the agenda of the general meeting and totable draft resolutions for items on the agenda'.[219] The directive requires Member States to not impose a threshold for the exercise of these rights of more than 5% of the company's share capital and that all shareholders should receive the final version of the agenda in sufficient time to prepare for the discussion

214. Article 1(3)(a) and (b) of the Shareholder Rights Directive.
215. However, some corporate funds, such as private companies and special corporate forms, are not required to hold annual meetings. This is for example the case with UK ICVCs and private companies, except for the removal of directors (and, in the case of UK private companies, auditors). *See* Articles 4.4.2(1) and 6.5.4(3) of the COLL and Articles 168, 336 and 510 of the UK Companies act. Next to annual meetings, funds may be required to hold special, extraordinary meetings requested by investors holding a certain stake in the fund. *See,* e.g., Article 303 of the UK Company Act (requiring directors to call a general meeting in case requested by 10% of the paid-up capital or, in case of a company with no share capital, 10% of the total voting rights, or 5% of the paid-up capital or voting rights in case of a private company that did not hold a meeting for twelve months) and Article 2:110(1) and 220(1) of the Dutch Civil Code, Burgerlijk Wetboek Boek 2 (10% or more of the voting capital is needed to request a special meeting).
216. Articles 2:114a(1) and 224a(1) of the Dutch Civil Code.
217. Article 2:224a(1) of the Dutch Civil Code.
218. Article 314(2) of the UK Company Act.
219. Recital 7 of the Shareholder Rights Directive.

and voting on each item on the agenda.[220] However, as mentioned, the directive only applies to listed funds. Moreover, the threshold requirement in fact restricts minority retail investors to place items or proposals on the agenda as they will often have insufficient share capital to do so. EU contractual funds are generally not required to hold annual meetings at all, so it will depend on their fund instruments whether or not they will hold annual or extraordinary meetings and whether investors may place items/submit proposals on the agenda or have other rights.[221]

3.6.2 (Super)Majority Vote

With respect to decisions made at investor meetings, it can be noted that fund rules and regulations may provide for a majority or 'supermajority' vote which makes it difficult for investors to propose or vote for any change in control or other fundamental changes as regards the fund. In addition, in some cases, a quorum of presence is required. This may also be required by mandatory national law. For example, in the UK, the charter of the fund can only be changed by a 75% majority vote.[222] Under Dutch law, a simple majority would suffice, but 100% of the outstanding shares must be represented at the meeting in order to constitute a charter change.[223] In case of proposals to remove directors, EU corporate laws impose fewer restrictions. In most fund jurisdictions, directors can be removed at any time (with no cause) by the investors by simple majority. This is for instance the case in the UK and the Netherlands.[224] However, in Germany, corporate fund board directors can only be removed by the supervisory board for an important reason (ein wichtiger Grund) though this can include a majority vote of no-confidence by the investors.[225]

3.6.3 Right to Participate in Meetings

There are a number of restrictions relating to investors' ability to participate in investor meetings. Firstly, meeting attendance is often hindered by the late notice periods or late

220. *Ibid* and Article 6(2) if the Shareholder Rights Directive.
221. For example, UK and Dutch law does not require UK AUTs and Dutch CVs to hold annual meetings, although they are also not prohibited to do so. This also follows indirectly from the UCITS Directive, which requires that, in case of mergers between UCITS (whether established under corporate or contractual law), Member States must ensure that prior approval of the investors does not 'require more than 75% of the votes actually cast by unit-holders present or represented at the general meeting of unit-holders'. *See* Article 44 of the UCITS Directive.
222. Articles 21(1) and 283(1) of the UK Companies Act.
223. Article 2:121(1) and 2:231(1) of the Dutch Civil Code.
224. Articles 168(1) of the UK Companies Act and 2:120(1), 132(1), 142(1), 144(1), 230(1), 242(1) and 244(1) of the Dutch Civil Code. Dutch companies can however deviate from this requirement by corporate charter or by including oligarchic clauses in their articles of association that further restrict the possibility for shareholders to remove directors. Many companies appear to be using this possibility. See for possible charter articles and clauses that can be adopted, B.F. Assink & D.A.M.H.W. Strik, *Ondernemingsbestuur en risicobeheersing op de drempel van een nieuw decennium: een ondernemingsrechtelijke analyse* 117-119 (Kluwer 2009).
225. Article 84(3) of the German Stock Corporation Act.

availability and inconsistent or incomplete information regarding the agenda items up for voting.[226] Under the Shareholder Rights Directive, listed funds should issue relevant information about the meeting no later than twenty-one days before the day of the meeting.[227] This information document should contain, among other things, details on when and where the general meeting is to take place, and the proposed agenda for the general meeting, the rights of shareholders to place items/proposals on the agenda, and the procedure on proxy voting and form used.[228] However, the directive does not state the type of information the fund should provide regarding the agenda topics and that it should be presented in a way that is understandable to retail investors, as it only requires it to issue a 'draft resolution' or 'comment from the competent body' with respect to 'each item on the proposed agenda of the general meeting'.[229] With respect to shareholder proposals, the directive requires that such proposals/resolutions 'shall be added to the Internet site as soon as practicable after the company has received them'.[230] The notice period for annual meetings of EU non-public funds are determined by national law and may therefore be much shorter than twenty-one days.[231]

Secondly, investors may be discouraged from attending investor meetings because of the cumbersome share blocking practices, whereby investors must deposit their shares for a few days before annual/special meetings to be able to vote.[232] While the Shareholder Rights Directive requires Member States to abolish share blocking and to replace it by a record date, i.e., the requirement that shares be held at a certain date before the annual/special meeting, share blocking is still being practiced by some Member States.[233] Despite these restrictions, it should however be noted that many investors appear to be not interested in participating investor meetings. Reason for this may be partly because of the restrictions mentioned above, but also due to practical issues. The date of the meeting or having to travel across the country or across borders may be unattractive for retail investors. Furthermore, in case of the existence of a controlling shareholders or group of shareholders, the votes of (a minority) of retail investors are not likely to affect the outcome of the vote. Institutional investors may not attend meetings at all or vote against board proposals as they are more interested in

226. P. Cziraki, L. Renneboog & P.G. Szilagyi, *Shareholder Activism through Proxy Proposals: The European Perspective*, 16:5 European Financial Management 748 (2010).
227. Article 5(1) of the Shareholder Rights Directive.
228. Article 5(3) of the Shareholder Rights Directive.
229. Article 5(4)(d) of the Shareholder Rights Directive.
230. *Ibid*.
231. For example, an annual meeting of a UK private company must be called by notice of at least fourteen days. *See* Article 307(1) of the UK Company Act. Dutch BVs are required to meet a notice period of only eight days. *See* Article 2:225 the Dutch Civil Code. EU contractual funds may even apply shorter periods in accordance with their fund rules and regulations as no national regulations in this respect apply.
232. P. Cziraki, L. Renneboog & P.G. Szilagyi, *Shareholder Activism through Proxy Proposals: The European Perspective*, 748.
233. Articles 7(1)(a), (b) and (2) of the Shareholder Rights Directive (requiring the record date to be not more than thirty days before the annual meeting) and European Commission, Internal Market Directorate General, Consultation Document – Fostering an Appropriate Regime for Shareholders' Rights, Internal Market Directorate General, MARKT/16.09.2004, 17 ('Although some Member States have taken steps to reform the law in this area, the practice of share blocking can still be found in many jurisdictions').

exercising influence at the fund's management via other means (i.e., the fund's investment committee or green lighting committee).[234] Alternatively, when they believe that the fund manager is not realizing maximum return on their investment, they may be more inclined to sell or redeem their shares ('vote with their feet') rather than to vote against board proposals or submit own proposals at an investor meeting.[235]

Thirdly, restrictions in attending a meeting may exists regarding to, among other things, the timeliness of information, admission fees to attend meetings charged by intermediaries, and the availability of information when shares are held via an intermediary.[236] Also, a fund may have issued no-voting shares to investors which makes it even impossible for them to vote.[237] With respect to these obstructions, it can be noted that the Commission has proposed changes to the Shareholders Rights Directive which would tackle most of these problems.[238] The proposal requires, among other things, that intermediaries transmit to shareholders the information necessary to exercise their rights without delay, facilitate the right to participate and vote in general meetings, and transmit voting confirmations of shareholders to the company in case the intermediary votes on their behalf. Where there is more than one intermediary in a chain of custody,which is the information should be transmitted between intermediaries without undue delay to prevent obstructions in the use of voting rights.[239] The proposals also include provisions on the disclose of remuneration policies and approval of remunerations, shareholder approval on related party transactions, transparency of proxy advisers and the disclosure of voting and engagement policies and certain aspects of asset management arrangements of institutional investors and asset managers.[240]

234. *See also* section 2.7.4.
235. T.X. Duong, *Essays on Agency Conflicts in Mutual Funds* 2 (ProQuest 2008) (stating, however, that these actions do presume that investors actively manage their investments).
236. EuroFinuse, *Barriers to Shareholders Engagement: Report on Cross-Border Voting* 8–12 (2012). The report can be found at: http://www.betterfinance.eu/.
237. The Shareholder Rights Directive does not prohibit deviations in national law from the principle of 'one vote – one share'. However, the possibilities to issues such shares is limited by law in most Member States. *See* E. Wymeersch (ed.), *Further Perspectives in Financial Integration in Europe: Reports Presented at the Brussels Meeting of the International Faculty for Corporate Market Law and Securities Regulations* 186, note 15 (De Gruyter 1994).
238. European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 9 Apr. 2014, COM(2014) 213 final ('Shareholder Rights Directive Proposal').
239. *Ibid.*, 5 ('In intermediated holding chains, especially when they involve many intermediaries, information is not passed to shareholders from companies or shareholders' votes get lost. There is also a greater likelihood of misuse of the voting rights by intermediaries. Three main causes affect the systems: the lack of investor identification, a lack of timely transmission of information and rights in the investment chain and price discriminations of cross-border holdings').
240. *Ibid.*, Articles 9a, 9b, 9c, 3i, 3f and 3g.

3.6.4 Electronic Voting

The above shows that EU investors that invest in funds that have their registered office in another Member State or non-EU investors may be faced with a number of practical difficulties in attending an investor meeting. This problem may however be solved if investors are able to vote electronically. In general, there are three ways through which electronic voting may occur: (1) electronic proxy voting, (2) electronic direct voting, or (2) virtual meetings.[241]

Proxy voting refers to the practice of appointing someone else to vote on your behalf. Article 10 of the Shareholder Rights Directive provides a right to shareholders to appoint any natural or legal entity as a proxy holder who will enjoy the same rights at the meeting as the shareholder and who votes at the meeting according to the shareholder's directions. According to Article 11 of the Shareholder Rights Directive, shareholders must be able to issue, or revoke, a proxy to the proxy holder by written electronic means (e.g., by mail). Furthermore, listed companies, including listed funds, should offer to their shareholders at least one effective method for giving notice to the company about the appointment, or the revocation, of the proxy by written electronic means.[242] Proxy holders wishing to solicit votes should be able to do so via a so-called proxy form which is placed on the fund's website. In case this is not possible, the fund's website should explain on the website how investors can obtain the form or it should be sent to investors at the fund's costs.[243] The rules on proxy voting are intended to remove administrative restrictions and other barriers placed by Member States on the effective use of proxy voting. However, with respect to proxy holders, there are some concerns regarding their voting transparency, which issue will most likely be addressed in the near future.[244]

Electronic direct voting, i.e., electronic voting without the use of a proxy holder, is also addressed Shareholder Right Directive, which requires that 'Member States shall permit companies to offer to their shareholders any form of participation in the general meeting by electronic means'.[245] The directive thus does not place a mandatory requirement on Member States to permit listed companies to accept electronic voting. Consequently, many EU Member States decided not to require listed companies to provide in their rules and regulations the right to shareholders to vote at annual/special

241. D. Zetsche, *Shareholer Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 J. Corp. L. Stud. 323 (2008).
242. Article 11(1) of the Shareholder Rights Directive.
243. Article 5(4)(e) of the Shareholder Rights Directive.
244. *See* Article 3i of the Shareholder Rights Directive Proposal (requiring proxy advisors to adopt and implement adequate measures to guarantee that their voting recommendations are accurate and reliable, based on a thorough analysis of all the information that is available to them and are not affected by any existing or potential conflict of interest or business relationship and requiring them to disclose certain key information related to the preparation of their voting recommendations).
245. Article 8(1) of the Shareholder Rights Directive.

meetings by electronic means.[246] However, companies are free to establish such a right if they choose to do so.[247]

Finally, virtual meetings, i.e., meetings that are held entirely online, wherein shareholders and directors directly communicate and deliberate through the Internet, are not expressly addressed by the Shareholder Rights Directive. However, the directive does not prohibit such meetings as it states that Member States may adopt other legal rules related to 'any form of participation by electronic means'.[248] While thus possible, however, in the EU, only Denmark has introduced the virtual meeting in its legislation.[249]

3.7 TRANSPARENCY AND DISCLOSURE RULES

As concluded in Chapter 2,[250] transparency and disclosure by (the managers of) investment funds are important tools in the context of investor protection. Through adequate disclosure, investors are able to evaluate risks and costs associated with an investment fund and to make an informed decision whether or not to invest in it. Sufficient and adequate disclosure also provides investors with the information they need to exercise investor rights, such as the right to vote at investor meetings.[251] Furthermore, it is generally assumed that disclosure enhances the verifiability of the fund's performance, reducing the 'moral hazard' problem of the fund manager.[252]

246. For example, in the Netherlands, Dutch law requires that the charter of incorporation of a Dutch NV may provide for such a provision, but there is not a requirement to do so. *See* Article 2:117a of the Dutch Civil code.
247. Zetsche, *Shareholer Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 326 (stating that '[t]his type of voting in absentia is widely used among Member States').
248. Article 8(2) of the Shareholder Rights Directive.
249. A. van der Krans, *The Virtual Shareholders Meeting: How to Make it Work?*, 2 J. Intl. Comm. L. & Tech. 33 (2007). Van der Krans points out a number of advantages of a virtual shareholder meeting. In general, he states that '[s]hareholders are better able to exercise their rights as a result of the increased length of time, the absence of travelling time and the improved distribution of information and communication among shareholders'. Furthermore, 'widespread shareholders may profit from a virtual meeting by increasing shareholders' participation', which may improve corporate governance and the financial results of the company. *Ibid.*, 36.
250. *See* section 2.8.
251. *See* in a similar way with respect to public companies, R.H. Kraakman, *Disclosure and Corporate Governance: An Overview Essay in Reforming Company and Takeover Law in Europe* 98 (G. Ferrarini & et al., eds, Oxford U. press 2004). Kraakman identifies three governance functions of mandatory disclosure for public companies: (1) an enforcement function, discouraging opportunistic behaviour and self-dealing, (2) an educative function, informing shareholders and enabling them to make important governance decisions, and (3) a legislative function, requiring corporate issuers to comply with certain corporate governance practices or explain why they do not. *Ibid.*, 96.
252. P. Östberg, *Disclosure, Investment and Regulation*, 15 J. Fin. Intermediation 286 (2006) ('[T]he disclosure level determines the verifiability of the firm's assets and therefore reduces the insider's moral hazard problem'). A moral hazard is where one party is responsible for the interests of another, but has an incentive to put his own interest first, such as fund manager that are driven by performance-based fees.

Categories of Disclosure Requirements

Both the UCITS and AIFM Directive provide for an extensive framework of transparency and disclosure rules requiring funds to provide information to their investors. In general, there are two categories of investor disclosure. Firstly, certain information may be disclosed to investors in a UCITS or AIF prior to their initial investment ('pre-contractual information'). Secondly, information is disclosed to investors after their investment ('ongoing information'). The pre-contractual disclosure documents that UCITS must provide to investors include the UCITS prospectus and KII. AIFMs are held to provide prospective investors with an AIF prospectus and a recent copy of the annual report under the AIFM Directive. In addition, AIFMs may be required to publish a prospectus under the Prospectus Directive if their shares are publicly offered or admitted to trading at an EU stock exchange, or publish a KID under the future PRIIP rules (if adopted), if they offer their shares to retail investors as defined in the PRIIP Proposal.[253] However, many AIF share offerings are private placements as a result of which they are exempt from these disclosure requirements.[254] Ongoing information for UCITS includes annual and half-yearly reports and, for AIFMs, annual reports, liquidity, risk, leverage, and conflicts of interest disclosures. In addition, both UCITS and AIFMs are held to inform investors about the UCITS' or AIF's NAV.

Timing and Method(s) of Disclosure

While the ongoing information is disclosed to investors on a continuous or periodic basis, pre-contractual information is normally provided before the investor has signed the subscription agreement for fund shares. However, some mandatory pre-contractual disclosure documents must be provided to investors at the initiative of the fund manager, and some documents, such as the UCITS prospectus, should only be provided beforehand at the request of the investor, although it will generally be available for investors via the fund's website.[255] In the latter case, investors might not request the information before investing in the fund. As a result, they will not receive important information contained in the document and read and consider it carefully before investing. Furthermore, the way in which (pre-contractual and ongoing) information is provided and whether or not investors should agree with the method of

253. In case the AIFM must publish a prospectus under the Prospectus Directive (or in accordance with national law), only the additional investor information that is required under the AIFM Directive should be disclosed separately or as additional information in the prospectus. *See* Article 23(3) of the AIFM Directive. *See* for the information that a prospectus under the Prospectus Directive must contain Ch. 2 and Annex I to the Prospectus Directive and for the proposed PRIIP information requirements, section II of the PRIIP Proposal.
254. *See*, e.g., S.A. McCrary, *Hedge Fund Course* 288 (John Wiley & Sons 2004) ('In most cases, hedge funds issue shares in a limited liability corporation or partnership interests in a limited partner as a private placement') and S. Dresner & E.K. Kim (eds), *PIPEs: A Guide to Private Investments in Public Equity* 175 (John Wiley & Sons 2010) ('The private equity line is generally considered to be a PIPE [Private Investments in Public Equity] because it is a private equity placement with registered resale').
255. Article 75(1) of the UCITS Directive.

delivery differs between UCITS/AIFs and among the different information forms. So may the UCITS prospectus and KII be provided through the fund's website with investors' consent and are AIFMs allowed to provide the AIF prospectus to investors electronically without their expressed consent.[256]

In Tables 3.1 & 3.2, these aspects are indicated, which show the key types of information documents and other disclosures published by UCITS and AIFMs which are most relevant in the context of investor protection, the timing of delivery or publication of this information to (potential) investors, and the methods of delivery or publication.

Table 3.1 Information and Delivery Requirements for UCITS

	UCITS Prospectus	*KII*	*Annual Report*	*Half-Yearly Report*	*NAV Disclosure*
Type of information	Pre-contractual information	Pre-contractual information	Ongoing information	Ongoing information	Ongoing information
Timing of delivery or publication	Prior to the investment on request of investors and free of charge.	In good time prior to the investment and free of charge.[257]	Annually, no later than four months following the end of the financial year.[258]	Semi-annually, no later than four months following the end of the period to which it relates.[259]	At least twice a month, or to once a month in case it does not prejudice the interests of the investors and is permitted by the Member State.[260]

256. Articles 75(2) of the UCITS Directive and 38(2)(b) and (c) Commission Regulation No. 583/2010. In addition, UCITS must notify the investor electronically of the address of the website. AIFMs are free to choose the way in which they provide the information, which may be via the AIFM's or AIF's website or by sending the information directly to investors and/or intermediaries through its standard offering document, as a result of which the information may become publicly available. *See* Zetsche, *The Alternative Investment Fund Manager Directive*, 340.
257. Article 80(1) and (2) of the UCITS Directive.
258. Article 68(2)(a) of the UCITS Directive.
259. Article 68(2)(b) of the UCITS Directive.
260. *See* section 2.6.2.

	UCITS Prospectus	*KII*	*Annual Report*	*Half-Yearly Report*	*NAV Disclosure*
Method(s) of delivery or publication	Through the UCITS' website with investors' consent or any other durable medium. A paper copy must be delivered to the investors on request and free of charge.[261]	Through the UCITS' website with investors' consent or any other durable medium and to intermediaries.[262]	In a manner specified in the UCITS prospectus and KII. A paper copy must be delivered to the investors on request and free of charge.[263]	In a manner specified in the UCITS prospectus and KII. A paper copy must be delivered to the investors on request and free of charge.[264]	In an 'appropriate manner'.[265]

Table 3.2 Information and Delivery Requirements for AIFMs

	AIF Prospectus[266]	*Annual Report*	*Liquidity, Risk and Leverage Disclosure*	*Conflicts of Interest Disclosure*	*NAV Disclosure*
Type of information	Pre-contractual information	Pre-contractual and ongoing information	Ongoing information	Ongoing information	Ongoing information

261. Article 75(2) of the UCITS Directive. A 'durable medium' means 'an instruments which enables an investor to store information addressed personally to that investor in a way that is accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored'. In particular, it includes USB memory stocks, CD-ROMs and DVDs. *See* Article 2(1)(m) of the UCITS Directive.
262. Article 80(3) of the UCITS Directive.
263. Articles 75(3) and 78(4) of the UCITS Directive.
264. *Ibid*.
265. Article 76 of the UCITS Directive.
266. If the AIF is closed-end and its shares are publicly offered in the EU or admitted to trading on an EU stock exchange, a prospectus pursuant to the Prospectus Directive is required, which exempts the AIFM from publishing an AIF prospectus. *See* Articles 1(2)(a) and 3 of the Prospectus Directive and 61(2) of the AIFM Directive. If adopted, AIFMs will also be held to publish a KID under the PRIIP rules in case they offer their shares to retail investors as defined in Article 4(c) of the PRIIP Proposal.

	AIF Prospectus[266]	*Annual Report*	*Liquidity, Risk and Leverage Disclosure*	*Conflicts of Interest Disclosure*	*NAV Disclosure*
Timing of delivery or publication	Prior to the investment.	A recent copy is provided prior to the investment and a new version is published annually, no later than six months following the end of the financial year, and provided to investors on request.[267]	Periodically, as required by the AIF's rules or instruments of incorporation, or at the same time as the prospectus and offering document, at least at the same time as the annual report is made available.[268]	Continuously for such period of time as the investor may reasonably need to inspect it.[269]	Periodically, as set out in the AIF rules or instruments of incorporation and at least once a year.[270]
Method(s) of delivery or publication	Through the AIFM's or AIF's website, directly in paper, or electronically, with or without investors' consent and/or provided to intermediaries.	Through the AIFM's or AIF's website, directly in paper, or electronically, with or without investors' consent and/or provided to intermediaries.	Through the periodic (annual) reports of the AIF and in 'a clear and understandable way'.[271]	Through the AIFM's or AIF's website or any other durable medium.[272]	In accordance with the applicable national law and the AIF rules or instruments of incorporation.[273]

267. Articles 23(1)(k) and 22(1) of the AIFM Directive.
268. Articles 108(2)(b), (4), (5), and 109(1), and 109(3) of the Commission Delegated Regulation on AIFMs. However, changes to the maximum leverage employed by the AIFM and new special arrangements should be disclosed to investors immediately. Article 108(3)(b) of the Commission Delegated Regulation on AIFMs.
269. Article 36(2)(c) of the Commission Delegated Regulation on AIFMs.
270. Article 19(3) AIFM Directive.
271. Article 108(1) and (b) of the Commission Delegated Regulation on AIFMs.
272. Article 36(1) of the Commission Delegated Regulation on AIFMs.
273. Article 19(3) AIFM Directive.

As the regulatory frameworks applying to UCITS and AIFMs differ from each other on a number of aspects, most notably with respect to the information to be provided and the level of details contained in the key disclosure documents, the following subparagraphs will discuss the main (pre-contractual and ongoing) disclosure requirements applying to UCITS and AIFs separately. In this context, it can be noted that the information required to be published in the annual report of AIFs, although it can be classified as both pre-contractual and ongoing information, will be discussed in the ongoing disclosure section due to its inherent periodic nature. Furthermore, NAV disclosures are not discussed separately below, as it can be referred to section 2.6.2 for more details on this disclosure type.

3.7.1 Pre-contractual Disclosure Requirements for UCITS

The UCITS pre-contractual disclosure regime has been recently subject to intensive review, which led to the adoption of the KII as key information document for investors replacing the 'simplified prospectus'. Reason for the review was the general dissatisfaction among market participations, although the financial crisis also worked as catalyst for the regulatory reform.[274] The new regime is part of the trend of EU regulators of a more disclosure-based approach towards financial regulations and 'the movement of the UCITS regime from market construction, via the UCITS passport, to market regulation in the form of a sophisticated disclosure policy'.[275] Nowadays, UCITS must publish both a prospectus [A] and KII [B]. These documents may be available to investors before they invest in the UCITS, as a result of which they function as pre-contractual documents.

[A] UCITS Prospectus

Since open-end funds are exempt from publishing a prospectus under the Prospectus Directive,[276] the UCITS Directive forms the basis of the prospectus disclosure requirement for UCITS. Under Articles 68(1)(a) and 69(1) of the UCITS Directive, UCITS must publish a prospectus containing 'the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto'. Schedule A of Annex I to the UCITS Directive provides a list of minimum information that should be included in the prospectus, among which basic information about the UCITS such as its name and address, date of establishment, and information about the fund's auditor, and detailed information on, among other things, the key characteristics of the UCITS' shares, its investment objectives, strategies, risks and costs, valuation and redemption policies, performance, and information regarding the remuneration paid to directors and managers. In the prospectus, UCITS

274. The financial crisis showed that even sophisticated investors misinterpreted investments risks on many occasions, most notably the risks of MBS.
275. Moloney, *EC Securities Regulation*, 325.
276. Article 2(a) of the Prospectus Directive (exempting 'units issued by collective investment undertakings other than the closed-end type' from the scope of the directive).

must furthermore provide information regarding the depositary and advisers, including material provisions which may be of relevance to investors.[277] In addition, the UCITS Directive requires that the prospectus mentions the categories of assets in which the UCITS invest and should contain a prominent statement about its investment policy in case the UCITS replicates a stock or debt index.[278]

The prospectus of a feeder UCITS must contain certain disclosures, to include a prominent statement that it is a feeder and the name of the master in which it invests 85% or more of its nets assets. The prospectus must also disclose certain information in relation to the underlying master UCITS, including information with regard to the investment objective and policy of the master, aggregate charges at the level of the feeder and the master and tax implications for the feeder arising from the investment in the master.[279] The 'essential elements' of the prospectus must be kept up-to-date.[280]

[B] KII

While the prospectus requirement set out in the UCITS Directive establishes extensive disclosure requirements on UCITS, the document was generally perceived to be too long and complex for the average investor to make an adequate investment decision.[281] Consequently, in 2001, the 'simplified prospectus' was introduced, which aimed at providing investors clear information on the fund key features only.[282] It contained a brief presentation of the UCITS 'investment information', including a description of its investment objectives, risk profile and historical performance, economic information regarding taxation, fees and expenses, and commercial information detailing the manner in which its shares can be bought and sold.[283] However, the simplified prospectus was not considered simple enough for the more 'alternative' or 'structured' UCITS that have emerged over the past decade as a result of the evolution of the global financial markets, the increasing complexity of financial products, and the expanded investment opportunities provided to UCITS by the UCITS III Product Directive.[284] A PwC study of 2008 noted that many UCITS use more alternative strategies and

277. *See* Schedule A of Annex I, under 2 and 3 to the UCITS Directive.
278. Article 70(1) and (2) of the UCITS Directive. In addition, in case of a high-volatility UCITS, the prospectus should contain a statement making notice of that fact. Upon request of investors, supplementary information regarding the risk management policy should be provided and the prospectus must contain, as an integral part of the prospectus and annexed thereto, the fund rules or instruments of incorporation. *See* Articles 70(3), (4) and 71 of the UCITS Directive.
279. Article 63 of the UCITS Directive.
280. Article 72 of the UCITS Directive. The directive does not state which elements are to be considered 'essential', i.e., fundamental to the investors' investment decision, although it makes sense that they include, at least, the UCITS' characteristics, investment policy, costs, and risk profile.
281. D.T. Schubauer, *Inadequacy of the UCITS Directive in a Global Marketplace*, 21:2 New York Law School Journal of International and Comparative Law 332 (2002).
282. The simplified prospectus had to be published alongside the prospectus. However, while the simplified prospectus had to be offered to investors before the conclusion of the contract, the full prospectus, annual report, and semi-annual report only had to be provided to investors upon request. *See* Article 13c(13) of the UCITS III Management Company Directive.
283. Schedule C of Annex I to the UCITS III Management Company Directive.
284. *See* about these investment possibilities section 3.2.1.

derivatives by which they 'to a certain extent, have come to resemble hedge funds'.[285] As a result, 'the risk of selling inappropriate products to clients who know too little about associated risks' may have increased due to insufficient disclosure documents.[286]

In addition, under UCITS III, the form and content of the simplified prospectus was implemented by Member States in different ways. While the Commission issued a Recommendation in 2004[287] outlining the specific contents of the simplified prospectus, it remained merely advisory. Consequently, the rules related to the simplified prospectus were implemented by Member States different ways and some Member States established additional stringent national requirements, as a result of which the document varied in length (some prospectuses were over 10 pages), complexity and content among fund manager to fund manager.[288]

With the introduction of the KII by UCITS IV, it was intended to solve these problems. The aim of the KII is similar to that of the simplified prospectus: to be a short document containing key investor information in order to facilitate retail investors' understanding of the product being offered.[289] However, other than the simplified prospectus, the KII also allows direct comparisons between UCITS to be made more easily and is the only document that needs to be translated into the official language of the UCITS host Member State.[290] The KII intends to enhance transparency and comparability through the use of a short and standardized fact sheet. CESR issued a number of guidelines to assist the industry in preparing their transition to the KII, among which a template consisting of the two-page A4 fact sheet containing minimum technical content.[291] CESR's guidelines also suggest the type and size of the font to be used, the page layout and that sentences should not exceed twenty-five words.[292]

Alongside these guidelines, the Commission published Regulation 583/2010 concerning the KII.[293] The form of a regulation is chosen to ensure that the detailed

285. PwC, *Investment funds in the European Union: Comparative Analysis of Use of Investment Powers, Investment Outcomes and Related Risk Features in Both UCITS and Non-harmonised Markets* 13 (2008).
286. *Ibid.*, 67.
287. Commission Recommendation 2004/384/EC of 27 Apr. 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC, OJ L 144, 45.
288. European Commission, DG Internal Market and Services Working Document ('Exposure Draft'), Initial orientations for discussion on possible adjustments to the UCITS Directive, 5. Simplified prospectus – Investor disclosure regime, 22 Mar. 2007, 2. The exposure draft can be found at the Commission's website: http://http://ec.europa.eu/.
289. Article 78(1) of the UCITS Directive.
290. Articles 78(5) and 94(1)(b) of the UCITS Directive.
291. CESR's template for the Key Investor Information document, CESR/10-1321, 20 Dec. 2010. Other guidelines include, among others, CESR, A guide to clear language and layout for the Key Investor Information document (KII), CESR/10-1320, 20 Dec. 2010, CESR's guidelines for the transition from the Simplified Prospectus to the Key Investor Information document, CESR/10-1319, 20 Dec. 2010, CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, CESR/10-673, 1 Jul. 2010, and CESR's guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document, CESR/10-674, 1 Jul. 2010.
292. CESR, A guide to clear language and layout for the Key Investor Information document (KII), 7–8.
293. Commission Regulation No. 583/2010.

content of the KII is fully harmonized and thus enables investors to better compare UCITS.[294] The regulation lays down the form and content of the KII and the conditions applying when providing KII or a prospectus to investors in a durable medium other than paper or by means of a website. Furthermore, it contains specific provisions related to compartments (umbrella UCITS), share classes, FoFs, feeder UCITS and structured UCITS.[295]

Form of the KII

The regulation has been prepared in cooperation with the CESR and many of the provisions in the regulation follow the guidelines of the CESR.[296] For example, both CESR guidelines as the Commission Regulation state that the KII should be avoided of jargon, technical terms and should use ‘clear, succinct and comprehensible’ language.[297] Also, the length of the KII has been limited to two A4 pages and the KII must include a Synthetic Risk and Reward Indicator (SRRI), which is in essence a number between 1 and 7 which allows investors to assess the risk applicable to a potential investment in a UCITS.[298] A numeric value of 1 will mean a low risk/low reward investment while a 7 means a high level of risk but an equally high level of potential return.[299] The calculation of an SRRI will be based on the volatility of a UCITS past performance. Volatility in this context relates to fluctuations in the NAV of the UCITS, which is calculated on the basis of the weekly performance of the fund or if this data is unavailable, the monthly returns of the fund.[300]

For new UCITS, the management company will need to base the SRRI calculation on a representative portfolio model and simulate the projected volatility.[301] CESR has also set out different calculation methods for absolute return funds, total return funds, life cycle funds and structured UCITS since the historical volatility method would not suffice for these funds because of inherent frequent changes in their portfolio allocations. In most cases, the calculation of a SRRI for these funds will incorporate a VaR method due to the nature of the investment strategies involved.[302]

294. Recital 2 to Commission Regulation No. 583/2010.
295. Ch. IV of Commission Regulation No. 583/2010.
296. *See* on the history of the KII also Moloney, *How to Protect Investors: Lessons from the EC and the UK*, 316–322.
297. Article 5(1)(b) of Commission Regulation (EU) 583/2010 and CESR, A guide to clear language and layout for the Key Investor Information document (KII), 6–7.
298. Article 6 and Annex I of Commission Regulation (EU) 583/2010, CESR’s template for the Key Investor Information document and CESR’s guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document.
299. Annex I of Commission Regulation No. 583/2010.
300. CESR’s guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, 5–6.
301. *Ibid.*, 12.
302. *Ibid.*, 9–15.

Content of the KII

CESR's KII template shows that the KII should consist of five sections that are put in separate boxes, each of them with specific requirements. The sections include: (1) objectives and investment policies, (2) risk profile, (3) charges, (4) past performance and (5) practical information.[303] The first section describes the objectives and the investment policy of the UCITS (and the main targeted investments) in plain language, not necessarily using the same technical language as that used in prospectuses.[304] In the second section, the SRRI is presented, along with a narrative explanation of the SRRI, its main limitations, and the risks materially relevant to the fund which are not adequately captured by the indicator, including credit risk, counterparty risk, liquidity risk, operational risk, and the impact of specific investment techniques such as derivatives.[305] The third section includes the main charges of the UCITS, which contains three sets of figures (all in percentage points): entry/exit fees, ongoing charges and 'charges taken from the UCITS under specific conditions', i.e., performance-based fees.[306]

With respect to these charges figures, the entry/exit fees will describe the maximum percentage of one-time charges taken out of the subscribed/redeemed amounts. Ongoing charges are payments that are deducted from the assets of the UCITS and that the UCITS would have to pay in the absence of any new purchases or sales of investments and if markets remained static through the period. The ongoing charges replaced the Total Expense Ratio (TER) required in the simplified prospectus and represents the annualized ratio of total costs related to the assets of the UCITS.[307] The calculation is based on a standardized methodology which identifies specific items for inclusion and exclusion.[308] It includes payments made to the directors, management, depositary or other service providers of the fund and the costs of acquiring and disposing fund assets.[309] It is broadly similar to the TER, but does not include performance-based fees, which must be disclosed separately.

The presentation of past performance includes a bar chart showing ten years (or five in specific cases) of annualized performance history (calculated following the calendar year). The past performance bar chart must be accompanied by several statements, including a warning about the limited value of the bar chart, a brief indication of charges which have been included or excluded, an indication of the year

303. *See* CESR's template for the Key Investor Information document.
304. CESR explicitly suggests 'not to copy-out the prospectus'. *Ibid.*, 4.
305. *Ibid* and Article 8(5) of Commission Regulation No. 583/2010.
306. Article 10 of Commission Regulation No. 583/2010.
307. *See* for the TER and the included/excluded costs required under the simplified prospectus regime, Annex I to Commission Recommendation 2004/384/EC.
308. The ongoing charges figure consists of the ratio of the total discloseable costs to the average net assets of the UCITS. Costs that are to be included in the ongoing, among others, the management annual fees, fees paid to custodians and depositaries and other service providers, legal fees, registration fees and audit fees. Costs that are to be excluded include, in addition to performance-based fees, entry/exit costs, interest on borrowings, and subscription and redemption fees. *See* CESR's guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document, 4–6.
309. *Ibid*, under 4.

that the UCITS came into existence and an indication of the currency in which past performance has been calculated.[310] The calculation of the past performance figures is based on the UCITS' NAV.[311] Where a benchmark forms part of the UCITS investment objective and policies section, a bar showing the performance of that benchmark should be included in the chart alongside each bar showing the past performance of the UCITS.[312] The benchmark should not be shown for years in which the UCITS did not exist.[313] Structured UCITS, i.e., UCITS which are linked to price changes or other conditions of financial assets, indices or other UCITS portfolios, should use prospective scenarios, rather than the 'past performance' section of the KII.[314] In this context, CESR has developed guidelines which aims to ensure comparability between structured UCITS and consistency in their choice of prospective scenarios and the format of those scenarios.[315]

Lastly, the practical information section should include a series of relevant information regarding the fund, including: contact details, depositary, law applicable to the UCITS and where to find additional information.[316]

The KII must be updated as frequently as needed in order to preserve its accuracy, but at least every year.[317] Any material change regarding investment policy has to be promptly updated, and the same applies for a material change in the ongoing charges figure or an increase/decrease of the SRRI.[318] The past performance must be updated thirty-five business days after the end of the calendar year.[319] Any change in the charge structure that result in an increase or decrease of the maximum front-end or back-end load should be properly reflected in the charges section.[320] Where the ongoing charges are no longer reliable, the UCITS management company should instead estimate a figure for 'ongoing charges' that it believes on reasonable grounds to be indicative of the amount likely to be charged to the UCITS in future, which must be accompanied with a warning statement.[321] To prevent fund managers to simply 'tick-the-box',

310. Article 15(5) of Commission Regulation No. 583/2010.
311. Article 16 of Commission Regulation No. 583/2010.
312. Article 18(1) of Commission Regulation No. 583/2010.
313. Article 18(2) of Commission Regulation No. 583/2010.
314. Article 36(1) of Commission Regulation No. 583/2010. Structured UCITS are, for the purpose of the regulation, defined as 'UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features'. *Ibid*.
315. CESR's guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS, CESR/10-1318, 20 Dec. 2010.
316. Article 20 of Commission Regulation No. 583/2010.
317. Article 22(1) of Commission Regulation No. 583/2010. The KII must be presented by investors by using a durable medium, which may be in a format other than paper provided certain conditions are met. *See* Article 38 of Commission Regulation No. 583/2010.
318. Article 22(2) and (3) of Commission Regulation No. 583/2010.
319. Article 23(3) of Commission Regulation No. 583/2010.
320. Article 24(1) of Commission Regulation No. 583/2010.
321. Article 24(2) of Commission Regulation No. 583/2010. The following statement should be disclosed: 'The ongoing charges figure shown here is an estimate of the charges. [Insert short description of why an estimate is being used rather than an ex-post figure.] The UCITS' annual report for each financial year will include detail on the exact charges made'. *Ibid*.

Article 79(1) of the UCITS Directive requires that the KII must be 'fair, clear and not misleading' and be 'consistent with the relevant parts of the prospectus'.

Specific Provision regarding the KII

Regarding specific operational structures that may be adopted by UCITS, the following observations can be made with respect to the KII. A UCITS umbrella structure will need to produce a KII for each sub-fund and potentially some share classes within a sub-fund may require a separate KII or SRRI, e.g., in the case of 'hedged' share classes.[322] UCITS FoFs or feeder funds must also publish a KII and the document must include, in the case of an FoF, a description on how the underlying funds are selected and the risk factors of the underlying funds or, in the case of a feeder, the proportion of the fund's assets invested in the master, the master's investment policy and whether the investment return will differ from that of the master.[323] In addition, feeder UCITS must provide some practical information about the master fund and describe whether the risk and reward profile differs from the master fund.[324] The charges section of the KII of a UCITS FoF or feeder fund must include the fees paid to the underlying funds or the master fund.[325]

Success of the KII

Despite the extensive effort to achieve maximum harmonization of key information regarding UCITS, caution is required. Almost 30% of the respondents of the KPMG 'Perfect UCITS' study note that the information in the KII could still be improved. Most notably, it has been mentioned that the average retail investor may not know that the management fee includes a fee for the distributor of the fund.[326] In addition, the respondents state that there is an over-reliance among investors on the SRRI. This is, according to the respondents, due to its visual representation and the fact that the KII does not provide enough space to explain the underlying strategy and objective of the

322. Articles 25(1) and 26(1) and (2) of Commission Regulation No. 583/2010. A UCITS management company may select a class to represent one or more other classes of the UCITS, provided the choice is 'fair, clear and not misleading to potential investors in those other classes'. Furthermore, an umbrella UCITS that publishes only one KII must ensure that: (1) the 'Risk and Reward Profile' section of the KII contains an explanation of material risks applicable to other share classes being represented, (2) the 'Practical Information' section of the KIID includes details of the representative share class, (3) the UCITS keeps a record of the other classes are represented by the representative share class and the grounds for selection of this share class, and (4) specific features of different share classes are selected and combined into a mixed profile of a representative share class. *See* Article 26(3), (4) and (5) of Commission Regulation No. 583/2010.
323. Articles 28, 29 and 31 of Commission Regulation No. 583/2010.
324. Articles 32 and 34 of Commission Regulation No. 583/2010. Feeder UCITS may not publish the performance records of the master funds, unless it is showed as a benchmark or when a 'a simulated performance' of the master or, in case it has a performance record from before it was a feeder, its own record, is shown. *See* Article 35 of Commission Regulation No. 583/2010.
325. Articles 30 and 33 of Commission Regulation No. 583/2010.
326. KPMG, *The Perfect UCITS*, 12.

fund in simple terms.[327] Investors that base their investment decision solely on the SRRI thus may not be informed sufficiently.

It is interesting to note that, if almost one-third of the questioned fund managers, who have an incentive to sell fund shares, state that KII is insufficient: how bad are things really?[328] Furthermore, the question can be raised whether the KII is really a comparable document that is understandable to investors as no evidence has been provided by the Commission as to whether the KII model on itself supports specific decision-making outcomes.[329] In this context, it can be noted that the proposed PRIIP rules may provide for new disclosure documents for UCITS in the future. If adopted, the rules would require each PRIIP, including UCITS, to publish a Key Information Document (KID) so that retail investors are able to compare different types of retail investment products.[330] UCITS are however excluded for at least five years from the KID rules, subject to a review by the Commission after four years to decide whether to continue those transitional arrangements or whether to align the KII under the UCITS Directive with the PRIIP KID.[331] The KID will differ from the UCITS KII on a number of points. So will the KID be expected to contain answers to a set of standardized questions, including: 'What is this product? What are the risks and what could I get in return? What are the costs?'.[332] Furthermore, it will contain information on the direct

327. *Ibid.*, 23.
328. Although on the other hand, not surprisingly, 90% of the respondents are against a ban on performance-based fees, which may stimulate short-termism among fund managers and are often not clearly disclosed to investors. Performance-based fees have nevertheless been placed high on the agenda of the Commission and the topic is included in both the AIFM and UCITS V. *Ibid.*, 13.
329. Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform*, 214. The Commission has been provided with a research performed by IFF Research Ltd and YouGov in which the content of the KII was tested to determine whether the areas that had been identified were the right areas for the KII and whether there were any important omissions. However, the research only includes qualitative results as to whether the KII will engage the retail investor's attention in the decision-making process and found that 'very few consumers who studied [the new KII documents] understood every word and concept of the content' and that many retail investors appear to use the KII as a 'good introduction to the fund and a means of arming themselves with questions to ask a financial advisor' [rather than basing their investment decisions on]. IFF Research and YouGov, *UCITS Disclosure Testing Research Report – Prepared for European Commission* 18 & 147 (June 2009). The report can be found at the Commission's Internal Market website: http://ec.europa.eu/internal_market/.
330. Recital 11 to the PRIIP Proposal (stating that '[r]etail investors should be provided with the information necessary for them to take an informed investment decision and compare different PRIIPs').
331. In the impact assessment on the Commission's initial PRIP proposal (an additional 'I' was introduced during the legislative negotiations to include insurance-based investment products in the scope of the regulation), the Commission has concluded that given the recent introduction of the UCITS KII, it would not be proportionate to apply the KID requirements to UCITS at first stage. *See* Impact assessment on the PRIP proposal, SWD(2012) 187, 3 Jul. 2012, 56. After four years, the Commission will assess how UCITS should be treated and whether the existing KII should be amended. Besides adjusting the KII framework, it may also be possible to: (1) prolong the transitional period, (2) move the substantive rules on the disclosure for UCITS to the PRIIP regulation, or (3) establish that the KII is equivalent to the PRIPs KID. *See* Proposal for a Regulation of the European Parliament and of the Council on key information document for investment products, COM(2012) 352 final, 2 Jul. 2012, 10.
332. Article 8(3)(b), (c) and (e) of the PRIIP Proposal.

and indirect costs of the product, while the KII only includes information on the charges, including exit/entry fees, 'ongoing charges' and performance-based fees. However, it is not yet clear how far the cost section in the KID is intended to extent and whether UCITS will be required to disclose more costs under the KID than the current KII.[333] ESMA guidelines clarifying these and other issues regarding the PRIIP rules will be needed.[334]

3.7.2 Ongoing Disclosure Requirements for UCITS

The ongoing disclosure requirements applying to UCITS require them to publish an annual report for each financial year and a half-yearly report covering the first six months of the year. The reports provide investors with the information to help them judge whether the UCITS is being managed in the way they have been promised and whether it is still appropriate for their investment needs. According to Article 69(3) of the UCITS Directive, the annual report must contain a balance sheet or statement of assets and liabilities, a detailed income and expenditure statement, a report on the activities during the financial year, information provided for in Schedule B of Annex I to the directive, and any other significant information to enable investors to make an informed judgments of the development of the activities of the UCITS. Schedule B of Annex I to the directive sets out detailed information that the annual report must include. So should the statement of assets and liabilities include the following items: 'transferable securities', 'bank balances', 'other assets', 'total assets', 'liabilities', and 'net asset value'.[335] Furthermore, the income and expenditure statement should include, among other things, the following items: 'income from investment', 'management charges', 'depositary's charges', 'other charges and taxes', 'transaction costs', and 'distributions and income reinvested'.[336] Other information included in the annual report includes: the NAV per share, the number of shares in circulation, a comparative table comparing the total NAV and the NAV per share of the last three years, information on the fund's portfolio composition, and details of the resulting number of commitments.[337]

The half-yearly report is less detailed than the annual report, although it must still contain information such as the balance sheet, the number of shares in circulation, the NAV per share, and other information relating to the portfolio of the fund. Furthermore

333. Article 8(3)(e) of the PRIIP Proposal only provides that direct and indirect costs comprise of 'one-off and recurring costs, presented by means of summary indicators of these costs, and, to ensure comparability, total aggregate costs expressed in monetary and percentage terms, to show the compound effects of the total costs on the investment'. Furthermore, it provides that distribution costs or costs paid to other service providers should be mentioned separately in the KID in case they are not included in the general direct and indirect cost section 'to enable the retail investor to understand the cumulative effect that these aggregate costs have on the return of the investment'.
334. *See also* Article 8(5)(c) of the PRIIP Proposal.
335. Schedule B of Annex I, under I to the UCITS Directive.
336. Schedule B of Annex I, under V to the UCITS Directive.
337. Schedule B of Annex I, under II, III, IV, VI and VII to the UCITS Directive.

where the fund opts to pay an interim dividend, the figures must indicate the results after tax for the half-year concerned and the interim dividend paid or proposed.[338]

UCITS FoFs must disclose the business of the underlying funds in which they invest in the annual and half-yearly report and the maximum proportion of management fees charged both to the UCITS itself and to the underlying funds.[339] The statement on the aggregate charges of a feeder UCITS and master UCITS must be included in the annual report of the feeder UCITS and in both the annual and half-yearly report it must be indicated how the annual and the half-yearly report of the master UCITS can be obtained.[340] Feeder UCITS must also provide investors -free of charge and on request- with a copy of the annual and half-yearly reports of the master UCITS.[341] 'Index-tracking UCITS'[342] should, according to ESMA guidelines, provide additional information in their annual and half-yearly reports (and prospectus and KII), including the size of the tracking at the end of year/half-year, an explanation of any divergence between the anticipated and realized tracking error for the relevant period, and (only in the annual report) the annual tracking difference between the performance of the UCITS and the performance of the index tracked.[343]

The UCITS Directive does not require UCITS to publish any other marketing materials than the prospectus, KII and annual and half-yearly reports. It only requires, in addition to the mandatory disclosure documents, that UCITS must publish 'in an appropriate manner' (e.g., on its website) the issue, sale, repurchase or redemption price of its shares each time it issues, sells, repurchases or redeems them, and at least twice a month.[344] With respect to marketing documents issued by UCITS, recital 58 to the directive provides that 'Member States should make a clear distinction between marketing communications and obligatory investor disclosures provided for under this Directive'. Marketing materials that are not required under the directive may be subject to national marketing rules provided that they are non-discriminatory and do not

338. Article 69(4) of the UCITS Directive and Schedule B of Annex I, under I to IV to the UCITS Directive.
339. Articles 50(1)(e)(iii) and 55(3) of the UCITS Directive.
340. Article 63(2) of the UCITS Directive.
341. Article 63(5) of the UCITS Directive.
342. An 'Index-tracking UCITS' is '[a] UCITS the strategy of which is to replicate or track the performances of an index or indices e.g., through synthetic or physical replication'. *See* ESMA, Report and Consultation paper: Guidelines on ETFs and other UCITS issues – Consultation on recallability of repo and reverse repo arrangements, 43.
343. *Ibid.*, 44 (under 11). The additional information provided in the prospectus includes: (1) a description of the indices including information on their underlying components, (2) information on how the index will be tracked and implications of the chosen method for investors, (3) information on the anticipated level of tracking error in normal market conditions, and (4) description of factors that are likely to affect the ability of index-tracking UCITS to track the performances of the indices, such as transaction costs, small illiquid components, dividend re-investment etc. Information on how the index will be tracked and implications of the chosen method for investors should also be included in a summary form in the KII of the index-tracking UCITS. *See ibid*, under 10 & 11.
344. Article 76 of the UCITS Directive. The competent authorities may permit a UCITS to publish this information only once a month on the condition that this does not conflict with the interests of investors. *Ibid*.

prevent UCITS from accessing the market.[345] The fact that these documents are not harmonized may result in complex, technical and duplicative disclosure that do not help (or, on the contrary, may even prevent) investors from making an informed investment decision. The UCITS Directive tries to prevent abuse by summarizing the key aspects of marketing rules: all marketing communications (whether mandatory under the directive or not) should be 'fair, clear and not misleading'.[346] Also, non-mandatory marketing communications must be consistent with prospectus and KII disclosure and must state that a prospectus and KII exists and how investors can obtain them.[347]

In addition to this 'principle-based' rule, the UCITS Directive provides some explicit requirements on marketing communications of certain specific UCITS types. For example, with respect to feeder UCITS, it requires such UCITS to disclose in any relevant marketing communication document that it permanently invests 85% or more of its assets in a master UCITS.[348] Furthermore, index-tracking UCITS should include a statement in their prospectus and any other marketing communications making notice of their specific investment policy and techniques used.[349] However, despite these provisions, the UCITS Directive leaves significant space to Member States related to the format and contents of other marketing communications than those obliged under the directive.

3.7.3 Pre-contractual Disclosure Requirements for AIFMs

Article 23 of the AIFM Directive lists a wide range of investor disclosures to be made prior to investment. These disclosures will be generally made in the AIF prospectus, although in some cases it is appropriate to include them in the annual report as part of the periodic or regular reporting requirements (see section 3.7.4).

The information that must be disclosed to investors is set out in Article 23(1) and (2) of the directive. This article nor any additional regulation or ESMA guidance prescribes a format for the disclosure, although national Member States may impose certain requirements on AIFMs regarding to the format and lay out of the disclosure document (or impose other, additional disclosure requirements).[350] The disclosure should only be done to prospective investors of each EU AIF the AIFM manages and for each AIF that it markets in the EU: public disclosure is not required (as opposed to the

345. Recital 64 of the preamble to the UCITS Directive (stating that 'this Directive should not prevent the competent authorities of the host Member State from verifying that marketing communications, not including key investor information, the prospectus and annual and half yearly reports, comply with national law before the UCITS can use them, subject to such control being non-discriminatory and not preventing that UCITS from accessing the market').
346. Article 77 of the UCITS Directive.
347. *Ibid*.
348. Article 63(4) of the UCITS Directive.
349. Article 70(2) and (3) of the UCITS Directive.
350. In case these requirements are only imposed on AIFMs that market AIF shares to retail investors, they may however not impose stricter or additional requirements on EU AIFs established in another Member States than on local AIFs. *See* Article 43(1) of the AIFM Directive.

UCITS prospectus). The AIFM Directive does not impose any translation requirements on the prospectus.

Article 23(1) of the AIFM Directive provides for a similar set of disclosures that must be made at the pre-contractual stage as those contained in the UCITS prospectus and/or KII. So must AIFMs disclose information about the AIF with respect to its investment strategies and objectives, including the procedures by which it may change its strategy and/or policy, the assets in which it invests, risk profile, the circumstances under which it may employ leverage, the types and sources of leverage permitted, the maximum level of leverage it may employ on behalf of the AIF, and restrictions on the use of leverage and collateral arrangements, and (if applicable) its master or underlying funds.[351] Other information that must be disclosed to investors before they invest in the AIF include:

- A description of the main legal implications of the contractual relationship (information on jurisdiction, applicable law, etc.).
- The identity of the service providers (AIFM, depositary, valuer, auditor, prime broker etc., their obligations, including depositary liability and investors' rights).
- A description and the identity of any delegated manager or delegated depositary and potential conflicts of interest that may arise from the delegation.
- A description of how the AIFM complies with the capitalization requirements.
- All fees and expenses to be borne by investors.
- Provisions to ensure fair treatment of investors, together with details of any preferential treatment.[352]
- Valuation procedures.[353]
- The latest NAV, procedure for the issue and sale of shares, and historical performance information where available.
- The latest audited annual reports within six months of the year end date.
- Liquidity management procedures, including how subscriptions and redemptions are processed.[354]

'Material changes' to any of the disclosures under Article 23 must be addressed in the annual report.[355] A material change has been defined as 'changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the

351. Article 23(1)(a) and (b) of the AIFM Directive.
352. *See* on the basic standards of conduct applying to AIFMs, including the general duties of loyalty and care, section 3.8.
353. *See* on the valuation of AIF assets and the valuation policies that AIFMs must adopt, section 3.4.4.
354. Article 23(1)(c)-(o) of the AIFM Directive.
355. Article 22(2)(d) of the AIFM Directive.

AIF'.[356] Material changes should be disclosed in line with the requirements of the accounting standards and accounting rules adopted by the AIF together with a description of any potential or anticipated impact on the AIF and/or investors of the AIF.[357]

While the information that must be provided to investor on an initial base seems to be excessive, the disclosure is, as stated, form-free and subject to much less detailed requirements than the UCITS disclosure documents or prospectus requirements under the Prospectus Directive.[358] AIFMs have the freedom to decide whether an AIF prospectus is provided to investors and, if so, how the prospectus is published. If they choose not to publish a separate prospectus document, they can provide the required information on their website as long as the information is 'clear, readable understandable, and clearly presented, whereas the usefulness of the information is enhanced when it is comparable from AIFM to AIFM and AIF to AIF and from one period to the next'.[359] This point of view is similar to the general aim of the KII for UCITS, but thus without the imposition of standardization regarding the exact form and contents of the disclosure. Although this freedom may be beneficial to the AIFM sector, the pre-sale disclosure requirements set out in the AIFM Directive did not put an end to the existing differences among Member States regarding pre-contractual investor disclosure.[360]

An example of where such differences may arise concerns costs disclosure. While the AIF prospectus (or information provided on the AIFM's or AIF's website) must contain a description of all fees and expenses directly or indirectly paid by investors and the maximum amounts thereof, it does not state how these costs should be disclosed. So may AIFMs only provide the total aggregated percentage or amount of costs and fees payable by investors or split those costs into item categories and disclose each category separately to investors. This may result in cost disclosures that 'bury' the underlying performance fees and soft dollar arrangements for investors. Nevertheless, since the disclosure requirements of Article 23 are mandatory, they still create an additional cost burden for AIFMs compared to the pre-AIFM Directive stage. According to research performed by Deloitte in 2012, 17% of the respondents rated the cost of disclosure compliance as 'considerable' and 12% as 'high' or 'major'.[361] A 2013 joined KPMG, AIMA and Managed Funds Association (MFA) research shows a more dramatic standpoint, as almost half of its respondents rated the cost of compliance as 'high' and

356. Article 106 of the Commission Delegated Regulation on AIFMs.
357. Article 22(3) of the AIFM Directive.
358. *Cf.*, Article 23 of the AIFM Directive and, e.g., Annex I to Commission Regulation (EC) No. 809/2004 of 29 Apr. 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, OJ L 149, 1 and Schedule A of Annex I to the UCITS Directive.
359. Recital 124 of the Commission Delegated Regulation on AIFMs.
360. Zetsche, *The Alternative Investment Fund Manager Directive*, 335. *See* for an overview of the different implementation measures of the AIFM disclosure rules in EU Member States L. van Setten & D. Busch, *Alternative Investment Funds in Europe – Law and Practices* (Oxford U. Press 2014).
361. Deloitte, *Responding to the New Reality: Alternative Investment Fund Managers Directive Survey* 20 (July 2012). The research can be found at Deloitte's website: http://www.deloitte.com/.

a further third (33%) as 'medium', although the 'costs of compliance' section in the research includes both authorization and disclosure requirements.[362]

3.7.4 Ongoing Disclosure Requirements for AIFMs

In addition to the AIF prospectus, AIFMs should comply with a number of ongoing disclosure requirements. According to Article 22(1) of the AIFM Directive, AIFMs are required to publish, for each EU AIF they manage and for each AIF they market in the EU, an annual report. AIFMs are not required to publish half-yearly reports. In general, the report must be presented in a manner that provides 'materially relevant, reliable, comparable and clear information' that investors need to understand the particular AIF structure.[363] In particular, it should contain a balance sheet or statement of assets and liabilities, an income and expenditure statement, a report on the activities during the financial year, material changes in the pre-contractual investor information (see above), the total amount of remuneration split into fixed and variable remuneration (which should also mention the carried interest paid by the AIF), and the aggregated amount of remuneration broken down by senior management and staff of the AIFM that have a material impact on the risk profile of the AIF.[364]

The Commission Delegated Regulation on AIFMs provides for additional, minimum rules related to the information included in the annual report.[365] For example, the regulation, which is to a large extent based on ESMA advice,[366] requires that the balance sheet or statement of assets and liabilities should contain an 'assets' section, comprising the AIF's 'investments', 'cash and cash equivalents', and 'receivables', a 'liabilities' section, comprising of the AIF's 'payables', 'borrowings', and 'other liabilities', and a 'net assets' section, representing the residual interest in the assets of the AIF after deducting all its liabilities.[367] The income and expenditure statement should represent 'any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors'.[368] Furthermore, it should contain, among other things, an 'investment income' section,

362. KPMG/AIMA/MFA, *The Cost of Compliance* 10 (2013). The research can be found at KPMG's website: http://www.kpmg.com/.
363. *See* Article 103 of the Commission Delegated Regulation on AIFMs.
364. Article 22(2) of the AIFM Directive.
365. It provides for 'key elements and a non-exhaustive list of items' providing for minimum standards with respect to annual reporting requirements. *See* recital 125 of the Commission Delegated Regulation on AIFMs. The annual report should furthermore be prepared in accordance with the accounting standards of the home Member State or of the third country where the AIF is established, the accounting rules laid down in the AIF rules of instruments or incorporation and the 'internationally accounting standards'. Furthermore, where applicable, it should comply with the accounting rules set out in the Transparency Directive. *See* Article 22(3) of the AIFM Directive.
366. ESMA, Final Report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive.
367. Article 104(1) of the Commission Delegated Regulation on AIFMs.
368. Article 104(2)(a) of the Commission Delegated Regulation on AIFMs.

including the AIF's 'dividend income', 'interest income', and 'rental income', and the AIF's realized and unrealized gains and losses.[369]

For the report of the financial activities of the AIF, the regulation provides that it should contain at least: (a) an overview of investment activities during the year or period and of the AIF's portfolio at year-end or period end, (b) an overview of AIF performance over the year or period, and (c) material changes in the information listed in Article 23 of the AIFM Directive not already presented in the financial statements.[370] The report of the financial activities should also include a 'fair and balanced' review of the activities and performance of the AIF, and description of principal risks and investment or economic uncertainties that the AIF may face.[371] Where necessary, analysis should include both financial and (where applicable) non-financial key performance indicators relevant to the AIF.[372]

Lastly, with respect to remuneration disclosure, the regulation requires that the annual report should specify to who the total remuneration relates. In this context, the AIFM can choose between three options: (1) the total remuneration of the entire staff of the AIFM, (2) the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF, or (3) the proportion of the total remuneration of staff of the AIFM attributable to the AIF.[373] The total remuneration should also concern any carried interest paid and AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff.[374] See with respect to requirements on the adoption of a remuneration policy by AIFMs, section 3.4.5[B].

In addition to the annual reporting requirement, AIFMs are subject to a number of other periodic disclosure requirements. These requirements can be divided into: (1) liquidity disclosures, (2) risk disclosures, (3) leverage disclosures, and (4) conflicts of interest disclosures.[375]

With respect to liquidity disclosures, AIFMs are required to disclose to investors the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature and any new arrangements managing the liquidity of the AIF. Special arrangements are 'arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors'.[376] This includes 'side pockets'[377] and other mechanisms where certain assets of the AIF are subject to similar

369. Article 104(2)(a) and (b) of the Commission Delegated Regulation on AIFMs.
370. Article 105(1) of the Commission Delegated Regulation on AIFMs.
371. Article 105(2) of the Commission Delegated Regulation on AIFMs.
372. Article 105(3) of the Commission Delegated Regulation on AIFMs.
373. Article 107(1) of the Commission Delegated Regulation on AIFMs.
374. Article 107(2) and (4) of the Commission Delegated Regulation on AIFMs.
375. Articles 14(2), 23(4) and (5) of the AIFM Directive.
376. Article 1(5) of the Commission Delegated Regulation on AIFMs.
377. Side pockets are separate accounts to which a percentage of fund assets are allocated for investments that differ from the main objective of the fund. A side pocket is treated separately for purposes of calculating the annual incentive allocation, the management fees, and for purposes of subscriptions and redemptions. In general, there is an unlimited lock-up period

arrangements between the AIF and its investors, such lock-up periods for redemptions and 'gates'.[378] The AIFM should provide an overview of any special arrangement in place, the valuation methodology applied to assets which are subject to such arrangements and how management and performance fees apply to these assets.[379]

The risk disclosure requirements relates to the risk profile of the AIF. The AIFM must disclose periodically the measures to assess any sensitivity in the AIF portfolio to the 'most relevant risks' to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded.[380] The Commission Delegated Regulation on AIFMs however does not state which risks are considered to be 'most relevant' as this is left up to the AIFM to decide and will depend on the specific type of AIF it manages. This requirement is in line with the principle of differentiation, recognizing the diversity of AIF models.[381] In case the risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.[382] The main features of the risk management systems implemented by an AIFM, including changes regarding these features and their impact on investors, must also be disclosed periodically to investors.[383]

Thirdly, with respect to leverage disclosure, the Commission Delegated Regulation on AIFMs provides that if an AIFM employs leverage, it must on a regular basis disclose any change to the maximum level of leverage permitted as well as any re-hypothecation rights or any guarantee granted under the leveraging arrangement and the total amount of leverage that it employs.[384]

Lastly, besides the above mentioned periodic disclosures, AIFMs are held disclose material conflicts of interest that arise in the course of managing AIFs to investors.[385] See on the examples of conflicts that must be disclosed to investors and the conflict of interest policies that should be adopted by AIFMs to identify, monitor and manage these conflicts, section 3.4.1.

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such that investor withdrawals are permitted only to the extent that the illiquid assets held in the side pocket are sold. *See* Bevilacqua, C*onvergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity Funds*, 264.

378. Gates limit the percentages of fund capital that can be withdrawn at a specific redemption date. *Ibid.*, 263, n. 86.
379. Article 108(2)(a) of the Commission Delegated Regulation on AIFMs.
380. Article 108(4)(a) of the Commission Delegated Regulation on AIFMs.
381. ESMA, Final Report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 232.
382. Article 108(4)(b) of the Commission Delegated Regulation on AIFMs.
383. Article 108(5) of the Commission Delegated Regulation on AIFMs. *See* on the risk management systems that AIFMs must implement, section 3.4.2.
384. Article 109(1) and (2) of the Commission Delegated Regulation on AIFMs. *See* on the limits on the level of leverage that an AIFM may employ with respect to the de minimis exemption, section 3.3.2[B].
385. Articles 14(1) and (2) of the AIFM Directive and 36 of the Commission Delegated Regulation on AIFMs.

3.8 CONDUCT OF BUSINESS RULES

In the EU regulatory landscape, the concept of 'conduct of business rules' was firstly introduced in the MiFID, which regulates firms providing investment services. The key objectives of the original MiFID were (and still are) 'to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Community'.[386] One of the objectives of the MiFID is thus the protection of investors. In the proposal of the original MiFID, conduct of business rules were described as one of the 'the mainstays of investor protection'.[387] Hence, it was viewed that the imposition of certain conduct of business rules on investment service provides contributes, in part, to the creation of a high level of investor protection.

The new MiFID (MiFID 2), adopted in 2014 and to be transposed into national laws in 2016, strengthened the existing conduct of business rules for investment service providers in light of the 'continuous relevance of personal recommendations for clients and the increasing complexity of services and instruments'.[388] Certain rules of the MiFID conduct of business regime, which is formed by the general duty of loyalty and care, were applied to UCITS under the UCITS III Management Company Directive. Reason for this was to ensure a level playing field in the management of individual portfolios, whether managed by a MiFID firm or UCITS management company.[389] With the adoption of the AIFM Directive, again certain aspects of the MiFID conduct of business regime were used to constitute the business principles applying to AIFMs.[390]

Under the UCITS Directive, a UCITS management company (or UCITS in case of a self-managed fund) should act honestly, fairly, with due skill and care and in the best interest of the UCITS it manages.[391] The rules of conduct applying to AIFMs rely heavily on those applying to UCITS and only provide for certain adjustments for AIFs that are closed-end and invest in other assets than liquid assets.[392] Similar to UCITS management companies, AIFMs are required to 'act honestly, with due skill, care and diligence

386. Recital 2 of Directive 2004/39/EC of the European Parliament and of the Council of 21 Apr. 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 96/6/EEC and Directive 2000/12/EEC of the European Parliament and Council and repealing Council Directive 93/22/EEC, OJ L 145, 1.
387. Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM(2002) 625 final, 19 Nov. 2002, OJ C 71/E, 82.
388. Recital 70 of the MiFID 2.
389. A. Leclair, *Pouring Old Wine into New Skins?: UCITS & Asset Management in the EU After MiFID: A CEPS-ECMI Task Force Report* 52 (CEPS 2008).
390. M. Pinedo & I. Walter (eds), *Global Asset Management: Strategies, Risks, Processes, and Technologies* 295 (Palgrave Macmillan 2013).
391. Article 14(1)(a) and (b) of the UCITS Directive.
392. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 39 ('The "conduct of business rules" of Article 12(1) of the AIFMD correspond to a large extent to the "conduct of business rules" of Article 14(1) of the UCITS Directive', but since 'the UCITS provisions are tailored for open-ended investment funds that generally invest in financial

and fairly in conducting their activities', act in the best interest of the AIFs or the investors of the AIFs they manage (in case there is no legal form established) and treat all AIF investors fairly.[393] By imposing these conduct of business rules on fund managers, EU regulators in essence codified the general fiduciary duties of loyalty and care that originally developed as part of the law of agency in common law jurisdictions.[394]

The duty of loyalty in the context of fund (asset) management can be defined as a duty to refrain from self-interested behaviour on the part of the fund manager, both as regard the manager's own interests and the interests of other clients.[395] It encompasses a range of other subduties, including the duty of confidentiality and the duty to act in the best interest of investors.[396] The duty of care can be summarized as a duty to always do what any reasonable fund manager would do in the same situation.[397] As mentioned, with the adoption of the conduct of business rules for fund managers that operate in the EU, it was aimed to create unifying principles that govern financial investment intermediaries' relationships with their clients. However, as some of these principles are already included, at least implicitly, in the contract between the investor and the fund manager, the directives have only reinforced these duties by elevating them into regulatory norms.[398] In addition, in some Member States, civil law judges may have laid upon financial institution, including fund managers, more far-reaching special duties of care than pursuant under the applicable financial laws.[399] However, the effectuation of this duty of care varies depending on the circumstances of the case, as a result of which no general duty of care under national (Member State) civil law can

instruments, the [ESMA] advice provides adjustments or exemptions for those AIFs that are not open-ended and invest in other assets than financial instruments').

393. Article 12(1)(a), (b) and (f) of the AIFM Directive.

394. Van Setten, *The Law of Institutional Investment Management*, 83 & 98 ('In the case of investment management agreements, the main source of implied duties on the manager (…) is the law of agency' and '[a] discretionary authority to use agency powers is normally characterized as a fiduciary responsibility and therefore, the exercise of the agency powers is subject to the principles that apply to the exercise of fiduciary responsibilities'). *See* for more on the agency relationship in the context of US fiduciary law, section. 4.9.1.

395. T. Spangler, *The Law of Private Investment Funds* 89 (2nd ed., Oxford U. Press 2012).

396. *Ibid.*, 91 (referring to the duty of confidentiality as one of the duties owed by a fiduciary under the duty of loyalty, where 'a fiduciary must only use information obtained in confidence from his customer for the benefit of that customer') and B.J. Richardson, *Fiduciary Law and Responsible Investing: In Nature's Trust* 117 (Routledge 2013) (stating that 'the duty of loyalty has tended to be interpreted as going beyond the basic proscriptive duty to encompass also a positive obligation to act in the best interests of beneficiaries').

397. Spangler, *The Law of Private Investment Funds*, 87 ('In the financial services area, the legal standard against which an investment manager would be held is the level of care and prudence that the ordinary skilled person in that field would use in such circumstances').

398. R. Helm, *Practitioner's Guide to Conflicts of Interest in the Financial Services Industry* 135 (Sweet & Maxwell 2012).

399. *See* in the context of banks, e.g., Dutch Supreme Court, 26 Jun. 1998, NJ 1998, 660 (Van de Klundert/Rabobank) and Dutch Supreme Court, 23 Dec. 2005, NJ 2006, 289 (Safe Haven). The Dutch Supreme Court imposes a special duty of care towards clients on account of their existent contractual relationship as well as towards third parties whose interests they ought to take into account under unwritten law. This civil law duty of care has been expanded to other financial institutions, including investment funds. S.B. van Baalen, *De bijzondere zorgplicht bij financiële contracten*, 4 Contracteren 75 (2006).

be extracted.[400] Consequently, these civil law duties will not be discussed separately in this book. Investors should however use the (contractual or civil law) remedies under national law in case one of the conduct of business duties set out in the UCITS or AIFM Directive is breached since the provision of the directives cannot be enforced in disputes between private parties.[401]

Below, the two general conduct duties that are set out in the UCITS Directive and the AIFM Directive will be discussed.

3.8.1 The Duty of Loyalty

The duty of loyalty has been expressed in Articles 14(1)(a) of the UCITS Directive and 12(1)(a) and (b) of the AIFM Directive as a duty of the UCITS management company/AIFM to act honestly, fairly and in the best interest of the UCITS or AIF and the integrity of the market. In addition, it is determined that managers should try to 'avoid conflicts of interests' and 'employ effectively the resources and procedures that are necessary for the proper performance of its business activities'.[402] These latter two duties, i.e., the duty to avoid conflicts and the duty not to make secret profit, can be seen as fundamental aspects of the core duty of loyalty since they serve the purpose of acting loyally and fairly towards investors.[403] Furthermore, UCITS management companies and AIFMs must establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.[404] This so-called duty of confidentiality, which is also often included in professional codes of ethics, relates to client information and information regarding to transactions. It not only intends to serve the interests' of investors, but also to help to prevent market abuse.[405]

In sum, the duty of loyalty under the two fund directives includes a number of subduties, including the duty to act in the best interest of investors, the duty of confidentiality, and the duty to avoid conflicts. Below, the first two duties, i.e., [A] the duty to act in the best interest of investors and [B] the duty of confidentiality, will be discussed in more detail. With respect to the duty to avoid conflicts, also known as the 'no conflict rule' under UK common law, the two directives require fund managers to

400. L.L.M. Wasima Khan, *Towards Context-Specific Directors' Duties and Enforcement Mechanism in the Banking Sector?* 2 Erasmus L. Rev. 105 (2013).
401. As Member States adopt public EU Directive into public national law, investors will generally only be able to enforce a breach of contractual or civil law duties through lawsuits (and thus not public conduct of business duties).
402. Articles 14(1)(c) and (d) of the UCITS Directive and Article 12(1)(c) and (d) of the AIFM Directive.
403. *See*, e.g., R. Miller, *Fundamentals of Business Law: Summarized Cases* 402 (Cengage Learning 2012) ('The agent's actions must be strictly for the benefit of the principal and must not result in any secret profit for the agent') and A.S. Gold & P.B. Miller (eds), *Philosophical Foundations of Fiduciary Law* 178 (Oxford University Press 2014) ('A leading conception of fiduciary loyalty holds that loyalty requires the avoidance of conflicting interests').
404. Articles 4(2) of Directive 2010/43/EU and 57(2) of the Commission Delegated Regulation on AIFMs.
405. It is the management company's duty to ensure the confidentiality of information in order to prevent market abuse and insider dealing. *See* Article 6(3) MAD.

implement conflicts of interest policies containing the procedures for identifying, preventing and managing any conflicts of interest. They also require adequate and immediate disclosure of potential conflicts to investors. Since these rules have already been discussed in 3.4.2[A] and 3.6, I refer to these paragraphs.

In addition to the 'no conflict rule', UK fiduciary law also speaks of a so-called no profit rule.[406] The no profit rule sets outs an obligation of the fiduciary to not profit from its fiduciary position. This includes any benefits or profits which, although unrelated to the fiduciary position, came about because of an opportunity that the fiduciary position afforded.[407] Since it would be impossible to maintain a fund management business without charging a fee that exceed the costs of the business, strict application of this rule is not found in (EU and US) laws applying to investment funds. However, if the manager makes a profit, by virtue of his role as manager for fund, or pays a fee to a third party service provider, he must disclose this profit to investors.[408]

[A] The Duty to Act in the Best Interest of Investors

The duty of loyalty essentially requires that one person that owes this duty to another person treats that person fairly. In Article 22 of Directive 2010/43/EU this rule has been applied to UCITS management companies as it requires that they must refrain from placing the interests of any group of investors above the interests of any other group of investors. Article 12(1)(f) of the AIFM Directive even provides for a more explicit fairness rules for AIFMs by requiring AIFMs to 'treat all AIF investors fairly', although preferential treatment is allowed under certain circumstances. Preferential treatment of an AIF investor is permitted in case other investors are informed of that preferential treatment and it 'does not result in an overall material disadvantage to other investors'.[409] Although the UCITS 'fair treatment' rules appears to be stricter than that applying to AIFMs, it still may have impacted the AIFM's and AIF's approach to side letters.[410] In addition, details of how the AIFM ensures the fair treatment of investors

406. *See also* Spangler, *Investment Management – Law and Practice*, 375 and Van Setten, *The Law of Institutional Investment Management*, 101.
407. The no profit rule is set out in *Regal (Hastings) Ltd v. Gulliver* 2 A.C. 114G-145A (1967): 'The rule of equity which insists on those who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon questions or considerations as whether the property would or should otherwise have gone to the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having in the stated circumstances been made'.
408. Articles 29 Directive 2010/43/EU and 24 of the Commission Delegated Regulation on AIFMs. However, it can be noted that under Article 24(8) of MiFID 2, inducement paid to a third party investment firm providing portfolio management is prohibited, unless three conditions are satisfied: (1) clear, prior disclosure of the inducement has been made to the underlying client of the firm, (2) the inducement has been designed to enhance the quality of the service to the underlying client of the firm, and (3) the payment or non-monetary benefit does not impair compliance with the firm's duty to act in the best interests of the underlying client.
409. Articles 12(1)(f) of the AIFM Directive and 23(2) of the Commission Delegated Regulation on AIFMs.
410. Side letters are separate agreements that supplement or modify the terms of the governing documents of a private fund. They are generally limited to the largest investors in the fund and

and of any preferential treatment will have to be covered in any information memorandum or offering document.

For both UCITS management companies and AIFMs, fair treatment does not necessarily mean equal treatment.[411] In the first place, fair treatment necessarily contains an element of subjectivity which takes account of the facts of a particular circumstance or case. Since there is no harmonizing definition of fair treatment, fund managers (and their competent authorities) will inevitable deal with fair treatment issues differently.[412] So may some Member States consider different treatment of investors to be 'fair' as long as it is properly disclosed prior to the investors, while others may require a more objective fairness standard.[413] The 'preferential treatment' option available to AIFMs even explicitly enables AIFMs to treat certain investors differently. For example, they may provide certain 'seed' investors with better terms, such as preferential fees, than those investing later in the AIF subject to disclosure of the different treatment.[414]

Second, there may be a difference in financial treatment among investors. For example, a fund manager that purchases shares at different prices could allocate to one fund account the more costly shares and to another account the less expensive ones or allocate shares on a first-come, first-serve basis.[415] However, if the fund clients have consented to the method of asset allocation used by the manager, it is in conformity with the allocation policy. If the allocation practice is furthermore unlikely to be 'overall to the disadvantage of any AIF, UCITS or a client whose order is to be aggregated', it is permissible under the duty of loyalty under the UCITS and AIFM Directive.[416]

UCITS management companies and AIFMs must also ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS/AIFs they manage and that they act in such a way as to prevent undue costs being charged to the funds and their investors.[417] With respect to UCITS, neither the UCITS Directive nor its implementing directives explain which costs are considered to be 'undue costs'. For

consist preferential terms in return of a substantial amount of capital being invested, ranging from discounted fees to additional investment capacity. *See* J.M. Mannon & N.M. Blatherwick, *Private Fund Side Letters-Investor Agendas, Tactics and Disclosure*, 19 Inv. Law. 3 (2012).

411. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisesr*, 14–34.
412. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 51.
413. Zetsche, *The Alternative Investment Fund Manager Directive*, 188.
414. Seed (or initial) investors are investors that invest in a business at an early stage, to support the business until it can generate cash of its own. In its advice on implementing measures of the AIFM Directive, ESMA considered that it is not unfair to grant preferential treatment to seed investors as this 'generally has no overall material disadvantage to investors that join the fund later where seed investors take an additional investment risk in relation to the start up – unlike the following investors'. *See* ESMA, Consultation paper – ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/209, Jul. 2011, 53.
415. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 14–31.
416. Articles 28(1)(a) of Directive 2010/43/EU and 29(1)(a) of the Commission Delegated Regulation on AIFMs.
417. Articles 22(3) and (4) of Directive 2010/43/EU and 67(1) and 17(2) of the Commission Delegated Regulation on AIFMs.

AIFMs, ESMA provides that excessive trading costs can be qualified as undue costs.[418] It is likely that such costs would also be considered unduly when charged by UCITS management companies.[419] Furthermore, it can be argued that certain soft dollar arrangements may result in undue costs for investors. In soft dollar arrangements, the manager's decision to direct trades to any particular broker for execution may be unduly influenced by a desire to reward that broker for the research it supplies. The lack of clear guidance as to how to interpret the 'undue costs' provision may have resulted in different interpretations among Member States as to regard to how to qualify such arrangement and thus whether or not they are in conflict with the duty of loyalty. In this context, it can also be referred to the obligation of both UCITS management companies and AIFMs to implement appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.[420] As with the undue cost provision, it is unclear what types of situations must be included in the policies adopted, other than those that might adversely affect the stability and integrity of the market, such as market timing and late trading practices.

As part of ensuring fair treatment for investors, UCITS management companies and AIFMs are required to act in the best interest of UCITS/AIF or, in the case of AIFMs, the AIF investors.[421] They should do so when: (1) directly executing dealing decisions on behalf of the UCITS or AIF, or (2) placing orders to deal on behalf of the UCITS or AIF with other entities for execution. The rationale behind this duty is the fact that '[c]ertain behaviour, such as market timing and late trading, may have detrimental effects on unit-holders and may undermine the functioning of the market'.[422] Consequently, UCITS management companies and AIFMs are required to, as mentioned above, put in place procedures to prevent malpractices and unreasonable charges and activities such as excessive trading, taking into account the investment objectives and policy of the UCITS or AIF they manage.[423]

The duty to act in the best interest of investors is derived from the 'best execution requirement' set out in the MiFID 2. MiFID 2 requires investment firms to take all reasonable steps to obtain the best possible result for the client taking into account price, costs, speed, likelihood of execution and settlement, size, nature, or any other consideration relevant to the execution of the order.[424] In Directive 2010/43/EU and the Commission Delegated Regulation on AIFMs, further details are provided regarding the best execution standard for UCITS management companies and AIFMs. Specifically,

418. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 41.
419. It is even likely that a greater degree of fairness is required for UCITS as they are generally targeted at retail investors which are deemed passive and unskilled in financial affairs. *See also* Zetsche, *The Alternative Investment Fund Manager Directive*, 188–189.
420. Articles 22(2) of Directive 2010/43/EU and 17(1) of the Commission Delegated Regulation on AIFMs.
421. Articles 14(1)(a) of Directive 2010/43/EU and 12(1)(b) of the Commission Delegated Regulation on AIFMs.
422. Recital 18 of Directive 2010/43/EU.
423. *Ibid* and recital 39 of the Commission Delegated Regulation on AIFMs.
424. Article 27(1) MiFID 2.

they require the implementation of an execution policy and ongoing monitoring of the effectiveness of their policy for the execution of orders in order to identify and, where appropriate, correct any deficiencies.[425]

In determining the relative weight of the best execution factors, the manager must determine the objectives, investment policy and risks specific to the UCITS or AIF, the characteristics of the order, the characteristics of the financial instruments that are the subject of that order, and the characteristics of the execution venues to which that order can be directed.[426] It follows from these rules that the best execution requirements are, in line with the MiFID 2 requirements, intended to be principle-based as they give fund manager considerable freedom as to how to comply with them. They focus on the implementation of execution policies that must include, in respect of each order, information on the different venues where the management company executes its orders and the factors affecting the choice of execution venue.[427] As a result, the best execution requirements do not require fund managers to determine whether they achieve with each order the best possible result for each individual investor or fund, but merely that the order is executed in accordance with the execution policy established by the manager.[428] However, this policy must reasonably be considered to be effective in order for it to meet the best interest standard set out in the UCITS and AIFM Directive. If, for example, conflicts arise in the context of the fee structure, as may for instance be the case in soft dollar arrangements, it might result in a burden of proof of the manager to demonstrate that the apparent conflict does not affect the effectiveness of the execution policy.[429] In addition, such conflicts must be disclosed to investors.[430]

[B] The Duty of Confidentiality

As stated above, the best interest standard should be applied by UCITS management companies and AIFMs for each UCITS or AIF they manage. However, in case the manager manages multiple funds, it may result in confidentiality issues between those funds. Under Articles 4(2) of Directive 2010/43/EU and 57(2) of the Commission Delegated Regulation on AIFMs, UCITS management companies and AIFMs are required to 'establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information'. When the manager uses electronic systems for data processing, it should, where appropriate, ensure a high level of security as

425. Articles 25(2), (3) and (4) of Directive 2010/43/EU and 27(2), (3) and (4) of the Commission Delegated Regulation on AIFMs.
426. Articles 25(2) and 26(2) of Directive 2010/43/EU and 27(2) and 28(2) of the Commission Delegated Regulation on AIFMs.
427. Van Setten, *The Law of Institutional Investment Management*, 55.
428. *Ibid.*
429. *Ibid.*, 262.
430. *See* n. 142, *supra*.

regards the integrity and confidentiality of the recorded information.[431] In some cases, however, the duty of confidentiality may conflict with the duty to act in the best interest of the UCST. For example, a UCITS management company may place a large order to buy company stock on behalf of one UCITS, driving the last known price of those shares upwards, and use that information to place a second order to sell that stock after the first order is transmitted on behalf of another UCITS. This would benefit the second UCITS and harm the first UCITS as the sale would downward the stock price. Apart from potential insider dealing violations, application of the duty of confidentiality would result in an affirmative duty of the fund manager to not use the information about the first transaction for the purpose of the second transaction, while the best interest rule would require the fund manager to use the information to generate the best possible result for the second UCITS. However, the duty of loyalty, while on the one hand imposing a legal duty to act in the best interest of the UCITS, also imposes the negative obligation 'to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers'.[432]

Because of this duty to refrain from doing anything that would injure the fund, it would be sensible to conclude that the management company should not sell the shares as this would harm the interest of one of the UCITS it manages, even though this would be in 'the best interest' of another UCITS. In addition, fund managers are required to comply with rules on order handling, which require, among other things that it may not 'misuse information relating to pending UCITS or AIF orders' and should carry out a UCITS or AIF order in aggregate with an order of another UCITS or AIF unless (1) it is unlikely that the order will work overall to the disadvantage of any UCITS or AIF and (2) the allocation policy provides for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.[433]

431. Articles 7(2) of Directive 2010/43/EU and 58(2) of the Commission Delegated Regulation on AIFMs.
432. C.W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgement Rule in Delaware*, 3 Utah L. Rev. 1068 & n. 7 (2009). *See also* L. Thévenoz & R. Bahar (eds), *Conflicts of Interest: Corporate Governance and Financial Markets* 344 & 345 (Kluwer Law International 2007) (stating that the duty of loyalty in the UCITS Directive imposes a duty on fund managers 'to avoid conflicts of interest that may affect the interests of investors in their funds' and '[i[f such conflicts cannot be avoided, [that] these interests must be "treated fairly", i.e., must not be "prejudiced."') and Gold & Miller (eds), *Philosophical Foundations of Fiduciary Law*, 178 ('This narrower conception of a fiduciary loyalty involves an anti-conflict obligation (a duty to avoid conflicts of interest), but without required a single undivided loyalty to one beneficiary', as a result of which, 'the fiduciary "must refrain from self-interested behavior that wrongs the fiduciary"').
433. Articles 27(2) and 28 of Directive 2010/43/EU and 25(4) and 29 of the Commission Delegated Regulation on AIFMs.

3.8.2 The Duty of Care

A UCITS management companies' and AIFM's duty of care have been expressed in the UCITS Directive and the AIFM Directive as the duty to act with 'due skill, care and diligence'.[434] This requirement consist of two pillars: (1) the requirement to act with due skill and care and (2) due diligence requirements.

With respect to the duty to act with due skill and care, Article 7(1)(b) of the UCITS Directive sets out that persons who effectively conduct the business of the management company must be 'of sufficiently good repute' and be 'sufficiently experienced in relation to the type of UCITS managed'. Article 8(1)(c) of the AIFM Directive provides for a similar requirements for the directors of AIFMs. In general, the duty of care sets the standard for the exercise of the performance of the management duty, which is the standard of professional judgment, knowledge and skill required of the manager in making investment decisions.[435]

For AIFMs, additional conditions are provided related to when its governing personnel conducts their activities in accordance with the duty of care. Under Article 21 of the Commission Delegated Regulation on AIFMs, the governing body of the AIFM must possess adequate collective knowledge, skills and experience regarding the activities of the AIFM, in particular regarding the main risks of the AIFM and types of investments it invests in. Furthermore, the governing body must commit sufficient time to perform their functions and the AIFM must devote adequate resources to the induction and training of the body. Lastly, each member of the governing body must act with 'honesty, integrity, and independence of mind'.

For UCITS management company, such requirements currently do not exist, but it can be argued that similar conditions should apply.[436] In both cases, however, the AIFM or UCITS management company that files for authorization at his home Member State will generally be required to proof the skills of its staff members by supplying relevant information about their work experience and expertise to the competent authorities in the financial field in general and with respect to the activities of the UCITS management company or AIFM in particular. Since no additional guidance exists as to when a staff member of the governing body, for example, possesses 'sufficient skills' or conducts 'sufficient time' to perform his management task, it will depend on how the particular Member State has implemented this provision in its authorization form. Nevertheless, in any event, the manager will have to provide information about its governing member's education and practical experience in order to cover all theoretical and practical aspects in the field of its business.

434. Articles 14(1)(b) of the UCITS Directive and 12(1)(a) of the AIFM Directive.
435. Van Setten, *The Law of Institutional Investment Management*, 84.
436. *See also* Setten & Busch, *Alternative Investment Funds in Europe – Law and Practices, 45 (note 230)*. Article 5(4) of Directive 2010/43/EU only requires that the Member States ensures that the management company takes into account 'the nature, scale and complexity of the business of the management company, and the nature and range of series and activities undertaken in the course of that business' when employing personnel with sufficient skill, knowledge and experience.

With respect to the requirement of 'being of good reputation', it makes sense that the persons in question have no criminal records, including convictions of financial crimes such as money laundering and insider trading.[437] Furthermore, in order to prevent conflicts, at least two persons must decide on matters related to the conduct of the fund's business and the existence of a 'close link' between the fund manager and persons is only allowed if this link does not prevent effective supervision.[438] In case a staff member of a UCITS management company performs multiple functions by relevant persons, the management company must ensure that the performance of those functions 'does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly, and professionally'.[439] There is no similar requirement in place for AIFMs.[440]

The duty to perform adequate due diligence for UCITS management companies has been specified in Article 23 of Directive 2010/43/EU. This article requires UCITS management companies to ensure a high level of diligence in the selection of and ongoing monitoring of investments. In addition, adequate knowledge and understanding of the assets in which the UCITS are invested are imposed as well as requirements to establish written policies and procedures on investment due diligence and on the risk management process.[441] In case the UCITS management companies has delegated its management powers to an external party, it will need to not only supervise this delegated manager, but also ensure that investment decisions on behalf of the UCITS are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS. To this end, they should implement written policies and arrangements.[442] Furthermore, when a management company enters into a management arrangement with a third party in relation to the performance of risk management functions, it should 'take the necessary steps in order to verify that the third party has the ability and capacity to perform the risk management activities reliably, professionally and effectively'.[443]

For AIFMs, similar rules apply, but the Commission Delegated Regulation on AIFMs sets out more detailed rules on the level of due diligence that has to be met by AIFMs that invest in assets with limited liquidity and have appointed certain third party service providers.[444] In case an AIFM invests in 'assets with limited liquidity', it must prepare a business plan for how these investments will be managed. This must be regularly updated by the AIFM. Transactions must be conducted in accordance with the business plan and due diligence must also be completed and documented on the

437. ESMA, Final report – ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 127–128.
438. Articles 7(1)(b) and (2) of the UCITS Directive and 8(1)(c) and (3)(a) of the AIFM Directive.
439. Article 5(3) of Directive 2010/43/EU.
440. Although AIFMs are, similar to UCITS management companies, required to ensure that conflicts of interests arising from multiple functions are managed and disclosed appropriately. *See* section 3.4.1.
441. Article 23(2) and (4) of Directive 2010/43/EU.
442. Article 5(2) and 23(3) of Directive 2010/43/EU.
443. Article 23(4) of Directive 2010/43/EU.
444. *See* for the general obligation to apply a high standard of diligence in the selection and ongoing monitoring of investments Article 18 of the Commission Delegated Regulation on AIFMs.

assets in question.[445] Performance of the AIF must then be monitored on an ongoing basis by the AIFM.[446] The regulation does not define 'limited liquidity', but it can be assumed that this includes, in any case, private equity, infrastructure assets and real property.

With respect to third party service providers, AIFMs must ensure that their prime brokers and counterparties: (1) are subject to ongoing supervision by a public authority, (2) are 'financially sound' (taking into account whether the prime broker or counterparty is subject to prudential regulation, including minimum capital requirements), and (3) have the necessary organizational structure and resources for the provision of the envisaged services.[447] The effect of the above requirement is that AIFs managed by AIFMs are, since the adoption of the AIFM Directive, precluded from entering into OTC derivatives trades or securities lending transactions with unregulated entities. This also explains the link to these rules with the financial crisis of 2007, which exposed a number of deficiencies, including inadequacies in due diligence applied by AIFMs and other professionals on risky investments.

Despite of the above rules, it must be noted that the duty of care does not include the duty to achieve a profit on the investments made by the manager on behalf of the fund. It is an obligation to perform an *effort* (not a result) to invest the capital of the investors in the UCITS or AIF with a view to obtain a certain specified return.[448] In order to prevent potential liability claims, most investment management and subscription agreements therefore include a 'no warranty' clause which denies the fund and its investors to complain, on hindsight, that they have relied on certain assurance about the future return of the fund.

3.9 DEPOSITARY MONITORING RULES

As discussed in section 2.3.3[A], the UCITS and AIFM Directives require funds falling under the scope of these directives to appoint a separate, independent depositary. This depositary has, among other things, the duty to carry out a number of oversight tasks and to monitor the fund's cash flows. In addition, the rules ensure that the depositary can be held liable in case of loss of assets held in custody as a result of a failure of the depositary to properly perform its duties under the UCITS or AIFM Directive.[449]

445. Article 19(1) of the Commission Delegated Regulation on AIFMs.
446. Article 19(2) of the Commission Delegated Regulation on AIFMs. AIFMs shall retain records of the activities carried out pursuant to Article 19(1) of the Commission Delegated Regulation on AIFMs for at least five years.
447. Article 20(2) of the Commission Delegated Regulation on AIFMs.
448. Van Setten, *The Law of Institutional Investment Management*, 76–77.
449. Articles 24(1) of the UCITS Directive and 21(12) of the AIFM Directive (requiring the depositary to be liable for any losses of financial instruments held in custody suffered by the UCITS/AIF or its investors, unless the depositary 'can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary' and 'for all other losses suffered by [the UCITS/AIF or its investors] as a result of the depositary's negligent or intentional failure to properly fulfil its obligation').

In general, the depositary has five key oversight duties: (1) reconciliation of subscription/redemption orders with the subscription proceeds/redemptions paid, and of the number of shares issued/cancelled with the subscription proceeds received/redemptions paid by the UCITS/AIF, (2) valuation of shares, (3) verification of compliance of UCITS/AIF with national law or its instruments of incorporation, as well as with investment restrictions and leverage limits defined in offering documents, (4) ensure timely settlement of transactions, and (5) correct income calculation with respect to UCITS/AIF instruments and applicable law, liaising eventually with auditors and verifying accuracy of dividend payments.[450]

These duties focus on ensuring that the fund manager complies with the applicable legal provisions and investment policies of the fund and are performed on an ex-post basis. This means that in order to comply with its oversight duties, the depositary is expected to perform ex-post controls and verifications of processes and procedures that are under the responsibility of the UCITS management company/AIFM, the UCITS/AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, is implemented and frequently reviewed. It follows from these rules that depositaries should only simply check the procedures and verify that the manager complies with its own rules.[451] The Commission has acknowledged with respect to AIFs that, while the processes and procedures for exercising the oversight function should be proportionate to the estimated risks of the relevant AIF and without prejudice to the depositary's ability to conduct appropriate ex-ante verifications, in principle most verification checks will be ex-post second level controls.[452] They thus only provide for a limited protection for investors.

The requirement to monitor the fund's cash flows can be qualified, as an ex-ante duty. The depositary will have to ensure that all cash of a fund from whatever source, is booked into an account at a central bank, an EU authorized bank or a non-EU authorized bank as well as develop procedures to reconcile cash flows daily and check the consistency of its own records against those of the fund manager.[453] This means that the depositary will need to monitor every instruction relating to every cash account maintained by the fund to ensure that the transactions match the cash accounts of the fund and that there is no fraud. In addition, significant cash flows, in particular in case they can be identified as being inconsistent with the fund's operations, such as (large) changes in positions in the fund's assets or subscriptions and redemptions, should be

450. Articles 22(3) of the UCITS Directive and 21(9) of the AIFM Directive.
451. *See* Articles 93, 94, 96 and 97 of the Commission Delegated Regulation on AIFMs. For UCITS, the implementing measures providing guidance as to the duties of depositaries under the UCITS Directive will be adopted by the end of 2015. Since the UCITS depositary rules have been drafted on the model of the AIFM Directive, it can be assumed that the implementing measures will provide investors with at least the same level of protection. *See also* Commission of the European Communities, Commission Staff Working Document, Impact Assessment on the proposed UCITS V Directive, 7 (noting that '[t]he precedent set by the AIFMD constitutes nevertheless an essential point of reference for the improvement of the current depositary rules for UCITS').
452. Recital 109 of the Commission Delegated Regulation on AIFMs.
453. Articles 22(5) of the UCITS Directive, 21(7) of the AIFM Directive and 86 of the Commission Delegated Regulation on AIFMs.

raised with the fund or fund manager and potentially competent regulators if the depositary is not satisfied that such movements are legitimate.[454] This duty thus seeks to prevent fraud, book-keeping errors, and (the concealment of) self-dealing transactions by the fund manager.

It can be noted that the duty of cash monitoring does not protect investors against risks of losses as a result of other high risk-taking behaviour of the manager, false or incomplete disclosure, and other bad business practices, such as excessive fees and (self-dealing) transactions between the fund and affiliates that do not constitute an 'inconsistency with the fund's operations'.[455] In addition, an AIF depositary may discharge of its liability which may result in a lower incentive to adequately fulfil its monitoring tasks and responsibilities. The depositary can do so by written contract with the AIF or the AIFM acting on behalf of the AIF (thus not the investors), expressly allowing the discharge and stating the objective reason to contract such a discharge. Such an 'objective reason' must be established each time the depositary intends to discharge itself of liability, and must be limited to precise and concrete circumstances characterizing a given activity and be consistent with the depositary's policies and decisions.[456] A depositary can be exempted from this liability only if an event (resulting in a loss) is 'external', 'beyond reasonable control' and the consequences would have been 'unavoidable'.[457] These criteria make it challenging for a depositary to discharge its liability, as the depositary will, for example, remain liable for the actions of both affiliated and non-affiliated sub-custodians. The depositary will also retain liability for instances of fraud or insolvency within the subcustody network since accounting errors, operational failures and failure to apply the asset-segregation requirements properly at sub-custodian level also constitute 'internal events' for which the depositary is liable.

3.10 CONCLUSION

In this chapter, a number of EU investor protection rules applying to (the managers of) UCITS and AIFs have been discussed in order to give an answer to the second research question regarding the way in which funds are regulated under EU law with respect to the protection of investors. After having discussed some general aspects of UCITS and

454. Article 86(e) and recital 98 of the Commission Delegated Regulation on AIFMs.
455. Such as transactions with affiliated parties that are not deemed significant and/or inconsistent with the fund's operation, such as the purchase of stock from an affiliated party by an equity fund.
456. Articles 21(13) of the AIFM Directive and 102(1) and (2) of the Commission Delegated Regulation on AIFMs. In situations where the depositary has no other option but to delegate its custody duties to a sub-custodian, the depositary will be deemed to have objective reasons for contracting the discharge of its liability. *See* Article 102(3) of the Commission Delegated Regulation on AIFMs.
457. Articles 21(12) of the AIFM Directive and 101 of the Commission Delegated Regulation on AIFMs. According to the Commission Delegated Regulation on AIFMs, an event is beyond the reasonable control of a depositary in case 'there was nothing a prudent depositary could reasonably have done to prevent the occurrence of the event'. This includes, among other things, natural events and acts of a public authority. *See* recital 118 to the Commission Delegated Regulation on AIFMs.

AIFs, the chapter continued with an analysis of the different categories of EU rules that were determined in Chapter 2 as being most relevant to this research. These six categories include: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, (5) conduct of business rules, and (6) depositary monitoring duties.

Both UCITS management companies and AIFMs are required to implement various internal control systems designed to secure compliance with the applicable rules and regulations, mitigate risks, and, most notably, protect investors. The internal control rules for UCITS management companies and AIFMs have a principle-based approach as they do not specify the exact policies that must be implemented. However, the applicable regulation contains a number of rule-based requirements specifying the specific types of policies that should be implemented (i.e., conflicts of interest, risk management, liquidity, valuation, and remuneration policies). In addition, there are some detailed rules on, most notably, the risk measurement methods that must be used by UCITS, and the supervisory function, including non-executive members, that must be implemented at AIFMs to determine and oversee the manager's remuneration. With respect to the remuneration of the fund manager, it can also be noted that recent rules for UCITS and the AIFM rules and regulations have placed some restrictions on the use of variable remuneration, including carried interest, although they are still allowed under both frameworks.

The use of leverage has been restricted for UCITS. UCITS may borrow up to 10% of their NAV on a temporary basis. While this suggested that any significant kind of long-term leverage would therefore be ineligible, their ability to invest in derivatives necessarily allows synthetic leverage. However, the restrictions on the global exposure of a UCITS fund to derivatives has been limited to the NAV of the fund. AIFMs are allowed to use unrestricted leverage, but should disclose their leverage exposure to investors on an ongoing basis.

With respect to investors' right to vote at investor meetings of funds, it can be concluded that EU law enables fund managers and boards to impose a number of restrictions on the exercise of this right. They include, among others: limits on investors' ability to submit agenda items or proposals, short notice periods, share blocking practices, admission fees to attend meetings charged by intermediaries, and the availability of information when shares are held via an intermediary. Some practical restrictions relating to the ability of investors to attend investor meetings can be solved if investors are able to vote electronically via electronic proxy voting, electronic direct voting, or virtual shareholder meetings. Although EU law gives Member States significant freedom to allow these forms of voting or to adopt virtual meeting legislation, only Denmark has adopted such a law thus far.

The UCITS and AIFM Directive both provide for an extensive framework of transparency and disclosure requirements. Investors in UCITS are provided with a prospectus and KII containing relevant, accessible and short (understandable) information about the fund. While the KII can be seen as an improvement of the former simplified prospectus document, some improvements may still be necessary with respect to the presentation of the management fees, the SSRI indicator (currently perceived by market participants to be too prominent), and the information on the investment strategies and objective of the fund included in the KII. AIFMs are subject to extensive pre-contractual information duties as well. The information that must be provided is very similar to the information included in the KII of UCITS, although they are much less detailed than the UCITS prospectus. In addition, the disclosure is form-free, but Member States may impose certain requirements on AIFMs regarding to the format and layout of the AIF prospectus. This may however result in difference between Member States as regards essential elements of the prospectus document, such as cost disclosure. The ongoing disclosure of UCITS is limited to the publication of an annual and half-yearly report and periodic NAV disclosures. AIFMs on the other hand are subject to more detailed ongoing disclosures regarding their liquidity, risk and leverage exposure and conflict of interests, in addition to periodic NAV disclosures. They should also publish an annual report, the latest version of which must also be provided to investors prior to the investments.

It follows from the assessment of the conduct of business rules that UCITS management companies and AIFMs are subject to the duty of loyalty and care under EU (securities) law. As part of duty of loyalty, they must act in the best interest of the UCITS/AIF or AIF investors when executing dealing decisions or placing orders to deal on behalf of the fund and refrain from doing anything that would harm the fund. The rules related to these aspects are principle-based in nature and focus on the implementation of an execution and allocation policy and ongoing monitoring of the effectiveness of these policies. The duty of care consists of a requirement relating to the skills and experience of staff members and due diligence requirements in the selection of and ongoing monitoring of investments, including the implementation of due diligence policies and, for AIFMs, the selection of third party service providers.

Lastly, the EU depositary monitoring rules requires the depositary of a UCITS or AIF to perform ex-post controls and verifications of processes and procedures that are under the responsibility of the UCITS, AIF, or an appointed third party. Due to this ex-post nature, the relevance of these oversight duties for investors may be low as inefficiencies may be detected by the depositary too late, i.e., after the fund has become insolvent. In addition, it should perform the ex-ante duty to ensure that proper procedures to reconcile all cash flow movements and identify potential ones inconsistent with the fund's operations, reporting anomalies to manager without undue delay, and a reconciliation process to be reviewed at least once a year to check consistency of depositary's records with those of the UCITS management company or AIFM. Although the monitoring of the fund's cash flows does not protect investors against risks of losses as a result of other high risk-taking behaviour of the manager, false or incomplete disclosure, and other bad business practices, such as excessive fees, it does minimize the risk of loss or diminution of the cash assets because of the (timely) detection of fraud, deficient administration/management, inadequate records or negligence.

Chapter 4
US Investor Protection Law

4.1 INTRODUCTION

This chapter addresses the second research question of this book ('How are EU and US funds available to EU retail investors currently regulated relating to the protection of investors?') with respect to US law. It contains an analysis of the investor protection laws in place in the US that deal with the protection of investors with respect to fund management activities and apply to US funds in order to determine how retail investors investing in these funds are protected under US law.

As discussed in section 1.3.3[C], there are two basic levels of US law: federal law and state law. US federal law applies to the nation as a whole and to all US states whereas state laws are only in effect within that particular state.[1] State law can be divided into statutory law, generally focusing on company law issues, such as the right to vote at annual meetings, and state common law, including the conduct of business standards (fiduciary duties). As a rule, federal law supersedes state law, but with respect to the two core federal acts applying to US funds and fund managers, the 1940 Act and the Advisers Act, only provisions that conflict with any provision of the acts or rules or regulations of the acts are set aside (see section 1.3.3[D]. Thus, for the purpose of this research, both law types are relevant in determining the way in which investors in US funds are protected.

The structure of the remainder of the chapter is as follows. In the following paragraph, the two key structures of US funds under US federal law, i.e., registered and unregistered funds, are described (sections 4.2 & 4.3). In the following paragraph, the registration duty of the US fund manager will be assessed (section 4.4). Next, the chapter addresses the different types of investor protection rules under US (federal and state) law that affect the protection of (US and EU) investors in US funds. Similar to the

1. In addition, US (private) law can also be applied in other jurisdictions as a result of the application of principles and rules of private international law.

previous chapter on EU law, the investors protection rules applying to US funds are discussed thematically, divided into the five categories derived from the general conclusions contained in Chapter 2 that are relevant to US funds: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, and (5) conduct of business rules (sections 4.5–4.9). Depositary (monitoring) rules will not be discussed in this chapter as US funds are not required by US law to appoint a depositary. Finally, the chapter will close with a conclusion (section 4.10).

4.2 REGISTERED FUNDS

Registered funds, defined as 'investment companies' in the 1940 Act, are required to register with the SEC under the 1940 Act and primarily invest in securities (thus *not* directly in real estate or other property).[2] They have been classified into three classes: (1) face-amount certificate companies (2) Unit Investment Trusts (UITs), and (3) management companies.[3] Face-amount certificate companies and UITs do not actively manage investment portfolios, whereas the third category does. Instead, they have fixed portfolios and, thus, usually pay a fixed amount of interest or dividend to investors.[4] Both groups represent only a small part of the total US fund industry.[5] Management companies constitute the largest group of investment companies and can be described as including all investment companies of which the shares are sold to the public and that are not face-amount companies or UITs.[6] Management companies can

2. Article 3(a)(1)(A) of the 1940 Act defines an investment company as 'any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities'.
3. Article 4 of the 1940 Act.
4. A face-amount certificate company is an investment company 'which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which have been engaged in such business and has any such certificates outstanding'. *See* Article 4(1) of the 1940 Act. Face-amount certificates of the installment type are debt securities that are backed by security interest on assets such as real property or other securities. Investors who hold such certificates are usually paid a fixed amount of periodic interest ('installments') and are refunded a definitive sum (the 'face-amount') of their certificates at a specified termination date. *See* Article 2(a)(15) of the 1940 Act. A UIT is an investment company 'which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust'. *See* Article 4(2) of the 1940 Act. UITs invest in a pool of equity securities and/or bonds and other fixed income securities and sells fractional undivided interests in that pool. They typically make a one-time 'public offering' of only a specific, fixed number of units and each UIT has a termination date at which the UIT will be terminated and dissolved. *See* Article 26 of the 1940 Act.
5. *See* with regard to face-amount certificate companies: http://www.sec.gov/divisions/investment/invcoreg121504.htm (accessed 13 Jan. 2011) (SEC states that there are only a few face-amount certificate companies), and for UITs, ICI, *2010 Investment Company Fact Book*, 9 (Total UITs assets by the end of 2009 were USD 38 billion, which was managed by 6,049 funds, a decrease in assets with almost 50% from 1995).
6. Article 4(3) of the 1940 Act and 2010 Investment Company Fact Book, p. 9 & 16 (The total number of management companies and their assets under management increased significantly since 1995, from 5,761 to 8,624 funds and USD 2,955 to USD 12,126 billion assets under management in 2009).

be further divided into open-end funds, also known as 'mutual funds', and closed-end funds and can have the status of a 'diversified' or 'non-diversified' company based on the composition of their assets.[7]

4.2.1 Open-End Registered Funds

To determine whether a management company is open-end or closed-end (and what type of regulation would apply), the SEC looks at whether or not the fund issues 'redeemable securities'.[8] Diversified funds must invest at least 75% of its assets in cash, cash items (including receivables), Government securities, securities of other investment companies, and other securities that are limited in respect of any one issuer to an amount not greater in value than 5% of the companies' NAV and to not more than 10% of the outstanding voting securities of the issuer. Consequently, there are four categories of management investment companies: (1) open-end diversified companies, (2) open-end non-diversified companies, (3) closed-end diversified companies, (4) closed-end non-diversified companies. The primary consequence of the non-diversified as opposed to the diversified status is that non-diversified funds will be required to disclose the general risks of their narrow portfolio selection in their prospectus.[9]

Additionally, it can be noted that open-end registered funds (mutual funds) may not invest more than 15% of their assets in illiquid securities so that they are able to meet investors' redemption requests.[10] An asset is considered 'illiquid' if a mutual fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.[11] According to the SEC Division of Investment Management, certain derivative instruments will generally be illiquid under all or most market conditions. According to the division, '[t]his will more likely be the case if a derivative is designed to meet the needs of a particular investor', as '[s]uch a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid'. With respect to

7. Article 5 of the 1940 Act.
8. *See* on when a fund is considered to issue redeemable securities section 2.6.2[B].
9. *See* on the prospectus disclosure requirements of US funds in general, section 4.8.1.
10. SEC, Revisions to Guidelines – Revision of Guidelines to Form N-1A, Release Nos. IC-18612, 33-6927, Federal Register Vol. 57, No. 55, 20 Mar. 1992, 9828.
11. SEC, Final Rule – Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Release No. IC-14983, Federal Register, Vol. 51, No. 55, 21 Mar. 1986, 9777. Futures and options that trade on a regulated exchange generally are treated as liquid instruments. The SEC has found 'restricted securities' (i.e., securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer) and securities of small businesses to be illiquid. *See* SEC, Final Rule – Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Federal Register Vol. 55, No. 83, 30 Apr. 1990, 17940 and SEC, Revisions to Guidelines – Revisions of Guidelines to Form N-1A, 9828. It can be noted that mutual funds that are regulated as MMFs under rule 2a-7 of the 1940 Act are subject to a 3% limitation in illiquid assets. *See* rule 2a-7(b)(5)(i) of the 1940 Act. In addition, rule 2a-7 imposes the general requirement on MMFs that such funds hold assets that are sufficiently liquid to meet reasonably foreseeable redemptions and minimum amounts of 'daily liquid' and 'weekly liquid' assets.

other derivative instruments, the division notes that their liquidity 'may vary depending on market conditions' and that '[a]n instrument that is liquid in one market environment may become illiquid in another market environment'. As a rule, however, the division states that 'the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or trustees'.[12]

4.2.2 Closed-End Registered Funds

Closed-end registered funds may also choose to redeem their shares in accordance with various rules adopted by the SEC permitting the repurchase of shares in certain limited circumstances.[13] In case fund shares may be redeemed, Article 22(e) of the 1940 Act requires that the redemption payments must be made within seven days, and the right of redemption can be suspended only in limited circumstances, such as when the NYSE is closed or when trading on that exchange is restricted. By contrast, MMFs, expect for government MMFs and feeder funds, are required to suspend redemptions for up to ten business days in a ninety-day period, if the fund's weekly liquid assets fall below 30% of its total assets and the fund's board of directors (including a majority of its independent directors) determines that imposing a gate is in the fund's best interests.[14]

4.2.3 Legal Structure

While the 1940 Act does not explicitly state that registered funds must have a specific legal structure, it does impose certain requirements that assume a corporate or trust form as typical structure, such as the requirement to have a board of directors consisting of multiple directors (whose function is to oversee the operations of the fund and review contracts with service providers) and rules on voting (e.g., the right of investors to elect directors, approve fee arrangements included in the investment

12. SEC Division of Investment Management, Letter to Chairman Levitt: Mutual Funds and Derivative Instruments, 26 Sep. 1994, 18–19. The letter be found at SEC's website: http://www.sec.gov/. Examples of factors that may be taken into account in determining liquidity trustees include: (1) the frequency of trades and quotes for the instrument, (2) the number of dealers wiling to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer. *Ibid.*, 19. Many registered funds include a provision in their governing documents that allows the free transferability of swap transactions and other OTC derivatives or a right to break the transaction at an agreed price since inclusion of a transfer right or break right is consistent with prior SEC interpretations of when an instrument may be treated as liquid. *See* G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 17 Inv. Law. 19 (2010).
13. Rule 23c-1, 23c-2 and 23c-3 of the 1940 Act.
14. SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616, IA-3879, IC-31166, 23 Jul. 2014, 269–270. Weekly liquid assets include: cash, US Treasury securities, certain other Government securities with remaining maturities of sixty days or less, or securities that convert into cash within one week. *See ibid*, 815.

management contract, and approve fundamental investment policy changes).[15] Consequently, registered funds are, in practice, structured as either corporations or business trusts.[16] Most corporate funds are organized in Delaware or Maryland. Business trust funds are generally established in Massachusetts or Delaware.[17]

4.2.4 Capital Requirements

US registered funds, whether open- or closed-end or structured in the corporate or trust form (or any other legal form), are required to have a minimum capital of at least USD 100,000 in case they wish to make a public offering of shares or have made such an offering and, at the time of that offering, had a net worth of at least USD 100,000, which is the market value of assets owned by the fund minus the fund's liabilities.[18] However, in case the fund has made a public offering in the past, and at the time of that offering fulfilled the minimum capital requirement, it no longer has to meet the capital requirements set out in the 1940 Act.[19] Thus, the minimum net worth requirements of US registered funds is not an ongoing requirement (so assets may drop in value after the initial offering has been made). In this context, it is worth noting that the SEC has adopted a 'floating NAV' rule for institutional prime MMFs and liquidity fee and redemption gates for non-governmental MMF's, mainly because a capital buffer 'that was designed to absorb such large losses may be too high and too costly because the opportunity cost of [holding] this capital would be borne at all times even though it was likely to be drawn upon to any degree only rarely'.[20] With this reasoning, the SEC has met the concerns expressed by several market participants and the ICI that stated that '[t]he costs of added fees, assessments, and capital requirements could be substantial, and while their exact level is uncertain, it would not take much to increase the fees that investors in the largest regulated US funds currently pay'.[21]

15. Articles 16 (board of directors) and 13 (changes in investment policy) of the 1940 Act. With respect to fee arrangements set out in the management contract, investors are only permitted to approve the contract with the fund manager in which the compensation of the manager is described in case this power is not reserved to the board. The board furthermore has the duty to evaluate the fund's contract with the manager under certain conditions. *See* Article 15 of the 1940 Act.
16. Kirsch (ed.), *Mutual Fund Regulation,* 1–18. The LP form, although not excluded from the definition of investment companies in the 1940 Act, is not typically used as legal form for an investment company. The LP structure is generally adopted by funds that are offered in a manner that makes them eligible for exceptions to the definition of investment company in Articles 3(c)(1) and 3(c)(7) of the 1940 Act ('qualified-investors' and '100-investors' exceptions). The LP form may also not be suitable because of the fact that the general partner (often the fund's management) has unlimited personal liability, although in case the general partner is set up as a separate legal entity with limited liability (such as a limited liability company or corporation) liability is avoided.
17. *See also* section 1.4.
18. Article 14(a)(1) of the 1940 Act.
19. Article 14 (a)(2) of the 1940 Act.
20. SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, 672.
21. ICI, *Letter to the Secretariat of the Financial Stability Board: Assessment Methodologies for Identifying Non-bank Non-insurer Global Systemically Important Financial Institutions: Proposed*

Of all registered funds, open-end registered funds/mutual funds are the most commonly used type of funds.[22] The main reason for this is the fact that these funds offer professional portfolio management and flexibility regarding the purchasing and selling of shares because of the fact that they issue open-end shares.[23] The open nature of mutual funds also has the additional advantage that these funds are required by the 1940 Act to price their shares at least once a day in accordance with the NAV of their underlying portfolio.[24] Because mutual funds predominate among the funds that are registered, the remainder of the chapter will, with respect to registered funds, focus on this fund type. When referred to 'registered funds', it is thus meant to refer to mutual funds. However, if the regulations discussed apply specifically to MMFs or other types of open-end registered funds, not being mutual funds, these types of funds will be expressly mentioned. Additionally, reference is made to closed-end funds in case this is considered relevant or in case it would provide additional insight into the subject matter discussed.

4.3 UNREGISTERED FUNDS

Unregistered US funds can be defined, as their name indicates, as funds that are not required to register with the SEC and are therefore not subject to regulations under the 1940 Act.[25] They can be structured in many different ways, including the corporate, trust, and LP form. With respect to LPs, Delaware is often indicated as the leading

High-Level Framework and Specific Methodologies 31–32 (7 Apr. 2014). The letter can be found at ICI's website: http://www.ici.org/.

22. ICI, *2010 Investment Company Fact Book*, appendix A. ('The vast majority of investment companies are mutual funds, both in terms of number of funds and assets under management'). *See also* Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 1–17 ('[S]ince the 1980s, at least, most investment companies are open-end investment companies'). ICI data shows that closed-end funds are second in range in popularity after mutual funds (and ETFs) representing USD 288 billion of assets under management of the total USD 12.164 billion assets under management of the registered fund industry in 2010. ICI, *2010 Investment Company Fact Book*, 9 (total mutual funds (including ETFs) assets were USD 11,898 and UITs assets accounted for USD 38).
23. UITs also issue redeemable securities, but they do not offer professional management since they are unmanaged. *See* Article 4(2)(B) and (C) of the 1940 Act. The certificates of face-amount certificate companies do not qualify as redeemable securities under the 1940 Act as the holders of the certificates are not entitled to receive a pro rata share of the fund's net assets. Instead, they receive a fixed amount of interest on a periodic basis. According to the SEC Staff, face-amount certificate companies are also not allowed to issue redeemable securities next to face-amount certificates of the installment type, as this would qualify them as open-end company and thus, makes them subject to Article 18(f)(1) of the 1940 Act. This article prohibits open-end companies to issue senior securities, which the Staff qualifies face-amount certificates of the installment type to be. *See* R.H. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions*, 86.
24. Article 2(a)(41) of the 1940 Act and rules 2a-4 and 22c-1 of the 1940 Act.
25. However, similar to registered funds, unregistered funds and their managers are subject to a broad scale of other rules, including federal anti-fraud and anti-manipulation provisions, the prohibition on insider trading, certain reporting requirements relating to the ownership of equity securities, and state law (e.g., registration requirements, company law provisions and common law fiduciary duties).

market for establishing such a structure.[26] Unregistered funds are generally exempt under the 1940 Act special provisions Article 3(c)(1) and 3(c)(7) for non-public funds.[27] These articles are most often used by alternative funds, including hedge funds and private equity funds, although other funds (e.g., certain real-estate funds) may also rely on them. Specifically, they exempt an investment fund from the registration requirements when that fund has no more than 100 investors ('3(c)(1) fund')[28] or only qualified investors ('3(c)(7) fund')[29] and does not make or propose to make a public offering of its shares.

Next to the '1940 Act-registration', a fund may furthermore be required to register with the SEC and publish a prospectus under the 1933 Act, although an exemption also applies to non-public funds. A fund is exempt in case its offering is considered to be non-public is nature under Article 4(2) of the 1933 Act. For that reason, this rule is generally referred to as the 'private offering' exemption. Since the 1933 Act does not define what constitutes a public offering, courts have considered several factors to determine whether a public offering occurred, including the number of persons to whom the offering is made, the sophistication of these persons, the nature of the information disseminated and the manner of the solicitation.[30] As these factors are rather vague and unpredictable in application, most private placements of funds are made in accordance with the non-exclusive safe harbour contained in rule 506 of SEC Regulation D of the 1933 Act. Under this rule, an offer and sale of fund shares to an unlimited number of 'accredited investors' and a maximum of thirty-five non-accredited investors is permitted.[31] Rule 506 does not limit the dollar amount of

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26. *See* section 1.4.
27. The 1940 Act also excludes a number of other entities from the definition of 'investment company' or specifically exempts them from regulation under the Act, including issuers primarily engaged in non-investment business (Article 3(b)(1) and (2)), underwriters, brokers and dealers in securities (Article 3(c)(2)), banks and certain other financial institutions (Article 3(c)(3), (4), (5), (6) and (11)), and companies designed to promote investment in small business (Article 6(a)(2)). *See* for an extensive analysis of these and other exceptions and exemptions Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Adviser*s, Ch. 6 and 7.
28. In case the investor is another fund, each investor in that fund is counted as an investor of a 3(c)(1) fund for the purpose of the 100-investor (or 100-owner) limit if the fund owns 10% or more of the 3(c)(1) fund's outstanding voting securities. *See* Article 3(c)(1)(A) of the 1940 Act.
29. Qualified investors (or, in the terminology of Article 2(a)(51) of the 1940 Act, 'qualified purchasers') include individuals who hold at least USD 5,000,000 in investments (as defined in rule 2a51-1 of the 1940 Act) and an entity that in the aggregate owns and invests on a discretionary basis not less than USD 25,000,000 in investments. For a complete definition of qualified purchaser see Article 2(a)(51) of the 1940 Act. Pursuant to rule 2a51-3 of the 1940 Act, a qualified purchaser also includes a company not meeting the above requirements as long as all of the beneficial owners of the securities of that company are qualified purchasers.
30. *See* for an overview of court cases considering this issue D.L. Hammer, *U.S. Regulation of Hedge Funds*, 114–115.
31. Rule 506(b)(2) of the 1933 Act. An 'accredited investor' refers to an individual whose net worth, or joint net worth with a spouse, exceeds USD 1 million or whose individual income exceeded USD 200,000 or whose joint income with a spouse exceeded USD 300,000 in each of the two most recent years and can be expected to meet that income in the current year. Similar to the definition of a qualified purchaser, an entity in which all of the equity owners are accredited investors is also an accredited investor. *See* rule 501(a) of the 1933 Act. It can be noted that in 2011, the SEC adopted amendments to the net worth standard for accredited investors to exclude

securities that can be offered, but rule 502(c) of the 1933 Act prohibits any offerings or sales of shares through general solicitation or advertising.[32]

4.4 REGISTERED/UNREGISTERED FUND MANAGERS

In addition to the registration requirements for funds, US fund managers may also be held to register with the SEC under the Advisers Act. Registered fund managers are subject to a number of rules and regulations, including, among others, anti-fraud provisions, disclosure obligations, restrictions on fee provisions, an advertising restrictions.[33] Fund managers that are prohibited from registering with the SEC generally must register with the state(s) in which they manage funds, unless they are exempt from the specific regulation under state law. State-registered fund managers are however still subject to Article 206 of the Advisers Act, which prohibits fraudulent conduct, and Articles 204A (the implementation of procedures designed to prevent the misuse of material non-public information), 205 (containing, among other things, prohibitions on the use of certain performance fee arrangements), 206(3) (disclosure obligation of transactions where the manager acts as principal for its own account) of the Advisers Act.

With respect to these rules, Article 205 of the Advisers Act is particularly noteworthy. Under this article, SEC-registered managers (and unregistered managers that are registered with a US state), unless exempted from registration under Article 203(b) of the Advisers Act,[34] are prohibited from receiving a performance-based fee from an open-end registered fund (mutual fund), unless the fee is structured to comply with four requirements: (1) the fee must be based on the funds NAV (thus not on the total return of the fund), (2) the NAV is averaged over a 'specified period', (3) the fee increases or decreases proportionately with the fund's investment performance over a specified period, and (4) the fund's investment performance relates to the investment record of an 'appropriate index' of securities prices.[35] Such a fee is also known as a 'fulcrum fee', i.e., a fee earned by the manager when the fund's performance is equal

the value of an individual's primary residence from the USD 1 million calculation. *See* SEC, Final Rule – Net Worth Standard for Accredited Investors, Release Nos 33-9287, IA- 3144, and IC-2981, 21 Dec. 2011. *See* for the term 'qualified purchaser' n. 29, *supra*.

32. Accordingly, a fund relying on the safe-harbour exemption of rule 506 Regulation D may not use cold calling (i.e., unsolicited phone calls), advertising, mass e-mails or spam, web sites or other similar forms of promotion to solicit investors or promote or solicit investment in the fund.
33. *See* Articles 205, 206 of the Advisers Act and rules 204-3 and 206(4)-1 of the Advisers Act.
34. Article 203(b) of the Advisers Act exempts any manager: (1) all of whose clients are within the same state as the manager's principal business office, and that does not provide advice or issue reports about securities listed on any national securities exchange, (2) managers whose only clients are insurance companies, (3) any manager that during the previous twelve months has had fewer than fifteen clients, does not hold itself out generally to the public as an investment adviser, and does not act as an investment adviser to a registered fund or business development company, (4) any manager that is a charitable organization, or is employed by a charitable organization, and provides advice, analyses, or reports only to charitable organizations, or to funds operated for charitable purposes, and (5) manager to church employee pension plans.
35. Article 205(b)(2) of the Advisers Act.

to the index.[36] With respect to the second and third requirement, requiring averaging and payment over a specified period, the SEC finds that the calculation of the performance-based fee should use a measuring interval that is 'sufficiently long to provide a reasonable basis for indicating the adviser's performance' and suggests the use of at least a one year interval.[37] Rule 205-2 of the Advisers Act furthermore provides the possibility to pay fund manager's performance-based fees within this period in case (1) the variable performance component must be computed over a 'rolling period' and the fee is only payable at the end of each subperiod of the rolling period and (2) the fulcrum fee must be computed on the basis of the NAV averaged through the most recent subperiod or subperiods of the rolling period.[38] Lastly, Rule 205-1 of the Advisers Act provides that an appropriate index to which the performance should relate should be representative of the typical portfolio securities held by the fund and not be too narrow in scope. Registered/unregistered fund managers managing unregistered funds and registered closed-end funds are generally not subject to any rules related to the use of (performance-based) fees.[39]

Before 2010, managers of US funds were exempt from registration under the Advisers Act in case they have fewer than fifteen clients and investors in the US in 'private funds'.[40] However, as each private fund counted as one client, managers could form up to fourteen private funds, regardless of the total number of investors investing

36. Rule 205-2(a)(1) of the Advisers Act (defining a fulcrum fee to be the 'fee which is paid or earned when the investment company's performance is equivalent to that of the index or other measure of performance').
37. SEC, Factors To Be Considered in Connection With Investment Company Advisory Contracts Containing Incentive Fee Arrangements, Release No. IC-7113, 6 Apr. 1972, n. 12.
38. Rule 205-2(a)(2) of the Advisers Act (defining a rolling period to be 'a period consisting of a specified number of subperiods of definite length in which the most recent subperiod is substituted for the earliest subperiod as time passes').
39. Article 205(b)(4) and rule 205-3(a) of the Advisers Act (exempting private funds excepted from Article 3(c)(7) of the 1940 Act and clients with at least USD 750,000 under management with the fund manager or more than USD 1,500,000 of net worth or clients who are 'qualified purchasers' under article 2(a)(51)(A) of the 1940 Act. Private funds exempted from the 1940 Act under Article 3(c)(1) of that act are however not exempted from the performance-based fee restrictions. Also exempted are registered funds and clients having more than USD 1 million in managed assets and business development companies, if specific conditions are met, clients that are not US residents, and certain knowledgeable employees of the fund manager. *See* Article 205(b)(2)(B), (3), (5) and rule 205-3(a) and (d)(iii) of the Advisers Act.
40. Rule 203(b)(3)-1(a)(2) of the Advisers Act. The term 'private fund' is defined by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ('Dodd-Frank Act', Pub.L. 111-203, 124 Stat. 1376, H.R. 4173, enacted 21 Jun. 2010) and codified in Article 202(a)(29) of the Advisers Act, to mean 'an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act'. The definition covers hedge funds and private equity funds, including venture capital funds, and most real-estate funds. Prior to the Dodd-Frank Act, the definition was limited to manager of hedge funds, excluding managers of funds that have more than a two year 'lock-up', such as most private equity, venture capital and real-estate funds. Reason for this initial limitation was the fact that the SEC has not encountered significant enforcement problems with managers to such funds, in contrast to its experience with hedge fund managers. *See* SEC, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333, Federal Register, Vol. 69, No. 237, 10 Dec. 2004, 72074. In the Dodd-Frank Act, only managers of venture capital funds are exempted from registration under new Article 302(1) of the Advisers Act.

in the funds, without having to register with the SEC.[41] The Private Fund Act 2010 eliminated this exemption and also raised the dollar threshold for SEC registration from USD 25 million of total assets under management to USD 100 million (i.e., mid-sized manager exemption).[42] In addition, in the Act, Congress directed the SEC to create, among others, two new exemptions applying to: (1) managers managing solely venture capital funds (i.e., venture capital fund exemption), and (2) managers managing solely private funds with less than USD 150 million in assets under management in the US (i.e., small private fund exemption).[43] To this end, the SEC adopted final rules that implemented these exemptions.[44]

With respect to the first exemptions, Congress intended to distinguish managers of venture capital funds from the larger category of private equity funds.[45] Reason for this is the fact that venture capital funds are considered to, as opposed to private equity funds, not pose a systemic risk as they are generally not leveraged.[46] In implementing the exemption, the SEC has adopted a definition of a venture capital fund that is in line with the language previously used by the Congress to describe these funds.[47] The

41. Concerns about this lack of oversight led to the adoption of rule 203(b)(3)-2 in 2004 requiring fund managers to count each owner of a private fund for purposes of the 14 client-threshold and, subsequently, the requirement to register with the SEC. *See* SEC, Registration Under the Advisers Act of Certain Hedge Fund Advisers, 72075. However, this rule was vacated by the District Court of Colombia in 2006. *See Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).
42. Article 410 of the Private Fund Act and (new) Article 203A(a)(1) of the Advisers Act. However, the Private Fund Act shifts primary responsibility for their regulatory oversight to the state securities authorities by determining that a mid-sized fund manager is only prohibited from registration with the SEC if it is not required to be registered with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business or if registered, would not be subject to examination as an investment adviser by that securities commissioner, or if the fund manager is required to register in fifteen or more states. In addition, a mid-sized fund managers also will be required to register with the Commission if it can be qualified as an investment adviser to a registered investment company or business development company under the 1940 Act. *See also* Article 410 of the Private Fund Act.
43. Articles 407, 408, and 403(2) of the Private Fund Act. The Act also created exemptions and exclusions in addition to the three mentioned here. *See*, e.g., Articles 403 and 409 of the Private Fund Act (exempting fund managers to licensed small business investment companies and non-US managers with, among other things, less than USD 25 million in aggregate assets under management from US clients and investors and fewer than fifteen such clients and investors from registration under the Advisers Act and excluding family offices from the definition of 'investment adviser' under the Advisers Act).
44. SEC, Final Rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222, 22 Jun. 2011.
45. SEC, Proposed rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3111, 19 Nov. 2010, 10–12.
46. *Ibid.*, 11.
47. In summary, the rule defines a venture capital fund as a private fund that: '((i) holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings) ("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund (…)); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors

second, exemption enables a fund manager with USD 150 million or less assets under management to manage an unlimited number of private funds without having to register with the SEC.[48] As a result of this exemption in combination with the mid-sized manager exemption, managers of only private funds that hold between USD 100 and USD 150 million assets and managers of any fund, including private funds, with less than USD 100 million of assets under management in the US are exempt from federal registration. In case a manager manages solely private funds with between USD 100 and USD 150 million of assets under management, however, forms only one non-private fund, it would be required to register with the SEC.

4.5 INTERNAL CONTROL SYSTEMS

Rule 38a-1 of the 1940 Act and rule 206(4)-7 of the Advisers Act requires registered funds and registered fund manager to (1) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, (2) revise those policies and procedures each year for adequacy and effectiveness, and (3) designate a Chief Compliance Officer (CCO) to be responsible for overseeing and administering said policies and procedures. The rules do not prescribe the exact elements that the compliance policies and procedures should contain.[49] However, the SEC has stated that it expects fund managers and funds to, among other things and where relevant, identify risks and potential conflicts and implement policies to address those risks and conflicts.[50]

The rules furthermore do not state how funds should conduct compliance reviews or who should conduct them. As a result, funds have flexibility to design and carry out compliance reviews in a manner that best suits their particular circumstances.[51] They however do provide that the CCO should be involved in these reviews and imposes some general duties on the CCO with regard to its monitoring and reporting duties. Since US funds and their managers obtain a certain amount of freedom as regard to the adoption of compliance policies, these duties play an important role in regulatory enforcement and forms a keystone in the protection of investors with respect to internal control systems. Therefore, below, I will assess, in

redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company ("BDC")'. *See* SEC, Final Rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, 9.

48. *Ibid.*, 75–76.
49. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA–2204, IC–26299, Federal Register, Vol. 68, No. 247, 24 Dec. 2003, 74716 (stating that 'funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements' and '[t]he policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred').
50. *Ibid.*, 74716–74717.
51. ICI, *Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedures*, December 2005, 2. This paper can be found at ICI's website: http://www.ici.org/.

addition to the rules related to the compliance policies of funds and fund managers, the duties of the CCO.

4.5.1 Compliance Policies

All US registered funds must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for the oversight of compliance by their service providers, including external managers.[52] A fund may apply this requirement in the manner best suited for its particular structure. It may, for example, adopt policies and procedures that solely cover the activities of the fund and would approve the policies of its service providers, but it may also adopt policies and procedures that covers the activities of its service providers (and would approve their policies). The fund's board is required to approve the fund's compliance policies. This approval must be based on a finding by the board that the policies are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers.[53] In this context, the SEC stated that the board must consider the following factors when determining whether to approve the policies: (1) the nature of the fund's exposure to compliance failures, (2) the adequacy of the policies and procedures in light of their recent compliance experiences, and (3) best practices used by other fund complexes.[54]

[A] Policies for US Fund Managers

Registered fund managers are also required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the manager and the manager's supervised persons.[55] A fund manager may take into account its specific nature, as a result of which, for example, small managers may adopt simpler policies than large managers. There is no board approval required, but the manager's policies must be, as is also the case for fund policies, annually reviewed and monitored by the CCO (see below).

In general, a fund manager should first identify its conflicts and other compliance factors creating risk exposure for the manager and its funds, after which it should design policies and procedures that address those risks. The policies should, as mentioned, vary from manager to manager, depending on factors as size and complexity of

52. Rule 38a-1(a)(1) of the 1940 Act. Service providers include fund managers, principal underwriters, administrators, and transfer agents. *See* SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74717, n. 28.
53. Rule 38a-1(a)(2) of the 1940 Act.
54. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74717.
55. Rule 206(4)-7(a) of the Advisers Act. Article 202(a)(25) of the Advisers Act defines a 'supervised person' as 'any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser'. The CCO is also a supervised person, *See also* article rule 206(4)-7(c) of the Advisers Act.

the manager's business, types of potential conflicts and types of funds managed and affiliated persons. The SEC has identified the following topics that should be addressed by the manager's compliance policies to the extent that they are relevant to the particular manager:

- Portfolio management processes, including investment allocation and consistency of the underlying portfolios held with the funds' investment objectives, disclosures to the funds managed, and applicable regulatory investment restrictions.
- Proprietary trading by the manager and the personal trading activities of the manager's personnel and policies on the prevention of insider trading.
- Trading practices, including best execution efforts, soft dollar arrangements, and the allocation of aggregated trades among funds.
- Disclosure accuracy, including information provided in Form ADV and other regulatory filings, fund account statements and advertisements.
- Custody of assets, including adherence to applicable requirements and the general safeguarding of the assets of the funds managed.
- Recordkeeping, including the timely creation and proper use of all required records.
- Privacy of information, including safeguarding fund information.
- Marketing, including the advertising of the manager's services and the use of solicitors.
- Portfolio valuation of client holdings, including the valuation of holdings and fees based on those valuations.
- Business continuity and disaster recovery plans, including efforts to address risks that might impact the continuity of the business, such as natural disasters or, in the case of a small manager, the death of the owner or key personnel.[56]

Although the exact policies and procedures are neither defined by the Advisers Act nor the SEC, the SEC has brought an enforcement action against an advisory firm that adopted a pre-packaged policies and procedures manual that did not adequately address the conflicts of interest unique to the firm's business.[57] The SEC thus expects fund managers to perform an adequate risk assessment and to implement and maintain compliance policies and procedures in accordance with this assessment and taking into account the areas mentioned in the SEC guidelines.

[B] Policies for US Funds

With respect to the compliance policies of registered funds, the SEC has stated that they should adhere to the same areas as those identified for fund managers, but added a number of areas:

56. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74716.
57. SEC, In the Matter of Consulting Services Group, LLC, Release No. IA-2669, 4 Oct. 2007.

- Valuation of funds shares, including the use of fair value prices for open-end funds and the methodology by which the fund determines the current fair value of portfolio securities.
- Processing of fund shares, including the segregation of investor orders received before open-end funds price their shares to ensure protection against late trading.[58]
- Identification of affiliated persons to prevent conflicting transactions such as self-dealing.
- Protection of non-public information, including preventing insider trading by the manager or any other person and other potential misuses of non-public information.
- Compliance with fund governance requirements, including safeguarding the election of a properly constituted board (with sufficient independent directors).
- The monitoring of investor trades or flows of money in and out of open-end funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing.[59]

Similar as for fund managers, registered funds must conduct a risk assessment in which they identify potential conflicts of interests and other compliance issues that may create risks for them. After this assessment, they must determine the specific policies and procedures which should be implemented in order to enable them to comply with the federal securities laws. However, although rule 38a-1 of the 1940 Act does not list the exact risks and the policies and procedures to be implemented by registered funds, by complying with the 1940 Act, a fund will have to address a number of risk areas, including credit risk, market risk and liquidity risk.[60] By complying with these rules, funds are already provided with a framework for developing compliance policies.[61]

58. The SEC however stated that simply having procedures designed to prevent late trading is not sufficient, but that a fund should also take 'affirmative steps to protect itself and its shareholders against late trading by obtaining assurances from its transfer agent that its policies and procedures are effectively administered'. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74719.
59. *Ibid.*, 74718–74720.
60. For example, the requirements set out in Article 22(e) of the 1940 Act regarding the suspension of redemptions seek to limit a fund's exposure to losses due to credit, market, and liquidity risks. In addition, SEC guidance allows open-end funds to invest 15% of their assets in illiquid assets, as a result of which 85% must be liquid. SEC, Revisions of Guidelines to Form N-1A, Release no. IC-18612, Federal Register, vol. 57, no. 55, 20 Mar. 1992, 9828. MMFs cannot acquire illiquid securities if, after the purchase, more than 5% of the fund's total assets would consist of illiquid securities. *See* Rule 2a-7(c)(5) under the 1940 Act. SEC guidance has further indicated that, in case more than 5% of a fund's net assets are exposed to derivative instruments and derivative-based transactions, the fund prospectus should include, among other things, the risks underlying the derivatives and the risks associated with the derivatives themselves, such as leverage, credit risk, market risk and liquidity risk. *See* G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 23.
61. S.H. Bier & M.A. Wolfe, *Risk Management Issues for Registered Investment Companies*, 16 Inv. Law. 10 (2009).

With respect to the valuation of shares, the 1940 Act however provides for additional guidance. Rule 2a-4(a)(1) and Article 2(a)(41)(B) of the 1940 Act determine that the underlying portfolio securities owned by the fund should be valued by using the 'market value method' when market quotations are readily available. When market quotations are not readily available, a fund must use fair values, as determined in good faith by the fund's boards of directors, to value its portfolio securities and other assets. Securities that are valued by the market value are classified by the SEC into two sub-types: (1) securities listed on or traded on a national securities exchange and (2) OTC securities. The valuation of the first category should be obtained through the last quoted sales price used. The valuation of OTC securities should be obtained through market quotations from broker-dealers or others.[62]

With respect to 'fair value method', the SEC determines that the fund's directors must satisfy that all appropriate factors relevant to the value of the securities or assets for which market quotations are not readily available have been considered and determine the method of arriving at the fair value of these securities or assets. According to the SEC, the current fair value of an issue of securities or assets being valued by the fund's board would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.[63] This valuation principle is also referred to as the current sale principle.[64] Methods which are allowed include, for example, methods that are based on a multiple of earnings, or a discount from market of a similar freely traded security.[65]

In this context, it can be noted that when a 'significant event' occurs, the fund must value the security pursuant to the fair value method and not the market value method.[66] However, the SEC did not establish specific criteria for determining when a significant event had occurred. The valuation policies and procedures established under rule 38a-1 of the 1940 Act should monitor the circumstances (i.e., valuation risks) that may necessitate the use of fair value prices, including significant events.[67]

62. SEC, Accounting Series Release No. 118, Release Nos. 40-6295, 33-5120, 34-0040, 23 Dec. 1970 (ASR 118), 19987–19988. The release can be found at SEC's website: http://www.sec.gov/.
63. *Ibid.*, 19988.
64. J.K. Smith, R.L. Smith & K. Williams, *The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6:2 Ford. J. Corp. & Fin. L. 429 (2001).
65. ASR 118, 19988.
66. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74718 (stating that funds may be required to fair value portfolio securities 'if an event affecting the value of the security occurs after the market closes but before the fund prices its shares'. According to the SEC, in these circumstances, 'a fund "must, to the best of its ability, determine the fair value of the securities, as of the time" that the fund prices its shares').
67. *Ibid.* ('[R]ule 38a-1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments'). According to ICI, significant events may include: 'events relating to a single issuer, such as corporate announcements on earnings; events relating to an entire market sector, such as significant governmental actions (e.g., raising interest rates); natural disasters that affect securities values, such as an earthquake; or

Furthermore, registered open-end funds must disclose to investors the circumstances under which the fund will use fair value pricing and the effects of using fair value pricing and the valuation procedures that they use in determining their NAV and the value of their investments.[68]

In addition to the above, reference can be made of three rules applying in specific circumstances regarding securities valuation. Firstly, in case of valuation of securities issued by controlled companies,[69] the board of directors may determine the value of such securities in good faith, provided that the value determined is not in excess of the higher market value of asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of the market value in the case of other controlled companies.[70] Secondly, in case of elimination of securities from the portfolio of the fund, rule 2a-2 of the 1940 Act provides that the valuation of such securities should give effect to the eliminations in accordance with one of the following methods: (1) the price of the specific certificate, (2) first in-first out, (3) last in-first out, or (4) average value. Thirdly, US funds that are required by state law to use another method of market value or fair value with respect to their securities are allowed to use this alternative method, provided that they state the facts and describe their methods and the facts justifying its adoption in their registration statement under Article 8 or in their reports under Article 30 of the 1940 Act (annual and semi-annual reports).[71]

Lastly, it is worth noting in this respect that funds and fund managers may also subject to certain written compliance policies under other US federal law provisions than rule 38a-1 of the 1940 Act. For example, rule 17j-1(c)(1) of the 1940 Act requires every registered fund (and each fund manager) to 'adopt a written code of ethics containing provisions reasonably necessary to prevent' certain persons affiliated with the fund, its manager or its principal underwriter from engaging in certain fraudulent manipulative, and deceptive actions with respect to the fund. Furthermore, MMFs are required to establish written procedures 'reasonably designed (…) to stabilize the money market fund's net asset value per share'.[72] With respect to fund managers, the Advisers Act requires registered fund managers to have a code of ethics that sets forth standards of conduct expected of manager personnel, addresses conflicts that arise from personal trading by the personnel, and to report their personal securities transactions, including transactions in any registered fund managed by the manager.[73]

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significant fluctuations in domestic or foreign markets'. *See* ICI, *The Role of the Board* 3 (Fair Valuation Series 2006). ICI's document can be found at ICI's website: http://www.ici.org/.

68. Form N-1A, Items 11 and 23. Form N-1A can be found at SEC's website: http://www.sec.gov/.
69. *See* Article 2(a)(9) of the 1940 Act.
70. Article 2(a)(41) of the 1940 Act. A majority-owned subsidiary is defined in Article 2(a)(24) of the 1940 Act as 'a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority owned subsidiary of such a person'.
71. Rule 2a-1(a) and (c) of the 1940 Act.
72. Rule 2a-7(c)(7) of the 1940 Act.
73. Article 204A and rule 204A-1 of the Advisers Act.

4.5.2 CCO

Rule 38a-1(3) of the 1940 Act provides that registered funds must review at least annually the adequacy of their and their service providers' policies and procedures as well as the effectiveness of their implementation. A similar requirement applies to registered fund managers under rule 206(4)-7(b) of the Advisers Act. Furthermore, both registered funds and fund manager must appoint a CCO to administer the policies.

There is little guidance as to what the CCO's 'administering' role is, but the SEC has stated that the CCO must 'be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm' in order to detect potential compliance failures.[74] The broadest interpretation of this standard imposed by the SEC would result in a requirement of the CCO to be involved in the implementation (or overseeing the implementation) of the compliance policies of the fund and fund manager to monitor the activities of the business of the fund (and its service providers) and manager by testing, measuring and reviewing their performance for compliance with the federal securities laws. However, in practice, the role of the CCO in the reviewing process may vary among funds and managers and may depend on various factors, such as size of the fund and complexity of its strategies. So may a CCO of a small fund play a larger role in this process, while a CCO of a large fund will focus more on planning and coordinating the compliance reviews, and reviewing the results of tests and analyses performed by the fund manager or fund board.[75]

For registered funds, rule 38a-1 of the 1940 Act provides for a number of additional duties for CCO's with respect to their administrating role. It requires the CCO to at least annually provide a written report to the fund's board that addresses the operation of the fund's and its service providers' policies and procedure, any material changes in the policies and procedures since the last report, any material changes in the policies and procedures recommended in the annual review, and each material compliance matter that occurred since the last report.[76] The CCO must also meet separately with the independent directors at least annually.[77] The fund's board, including a majority of its independent directors, must approve the designation of the

74. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720.
75. ICI, *Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedure*, 2. It however does not by definition includes supervisory responsibilities. *See* SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720, n. 73 (stating that '[h]aving the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)-7 (or rule 38a-1) would not necessarily be subject to sanction by us for failure to supervise other advisory personnel').
76. A 'material compliance matter' is any compliance matter about which the fund's board of directors would reasonably need to know to oversee compliance, and that involves, without limitation: (a) a violation of the federal securities laws by the fund and any service provider (or any officers, directors, employees or agents thereof), (b) a violation of the policies and procedures of the fund and its service providers, or (c) a weakness in the design or implementation of the policies and procedures of the fund (or separate account) and its service providers. *See* rule 38a-1(e)(2) of the 1940 Act.
77. Rule 38a-1(a)(4)(iv) of the 1940 Act.

CCO and can remove the CCO at any time.[78] Furthermore, the rule imposes specific recordkeeping requirements. Among other things, funds are required to maintain any records documenting their annual compliance reviews as well as copies of the written compliance reports required to be provided by the CCO to the fund's board.[79] In addition, the SEC has indicated that the duties of the CCO (of either a fund or fund manager) go further than just reviewing and monitoring the compliance with federal securities laws, as it should also 'identify potential and actual conflicts of interest issues'.[80] With respect to fund managers, the SEC furthermore requires the CCO to report regularly to the risk management committee and to report violations to the Chief Executive Officer (CEO) and the board of directors of the manager.[81]

The annual compliance review should consider any compliance matters that arose during the previous year, any changes in the business activities of the fund managers, funds, the separate accounts, the principal underwriters, and their service providers or in the applicable regulations that might suggest a need to revise the policies or procedures.[82] In case a fund has an external manager, the CCO's role would be limited to oversight of the manager's compliance policies and providing advice to the fund board on the operation of the policies.[83] Although the rules only require annual reviews, the SEC has noted that the fund/manager should 'consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments'.[84] Consequently, funds and fund managers should put policies in place for determining when interim reviews may be advisable in light of the entity's ongoing risk assessment. This will require additional risk assessment by the risk management committee, CCO, and/or other personnel performing such assessments.

The annual review must be formalized and documented and the documents retained for SEC inspection for a period of five years after the end of the fiscal year in which the review was conducted.[85] With respect to these inspections, the SEC has noted that it will be looking at whether a proper 'culture of compliance' is in place by assessing whether there are adequate checks and balances, internal controls and supervisory structure that make it more likely that ethical behaviour will be the norm within the entity, and communication of its culture of compliance to those outside the firm.[86]

78. Rule 38a-1(a)(4)(i) and (ii) of the 1940 Act.
79. Rule 38a-1(d) of the 1940 Act.
80. SEC, In the Matter of RS Investment Management Inc., et al., Rel. No. IA-2310, 6 Oct. 2004, under 28.
81. *Ibid.*
82. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720.
83. *Ibid.*, 74722.
84. *Ibid.*, 74720.
85. Rule 38a-1(d)(2) of the 1940 Act and Article 204-2(a)(17)(ii) of the Advisers Act.
86. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 9-126.14.

4.6 LEVERAGE RESTRICTIONS

As mentioned by the Committee of Federal Regulations of Securities in 2010, leverage that is embedded in many derivatives, has presented issues concerning how US funds should appropriately use derivatives, how they should disclose the related risks, and how the positions should be treated under applicable law.[87] Investors may understand the risks associated with an investment in a fund that uses leverage. As a result, regulatory authorities, including the SEC, focus on restricting the use of leverage by funds offered to retail investors and imposing disclosure obligations on funds to make investors aware of the risks involved in funds that expose their portfolio to significantly high levels of leverage.[88]

The 1940 Act imposes certain leverage restrictions on registered funds. Article 18(f)(1) of the 1940 Act prohibits open-end funds from issuing or selling so-called senior securities and provides that they may only borrow from US banks subject to a 300% asset coverage requirement (including the amount borrowed), i.e., direct leverage is allowed up to 33.33% of a fund's total net assets,[89] at all times that the borrowing is outstanding. Senior securities are defined in Article 18(g) of the 1940 Act as 'any bond, debenture, note or similar obligation or instruments constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends'.

Closed-end registered funds are subject to less restrictive provisions as they may issue or incur debt under Article 18(a), (c) and (e) of the 1940 Act: (1) through issuance of a single class of debt, so long as the fund maintains an asset coverage ratio of at least 300% and the debt is subject to specified restrictive covenants, (2) through issuance of one class of senior ('preferred') stock, so long as the fund maintains an asset coverage ratio of at least 200% and the preferred stock is subject to specified restrictive covenants, (3) by borrowings from a US bank or through a privately arranged financing, (4) for the purpose of refunding or a plan of reorganization subject to certain requirements. Both open-end and closed-end funds are allowed to issue temporary, short-term loans of up to 5% of the fund's total assets with any person. A loan is presumed to be for temporary purposes if it is repaid within sixty days and is not extended or renewed.[90]

87. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 6 Jul. 2010, 4. The report can be found at the American Bar Association's website: http://apps.americanbar.org/.
88. *Ibid.*, 11 & 40.
89. For example, an open-end funds that has USD 2 million of net assets and borrows USD 1 million from a bank, its total net assets is USD 3 million of which 1 million is loaned (33%). 'Asset coverage' is defined in Article 18(h) of the 1940 Act to mean, with respect to a class of senior security representing an indebtedness of an issuer, the ratio that the value of the total assets of an issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer.
90. Article 18(g) of the 1940 Act.

4.6.1 Application of Article 18 of the 1940 Act

With regard to these leverage restrictions, the SEC has issued a general statement of policy on the application of Article 18 of the 1940 Act for registered funds.[91] In this statement, the SEC addressed three types of transactions: (1) reverse purchase agreements, (2) firm commitment agreements, and (3) standby commitment agreements,[92] but emphasized that it 'intended to address generally the possible economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices' specifically discussed in the release'.[93] For purposes of Article 18 of the 1940 Act, the SEC stated that 'all contractual obligations to pay in the future for consideration presently received' fall under the scope of this article.[94] Further, the SEC stated that 'trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18'.[95] Consequently, engagements by (open-end or closed-end) registered funds in 'senior securities transactions' involving derivatives that create third party obligations (indebtedness), e.g., futures, forward contracts, written options (and securities-lending transactions, e.g., short sales) are covered by Article 18 of the 1940 Act, whereas investments in derivatives that do not impose any payment obligations above the initial investment (i.e., premium), such as purchased stock call options and leveraged inverse floating rate notes, are not.[96]

As a rule, the SEC determined that it would not treat the three transactions discussed as creating senior securities if funds segregates or 'cover' their obligations by establishing a segregated account equal in value to its obligations under the transaction holding only liquid assets, such as cash, US government securities, other appropriate high grade debt obligations or, according to a later no-action letter, equity and

91. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, Release No. IC-10666, Federal Register, Vol. 44, No. 83, 27 Apr. 1979.
92. Reverse purchase agreements involves the purchase of securities with the agreement to sell them at a higher price at a specific future date. In firm commitment agreement, the fund agrees to buy securities at a future date, stale price, and fixed yield. The standby commitment agreement is a delayed delivery agreement in which the fund contractually binds itself to accept delivery of securities with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. *Ibid.*, 25129–25131.
93. *Ibid.*, 25128.
94. *Ibid.*, 25131.
95. *Ibid.*
96. This follows from the fact that the SEC has focused on providing guidance as to the issuing of senior securities rather than on limiting the use of derivatives. When a fund buys a stock call option, it has the right (not the obligation) to purchase a specified number of shares of the underlying stock at the given strike price on or before the expiration date of the contract. To obtain this option, the fund pay an initial fee (called a premium) to the seller of the option. Inverse floating rate notes are instruments on which the rate paid increases as market floating rates declines. In leveraged inverse floating notes, the rate paid on the note is typically set by doubling the swap rate (fixed rate) in effect at the time the contract is signed, and subtracting the floating reference index rate for each payment period. *See* G. Gastineau & M. Kritzman, *Dictionary of Financial Risk Management* 266 (3th ed., John Wiley & Sons 1999).

non-investment grade debt, provided the assets are liquid.[97] The SEC explained that allocating assets into a segregated account would: (1) function as a practical limit on both the amount of leverage undertaken by a fund and the potential increase in the speculative character of the fund's outstanding shares, and (2) assure the availability of adequate funds to meet the obligations arising from such activities.[98]

4.6.2 Exemptive Relieves

After this statement, the SEC applied the standards in a number of exemptive relieves, no-actions letters and guidelines with regard to several derivative instruments and other leveraged transactions, including future contracts, commodity options, futures, and short selling.[99] The main questions that the SEC addressed in these documents relate to the amount of assets the fund must segregate with respect to these instruments. For example, with respect to futures, the SEC determined that an open-end registered fund must segregate liquid or other qualifying assets equal to (1) the purchase price of the futures contract, if the fund is long the positions or (2) an amount that, when added to the amounts deposited with a futures commission merchant, or broker as margin, equals the market value of the instruments or currency underlying the futures contract, if the fund is short the positions.[100]

In addition, short selling (both 'covered' and 'uncovered') is allowed in case the fund maintains in a segregated account on its books an amount that, when combined with the amount of collateral (not including short sale proceeds) deposited with the broker in connection with the short sale, equals the current market value of the security sold short.[101] In many cases, segregation of short selling is accomplished in case the fund physically posts liquid assets as collateral. Furthermore, the SEC approved 'off-setting exposure' to derivatives, i.e., entering into a position that fully off-sets its exposure on a derivative or short position, as a means by which a registered fund avoids violation of Article 18 of the 1940 Act.[102] With this approval, the SEC in fact

97. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25129 and SEC No-Action Letter, Merrill Lynch Asset Management L.P., 2 Jul. 1996. The no-action letter can be found at SEC's website: http://www.sec.gov/.
98. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25132.
99. *See* for an analysis of these no-action letters, G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 15–16 and Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 13–15.
100. *Ibid.*, 15.
101. SEC No-Action Letter, Robertson Stephens Investment Trust, 24 Aug. 1995, 3 and SEC Letter to fund CFOs, 7 Nov. 1997 (further relaxing the rules to allow funds to designate securities as segregated assets solely on the fund records and not on the fund's custodian's records). The no-action letter and SEC's Letter to the fund CFOs can be found at SEC's website: http://www.sec.gov/.
102. SEC No-Action Letter, Dreyfus Strategic Investing, 30 Mar. 1987. According to SEC, this would effectively eliminates the derivatives exposure and obviates the need to segregate assets to comply with the prohibition on senior securities contained in article 18(f) of the 1940 Act. For example, the SEC clarifies that a fund that has sold a put option could cover its position by selling short the instrument or currency underlying the put option at the same or a higher

confirmed that registered funds could use derivatives for investment purposes, although it did not make fully clear what constitutes an 'offsetting' transaction.[103]

4.6.3 Disclosure

According to the SEC, every registered fund that uses leveraged transactions and derivatives should disclose its investment trading strategies and how it segregates the amount of assets in order to avoid issues under Article 18 of the 1940 Act and to comply with Article 8(b)(1) of the 1940 Act. This article requires for general disclosure of a fund's issuance of senior securities and borrowings to the SEC.[104] In addition, it has written a letter on the issue providing registered funds with 'immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them'.[105] However, with respect to open-end registered funds, it can be noted that the document generally used for these disclosures (Form N-1A) does not call for such disclosures.[106] In this context, it can be noted that, in 2011, the SEC issued a concept release to seek public comment on a wide range of issues raised by the use of derivatives by funds regulated under 1940 Act.[107] The results of the consultation may be reason for the SEC to change the regulatory environment regarding the use of derivatives for registered funds by adopting more derivative disclosure rules, but also restricting the use of such instruments, and/or limiting the amount of economic exposure created by a fund's investment in derivative.[108]

price than the strike price of the original put). *Ibid.*, 9. The no-action letter can be found at SEC's website: http://www.sec.gov/.

103. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 19 (stating that the SEC did not address matters as 'pegged currencies, substantially correlated offsetting positions, different counterparties, and the like').
104. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25132 & n. 18.
105. SEC, *Letter from Barry D. Miller, Associate Director, Office of Legal Disclosure, SEC, to Karrie McMillan, Esq., General Counsel of the ICI: Derivatives-Related Disclosures by Investment Companies* 1 (30 Jul. 2010). The letter can be found at SEC's website: http://www.sec.gov/.
106. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 15, n. 27. Instructions 1 of Item 9 of Form N-1A only requires the disclosure of 'any policy, practice, or technique used by the Fund to achieve its investment objectives' and Item 9(c) requires the fund to '[d]isclose the principal risks of investing in the Fund, including the risks to which the Fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, or total return').
107. SEC, Concept Release – *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Release No. IC-29776, 31 Aug. 2011.
108. In fact, according to the Wall Street Journal of 7 Sep. 2014, the SEC is already preparing new rules that :(1) limits the use of derivatives by registered funds that sell shares to small investors, (2) requires internal policies and procedures for risks exposed by the use of derivatives, (3) enhances derivative disclosures, (4) mandates that funds have a resolution plan and (4) imposes enhanced stress-testing requirements. A. Ackerman, *SEC Preps Mutual Fund Rules*, The Wall Street Journal (7 Sep. 2014).

4.7 INVESTOR MEETINGS

Investor meetings are often not held by funds established in the US.[109] US law does provide for rules requiring funds to hold an investor meeting, but this requirement is subject to a number of limitations.

4.7.1 Elimination of Investor Meetings

Firstly, it can be noted that most US funds can eliminate the possibility of an investor meeting or may choose to not establish such meetings in their governing instruments.[110] However, Article 16(a) of the 1940 Act requires US registered funds to hold an annual meeting in two-third of the director elections.[111] Besides this, only funds listed on a US stock exchange, such as the NYSE, and Delaware corporate funds are required to hold annual meetings.[112] However, in the case of Delaware corporate funds, it is only required to hold a meeting when a director is elected, which is generally either once a year or often even less, depending on whether or not the fund is subject to the 1940 Act, has implemented the 'two-third' federal law provision in its charter and has more than three classes of directors. With respect to Delaware corporations, it is furthermore provided that the failure to hold an annual meeting does not affect otherwise valid corporate action or causes a forfeiture or dissolution of the corporation.[113] Thus, unless an investor meeting must be held on the basis of federal law or stock exchange rules, the board of directors of a Delaware corporate fund may have little incentive to hold an annual meeting. Next to annual meetings, a fund may also hold a special, or extraordinary, meeting. In Delaware and Maryland, investors are

109. *See*, e.g., J.A. Haslem, *Mutual Funds: Risk and Performance Analysis for Decision Making* 69 (Blackwell Publishing 2003) (stating that only few mutual funds hold shareholders meetings) and Jones, More & Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 453 (stating that 'after 1974 investment companies in trust form commonly omit the requirement to hold an annual meeting').
110. Article 2-105(b)(1) of the Maryland Corporate Code, Maryland Corporations and Associations Code Ann. § 1-101 et seq. (noting that for corporations registered under the 1940 Act an annual meeting is not required, except for the case that a director is to be elected), Articles 1 and 2 of the Massachusetts Voluntary Association Statute (codified in Ch. 182 of the Massachusetts General Laws Ann.) (providing that an annual meeting must only be held if it is required by trust agreement, or any amendment thereof), Article 3806(b)(5) DBTA (stating that the governing instrument may, but is not required to, set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on) and Article 17–302(c) of the Delaware Revised Uniform Limited Partnership Act (DRULPA), Del. Code Ann. tit. 6, § 17–101 et seq. (*ibid.*).
111. Article 16(a) of the 1940 Act ('No person shall serve as a director of a registered investment company unless elected (…) by the holders of the outstanding voting securities (…), at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in anywise legal manner if immediately after filling such vacancies at least two-third of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities at an annual or special meeting').
112. Article 302.00 of the NYSE Listed Company Manual and Article 211(b) DGCL. The manual can be found at NYSE's website: http://www.nyse.com/.
113. Article 211(c) DGCL.

permitted to call for a special meeting, but that right is often limited or eliminated by the fund.[114]

It appears that, in most cases, fund directors can thus quite easily avoid difficult questions and attempts of investors to overrule a prior decision or to be otherwise critical towards directors by not holding investor meetings. However, in this respect, it is important to note that even if a meeting is held, investors are often unable or unwilling to attend. Meetings may be held at places that are inconvenient for investors to attend or they are held at too short notice.[115] As generally known, attendance is also often low when no investor or group is able to exercise effective control over the management, which is the case when shares are widely dispersed among many small (retail) investors. Furthermore, when shares are held in the name of an intermediary, not the investors but the intermediary, as the record holder of the shares, has the authority to attend (and to vote at) meetings, although it generally solicits voting instructions from the underlying investors.[116] In addition, it can be noted that institutional investors are often not interested in attending investor meetings at all since they generally exercises influence on the fund's management through an investment committee or green lighting committee.[117]

114. Article 2-502(b) of the Maryland Corporate Code (stating that only a shareholder or group of shareholders representing 25% of the votes can call a special meeting, which threshold can be raised in the articles to maximum 50%) and 211(d) DGCL (noting that a special meeting can only be called by any person or group of persons if they are authorized to do so in the certificate or bylaws). *See also* R. Daines & M. Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. Econ. & Org. 96 (2001) (stating that approximately 24% of the sample corporations at the time of the IPO stage prohibit shareholders from calling a special meeting and that even when shareholders are permitted to call such a meeting, specified percentage of outstanding shares are usually needed to do so).
115. Only corporate funds are required by law to provide a written notice not less than ten (in Delaware) or thirteen days (in Maryland) and not more than sixty days before the date of the meeting. *See* Article 222(b) DGCL and 2-511(c)(i) of the Maryland Corporate Code. Other types of US funds should set forth procedures relating to the notice of a meeting in their fund agreement. If no such procedures are included in the fund agreement, there is no requirements on full and timely notice of annual/special meetings.
116. The voting rights of bank nominees are typically restricted by contractual arrangements with their clients and NYSE-registered brokers that act as nominees for their client only have 'discretionary' authority to vote at an annual meeting of US public companies if the following two conditions are met: (i) the subject matter of the vote has been deemed 'routine' by the NYSE, and (ii) the broker has not received voting instructions by the tenth day preceding the meeting date (rule 452 and Article 402.08 of the NYSE Listed Company Manual). Examples of non-routine matters include any contested proposal, merger proposals, the issuance of shares exceeding more than 5% of the outstanding shares and any proposal to materially amend an investment management contract between a fund manager and an investment company (Article 402.08(B) of the NYSE Listed Company Manual and Supplementary Material 1.1 to rule 452). *See also* generally A.L. Goodman & J.F. Olson (eds.), *A Practical Guide to SEC Proxy and Compensation Rules* 10-8 – 10-10 (4th ed., Aspen Law & Business 2007). Noteworthy in this respect is a recent amendment to rule 452, which became effective on 1 Jan. 2010, making uncontested director elections also non-routine matters under the rule, although elections at registered investment companies are explicitly exempted from the rule.
117. The 1940 Act does not impose requirements on the composition of any board committee. In the case of an audit committee, however, registered funds typically maintain an committee consisting of solely independent directors in compliance with rule 32a-4 of the 1940 Act in order to avoid shareholder ratification of a fund's independent accountant under rule 32a-2 of the 1940 Act.

4.7.2 Voting Obstacles

Secondly, when an investor meeting is held and a (retail) investor *does* attend the meeting, he will often be faced with a number of obstacles to voting. With respect to the election of directors, the general rule under US law is that investors of registered funds are entitled to elect their directors in accordance with Article 16 of the 1940 Act.[118] However, in the US, directors of corporate funds, whether registered or not, are generally elected by a plurality shareholder vote. A plurality shareholder vote means that nominees for available directorships who receive the highest number of affirmative votes are elected irrespective of how small the number of affirmative votes is in comparison to the total number of shares voted (i.e., all affirmative votes and withholding votes).[119]

Under this voting system, shareholders cannot vote against a director nominee. This means that in case of an uncontested election (only one nominee), they may only vote for a nominee or withhold, which only has a symbolic effect. As an extreme example, a nominee could be elected as a director with one affirmative vote and several million withholding votes and abstentions. Investors in US funds that are publicly held companies under the 1934 Act, usually registered funds,[120] can, however, nominate their own director nominees. However, they may only do so through proxy contests in which an investor must, at its own expenses, prepare, file with the SEC and disseminate its own proxy statement to solicit votes.[121] In practice, the fund's independent directors or its nominating committee, which typically also consists of solely independent directors, selects and nominates new directors.[122]

Other obstacles derived from US corporate law related to directors include the common use of staggered boards (i.e., a board that is made up of different classes of directors which are elected at different times for multiple years),[123] the inability to

118. Article 16 of the 1940 Act provides that 'no person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding securities of such company'.
119. Article 216(1) DGCL and Article 2-404(d) of the Maryland Corporate Code. The plurality vote-rule can be changed by charter (in Maryland) or bylaw (in both Maryland and Delaware) amendment, but it is very difficult for an investor to pass such an amendment. *See* notes 127-129 and accompanying text, *infra*.
120. Publicly held companies are companies (including LPs and business trusts) that are required by the 1934 Act to register their shares because of an offering to the public as described in the 1933 Act. In general, unregistered funds make use of the private offering exemption provided in the 1933 Act and are therefore not deemed to be 'public funds'. *See also* section 4.3.
121. *See* rule 14a-1 to 14b-2 of the of the 1934 Act. Under the SEC's adopted rule 14a-11 of the 1934 Act, shareholders who have owned at least 3% of the company's voting power for at least three years and who do not have a control intent would be allowed to include director nominees in the company's proxy statement unless they are prohibited from doing so by either state law or the company's governing documents. However, the rule was vacated by the District Court of Colombia in 2011. *See Business Roundtable et al v. Securities and Exchange Commission*, 647 F.3d 1144 (D.C. Cir. 2011).
122. Most fund groups do not have a formal nominating committee, but the independent directors perform the same function. *See* Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 4-30.2.
123. Board members of a staggered board are usually appointed for a period of three years. Under Article 16(a) of the 1940 Act, a fund is allowed to have a maximum of five classes, provided that

remove directors except for cause,[124] and difficulty to submit items to the agenda, including the item whether or not to remove directors.[125] When comparing registered with unregistered US funds, it can be noted that in an unregistered LP or trust fund, directors are not appointed by the investors or subject to replacement by them, except in extraordinary circumstances.[126] Thus, investors' involvement into the board composition of these funds will even be lower than in the case of registered funds (and unregistered corporate funds).

In addition to the right to elect or remove directors, the right to vote on fundamental matters, such as mergers and charter amendments, is also limited. Generally, investors are not able to propose fund transactions or charter amendments themselves, or to modify those proposed by directors, but can only vote in favour or against amendments proposed by the directors.[127] Investors in corporate funds however do usually have the right to amend the bylaws of the corporation, but the value

at least one class expires each year. Most funds with staggered boards however have three classes. *See* Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 12–44. If the number of directors is evenly divided among the classes, it will thus take at least two annual meetings before a majority investor could remove the majority of directors.

124. Article 141(k)(1)and 141(d) DGCL. This feature is common among Delaware corporations, including corporate funds, and effectively prevents shareholders to remove directors during their term.

125. Delaware's and Maryland's corporate statutes do not provide for a right for shareholders to place items on the agenda. However, under rule 14a-8 of the 1934 Act, shareholders in US public companies, who have at least 1% of the shares or USD 2,000 in market value for at least one year may submit proposals to the company requesting that items be put to a shareholder vote at the company's next annual or special meeting. However, in addition to the thresholds that must be met, the shareholder proposal rule permits a number of exclusions, such as the 'ordinary business exclusion', allowing the exclusion of proposals that deal with day-to-day matters and the 'election exclusion', permitting a corporation to exclude a proposal from its proxy statement if 'the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election'. *See* rule 14a-8(i)(7) and (8). In 2009, the SEC's proposed amendments to rule 14a-8(i)(8), which would narrow the election exclusion and require a company to include a proposal to amend its governing documents regarding nomination procedures or election disclosure provisions if submitted by a certain, qualifying shareholder (see for the proposed rule http://www.sec.gov/rules/proposed/2009/33-9046.pdf, accessed 29 Sep. 2014).

126. Article 3303(a) of the Delaware Code provides that a fiduciary is subject to removal by a court of competent jurisdiction for wilful misconduct, which is defined as 'intentional wrongdoing, not mere negligence, gross negligence or recklessness'.

127. Generally, fundamental corporate changes, such as mergers and similar transactions and charter amendments must be proposed by the directors. *See* with respect to Delaware and Maryland corporate funds, 251(b), (c) (mergers), 271(a) (sale of substantially all assets), 275(a) (dissolution), 242(b)(1) (charter amendments) DGCL and 3-105(b) (mergers and transfer of assets), 3-403(b) (dissolution), and 2-602(a) (charter amendments) of the Maryland Corporate Code. Investors may be able to put an agenda item up for voting proposing a charter amendment or fundamental change, but such a proposal is only a non-binding suggestion to the board. *See* rule 14a-8(i)(1) note to paragraph of the 1934 Act and n. 125, *supra*. A Delaware corporate fund may amend its certificate of incorporation without submitting such amendments to its shareholders for approval (unless otherwise expressly required by its certificate of incorporation) to: (1) change its name, (2) delete historical references to its incorporator, initial board of directors or initial subscriber for shares, or (3) delete provisions in any amendment to its certificate of incorporation effecting a change, exchange, reclassification, subdivision, combination or cancellation of stock if such change, exchange, reclassification, subdivision, combination or cancellation has become effective. *See* Article 242(a) DGCL.

and effect of such an amendment is highly questionable[128] and directors may have a concurrent (or even exclusive) power to do so.[129] In addition, a quorum of shareholders that must be represented at an annual meeting in order to make a valid decision may be required.[130]

With regard to fundamental transactions, it can furthermore be noted that not all transactions can be voted on by investors. So do investors in Delaware corporate funds, for example, not have the opportunity to vote on asset purchases and funds organized as business trusts are generally not required to receive investor approval before being acquired by another fund. However, with respect to the latter, it can be noted that in case of a merger between registered funds, rule 17a-8(a)(3) of the 1940 Act provides that the investors of the acquired fund have the opportunity to vote on the merger.[131] In connection with this, unless federal law thus provides otherwise, the voting rights of investors or a particular class or group of investors may even be totally eliminated with respect to any matter related to the fund (including the election of directors). This possibility is not just restricted to corporate funds: LP and business trust fund

128. For example, in *C.A., Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. Supr. 2008), the Delaware Supreme Court found that the proposed bylaw amendment that would compel the corporation to reimburse a shareholder, or group of shareholders, for reasonable expenses incurred in a proxy contest adopted by the shareholders of C.A., Inc., 'would violate the prohibition, which our decisions have derived from Article 141(a) [of the DGCL], against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders' (*ibid*., 240). As a result of this decision, some academics and practitioners have concluded that a proposed shareholder bylaw amendment will be invalid if it attempts to curb the substantive power of the board. *See*, among others, R.B. Thompson*, Delaware's Disclosure: Moving the Line on Federal-State Corporate Regulation*, 1 U. Ill. L. Rev. 188–189 (2009), J. Antignani, *Note: Delaware to the Rescue: A Proper Exercise of Deference by the SEC and the Future Implications of CA, Inc. v. AFSCME*, 3 Brook. J. Corp. Fin. & Comm. L. 431 (2009). This also follows from Article 109(a) DGCL, which states that the bylaws cannot be inconsistent with the law or the charter and rule 14a-8(i)(1) note to paragraph of the 1934 Act, permitting the company to exclude a shareholder proposal, e.g., a proposal to amend bylaws, if it 'is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization'.
129. Articles 109(a) DGCL (charter may confer power to amend bylaws on directors) and 2-109(b) of the Maryland Corporate Code (power to amend bylaws is provided to the shareholders, unless the charter or bylaws reserve this right to the directors).
130. Article 216 DGCL (charter may specify the number of voting shares that must be represented at a meeting in order to constitute a quorum. In no event, however, may a quorum consist of less than one-third of the shares outstanding) and 2-506(2) and (3) of the Maryland Corporate Code (charter may consist a quorum 'to approve any matter which properly comes before the meeting', which 'may not be less than one-third of the votes entitled to be cast at the meeting').
131. Investor approval is however not required in case: (1) the investment policy of the acquired fund that under Article 13 of the 1940 Act could not be changed without a vote of a majority of outstanding voting securities is not materially different from the policy of the acquiring fund, (2) the management contract is not materially different, (3) the acquired fund's independent directors who are elected by the investors comprise the majority of the independent directors of the acquiring fund, and (4) any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the acquiring fund in accordance with rule 12b-1 are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the acquired fund pursuant to such a plan.

structures may also have non-voting shares.[132] In addition, under US state law, the board of a US fund (irrespective of its legal structure) is generally allowed to set a record date.[133] This may further restrict the number of fund investors who are able to vote at the meeting.

4.7.3 Electronic Voting

In addition to the voting obstacles mentioned above, it can be that that if the investor lives in a state other than the state where the shareholder meeting is held or abroad (as is the case for EU investors), it may be difficult, if not impossible, to physically attend the meeting. Electronic voting is more convenient and could solve many practical issues for investors.

Investors in Delaware/Maryland corporate funds are permitted to vote by mail, e-mail or any other means of remote communication. However, this is at the sole discretion of the board of directors.[134] In a similar way are corporate virtual meetings regulated.[135] Limited partner meetings of Delaware LP funds can also be held online and voting in such meetings occurs electronically if the partnership agreement is silent on this issue.[136] However, when a limited partners meeting is held at a physical location, it is not possible to vote by electronic means, unless the partnership agreement provides otherwise.[137] Similar rules apply to funds organized as Delaware and Massachusetts business trusts.[138]

In addition to electronic voting and virtual meetings, proxy voting may also be possible. This allows investors to vote in the meetings of US funds through someone else without having to physically attend the meeting. However, heavy federal proxy regulation applying to registered funds has made it considerably difficult and expensive for (large) investors of such funds or other proxy entities to solicit votes from other

132. Article 302(a) DRULPA ('A partnership agreement may provide for classes or groups of limited partners having such relative rights, powers and duties as the partnership agreement may provide') and Article 3805(4) DBTA (providing that the trust instrument '[m]ay grant to [or withhold from] all or certain trustees or beneficial owners, or a specified class, group or series of trustees or beneficial owners, the right to vote').
133. Articles 213(a) DGCL, 2-511(a) of the Maryland Corporate Code, 17-405(a) DRULPA and 3806(5) DBTA. The board of a corporate fund established in Delaware or Maryland cannot require shares to be held more than sixty days before the meeting and the record date can also not be set less than ten (in Delaware) or thirteen (in Maryland) days before the meeting.
134. Articles 211(a)(2) DGCL and 2-502.1(a) of the Maryland Corporate Code.
135. Articles 211(a)(1) DGCL (2002) and 2-503(b) of the Maryland Corporate Code (2003).
136. Article 302(e) DRULPA ('Unless otherwise provided in a partnership agreement, meetings of limited partners may be held by means of conference telephone or other communications equipment').
137. Article 302(e) DRULPA ('Unless otherwise provided in a partnership agreement, on any matter that is to be voted on by limited partners, the limited partners may vote in person or by proxy, and such proxy may be granted in writing, by means of electronic transmission or as otherwise permitted by applicable law').
138. Article 3806(f) and 3806(f)(2) DBTA and the Massachusetts Voluntary Association Statute (statute does not state any requirement to hold physical annual meetings or to vote physically).

investors for an annual or special meeting, which may have resulted in investors either voting in line with the fund's management recommendations or not voting at all.[139]

The above shows that electronic/online voting and/or via proxy is allowed under US law, but that these ways of voting are, at this moment, far from ideal. The fact that it is up to the fund's directors to decide whether or not to allow electronic voting or to switch to a virtual meeting undermines the involvement of investors in this. With respect to virtual meetings, there are also some concerns regarding the safeguarding of investor rights. So may investors not be able to communicate with each other during the meeting and there are no guarantees that their questions will be answered.[140] But more importantly than this, virtual meetings in general appear to be lacking popularity.[141] As a result of all this, most (EU and non-EU) investors in US funds are likely to be currently unable to vote electronically or to attend (and vote at) online meetings. With respect to proxy voting in a registered fund, it can be noted that although this is generally allowed, there are regulations that may hinder it.

4.8 TRANSPARENCY AND DISCLOSURE RULES

Transparency and disclosure requirements imposed on US funds can have their basis in both state and federal law. As for state law, Delaware corporate law for example provides investors in corporate funds with the right to inspect the fund's books and records.[142] A similar inspection right is usually available to limited partners in a LP fund and investors in Maryland funds and trust funds.[143] However, this right is generally very limited and often even non-existent as investor must comply with several statutory requirements impeding the effectiveness of this right.[144] Nevertheless,

139. J. Velasco, *Taking Shareholder Rights Seriously*, 41 UC Davis Law Review 615–616 (2007). The main obstacle related to proxy solicitation is preparing the necessary proxy materials relating to registered shares in accordance with the requirements specified in Schedule 14A to Regulation 14A of the 1934 Act. Other than investors, the management of a fund can use the company's resources to cover these costs. As of July 2007, however, soliciting persons can furnish proxy materials to shareholders by posting them online (see 17 CFR Parts 240, 249 and 274 available at http://www.sec.gov/rules/final/2007/34-55146.pdf, accessed 29 Sep. 2014). Although this rule eliminated the printing and delivery costs of the proxy materials, it has not eliminated the significant preparation and campaigning costs.
140. Van der Krans, *The Virtual Shareholders Meeting: How to Make it Work?*, 35.
141. *Ibid.*, 34 and E. Boros, *Virtual Shareholder Meetings*, 8 Duke L. & Tech. Rev. 7 (2004).
142. Article 220 DGCL. This article provides that a shareholder may inspection (and copy) a corporation's share ledger, a list of its stockholders, and its 'other books and records', including its subsidiary's books and records, so long as: (a) the parent corporation has possession and control of the records sought, or (b) the parent could obtain them through the exercise of control over the subsidiary – at least when the subsidiary has no legal right to deny its parent access to its records.
143. Articles 3819 DBTA, 17-305 DRULPA, and 2-512 and 2-513 of the Maryland Corporate Code.
144. For example, Delaware's corporate statute requires that a demand is made in writing, under oath, and directed to the corporation's registered office in Delaware or to its principal place of business. Furthermore, an investor making a demand must specify the documents sought and state the purpose of his demand, which must reasonably related to his interests as a shareholder. An investor must also make sure that the documents requested are appropriate to meet the stated purpose of the inspection. To this end, the investor must provide sufficient evidence of a credible basis that actual mismanagement or wrongdoing has occurred. *See*

federal law already requires a large amount of information to be provided to investors, regardless of whether the fund is registered or not. Furthermore, fund managers are also subject to certain disclosure rules.

Disclosure Requirements for US Registered Funds

In the pre-contractual phase, US registered funds are required to publish either a statutory or summary prospectus under the 1933 Act and 1940 Act.[145] The statutory prospectus is supplemented by the Statement of Additional Information (SAI), and both documents are part of a registration form with the SEC under the registration requirements of the 1933 and 1940 Act (usually Form N-1A).[146] If the fund is an open-end fund that chooses to rely on rule 498 of the 1933 Act, a shorter, simple version summary prospectus would suffice.[147] Ongoing disclosures that US registered funds should make to investors include annual, half-yearly, quarterly reports, and the publication of the fund's NAV.

Disclosure Requirements for US Unregistered Funds

Unregistered funds relying on the private offering exemption of Article 4(2) of the 1933 Act are not required to publish a statutory or summary prospectus and periodic reports, but must still provide investors with relevant information based on the *SEC v. Ralston Purina Co*. case in order to be exempt from Article 5 of the 1933 Act.[148] According to US Supreme Court, disclosure of information should be the 'kind of information that the [1933] [A]ct would make available in the form of a registration statement'.[149] Funds relying on the safe harbour provision provided in Regulation D of the 1933 Act must deliver the same kind of information to non-accredited investors as would be required in a statutory prospectus under the registration form that the fund would be entitled to use in case of registration under the 1933 Act, to the extent material to the investor.[150]

Article 220(b) DGCL and *City of Westland Police and Fire Retirement System v. Axcelis Technologies, Inc.*, WL 3086537, 4 (Del. Ch. 2009). Furthermore, in a Maryland corporation, only an investor (or group of investors) holding 5% of the outstanding securities of the corporation for six months has a statutory right to inspect the books and records of the corporation, including the share ledger. *See* Article 2-513(a) of the Maryland Corporate Code.

145. Article 5(a) of the 1933 Act and Article 8(a) of the 1940 Act.
146. The SEC has designated Form N-1A as the form of registration statement for open-end funds that are required to register under the 1933 and 1940 Act. *See* Form N-1A, General Instruction B.1. Closed-end registered funds must file Form N-2, which to a large extent requires similar information to be provided. Form N-2 can be found at the SEC's website: http://www.sec.gov/.
147. Rule 498(b) of the 1933 Act permits open-end funds to satisfy their prospectus delivery obligations under the 1933 Act by sending or giving key information directly to investors in the form of a summary prospectus.
148. 346 U.S. 119 (8th Circ. 1953).
149. *Ibid.*, 125–126. Furthermore, in absence of proof that an investor has access to such information, the issuer must, according to the US Supreme Court, provide the 'full and fair disclosure' afforded by registration with the SEC and deliver a statutory prospectus containing information necessary to enable potential investors to make an informed investment decision. *Ibid.*, 124.
150. Rule 502(b)(1), (2)(A) and (B) of the 1933 Act.

The information provided by such funds to accredited investors is unclear.[151] However, in practice, most unregistered funds will provide investors with at least the same information as provided by the statutory prospectus as it is commonplace for such funds to disclose their investment policies and goals, subscription and redemption policies, conflict of interests, and other information to investors that is material to their decisions to invest.[152] In any case, a fund that is subject to Regulation D would be wise to disclose all relevant information to potential investors to avoid potential fiduciary liability under state law (as discussed in section 4.9). Finally, unregistered funds are not required to publish their NAV, although they usually will do so on a regular basis.

Disclosure Requirements for US Fund Managers

US registered funds managers have to disclose various information to the funds they manage containing all the information included in Part 2 of Form ADV, the registration form used to register with the SEC.[153] This information should thus only be disclosed to the fund itself, not the investors in the fund.[154] However, Form ADV is published on SEC's website, as a result of which investors can access the information if they actively seek for it.[155] Furthermore, fund managers that manage or trade 'commodity pools' and are required to register as Commodity Pool Operators (CPO) or Commodity Trading Advisors (CTAs) must deliver to investors a disclosure document.[156] This document contains information about, among other things, the risks of the commodity pool, fees and expenses, actual or potential conflicts of interest, and information on the assets and past performance of the pool.[157] However, most CPO's and CTA's are exempted

151. SEC, Interpretive Release on Regulation D, Release No. 33-6455, 3 Mar. 1983, n. 26. Rather, the regulation provides that in certain instances the exemptions from registration will not be conditioned on a particular content, format or method of disclosure. Regulation D however does require a fund to provide investors with the exhibits required to be filed with the registration statement, among which include the fund's articles or certificate of incorporation and bylaws and management agreements. *See* rule 502(b)(2)(iii) of the 1933 Act and Form N-1A, Item 28. Funds that make an offering to accredited investors must also deliver to those investors the financial statements that would be required in a registration statement filed with the SEC under the 1933 Act. *See* rule 502(b)(2)(i)(B)(3). Non-accredited investors must be provided with certain financial statements under rule 502(b)(2)(i)(B)(1) and (2) of the 1933 Act.
152. Hammer et al., *U.S. Regulation of Hedge Funds*, 161 (stating that '[h]edge funds ordinarily should satisfy this requirement by providing each offeree with a private offering memorandum that discloses the required information').
153. Rule 204-3 of the Advisers Act. The information is not required to be delivered to, among others, clients who are registered funds or business development companies and the management contract meets the requirements of Article 15(c) of the 1940 Act (requiring the management contract with the fund to be approved by the majority of independent directors). *See* rule 204-3(b)(2).
154. According to the SEC, a 'client' in the case of a hedge fund, private equity fund or other (private or non-private) investment fund is the fund itself and not the ultimate investors. SEC, Final Rule: Amendments to Form ADV, 47, Release No. IA-3060, 28 Jul. 2010, n. 192 (referring to the Goldstein-case, in which the Court of Appeals for the D.C. Circuit stated that the 'client' of an fund manager managing a hedge fund is the fund itself, not an investor in the fund).
155. SEC, Final Rule: Amendments to Form ADV, 25, n. 90.
156. A pooled investment fund is a commodity pool under the CEA if it trades or invests in commodity interests, including, among other instruments, futures contracts and commodity options. *See* Article 4.10(d) of the Commodity Exchange Act, 7 U.S.C. §§1, et seq. (CEA).
157. Article 4.24 and 4.25 of the CEA.

from registration or provided with partial relief from certain disclosure requirements, including the disclosure document for investors, provided that the commodity pool is offered only to 'qualified eligible participants'.[158]

Timing and Method(s) of Delivery

Both the statutory and summary prospectus must be delivered directly to investors at or before the carrying or delivery of the fund's shares. As 1933 Act does not require delivery of a prospectus until the 'carrying or delivery' of the purchased security, this may occur after the sale. As a result, while technically classified as pre-contractual information, investors may receive (and read) the information post-sale. The statutory prospectus must be delivered in paper or electronically with investors' consent and the summary prospectus should be published on the fund's website and provided to investors electronically upon request.[159] In this respect, it can be referred to rule 159 of the 1933 Act. This rule imposes liability on them for losses suffered by investors, if, at the time of the sale, the information investors had received included either untrue statements of a material fact or omitted to state material facts necessary in order to make the statements made not misleading at the time of sale. This means that a prospectus which is provided to the investor at the time of sale that includes modifications, amendments or corrections to the information that was previously available, will not be considered for determining whether the issuer or other offering participant is subject to liability under the 1933 Act. Accordingly, all material information will have to be available to an investor before the time of sale. However, despite the fact that this rule is technically applicable to (corporate) funds, both the sector and the SEC has not applied it to the sale of fund shares.[160] Consequently, point-of-sale delivery of a fund's (statutory or summary) prospectus remains sufficient to meet the prospectus delivery requirements under the 1933 Act. However, it can be noted that liability may arise from fiduciary law (see section 4.9). As a result, most funds will

158. Articles 4.14(a)(8)(i)(D) and 4.7(b)(1) of the CEA. Article 4.13(a)(3) of the CEA generally provides for exemption from CPO registration if the interests in the commodity pool are exempt from registration under the 1933 Act and are offered only to qualified eligible participants which include qualified purchasers as defined under the 1940 Act, accredited investors or knowledgeable employees, and the commodity pool's aggregate initial margin and premiums attributable to commodity interests do not exceed 5% of the liquidation value of the commodity pool's portfolio.
159. Rule 498(e) and (3) of the 1933 Act (summary prospectus). With respect to the statutory prospectus, SEC guidance typically requires affirmative consent from individual investors, to send or give a prospectus by electronic means. Online delivery via the fund's website may be, according to the SEC, allowed under certain circumstances, for example if explicit consent is given that also covers the specific electronic medium or media (e.g., Internet website, PDF or other programme necessary to download the prospectus) that may be used for delivery. *See* SEC Interpretation – Use of Electronic Media, No. 33-7856, 28 Apr. 2000.
160. M.A. Bancroft, *One Act and Two Scenes: The Securities Act and Delivery of Mutual Fund Prospectuses*, 17 Inv. Law. 3 & n. 5 (2010). Article 913 of the Dodd-Frank Act authorized the SEC to require pre-sale disclosure by brokers and other financial intermediaries to retail investors regarding the investment objectives, strategies, risks, costs and any compensation received by them with respect to any investment the intermediary recommends, including mutual fund shares. As of the date of the manuscript of this book, the SEC has requested comments on pre-sale disclosures to investors but has not yet proposed any rules.

provide the information in time to information and, in case of a summary prospectus, point out to investors where to find it on their website.

Annual and half-yearly reports should be transmitted to investors within sixty days after the end of the fiscal period for which the report is being prepared.[161] Quarterly reports should be transmitted within sixty days of the end of the first and the third quarter.[162] All periodic reports must be filed with the SEC within ten days after the transmission date.[163] Furthermore, the most recent reports should be sent to investors on request (in paper or electronically with investors' consent) or, in case the fund relies on rule 498 of the 1933 Act, published on the fund's website.[164]

In Table 4.1, the key information disclosure requirements of US registered is set out. It shows whether the information should be provided to investors pre-contractually or after the fund's shares are sold, the timing and methods of delivery or publication of this information to (potential) investors. It can be noted that the disclosure requirements applying to fund managers are not included in the tables since they require fund managers to disclosure certain information to the funds, not investors.[165] Furthermore, the disclosure requirements for US unregistered funds are also not included since these funds are not subject to any disclosure requirements under federal statutory law. However, as noted above, they will generally provide investors with similar information as that contained in the statutory prospectus for registered funds to avoid liability based on fiduciary law or in order to comply with Regulation D of the 1933 Act (in case of offerings to non-accredited investors).[166] In addition, they will publish their NAV on their website.

161. Form N-CSR, General Instruction A. Form N-CSR can be found at the SEC's website: http://www.sec.gov/.
162. Form N-Q, General Instruction A, Article 30(e) of the 1940 Act and rules 30e-1 and 30b1-5 of the 1940 Act. Form N-Q can be found at the SEC's website: http://www.sec.gov/.
163. Article 30(b)(2) of the 1940 Act.
164. Articles 5(b) and rules 498(e) and 430(b)(2) of the 1933 Act. Online delivery may also be allowed for fund's not relying on rule 498 of the 1933 Act under certain circumstances. *See* SEC Interpretation – Use of Electronic Media and n. 159, *supra*.
165. *See* n. 154 and accompanying text, *supra*.
166. *See* n. 152, *supra*.

Table 4.1 Information and Delivery Requirements for US Registered Funds

	Statutory Prospectus	*Summary Prospectus*	*SAI*	*Annual Report*	*Half-Yearly and Quarterly Reports*	*NAV Disclosure*
Type of information	Pre-contractual information	Pre-contractual information	Pre-contractual	Ongoing information	Ongoing information	Ongoing information
Timing of delivery or publication	No later than the delivery of the fund's shares.	No later than the delivery of the fund's shares.	Delivery is not required, the SAI is published as part of the registration statement with the SEC.	Annually, no later than sixty days following the end of the financial year.	Semi-annually or quarterly, no later than sixty days following the end of the period to which it relates.	Once a day at the close of the NYSE or, in case of a closed-end fund relying on rule 23c-3 of the 1940 Act, no less frequently than weekly and daily on the five business days preceding a repurchase request deadline.[167]

167. *See* section 2.6.2.

Method(s) of delivery or publication	In paper or electronically with investors' consent and/or provided via intermediaries or, in case the fund relies on rule 498 of the 1933 Act, by sending (by the fund or an intermediary) a direct link to the document on the fund's website.[168]	On the fund's website and electronically upon request and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	No requirements apply. Most funds publish their NAV in the daily newspaper and on their website.

Below, the different pre-contractual and ongoing information requirements will be discussed in more detail.

168. Rule 498(e) the 1933 Act. Access must be free of charge, at the website address specified on the cover page or the beginning of the summary prospectus. The statutory prospectus must be accessible at or before the time that the summary prospectus is sent. The current versions of must remain on the website for at least ninety days after the date that the fund's securities are delivered. However, failure to comply with this rule does not result in a violation of the requirement of delivery of a prospectus to investors under the 1933 Act. Rule 498(f)(5). *See* with respect to the requirement of US intermediaries to send the statutory prospectus to investors, rule 15c2-8(b)-(d) of the 1933 Act.

4.8.1 Pre-contractual Disclosure Requirements

The summary prospectus for open-end registered funds must meet several content requirements, which requires the fund to provide the key information included in Items 2 through 8 of Form N-1A.[169] This key information comprises the following components: a risk/return summary, including information about the fund's investment objectives, strategies, performance, risks and costs (consisting of a fee table, expense illustration example, and the fund's average assets holding period), certain information about the purchase and sale of fund shares and payments to broker-dealers and other financial intermediaries, and tax information.[170] US FoFs must include an additional line in their fee table which shows the fees charged by the funds in which they invest. Feeder funds must include a single fee table in their prospectus for the master fund and state that the fee table and costs example reflect the expenses of both the feeder and master funds.[171] Furthermore, it has been expressly stated by the SEC that the summary prospectus must use clear, jargon-free language (plain English) and that the information is provided in a standardized form.[172] There is furthermore no set requirement related to the length of this prospectus, but the SEC expects it to be 'on the order of three or four pages'.[173]

Similar to a summary prospectus, all information provided in the statutory prospectus must be presented in a 'clear, concise and understandable manner' and must be drafted in compliance with the SEC's plain English writing principles by using,

169. Rule 498(f)(4) of the 1933 Act.
170. Form N-1A, Items 2-8. The summary prospectus must also include on the cover page of the prospectus or at the beginning of the prospectus certain general information about the fund and an exchange ticker symbol. An exchange ticker symbol is a short abbreviation used to identify a particular publicly traded security and is applied as a tool of obtaining information about that security and its movement. Symbols with five letters ending in X are exchange ticker symbols of mutual funds. A mutual fund is also required to include its exchange ticker symbol on the cover pages of the statutory prospectus and SAI. *See* rule 498(b)(1)(ii) of the 1933 Act and items 1(a)(2) and 14(a)(2) of Form N-1A.
171. Form N-1A, Item 8, Instructions 3(f) and 1(d)(i). Fund of funds and feeder funds are not required to disclose specific information about the funds they invest in, but they must describe the strategy to invest in a particular type of security, the risks of those strategies, and the policies and procedures with respect to the disclosure of the fund's portfolio securities, including other funds. *See Ibid.*, Items 4(a) and 16(a).
172. SEC, Enhance Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Release Nos. IC-28584 & 33-8998, 13 Jan. 2009, 14. *See also* Form N-1A, General Instruction B.4.(c) ('The plain English requirements of rule 421 under the Securities Act [17 CFR 230.421] apply to prospectus disclosure in Part A of Form N-1A. The information required by Items 2 through 8 must be provided in plain English under rule 421(d) under the Securities Act'). Rule 421(d)(2) lists the following plain English principles: (1) short sentences, (2) definite, concrete, everyday words, (3) active voice, (4) tabular presentation or bullet lists for complex material, wherever possible, (5) no legal jargon or highly technical business terms, and (6) no multiple negatives.
173. *Ibid.*, 24. For a multi-fund prospectus, this three to four page length guideline applies separately to the summary prospectus for each fund.

for example, short sentences, the active voice and everyday words.[174] The fund's statutory (or summary) prospectus may include pictures, charts or other design into the prospectus, but this design may not be misleading as is the case for all information provided to investors.[175] Besides a 'summary section', which is a comparable equivalent of the summary prospectus discussed above, the statutory prospectus must contain additional information about virtually all aspects included in the summary section and about, among other things, its share distribution arrangements, the pricing procedures, redemption and purchasing of fund shares, financial conditions and capital structure.[176] Both the statutory prospectus and summary prospectus must be current upon first use and updated annually.[177]

The SAI document goes further into detail on the matters discussed in the statutory prospectus. For example, the fund's SAI must describe its conflicts of interest policies and actual material conflicts of the fund manager, allocation policies, its policies with respect to the issuing of senior securities, borrowing of money/leverage (including the purpose for which the money will be used), underwriting securities of other issuers, concentrating investments in a particular industry or group of industries, purchasing or selling real estate or commodities, making loans and any other policy that the fund deems fundamental or that may not be changed without investor approval.[178] Furthermore, the fund must disclose in the SAI the total amount of fees paid for investment management and other services and the structure and method of determining the compensation received by the portfolio manager(s) of the fund, including salary, bonuses, deferred compensation and pension and retirement plans.[179] For each type of management compensation, the SAI must also describe the criteria on which that type of compensation is based. However, the actual amount of fees that are paid out of the fund assets to portfolio managers is not required to be disclosed in the SAI.[180]

Generally, in the SAI, the fund may expand on any information it discloses in the prospectus if it finds the information to be of interest to some investors.[181] However,

174. Form N-1A, General Instruction B.4(c) and rule 421(d)(1) and (2) of the 1933 Act. *See also* n. 172, *supra*.
175. Rule 421(d)(3) of the 1933 Act. *See* n. 185, *infra*.
176. Form N-1A, Items 1-13 and 23.
177. Article 10(a)(3) of the 1933 Act generally requires that when a prospectus is used more than nine months after the effective date of the registration statement, the information in the prospectus must be as of a date not more than sixteen months prior to such use. The effect of this provision is to require mutual funds to update their prospectuses annually to reflect current cost, performance, and other financial information.
178. Form N-1A, Items 16(c), (f), 20(a) and 21.
179. Form N-1A, Items 19 and 20(b).
180. Form N-1A, Item 20(b), Instruction 2. In the statutory prospectus, the fund must outline the compensation of each portfolio manager as a percentage of the fund's average net assets or, if the fee is not based on a percentage of the fund's assets (e.g., a performance-based fee), the basis of the compensation. *See* Item 10(a)(ii).
181. Form N-1A, General Instruction C.2.(b).

duplication of information is prohibited, unless it is necessary to make the SAI comprehensible as a document independent of the prospectus.[182] The third part of the registration statement includes other information which must be filed with the SEC, including the articles of incorporation or trust agreement of the fund and its bylaws, the investment management contract and underwriting and custodian/depository agreements, rule 12b-1 fee plans,[183] and codes of ethics adopted by the fund under rule 17j-1 of the 1940 Act.[184]

All information that a fund discloses to investors in connection with the sale and purchase of its shares, whether contained in the summary or statutory prospectus, the SAI or other information document, must not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[185] Rule 10b-5 of the 1934 Act creates liability for such statements or omissions made by the 'maker' of the prospectus. It must be noted that the fund manager, although often the one who creates the fund and also creator of the fund's information documents, is not liable for misstatements in these documents under US federal law. In 2011, the US Supreme Court rendered in the Janus case that a manager of a fund is not liable for misleading statements in the sponsored fund's prospectus because not the manager, but the fund itself, represented by the board of directors, board of trustees or general partner (which is often also the fund manager), as the one with 'ultimate authority' over the statements and thus the 'maker' of such statements, provided that the fund is considered a separate legal entity.[186] Applying this theory to unregistered funds, which are often LPs or business trusts, it can be concluded that the manager will often not be liable as these entities are considered legal entities, although the

182. *Ibid.*
183. Registered funds are allowed to charge either a monthly or annual flat fee or asset-based fee (i.e., a fee based on the total amount of assets under management) based on rule 12b-1 of the 1940 Act to compensate portfolio managers or other third-party service providers for providing marketing and distribution services to the fund (known as '12b-1 fees'). Any plan entered into by the fund under rule 12b-1 must be disclosed to the SEC. Information about 12b-1 fees is also disclosed in the fund's summary prospectus or summary section. *See* Form N-1A, Item 3.
184. Form N-1A, Item 28. Under rule 17j-1 of the 1940 Act, every registered fund, other than a money market fund or a fund that does not invests in covered securities, and each manager of and principal underwriter for the fund, must adopt a written code of ethics containing provisions reasonably necessary to prevent the directors, officers or other affiliated persons to the fund, manager or principal underwriting from defrauding the fund or from making any untrue statement of a material fact to the fund or omitting to state a material fact or from engaging in any manipulative practice with respect to the fund (see under (b) and (c)). The SAI must provide a brief statement disclosing whether the fund and its manager and principal underwriter have adopted codes of ethics under rule 17j-1 and whether these codes of ethics permit personnel subject to the codes to invest in securities, including securities that may be purchased or held by the fund. *See* Form N-1A, Item 17(e).
185. Article 10(b) of the 1934 Act.
186. *Jones Capital Group, Inc., et al. v. First Derivative Traders*, 564 U.S. –, 131 S. Ct. 2296, at. 5–12 (US Supr. 2011). To 'make' a statement, the Court held, literally means only to actually 'make' a statement – but does not embrace drafting, preparation, or anything else.

Massachusetts business trust may lack legal personality in some state jurisdictions in certain situations.[187]

4.8.2 Ongoing Disclosure Requirements

Ongoing disclosure requirements applicable to US funds include the requirement to provide annual reports. In both Delaware and Maryland, corporate funds are required to submit an annual report to the Secretary of State in connection with the payment of corporate franchise or other taxes.[188] The information included in this report consists of the name and location of the fund and its directors and tax due. More specific information includes the total number of shares and the par value of the shares of a Delaware corporate fund, and, in the case of a corporate fund located in Maryland, the fund's balance sheet and the sources of property owned by the corporation.[189]

In addition to a state report, registered funds are required to file annual, half-yearly, and quarterly reports under the Article 30(b)–30(e) of the 1940 Act and the rules thereunder with the SEC and their investors.[190] Information required in these reports include detailed financial information and information about, among other things, the funds' investment performance, portfolio holdings, total amount of fees and costs and proxy votes for the current reporting period. Furthermore, investors should also be informed about the location of each upcoming shareholder meeting that will be held during the period covered by the periodic reports, including a brief description of the matters voted upon at the meeting.[191] In light of these periodic requirements, it is noteworthy that many funds are also subject to certain audit and reporting requirements that follow from the Sarbanes-Oxley Act of 2002.[192] Although the Act is primarily

187. *See* on the legal status of trust funds section 2.7.3[A].
188. Article 502 DGCL and 11-101 of the Tax Property Article of the Maryland Code.
189. Article 502(a) DGCL and the Maryland Personal Property Form. The Maryland form can be found at http://www.dat.state.md.us/.
190. *See* rules 30b1-1 (semi-annual report for registered management investment companies), 30b1-2 (semi-annual report for totally owned registered management investment company subsidiary of registered management investment company, 30b1-3 (transition reports), 30b1-4 (report of proxy voting record), 30b2-1 (filing of reports to stockholders), 30d-1 (filing of copies of reports to shareholders), and 30e-1 (reports to stockholders of management companies) of the 1940 Act.
191. Rule 30e-1(b) of the 1940 Act. It can however be noted that directors of funds may simply suffice by providing a brief summary of the proposed action, which means that they can leave out many details as regard the specific action subject to approval in the notice. State law also does not provide additional protection to investors in this respect. *See*, e.g., Article 251(c) DGCL (requiring that the notice to shareholders in case of approval of a merger should contain either a copy of the merger agreement or (only) a brief summary thereof). On the other hand, unregistered LP funds are often not required to notice the business to be discussed at, nor the purpose of, any shareholder meeting at all. *See* Article 302(c) DRULPA (providing that the partnership agreement may, but is not required to, provide provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any limited partners).
192. Pub.L. 107-204, 116 Stat. 745, enacted 30 Jul. 2002.

intended to apply to public companies, several of its provisions related to control and reporting also affect registered funds. So requires Article 301 of the Sarbanes-Oxley Act, which amended the 1934 Act, that directors who serve on a public's company's audit committee must be 'independent' and responsible for selecting and overseeing the fund's external independent auditor. However, in practice, this requirement was already implemented by virtually all registered funds in order to comply with rule 32a-4 of the 1940 Act.[193]

Rule 32a-4 of the 1940 Act also requires that a fund's audit committee has the responsibility to oversee the fund's accounting and auditing process. Other duties of the audit committee include, among other things: overseeing, or assisting the board in overseeing, the fund's compliance with laws and regulations relating to accounting and financial reporting, internal controls over financial reporting, and the independent audits, and overseeing the quality and integrity of the fund's financial statements and the independent audits thereof.[194] The Sarbanes Oxley Act furthermore contains two certification requirements in Articles 302 and 906 that apply to registered funds.[195]

Article 302 requires a separate certification requirement for chief executive officer and chief financial officer of public companies. More specifically, these officers must personally certify, to the best of their knowledge, that each periodic report of the company filed under the 1934 Act[196] does not contain any untrue statements of material fact or omit any material facts to make the statements in the report not misleading, and that the financial statements and information in the reports represent in all material respects the financial condition and results of the operation of the company.[197] Article 302 also provides that the officers make certifications as the company's internal controls.[198] The certification of Article 906 is required only in periodic reports that contain financial statements and states that the report fully complies with SEC rules and that it fairly presents the financial condition and results of

193. *See* n. 117, *supra*.
194. Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 4–28.
195. Other provisions of the Sarbanes Oxley Act requiring improved financial disclosures and mandating changes in governance do not apply to investment funds as existing federal securities regulations applying to funds were considered to be already sufficient at the time of the adoption of the Act. *See* H.E. Bines & S. Thel, *Investment Management Law and Regulation* §2.04[A] (Aspen Publishers 2004).
196. In accordance with Article 13(a) or 15(d) of the 1934 Act. Under Articles 13(a) and 15(d) of the 1934 Act, companies with registered publicly held securities on a national securities exchange that are of a certain size and companies that have filed a registration statement under the 1933 Act that has become effective are 'reporting companies' under the 1934 Act meaning that they must disclose continuously by filing annual reports, quarterly reports, and reports when certain events occur. Information in these reports includes information about the company's officers and directors, the company's line of business, audited financial statements, the management discussion and analysis section (in which the company's management discusses the prior year's performance and plans for the next year), and audited financial statements. Mutual funds are required to file their periodic reports on Form N-CSR. *See* rule 30d-1 of the 1940 Act. Form N-CSR can be found at the SEC's website: http://www.sec.gov/.
197. Article 302(a)(2) and (3) of the Sarbanes Oxley Act.
198. Article 302(a)(4) of the Sarbanes Oxley Act.

operations of the company.[199] Both articles have been implemented by the SEC with respect to registered funds in rule 30a-2 of the 1940 Act.[200]

4.9 CONDUCT OF BUSINESS RULES

Under US law, the standards of conduct of business are known as fiduciary duties imposed on fiduciaries when they do business with investors. Historically, the concept of fiduciary duties stems from common law, which can be described as the part of the law that refers to all case law developed by courts.[201] Today, fiduciary duties also arises from state statutory law and, most notably, US securities law. State statutes frequently impose statutory fiduciary standards upon corporate officers and directors, which generally require them to act in good faith and in the best interest of the corporation. These statutes often form the basis of a claim or defence for breach of fiduciary duty. At the federal level, the Advisers Act created a fiduciary standard for fund managers, which is embodied in the overreaching principles derived from the anti-fraud provisions in Article 206 of the Act.[202] This fiduciary duty applies to all managers, whether

199. Since the periodic reports of mutual funds (on Form N-CSR) contain financial statements, both Articles 302 and 906 of the Sarbanes Oxley Act apply. Although the certification statement of Article 906 is almost similar to a part of the 302-statement, there are some (minor) differences. First, where Article 302 requires the separate statement of each officer, Article 906 does not require separate certifications from the officers so that the certifications could be consolidated into a single statement signed by both officers. Second, other than Article 302, Article 906 does not include the qualifying language 'based on the officer's knowledge', although in practice, this phrase will often be included in the 906-certification as well.
200. A CEO or CFO signing a false certification potentially could be subject to an SEC enforcement action for violating Article 13(a) of the 1934 Act and private actions under Article 10(b) of the 1934 Act and rule 10b-5 thereunder. A false certification also may have liability consequences under Articles 11(a) and 12(a)(2) of the 1933 Act where the annual report is incorporated by reference into a registration statement.
201. *See*, e.g., *Roland International Corp. v. Najjar*, 407 A.2d 1032, 1036 (Del. Supr. 1979) (stating that the duty did not arise from the statute, but from 'long-standing principles of equity [which are] superimposed on many sections of the Corporation Law'). The term common law is also often used to indicate the difference between a common law and a civil law legal system (i.e., a system based on the legal precedence of court decisions as opposed to only written, codified law), to describe judge-made laws in the absence of statutory law, and to refer to all law in a broad sense (statutory and case law) in England and the American colonies before the American Revolution. *See also*, e.g., J.H. Merryman, *On the Convergence (and Divergence) of the Civil Law and the Common Law*, 17 Stan. J. Intl. L. 358 (1981) (stating that 'all national legal systems of the Western world are members of two great legal families: the Romanic Civil Law and the English Common Law'), J.S. Kaye, *State Courts at the Dawn of a New Century: Common Law Courts Reading Statutes and Constitutions*, 70 N.Y. L. Rev. 5 (1995) ('The common law is, of course, lawmaking and policymaking by judges'), and F.W. Hall, *The Common Law: An Account of Its Reception in the United States*, 4 Vand. L. Rev 791–825 (1951) (discussing the adoption of English common law in the original American colonies).
202. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (US Supr. 1962) (stating that '[t]he Investment Advisers Act of 1940 […] reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship' (quotation marks omitted)) and *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d. 622, 644 (E.D. Va. 2003) ('§ 206(2) [of the Advisers Act] is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers').

registered or not.[203] In addition, the 1940 Act imposes certain fiduciary duties on managers, directors and other affiliated persons of registered funds. Investors can bring forth a claim for breach of these duties on the basis of Article 36(b) of the 1940 Act, although they can only do so 'with respect to the receipt of compensation for services'.[204] This phrase has been interpreted by courts to mean that the services provided must stand in a reasonable relationship to the compensation paid.[205]

As regards the fiduciary duties derived from the Advisers Act, it is worth noting that there is generally no private right of action.[206] The fiduciary duties thereunder are thus not enforceable by individual investors. The SEC interprets and applies the fiduciary provisions of Article 206 of the Advisers Act and the accompanying rules through enforcement proceedings against individual investment advisers, including fund managers.[207] Other duties imposed on registered fund managers by the Advisers Act, such as requirements relating to registration, disclosure, advertising, the custody of client assets, and duty to adopt a code of ethics, are also enforced by the SEC in case the fund manager in question is registered or otherwise is subject to a particular provision or rule. While investors in registered funds are thus limited in their possibilities to enforce a federal fiduciary duty, they may be able to bring actions

203. The language of Article 206 of the Advisers Act prohibits *any* adviser, thus whether registered or not, to 'engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client'.
204. And such a claim can only be brought by investors derivatively. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (US Supr. 1984) (interpreting the language and legislative history of Article 36(b) of the 1940 Act). In this respect, it can also be noted that investors generally do not have a private right of action under Article 36(a) of the 1940 Act for breach of fiduciary duty against managers for general misconduct as this right appears to be restricted to the SEC. *See Stegall v. Ladner*, 394 F.Supp.2d 358, 371 (D. Mass. 2005) (no private right of action under Article 36(a) for breach of fiduciary duty against managers for misconduct) and *Mutchka v. Harris*, 373 F.Supp.2d 1021, 1026–1027 (C.D. Cal. 2005) (noting that Congress's inclusion of an express right of action for Article 36(b) but not for Article 36(a) 'suggests that omission of an explicit private of right to enforce other rights was intentional' (quotation marks omitted)).
205. *See*, e.g., *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923, 928 (2nd Cir. 1982) (stating that, for purposes of Article 36(b), a plaintiff-shareholder must show that the fund manager charged a fee 'so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining') and *Jones v. Harris Associates*, L.P., No. 08-586 (US Supr. 2010) (affirming the Gartenberg standard).
206. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, at 24 (US Supr. 1979) (holding that 'there exists a limited private remedy under [Article 215(b) of] the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable').
207. *See* for an overview of SEC enforcement actions for breach of Article 206 of the Advisers Act, SEC, *Staff Study on Investment Advisers and Broker-Dealers* 22–46 (January 2011) and for interpretations of article 206 by the SEC, *Ibid*. and SEC No Action Letter, Heitman Capital Management, LLC, 12 Feb. 2007 (SEC provided guidance as to whether the use of a hedge clause, i.e., a contractual provision limiting an fund manager's liability to gross negligence, reckless disregard, wilful misconduct or bad faith, would be a violation of the anti-fraud provisions of Article 206(1) and (2) of the Advisers Act) and SEC, *Interpretation of Section 206(3) of the Investment Advisers Act of 1940* (17 Jul. 1998) The SEC study, no-action letter, and interpretation can be found on SEC's website: http://www.sec.gov/.

against fiduciaries under (statutory or common) state law. Both the 1940 Act and the Advisers Act do not pre-empt this possibility.[208]

In general, state courts accept breach of fiduciary duties claims in case they find that a fiduciary relationship between two or more parties exists. In the case of an investment fund, a fiduciary relationship may exist between the manager and the fund and the internal board and the fund.[209] Below, these different possible fiduciary relationships will be discussed, after which the specific duties that may arise out of these relationships will be described. In examining the scope of the fiduciary duties, I will focus on the duties derived from state law, as a claim for breach of a fiduciary duty is generally based upon this law type. In addition, fiduciary duties have, as mentioned, common (state) law origins and have formed the main source of federal duties. This has been affirmed by the US Supreme Court in the Capital Gain case,[210] in which the Supreme Court stated that a fiduciary relationship originates in the common law of fraud and that Congress was, in enacting the Advisers Act, aware of the developments in this area of law.[211] However, where appropriate, it will be referred to federal obligations imposed by federal law.

4.9.1 The Fiduciary Relationship

In general, a fiduciary relationship is a relationship in which one person has a duty to act for the benefit for another on matters within the scope of the relationship.[212] The two core fiduciary relationships under common law are the agency and trust relationships. An agency relationship is created when one person, the 'principal', agrees that

208. *See* section 1.3.3[D].

209. In addition to fund managers and directors, brokers (i.e., a person or entity in the business of selling or buying securities for the account of others) selling funds may also stand in a fiduciary relationship to their clients and thus owe fiduciary duties to them. Brokers are generally not considered 'fiduciaries' under federal law, but state common law imposes several fiduciary duties on them. *See*, e.g., *Paine Webber, Jackson & Curtis, Inc. v. Adams,* 718 P.2d. 508 (Colo. 1986) and *Duffy v. King Cavalier*, 215 Cal. App.3d 1517 (Cal. App. 1989). As a result of the Dodd-Frank Act, however, the SEC has submitted to Congress a staff study recommending a uniform fiduciary standard of conduct for brokers, similar to the standard currently applied to advisers under the Advisers Act, when those brokers provide personalized investment advice about securities to retail investors. *See* SEC, *Staff Study on Investment Advisers and Broker-Dealers*. If adopted, the fiduciary status of brokers will also be recognized by federal law. In this book, however, the fiduciary duties of brokers will not be discussed separately as they fall outside the scope of this research.

210. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (US Supr. 1962).

211. *Ibid.*, 193–195. The Supreme Court also ruled 'that Congress codified the common law [of fraud in the Advisers Act] "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels' and that, therefore, Congress 'did not intend to require proof of intent to injure and actual injury to the client'. Under common law, some form of intent is generally required, although intent to cause harm is only of importance with respect to punitive damages. In this context, the Supreme Court mentioned that, under common law, 'it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself; it is only necessary that he intend action in reliance on the truth of his misrepresentations'. *See Ibid.*, 192, n. 39.

212. *Burdett v. Miller*, 957 F.2.d 1375, 1381 (7th Cir. 1992).

another person, the 'agent', shall act on his behalf and subject to the his control, and the agent consents so to act.[213] In essence, in an agency relationship, the principal has, expressly or impliedly, authorized the agent to perform activities on his behalf. An agent may not exceed the scope of its authority and must comply with the principal's instructions in connection with the agency contract.[214] A trust relationship is the relationship in which legal title to the property resides in one person, the 'trustee', who has the duty to deal with the property for the benefit of one or more others, the 'beneficiary' or 'beneficiaries'.[215] Thus, a trustee is the legal owner of the trust's property and makes decisions as to what to do with the property, whereas the agent is no legal owner and must perform his activities within the terms of the mandate given by the principal.

With respect to fund managers, either agency or trust law governs the activities of the manager.[216] Looking at the definition of a trustee, it can be concluded that in case the legal title of the fund property is vested with a manager who holds it on behalf of the investors in the fund, the manager can be qualified as a trustee. Under US law, the legal title to the fund's property is held by the individual trustees jointly comprising the trust board in the case of a trust fund, the partnership if the fund is an LP fund or by the corporation in a corporate fund.[217] It is thus not in the hands of the manager of the fund nor the directors individually, the board of directors of a corporate fund or the partners of a LP fund. However, it can be argued that the board of directors of a corporate fund and the general partner of an LP hold the 'equitable title' to the underlying fund, as the only function of the corporation or the partnership is to hold the legal title on behalf of the directors, respectively general partner for the benefit of the investors.[218]

213. Restatement (Third) of Agency, American Law Institute, 2006, § 1.01 ('Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act'). *See also* Restatement (Second) of Agency, American law Institute, 1958, § 1. While Restatements do not have binding authority, courts throughout the US have widely adopted the principals set out in the Restatements into their common law judgments.
214. Van Setten, *The Law of Institutional Investment Management*, 83.
215. Restatement (Third) of Trusts, American Law Institute, 2007, § 2 ('A trust (…) is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee'). *See also* Restatement (Second) of Trust, American Law Institute, 1959, § 2.
216. Bines & Thel, *Investment Management Law and Regulation*, §2.02[A] (stating that '[t]ogether, agency and trust law cover every investment management service for which an investment manager expressly or impliedly has any discretion to act on behalf of and bind a client or beneficiary').
217. Rounds & Dehio, *Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal Structures*, 490. *See also* Article 3805(f) DBTA ('Except to the extent otherwise provided in the governing instrument of the statutory trust, legal title to the property of the statutory trust or any part thereof may be held in the name of any trustee of the statutory trust, in its capacity as such, with the same effect as if such property were held in the name of the statutory trust') and Article 203 of the Uniform Partnership Act (UPA) of 1997 ('Property acquired by a partnership is property of the partnership and not of the partners individually'). The UPA can be found at: http://www.nccusl.org/.
218. *Ibid.*, 493–494 (noting that 'in equity the corporate entity is merely a custodial trustee, as nominee as it were, with each director-trustee having a direct equitable duty to act solely in the

Consequently, the individual directors of a corporate fund and the general partner of a LP fund may be viewed by courts as trustee-like fiduciaries, although they are technically not.

When determining whether or not a fund manager can be qualified as a trustee under common law, a distinction should be made between manager and externally managed funds.[219] In case the fund is internally managed, the manager would function as individual fiduciary trustee of the fund investors in case the fund is organized as a business trust. In case the board of trustees consist of multiple trustees, it is one of the members sitting on the board.[220]

Such an external manager can either operate under a separate management contract or act as a managing trustee, director or general partner of the fund. In the first case, the manager invests on behalf of the fund under the terms and conditions of the management contract between the fund and the manager. In that case, the relationship between the fund and the manager can be qualified as an agency relationship, in which the manager represents the agent and the fund the principal. In the latter situation, i.e., the manager is (one of) the fund's trustee(s), director(s) or general partner(s), the external manager operates on the basis of the trust agreement, the fund's charter and bylaws, or the partnership agreement, which in fact represents the 'management contract' between the manager and the fund. The manager then qualifies as a fiduciary trustee in case he (individually or jointly) holds the legal title to the fund property, which will only be the case when, as mentioned above, he is a trustee board member of a trust fund.[221]

In addition, it can be noted that in case the external manager qualifies as an 'investment adviser' under Article 2(a)(20) of the 1940 Act, which will often be the case,[222] he is required to work under contract pursuant to Article 15 of the 1940 Act, which also dictates several items in connection with the contract.[223] With respect to fiduciary duties, both the manager that operates as an agent and the manager-trustee

interests of the (…) fund investors' and 'that there are actually two trusts: the corporate nominee trust and the directors' trust, with the latter containing beneficial interest in the former').

219. *See also* Ch. 2 for these structures.
220. Registered funds are required to have multiple trustees which together comprise the board of directors of the fund, consisting of both dependent (which can be the manager) and independent director (which cannot be the manager). Such a requirement does not exist for unregistered trust funds, so only these funds can also have one trustee (which can be the manager) on the basis of the 1940 Act.
221. *Ibid.*
222. Article 2(a)(2) of the 1940 Act includes among the definition of an investment adviser, among others, 'any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company'.
223. Article 15(a) of the 1940 Act requires shareholder approval of investment management contract and determines that the contract must prescribe all compensation to be paid under the contract. This article, in combination with Article 15(c), also provides that the contract may continue for more than two years only if it is 'specifically approved at least annually by the board of directors' who are not parties to the contract or interested persons of any such party. Article

are subject to fiduciary duties imposed under state law (in addition to possible federal duties). However, it is important to note that where a manager-trustee owes fiduciary duties directly to the fund investors, an (external) manager-agent generally only owes such duties to the fund (being the direct client of the manager).

As mentioned in the beginning of this paragraph, next to manager, the internal fund board members may also be fiduciaries. Courts have applied the label 'fiduciary' to, among others, directors of corporations, trustees of business trusts and general partners of LPs.[224] These parties are considered to be subject to fiduciary duties in nature as the underlying relationships are referred to as legal fiduciary relationships or fiduciary relationships 'as a matter of law'.[225] As such, these relationships are, similar to an agency/trust relationship, of the 'general'-type. In my view, individual board members of a fund may also qualify as 'trustee' under common law in case they jointly hold the legal title of the fund property, which is the case with respect to the board of trustees of a trust fund.[226] At any rate, the internal board members owe fiduciary duties to the fund investors. These duties include the duty to supervise the external manager.[227]

In line with this, the 1940 Act requires that the independent directors of a registered fund must approve the management contract and other contracts with service providers who may or may not be affiliated with the manager. In this context, it is also provided that the directors of a registered fund have the duty to request, and the manager to provide, any information that may be necessary to evaluate the terms of the contract of the manager.[228] In addition, directors have a number of other duties under federal law related to a fund's operation.[229] Based on the above, it can be

15(a) finally states that the contract must provide a termination clause, which allows the contract to be terminated at any time by either the board of directors or by vote of the majority of shareholders.

224. *See Smith v. Van Gorkom,* 488 A.2d 858, 872 (Del. Supr. 1985) ('In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders'), *Loft, Inc. v. Guth*, 23 Del.Ch. 255, 270, 5 A2d 503 (Del. Supr. 1939) ('While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders'), In re USA Cafes, L.P. Litigation, 600 A.2d 43, 49 (Del. Ch. 1991) ('The theory underlying fiduciary duties is consistent with recognition that a director of a corporate general partner bears such a duty towards the limited partnership'), *Cargill, Inc. v. JWH Special Circumstance*, LLC, 959 A.2d 1096, 1111 (Del. Ch. 2008) ('[U]nless the Trust Agreement or the [Delaware business trust] Act "otherwise provides", existing trust law applies, including default fiduciary duties provided by statute or common law').

225. *Davion v. Williams,* 352 So. 2d 804, 807 (Miss. Supr. 1977).

226. By contrast, the relationship between any type of internal fund board and the fund investors cannot qualify as a relationship of agency, as the specific features of agency, i.e., the complete right of control of the principal over the agent and the duty of the agent to turn over all profits and benefits to the principal, are absent. *See*, e.g., P.D. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 Hous. Bus. & Tax J. 309–310 (2008) (stressing that the existence of the 'agency problem' between shareholders and the board of directors in a corporation 'has led some people to [mistakenly] refer to the shareholders as "principals" and boards as "agents" of the shareholders').

227. Kirsch, *Financial Product Fundamentals: Law – Business – Compliance*, 6–13.

228. Article 15(c) of the 1940 Act.

229. For example, directors have the duty to select the fund's independent accountants, to approve multiple classes of voting stock, to approve mergers within the same fund complex, to approve the fund's plan for distribution, to approve depository arrangements, to approve, and monitor

concluded that both the fund manager and individual the board members of a fund's internal board stand in a fiduciary relationship with either the fund (in case of the external manager) or the fund and its underlying investors (in case of the board members), which gives rise to certain fiduciary duties.

4.9.2 Fiduciary Duties

Although there is no uniform standard to determine which specific duties are encompassed in the term 'fiduciary duties', the two cornerstone duties traditionally applied by US courts are the duty of loyalty and the duty of care.[230] In addition to the duty of loyalty and the duty of care, two other duties have emerged over the past years in common law: the duty of disclosure and the duty of good faith. Although US courts traditionally have recognized these duties as being part of a fiduciary's duties, recent case law suggest that they should be seen as an application of the duties of loyalty and care.[231] For this reason, these subduties will be discussed, where appropriate, within the context of the key duties of loyalty and care.

Before turning to the two duties, the following note can be made. In general, common law duties do not require a contract to be created, as they may arise out of any relationship where both parties understand that a special trust or confidence has been reposed.[232] Thus, although funds generally contract with an external manager, this is not required to impose fiduciary duties as they are imposed by the law, and the fiduciary cannot negotiate around them.[233] However, it should be mentioned that state

compliance with, the fund's code of ethics, and to monitor trades with affiliated funds. *See* Articles 32(a), 18(f)(3), 17(j), 17(a) and rules 12b-1 and 17(f)(4), 17(j)(1), 17(a)(8), and 17(a)(7) of the 1940 Act.

230. *See*, e.g., T. Frankel, *Fiduciary Duties as Default Rules,* 74 Or. L. Rev. 1226–1227 (1995) and J.H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L. J. 642 (1995).

231. *See*, e.g., *Malpiede v. Townson*, 780 A.2d 1075, at 1086 (Del. Supr. 2001) ('We begin by observing that the board's fiduciary duty of disclosure (…) is not an independent duty but the application in a specific context of the board's fiduciary duties of care, good faith, and loyalty'), In re Walt Disney Company Derivative Litigation, 907 A.2d 693, at 745, n. 400 (Del.Ch. 2005) ('The Delaware Supreme Court [in *Malpiede v. Townson*] has been clear that outside the recognized fiduciary duties of care and loyalty (and perhaps good faith), there are not other fiduciary duties. In certain circumstances, however, specific applications of the duties of care and loyalty are called for, such as (…) the duty of candor or disclosure'), In re Transkaryotic Therapies, Inc., 954 A.2d 346, at. 357 (Del. Ch. 2008) ('Although usually labeled and described as a duty, the obligation to disclose all material facts fairly when seeking shareholder action is merely a specific application of the duties of care and loyalty'), *Stone v. Ritter*, 911 A.2d 362, at 369–370 (Del. Supr. 2006) ('The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element[,] i.e., a condition, of the fundamental duty of loyalty').

232. T. Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 817 (1983) ('[The] classification [of a relationship] as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties intended the legal consequences of such a relation').

233. Although some authors, referred to as the 'contractualists', argue otherwise. *See*, e.g., Langbein, *The Contractarian Basis of the Law of Trusts*, 658 ('Loyalty and prudence, the norms of trust fiduciary law, embody the default regime that the parties to the trust deal would choose

statutory law may provide rules that enable fund fiduciaries to limit their liability for breach of a fiduciary duty by a provision in the fund's governing instrument or management contract, also referred to as 'hedge clause'.[234] This effectively imposes only a contractual default rule on fiduciaries. For example, Article 1101(d) of DRULPA permits a partner's duties, including fiduciary duties, to be 'expanded or restricted or eliminated' by the partnership agreement. A similar provision is contained in the Delaware Limited Liability Company Act (DLLCA) and the DBTA.[235] Delaware corporations may eliminate the liability of directors for monetary damages for breach of fiduciary duty, although they may not do so as regard the duty of loyalty.[236] However, Delaware law does not seem to enable corporate fiduciaries to eliminate any fiduciary duty completely as it also provides that the liability of a director may not be restricted 'for any transaction from which the director derived an improper personal benefit'.[237]

In addition and more importantly, federal law limits the possibility to use of hedge clauses by fund directors and managers. In the case of registered funds, any hedge clause in the fund's governing instrument or contract with the manager limiting the board's or manager's duties for conduct that constitutes 'wilful misleading, bad faith, or gross negligence', is prohibited.[238] Thus, under federal law, the liability of a registered fund's board or manager can only be limited in cases where there is no wilful misconduct or gross negligence on the side of the board respectively the manager. This is also the rule under state statutory and common law.[239] In addition, a provision that purports to limit the board's or manager's liability may be prohibited under the

at the criteria for regulating the trustee's behavior (…)') and F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* 427 (Harvard University Press 1991) ('a "fiduciary" relation is a contractual one (…)'). *See also* Frankel, *Fiduciary Duties as Default Rules*, 1211–1212 (stating that 'most fiduciary rules constitute default rules', but also that beneficiaries 'may only waive fiduciary duties owed to them if they follow a two-step procedure', consisting of: (1) a clear notice of the beneficiaries that they can no longer rely on the fiduciary with respect to the waived duties and (2) sufficient information provided by the fiduciary to enable beneficiaries to make an informed decision regarding the waiver). Despite these views, courts generally find that fiduciary duties arise irrespective of a contract saying otherwise. *See*, e.g., *Meinhard v. Salmon,* 249 N.Y. 458, 164 N.E. 545 (NY Supr.), in which the NY Supreme Court applied fiduciary rules despite the exclusion of certain rights by contract.

234. *See* SEC, *Staff Study on Investment Advisers and Broker-Dealers*, January 2011, 43.
235. Article 1101(c) of the DLLCA (Del. Code Ann. tit. 6, ch. 18, § 101 et seq.) and 3806(c) DBTA. However, in these cases, the parties may not eliminate the 'implied contractual covenant of good faith and fair dealing'. This obligation applies under Delaware law to all contracts 'and requires that contracting parties refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party from receiving the fruits of the contract' (*See Kelly v. Blum,* 2010 WL 629850,13 (Del. Ch. 2010)). Although the obligation of the implied covenant may not be eliminated by contract, Delaware courts are reluctant to infer implied obligations in a contract. Moreover, courts will not use the implied covenant obligation to override express provisions of an agreement. *See* P.M. Altman & S. M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing under Delaware Law*, 60 The Business Lawyer 1485 (2005).
236. Article 102(b)(7)(i) DGCL.
237. Article 102(b)(7)(iv) DGCL.
238. Articles 17(h) and (i) of the 1940 Act.
239. *See* n. 234, *supra*. A hedge clause that limits a fiduciary's liability entirely would also constitute a breach of the duties of loyalty and care that fund managers and board members owe under common law.

Advisers Act.[240] And even if such a provision is permitted, it can be argued that the provision must be at least appropriately disclosed to clients/investors.

4.9.3 The Duty of Loyalty

The most commonly used expression of the duty of loyalty under US law can be found in the case of *Meinhard v. Salmon*.[241] In this case, the New York Court of Appeals stated that '[a] trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior'.[242] This formulation has become the standard formulation used by US courts in applying the duty of loyalty, which has also been defined as the 'duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so'.[243] In essence, the duty of loyalty means that a fiduciary is held to act honestly, with utmost good faith and with a view to the best interest of the beneficiaries. As a result, this duty has also been described as a duty of 'unselfishness'.[244] While it is clear that the duty of loyalty is about constraining self-interested behaviour of a fiduciary, US law requires a fiduciary to comply with a number of subduties that in order to act in accordance with this duty of loyalty. These subduties can be divided into [A] the duty to act in the interest of investors, [B] the duty of disclosure, and [C] the duty of confidentiality. These subduties will be discussed below.

240. The Advisers Act make it unlawful to waive a manager's liability for actions concerning wilful misconduct or gross negligence as such actions are in violations of the anti-fraud provisions. In addition, in case a fund manager uses a hedge clause that would limit his liability to acts of wilful misconduct or gross negligence, the Advisers Act may also be violated. The SEC Staff has determined that whether or not this is the case depends on 'the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client'. *See* SEC No-Action Letter, Heitman Capital Management, LLC, 12 Feb. 2007, 4. In any case, fiduciary duty waivers, especially open-end waivers, may not be enforceable in court. *See* for a discussion of the interpretation of fiduciary duty waivers in partnership agreements, L.E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927 (2004) (stating that '[o]n the one hand, the courts have concluded that limited partners need some protection against open-ended waivers whose effects the partners cannot fully evaluate at the time on the agreement. On the other hand, the courts have recognized the strong practical reasons for enforcing fiduciary duty contracts in LPs and the implications of the parties' having deliberately selected an entity form that serves specific business functions and that notoriously permits freedom of contract').
241. *See* n. 233, *supra*.
242. *Ibid.*, 546.
243. Restatement (Second) of Trust, American Law Institute, 1959, §170, comment a. *See also* Restatement (Third) of Trusts, § 78 and Restatement (Third) of Agency, § 8.02 ('An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position') and 8.04 ('Throughout the duration of the an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors').
244. L.E. Ribstein, *Fiduciary Duty in Contracts in Unincorporated Firms*, 54 Wash. & Lee L. Rev. 542 (1997).

[A] The Duty to Act in the Interest of Investors

Best Interest Rule

The duty to act in the interest of investors stems from the general obligation under the duty of loyalty to exercise good faith. The term 'good faith' is often used in the context of fiduciary duties to describe the requirement of a fiduciary to act in the interest of the beneficiaries as to all matters connected with the fiduciary relationship.[245] Agents are, however, allowed to act in their own interest, provided that they also act in the interest of the beneficiaries and the agent's interests are not placed above the beneficiaries' (or principals') interests.[246] This rule can be referred to as the 'best interest rule' or 'best interest standard', i.e., the duty to ensure that principals' best interest are served when executing orders. The best interest rule enables an agent to undertake transactions in which he has a (potential) conflict of interest as long as the transaction was also undertaken in the best interest of the beneficiary.[247] For example, an external manager-agent of a fund is permitted to switch some or all of the fund's assets which may give him some benefit (such as a commission), but may also benefit the fund in terms of asset diversification or return expectations. The rule also applies to directors of corporate funds, trustees of Delaware business trust funds, and general partners of Delaware LP funds.[248]

245. *See*, e.g., L.E. Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L. J. 671(2010) (stating that the Delaware Supreme Court's decision in Revlon 'demonstrates the use of good faith to define the core mandate of loyalty, which is to act solely in the interest of the corporation and its stockholders') and D.A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context,* 25 Wake Forest L. Rev. 24 (1990) ('[A]s applied to the decisions of corporate directors, good faith focuses on directors' position as fiduciaries obliged to serve the interests of others').
246. Restatement (Third) of Agency, § 8.01, comment b.
247. M.L. Fein, *The Fiduciary Duty of Securities Brokers and Investment Advisers: Sole Interest or Best Interest?, An Analysis of the Administration's Proposal*, Paper prepared for Federated Investors, Inc., 2009, 17–18 (2009). Available at SSRN ('One alternative [to the sole interest standard] is a "best interest" standard whereby an investment firm is required to act in the best interest rather than sole or exclusive interest' and '[a] "best interest" standard would be similar to the standard reflected in the duty of loyalty imposed on agents under state agency law').
248. J.H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L. J. 958–959 (2005). The Uniform Statutory Trust Entity Act of 2009 (USTEA), the most recent product of the NCCUSL in the area of business entity legislation, applies the corporate 'best interest rule' rather than the more restrictive trust law 'sole interest rule' to Delaware business trusts. *See* Article 505 of the USTEA and the comment to Article 505 of the USTEA. The USTEA can be found at: http://www.uniformlaws.org/. Furthermore, Delaware Courts have often applied the corporate law fiduciary duties to general partners of Delaware LPs, including the best interest standard. *See*, e.g., *Boxer v. Huskey Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981) ('[The] fiduciary duty of partners is often compared to that of corporate directors'), In re Boston Celtics L.P. Litigation, 1999 WL 641902, 4 (Del. Ch. 1999) ('[I]t is well settled that, unless limited by the limited partnership agreement, the general partner of a Delaware limited partnership and the directors of a corporate General Partner who control the partnership, like directors of a Delaware corporation, have the fiduciary duty to manage the partnership in the partnership's interests and the interests of the limited partners' and that '[a]s a result, Delaware law requires the general partners of limited partnerships to exercise due care and to act in the best interest of the partnership and the limited partners').

Under the Advisers Act, fund managers are also required to act in the best interest of their clients.[249] Thus, when a manager falls under the definition of 'investment adviser' of the Advisers Act, he is subject to this standard, irrespective of the standard that would have applied under common law (and irrespective of whether or not he is registered).

Sole Interest Rule

With respect to a trustee of a business trust fund based on common law instead of statute (i.e., the Massachusetts business trust, 'MBT'), the rule is somewhat different. A trustee is required to manage the assets of the beneficiaries in the *sole* interests of the beneficiaries.[250] This 'sole interest rule' or 'sole interest standard' is a formulation of the strict duty of loyalty in common trust law.[251] The standard applies to all common law trustees, expect for trustees that qualify as investment advisers under the Adviser Act, which are subject to the federal prevailing best interest standard.[252]

The sole interest rule precludes transactions where the trustee has any interest in the transaction whatsoever, regardless of whether or not the beneficiaries of the MBT also benefit from it. The rule would, for instance, prohibit an MBT fund's trustee to undertake transactions between the fund and an affiliated entity or person (i.e., an entity in which the trustee is a director, general partner, agent or employee, an entity or person that controls one or more of such outside entities, or an individual who is a general partner, principal or employer of the trustee). Furthermore, there is a potential conflict when a trustee of a MBT would receive asset-based or performance-based

249. SEC, In re Arleen W. Hughes, Release No. 34-4048, 18 Feb. 1948 ('The very function of furnishing investment counsel on a fee basis (…) cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests').
250. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?,* 931 ('[The] "sole interest" rule is widely regarded as "the most fundamental" rule of trust law' (notes omitted)).
251. Restatement (Second) of Trusts, § 170(1) and Restatement (Third) of Trusts, American Law Institute, 2007, § 78(1). The Restatements appear to exclude business trusts from their coverage by stating that 'the business trust is a business arrangement that is best dealt with in connection with business associations'. *See* Restatement (Third) of Trusts, § 1, comment b. However, the Uniform Trust Code of 2000 (last amended in 2005) (UTC), the first codification of the law of trusts in the US, also applies to trusts that have a business or commercial purpose to the extent that neither the trust instrument nor other legislation displace the UTC's provisions. *See* comment to Article 102 of the UTC. Thus, the common law of trusts set out in the Restatements and the UTC applies to all trusts arising under the common law, including those that have a business purpose, to the extent that the common law is not displaced by the trust instrument or by specialized legislation. With respect to statutory business trusts, e.g., the Delaware business trust, Article 105 of the USTEA states that the common law of trusts supplements the USTEA, but only to the extent not modified or displaced by the USTEA or the governing instrument. Article 505 of the USTEA modifies the fiduciary duties of the trustee of a statutory trust, which are drawn from corporate law.
252. Consequently, in case an external manager holds the legal title of a trust fund's assets, the best interest rule does not apply, while an internal trust board is subject to the sole interest standard.

compensation. The most commonly used remuneration arrangements by a trust fund, whether the trustee is a separate legal entity or not, are asset-based fees.[253] Such fees may incline the trustee to overvalue the assets in the fund or to attract more assets than would be in the interests of the investors.

Conflict of Interest: Sole Interest or Best Interest

Whether a fund fiduciary is required to act in the sole or best interest of investors, conflicting transactions and remuneration policies are very common in the fund industry, including funds organized as MBTs. An external manager managing multiple funds may be faced with several potential conflicts of interest relating to the allocation of limited time and attention and investment opportunities, pursuit of different investment strategies, selection of brokers/dealers, variation in compensation and related business opportunities, such as distribution or recordkeeping. For example, with respect to the use of different strategies, the manager may determine that an investment opportunity is appropriate for only some of the funds for which he exercises investment responsibility, or may decide that certain funds should take differing positions with respect to a particular security. In these cases, the manager may place separate transactions for one or more funds or accounts which could affect the market price of the security or the execution of the transaction, or both, to the detriment or benefit of one or more other funds and/or accounts. Internal fund managers that sit on a number of different boards are faced with similar problems.[254]

Another conflicting situation specifically related to fund managers occurs when a manager manages or advises more than one client. In such a case, he may be faced with the risk that when he acts in the interest of one client, he would harm another fund (i.e., not act in the best interest of this client, but something less). As a result, for example, a conflict arises when the manager has a client relationship with a company's pension fund and has to vote on the shares that the fund he manages holds in that company or when the manager has a commercial relationship with a company in which the fund hold shares in the event of a takeover bid on that company. Other potential conflicting transactions result from possible beneficiary incentives of the manager, which may form a motivation to favour certain funds in which he has an interest or in which its affiliates have interests. For example, potential conflict of interest issues arise in situations where the manager is affiliated with a broker through which clients' transactions will be traded or the manager compensates a third party for referring a client or in exchange for services, i.e., soft dollar arrangements.[255]

253. As a result of the restrictions placed on the use of performance-based fees by registered managers, most registered managers charge large asset based fees. *See* J. Golec, *Regulation and the Rise In Asset-Based Mutual Fund Management Fees*, 26 J. Fin. Res. 19 (2003).
254. A.B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 82 (2005) ('Some have questioned whether a director who sits on eighty or one hundred boards can effectively monitor the activities of each'). In addition, directors may have competing interests between the fund they owe a duty of loyalty to and some other person or entity.
255. According to US federal law, soft dollar arrangements are permissible provided that the manager receives qualifying research or brokerage services from its broker(s). *See* Article 28(e)

As mentioned, fiduciaries of funds also have a conflict of interest if they are able to exercise significant influence on the amount they receive as compensation for their services/management. This involves both performance-based fees and asset-based fees. The conflict arises because a fiduciary may be inclined to overvalue the fund's assets (or performance) to gain a higher fee. Furthermore, as fund fiduciaries can hide such fees from investors by deducting them from fund assets before distributing earnings to the investors, investors are often unable to effectively monitor the amount of fees being withheld from each payment. In both instances, (state and federal) statutory law do not provide investors with sufficient tools to change these arrangements, although they are able to put forward a breach of federal fiduciary duty claim stating that the fees are 'excessive' under Article 36(b) of the 1940 Act.[256] With respect to internal directors' fees, it might be possible to amend the fund agreement or bylaws to change the fee structure/fee height established in these documents. However, as mentioned, this right is usually very limited.[257] Additionally, as the originators of the fund are typically either the future board members (in case of an internally managed fund) or the manager (in case of an externally managed fund), the original directors' fee is generally determined by the manager or the directors themselves. In any case, the first investors of the fund will have no influence on this. With respect to the external manager's fee, the fund's board has the responsibility to negotiate this fee with the manager. However, the manager, often also the initial shareholder of the fund, will typically be the one who appoints the first internal officers and directors of the fund.[258] Of course, when the fund's directors owe their appointment to the manager, and perhaps also perform a function at the office of the manager, they will be less inclined to bargain a lower fee in the management contract for the benefit of the investors.

As a consequence of the potential for conflicts of interest, strict application of the sole interest rule would be impossible to maintain in practice. However, the sole interest rule is not that stringent as it may appear at first sight. Trust common law provides that conflict of interest transactions are allowed when specifically authorized beforehand by law or court order, by the trust instrument, or with informed, expressed consent of all beneficiaries.[259] In addition, compensation arrangements are also permissible under trust common law provided that they are fair and properly disclosed to the beneficiaries.[260] Since fund managers will generally fall under the best interest rule of the Advisers Act, this rule only has limited value as it only applies to fund directors, trustees and general partners which are not also manager of the fund.

of the 1934 Act. Conduct outside of the safe harbour of Article 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities law, most notably under the 1940 Act and the Advisers Act.

256. *See* notes 204 & 205 and accompanying text, supra.

257. *See* section 4.7.2.

258. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 152–153.

259. Restatement (Third) of Trusts, § 78, comment c.

260. *Ibid.* and Restatement (Third) of Trusts, § 78, comment c(4) (noting that '[t]he strict prohibitions against transactions by trustees involving conflicts between their fiduciary duties and personal interests do not apply to the trustee's taking of reasonable compensation for services rendered as trustee').

By contrast, the best interest standard has high relevance in the context of US funds. This standard indicates that fiduciaries, including fund managers, are allowed to perform conflicting transactions provided that the beneficiaries benefit from the transactions, even if the fiduciary also benefits or may benefit. Overlaps of interests are thus allowed. In case of a conflict, it is, however, not always clear whether there is mutual advantage between the relevant parties. As a result, the rule that has been developed to deal with this problem is that in (potential) conflict of interest situations, the fiduciary should either resolve the conflict, or, in the case there is no resolution, pass on any profit the manager accrues from the particular conflict to the beneficiaries.[261] In any case, disclosure of the conflict is required (see below).

[B] The Duty of Disclosure

One of the most important ways of resolving a conflict of interest, which follows from both US trust and agency law, is disclosure.[262] With respect to internal corporate fund officers and directors, this viewpoint has also been accepted by US courts. For example, in *Underwood v. Staffor*, the New York Court of Appeals held that officers and directors possess fiduciary obligations toward the corporation and its shareholders, and must show 'full disclosure and fair dealing' to the shareholders when a conflict of interest arises.[263] Other state courts have ruled in similar ways.[264] Other than other trustee fiduciaries, however, internal corporate fund officers and directors do not need the consent of the beneficiaries in a conflict situation: mere disclosure is sufficient. This

261. Restatement (Third) of Trusts, § 205 (1992) and Restatement (Third) of Agency, § 8.02, 8.03 and 8.06.
262. Restatement (Third) of Trusts, § 83 comment c ('[T]rustee has affirmative duty to disclose relevant information'). This duty to disclose exists even if the trustee is acting in a personal capacity. Restatement (Third) of Trusts, § 78(3) ('Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter'). Restatement (Third) of Agency, § 8.06 ('Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 does not constitute a breach of duty if the principal consents to the conduct, provided that: (a) in obtaining the principal's consent, the agent: (i) acts in good faith, (ii) discloses all material facts that the agent knows has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship'). Courts have affirmed this duty. *See*, e.g., *Regnery v. Meyers*, 679 N.E.2d 74, 79 (Ill. App. Ct. 1997) ('It is well settled that a trustee owes the highest duty to his beneficiary to fully and completely disclose all material facts relating to dealings with the trust') and *Ziswasser v. Cole & Cowan, Inc.*, 210 Cal. Rptr. 428, 429–430 (Cal. Ct. App. 1985) ('It almost goes without saying that the general fiduciary duty owed by the agent to his principal includes the duty to make a full and complete disclosure to him of all material facts which the agent knows and which might influence the principal with respect to the transaction and his willingness to enter into it').
263. *Underwood v. Stafford*, 155 S.E.2d 211, 212–213 (N.C. App. 1967).
264. *See*, e.g., *Kapushion v. Colorado W. Packers, Inc.*, 701 P.2d 625, 627 (Colo. App. 1985) (listing the full and fair disclosure of all material facts as one requirement for a director contracting with the corporation).

indicates that the duty of disclosure is relevant in the context of both the sole interest and the best interest standard, although the evidential burdens in court proceedings differ between the two standards.[265] In other words, full and accurate disclosure of actual and potential conflicts by a fiduciary is an important aspect of acting in good faith and thereby of the duty of loyalty.

When a fund fiduciary intends to conduct a potentially conflicted transaction, he should, in order to avoid a breach of the duty of loyalty and a possible claim thereof, make sure that he provides all material facts related to that transaction to the fund and/or its investors before he initiates the transaction. Such disclosures must be made before the fiduciary relationship is created (in the investment management contract or the fund agreement, i.e., the trust agreement/corporate charter/LP agreement) as well as after the relationship has started and an actual or potential conflict arises. However, it should be noted that a fiduciary remains under an immutable duty to always act fairly and in accordance with the interests of beneficiaries, regardless of the whether a conflict of interest has been disclosed. This means that a fiduciary is not allowed to provide misrepresentations or false or incomplete statements,[266] to engage in self-dealing transactions which are not performed on an arm's-length basis,[267] or otherwise act opportunistically to the detriment of the primary beneficiary or beneficiaries (i.e., 'the duty of fair dealing').[268]

265. Under the sole interest standard, a conflicted transaction is void unless the trustee acquires consent of the beneficiaries (or the conflict has been authorized by law, trust agreement or court order – see n. 259, *supra*) and, of course, the trustee has acted fairly towards the beneficiaries. This rule, also known as 'no further inquiry' rule, makes all self-dealing transactions entered into by the trustee that are not allowed under trust law per se voidable by the beneficiaries, requiring no proof that such transactions were unreasonable or harmful. As a result, a trustee is unable to defend a breach-of-loyalty case by proving that a conflicted transaction was undertaken in de best interest of the beneficiaries, while other fiduciaries, subject to the best interest standard, may do so. *See* Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?,* 931–932.

266. M.A. Eisenberg, *The Duty of Good Faith in Corporate Law,* 31 Del. J. Corp. L. 39, n. 102 (2006) (citing several court cases relating to the duty of full and fair disclosure of corporate fiduciaries). It can be noted that a knowingly false statement (i.e., fraud) may give rise to liability under federal securities law (rule 10b-5 of the 1934 Act).

267. When parties are not dealing at arm's length, i.e., not upon an equal footing, the transaction is considered to be, in the eyes of the law, not performed in good faith and, consequently, in conflict with the duty of loyalty. *See also* V. Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 632 (1997) ('Fairness in corporate law fiduciary terms is said to embody limits on the consensual allocation of gains to management or controller from self-aggrandizing conduct by reference to arm's length bargains or the market' (notes and quotation marks omitted)).

268. The duty of fair dealing requires a fiduciary to manage the assets of the beneficiaries for the good of the beneficiaries, not for their own private, personal gain or for the advantage of third parties. It is thus consistent with the concept of fiduciary behaviour as traditionally applied to require arm's-length dealing. This duty traditionally stems from contract law, although, in contract law, fair dealing and good faith are placed side-by-side, as though fair dealing is something in addition to good faith. *See* Restatement (Second) of Contracts, American Law Institute, 1997, § 205 ('Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement'). In corporate law, 'fairness' has two basic aspects: fair dealing and fair price. Together, these two aspects are generally referred to as the 'entire fairness test'. *See Weinberger v. UOP,* Inc. 457 A.2d 701, 711 (Del. Supr. 1983) (explaining the entire fairness test and its two aspects as follows: 'The former [fair dealing]

It can be noted that under federal law, an officer, director, manager or other affiliated person[269] to a registered fund is prohibited to perform certain transactions in view of the potential conflicts of interest that may exist. For example, Article 17(a) of the 1940 Act generally prohibits affiliated persons of a registered fund from borrowing money or other property from, or selling or buying securities or other property to or from, the fund or any company that the fund controls, although the SEC can approve reasonable, fair transactions that do not involve overreaching and are consistent with the fund's investment policy and other requirements of the 1940 Act.[270] Thus, similar to state common law, any form of self-dealing that is not performed on an arm's length basis is prohibited under federal law, without exemption from the SEC. Furthermore, Article 17(e)(1) of the 1940 Act makes it unlawful for an affiliated person of a registered fund, acting as its agent, to accept 'from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale' of property, including securities, by such fund (i.e., soft dollar arrangements).[271]

In addition, under Article 206 of the Advisers Act, a fund manager has a federal fiduciary duty to disclose all material conflicts of interest, or potential conflicts of

embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness [fair price] relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. (…) However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness'). The entire fairness test only applies in case the directors' conduct does not qualify for the business judgment rule, which involves, among other things, conflict of interest situations. *See* DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 16.

269. Article 2(a)(3) of the 1940 Act.
270. Article 17(b) of the 1940 Act. Furthermore, certain rules under the 1940 Act provide specific exemption of the prohibition set out in Article 17(a) of the Act. For example, rule 17(a)(2) provides that the purchase, sale or borrowing transactions occurring in the usual course of business between affiliated persons of registered investment companies is permissible, provided that: (1) the transactions involve notes, drafts, time payment contracts, bills of exchange, acceptance or other property of a commercial character rather than of an investment character, (2) the buyer or lender is a bank, and (3) the seller or borrower is a bank or is engaged principally in the business of installment financing. Other exemptions include, among others, transactions with fully owned subsidiaries, transactions with portfolio affiliates, transactions between affiliated registered funds, and transactions with certain sub-manager affiliates. *See* rule 17(a)(3), (6), (7), and (10) of the 1940 Act.
271. However, it can be noted that soft dollar arrangements are allowed in case they are used for services that are included in the 'safe harbour' list of Article 28(e) of the 1934 Act, including research or brokerage services. *See* n. 255, *supra*. Other restrictions on affiliate transactions also may be relevant depending on the particular trading practice or situation. The most notable are Article 17(d) and 17(e)(2). Article 17(d) of the 1940 Act restricts an affiliated person of a registered fund from participating in or effecting a transaction in connection with any joint enterprise or other joint arrangement in which the company or a company controlled by that company is a participant. Article 17(e)(2) limits the remuneration an affiliated person can receive when effecting securities transactions as a broker for a registered investment company to not more than 1% of the purchase or sale of the securities.

interest, to its fund clients that arise during the management relationship.[272] Article 206(3) of the Advisers Act requires that fund managers must also disclose the principal or agency transactions that they are conducting to their fund clients.[273] However, it must be kept in mind that mere compliance with the information specified in these documents may not fully satisfy the disclosure obligations required under the common law duty of loyalty (or even the federal fiduciary duty of the 1940 and Advisers Act). As such, the specific disclosure requirements set out in federal law establishes only a minimum level of disclosure. More disclosure required by fiduciary law does not undermine the applicability of the specific federal disclosure requirements of the 1940 and Advisers Act and thus does not conflict with these requirements.

[C] The Duty of Confidentiality

Next to the aforementioned duties of acting in the best or sole interests of the investors and disclosure, the last subduty required by the duty of loyalty is the duty of a fiduciary to retain the confidentiality of confidential information.[274]

Confidential information is information that is explicitly deemed confidential by the fund, as well as information that appears to be confidential from its nature.[275] An important problem that particularly may arise with respect to the duty of confidentiality is the issue of conflicting duties. For example, a director that serves as a trust fund manager and also sits on the board of a corporation may learn of confidential information from the corporation that would be beneficial or detrimental to the fund. For example, if the director at a certain moment learns that the corporation is in financial trouble and the trust fund he manages holds shares in the capital of the corporation, is he bound to sell the shares of the fund? Selling the shares would be beneficial to the fund, but may drive the price of the shares of the corporation down, which would harm the other shareholders in the corporation in their ability to sell their shares at a certain profit.

Apart from possible federal insider dealing prohibitions, the general rule in fiduciary law is that the fiduciary must refrain from causing harm. This generally holds

272. SEC, *Staff Study on Investment Advisers and Broker-Dealers*, 22 (citing the Capital Gains case).
273. Article 206(3) of the Advisers Act makes it unlawful for any fund manager, directly or indirectly 'acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction'. Thus, it imposes a prior consent requirement on a fund manager that acts as principal in a transaction with a client, or that acts as broker (i.e., an agent) in connection with a transaction for, or on behalf of, a client. *See* SEC, *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*.
274. Restatement (Third) of Agency, § 8.05.
275. *Ibid.*, comment c (distinguishing two types of confidential information, namely 'any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others' and 'confidential information [that an agent has acquired] in the course of the agency relationship that does not have competitive or other economic value', such as information about the principal's health, life history, and personal preferences).

that the fiduciary has no positive duty to act in a conflict of duties situation.[276] In the above example, this would support the view that the director should not sell the shares.

4.9.4 The Duty of Care

[A] Prudence Standard

The traditional formulation of a fiduciary's duty of care is the duty of a fiduciary to make only investments that a prudent investor would make with his own property. This standard of prudence derives from trust law and traces back to the *Harvard College v. Amory* case of 1830.[277] In this case, it was held that a trustee has an obligation to 'observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested'.[278] Although the general concept of the duty of prudence remained unchanged since the Amory case, the Restatement (Third) of Trusts of 1992 redefined this duty into an obligation to invest 'as a prudent investor would',[279] thereby changing the Armory 'prudent man rule' into the 'prudent investor rule'. The Restatement formed the model for the Uniform Prudent Investor Act (UPIA), drafted by the NCCUSL in 1994, which sets out a similar prudence standard.[280]

In essence, the Restatement and the UPIA transformed the prudent investing standard generally applicable to trustees of MBT funds (*not* Delaware business trusts)[281] from a rule based on avoiding speculation and preserving capital into a rule based on the so-called modern portfolio theory.[282] The modern portfolio theory is an investment theory which focuses on the investment portfolio as a whole instead of the individual assets in isolation and aims at maximizing the return of the portfolio for a given amount of risk or minimizing the risk for a given level of expected return.[283] In general, the modern portfolio theory brought about three main changes in the prudence standard applicable to trustees, including trustees of MBTs.

276. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 149 (concluding after having performed an extensive analysis of case law that '[t]he principal's first claim is that the fiduciary must refrain from causing harm; a claim to the performance of positive acts is secondary').
277. *Harvard College v. Amory,* 26 Mass. 446, 9 Pick. 446, 1830 WL 2554 (Mass. Supr. 1830).
278. *Ibid.*, 461.
279. Restatement (Third) of Trusts, § 227.
280. UPIA, prefatory note ('This Act draws upon the revised standards for prudent trust investments promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992)') and Article 2(a) of the UPIA. The UPIA can be found at: http://www.uniformlaws.org/.
281. Delaware business trusts are subject to a different standard pursuant to Article 505(b) of the USTEA ('A trustee shall discharge its duties with the care that a person in a similar position would reasonably believe appropriate under similar circumstances').
282. UPIA, prefatory note ('[The] changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as modern portfolio theory' (quotation marks omitted)).
283. The theory was introduced by Markowitz in the Journal of Finance in 1952. *See* H.M. Markowitz, *Portfolio Selection,* 7 J. Fin. 77–91 (1952).

First, both the Restatement and the UPIA adopted an active duty to diversify trust investments. Although under the former Restatement, courts had already recognized this duty, the scope of it was narrow as trustees were not allowed to perform investments that were deemed to be 'speculative'.[284] The second change imposed by both the Restatement (Third) of Trusts and the UPIA is the possibility for trustees to diversify their investments among any type of investment, irrespective of the risk nature of that investment.[285] This duty to diversify is not absolute: in case the trustee reasonably determines that the trust, under special circumstances, is better served without diversifying, it is considered prudent to not do so.[286]

The official comment to the UPIA gives two examples of such situations: first, when the tax costs of selling low-basis securities would outweigh the gain from diversification, and second, when there is a wish that the trust retains a family business.[287] It is apparent that with respect to investment funds, only the first situation is relevant. In addition, it can be noted that a MBT trustee also cannot be held to this duty if both prudent risk management and impartiality can be satisfied without doing so, or in case it would violate the purposes of the trust.[288] The UPIA provides a non-exclusive list of factors that the trustee must consider as a part of its investment decision-making process, such as economic conditions, inflation, and taxes, as well as the beneficiary's needs and resources. For example, REITs and RICs (and other funds designed to improve tax conditions) that are organized as MBTs should consider how certain investment decisions would influence their favourable tax status before making a particular decision relating to this issue.

A trustee also must consider the portfolio's expected return, an asset's role within the overall portfolio, and, if applicable, an asset's special relationship to the trust or its beneficiaries.[289] Consequently, if a trustee decides to invest the trust's assets in a non-diversified portfolio, the trustee must have considered these factors set out in the UPIA and have concluded that there are no 'special circumstances' present. Because of this, it has been argued that the Restatement and the trust laws of many jurisdictions

284. Under the Restatement (Second) of Trusts, it appeared that any investment in equity was considered speculative, unless such an investment was in a company 'with regular earnings and paying regular dividends which may reasonably be expected to continue'. *See* Restatement (Second) of Trusts, § 227, comment a and m ('The trustee does not use due care in making an investment unless he makes an investigation as to the safety of the investment and the probable income to be derived therefrom' and '[t]he purchase of shares of preferred or common stock of a company with regular earnings and paying regular dividends which may reasonably be expected to continue is a proper trust investment if prudent men in the community are accustomed to invest in such shares when making an investment of their savings with a view to their safety').
285. Restatement (Third) of Trusts, § 90(b) and Article 3 UPIA *See also* the comment to Article 2 UIPA ('The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments').
286. *Ibid*.
287. *See* the comment to Article 3 UPIA.
288. Restatement (Third) of Trusts, § 90, comment g and Article 2 UPIA.
289. Article 2(c) UPIA.

provide a rather poorly duty to diversify as it can be relatively easily set aside in the trust instrument with reference to the trust purpose presented in the instrument.[290]

The third and last change that the Restatement and the UPIA made is the revision of the traditional rule that prohibited trustees from delegating management functions.[291] This was not allowed under the old rule.[292] However, a variety of 'special purpose state statutes' already reversed the non-delegation rule for investments.[293] This reform is thus a general codification of what was already practice in most state trust laws.

The Restatement's duty of prudence requires a trustee of a MBT fund to exercise 'reasonable care, skill, and caution' in the administration of the trust.[294] This general standard of reasonable care also, in a broad sense, applies to other fund fiduciaries.[295] However, the above mentioned prudence standard as well as the specific duties that arise out of the duty of care may differ among fund fiduciaries. With respect to managers-agents, the Restatement (Third) of Agency has described an agent's duty of care as a duty to act with 'the care, competence, and diligence normally exercised by agents in similar circumstances'.[296] The prudence standard for fund managers appears to be how other managers would act in similar circumstances instead of how a prudent investor would act. A similar description of a fund manager's duty of care can be found in federal law, which prevails over the prudent investing standard for common law trustees.[297]

290. E.C. Halbach, *Trust Investment Law in the Third Restatement,* 77 Iowa L. Rev. 1179 (1992) ('The diversification requirement is not inflexible in any event, and the discussion recognizes that the duty to diversify may be further relaxed by authorization in the instrument, particularly in light of special objectives of the settlor and special opportunities or difficulties presented to the trust').
291. Restatement (Third) of Trusts, § 90, comment j ('In administering the trust's investment activities, the trustee has power, and may sometimes have a duty, to delegate such functions and in such manner as a prudent investor would delegate under the circumstances') and Article 9(a) UPIA ('A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances').
292. Restatement (Second) of Trusts, § 171.
293. J.H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. R. 652 (1996).
294. Restatement (Third) of Trusts, § 77(2).
295. *See*, e.g., Restatement (Third) of Agency, § 8.08 ('Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances'), Article 505(b) Uniform Statutory Trust Act ('[I]n exercising the powers of trusteeship, a trustee shall act in good faith and in a manner the trustee reasonably believes to be in the best interests of the statutory trust'), and *Smith v. Van Gorkom*, 488 A.2d 858, 872–873 (Del. Ch. 1985) ('[A] [corporate] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty').
296. Restatement (Third) of Agency, § 8.08.
297. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (US Supr.) ('Courts have imposed on a fiduciary [,which the Congress recognized Capital Gains to be,] an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts", as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients' (notes omitted)). . *See also* n. 249, *supra*. A breach of this fiduciary duty constitutes a violation of the anti-fraud provisions (Article 206) of the Advisers Act. It is not entirely clear whether the US Supreme Court in Capital Gains distinguishes a fund manager's common law fiduciary duty from its

The accepted standard is that a manager is under the duty to utilize the 'care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field'.[298] The same standard applies to the internal board of a corporate fund and the trustee of Delaware business trust.[299] Thus, for these fiduciaries, the degree of care, knowledge and skill expected of the average professional person or entity alike should be looked at to discover the fiduciary's standard of care. In fulfilling the duty of care of a fund manager it is thus expected that the manager meets the standard of care applicable to the profession of performing management services to funds.

In this context, industry standards and codes of conduct will be relevant factors to take into account. US courts will generally use these as an indication of what would be expected of fund managers in respect of care exercised. However, they are not conclusive and courts will not always accept industry practice as the benchmark for determining whether a fund manager's duty of care is fulfilled. It may well be that a court will not find a fund manager liable for failing to comply with unduly high industry standards. On the other hand, a manager might be held liable even though he complied with the industry standard. This may especially be the case when the applicable code of conduct sets out minimum requirements a fund manager member is expected to achieve.[300] In addition, it can be noted that the standard of care may change over time along with the expectations that come with the duty of care due to law changes and the development of new services and products.[301]

Lastly, it is important to note that as part of the duty of care, both the fund manager and fund board must employ reasonable care to avoid misleading funds/ investors. For registered fund managers, this also follows from rule 206(4)-1 of the Advisers Act, which states that a fraudulent practice within the meaning of Article 206(4) of the Advisers Act includes any advertisement 'which contains any untrue statement of a material fact, or which is otherwise false or misleading'. Under common law, this duty also requires funds managers and boards to provide full and fair disclosure of all material facts to fund clients/investors and prospective clients/ investors, thus prior to the investment.[302] Whether 'all material information' is

federal duty under the Advisers Act. However, the Court rejected the idea that the Advisers Act prohibitions on fraud and deceit are constrained by principles of common law. *See* the Capital Gains case, note. 6.

298. *Erlich v. First Nat. Bank of Princeton*, 505 A.2d 220, 291 (NJ Super. 1984).
299. In re Walt Disney Company Derivative Litigation, 907 A.2d 693, 749 (Del. Ch. 2005) ('The fiduciary duty of due care requires that directors of a Delaware corporation use that amount of care which ordinarily careful and prudent men would use in similar circumstances' (quotation marks omitted)) and n. 280, *supra*.
300. Under federal law (rule 204A-1 of the Advisers Act), a SEC-registered fund manager is required to adopt and enforce a written code of ethics which set forth a standard of business conduct. While the code of ethics must reflect the adviser's fiduciary obligations and those of its supervised persons, and must require compliance with the federal securities laws, it would have to contain only minimum provisions.
301. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 193 (US Supr.) ('The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue').
302. *Smith v. Van Gorkom*, 872.

provided is determined by the quality of the information, the advice considered by the manager/board, and whether the manager/board had 'sufficient opportunity to acquire knowledge concerning the problem before acting'.[303] Generally, facts are 'material' if a reasonable investor would consider them to be important.

[B] Business Judgment Rule

It follows from the prudence standard that a MBT fund trustee (*not* qualifying as an 'investment adviser' under the Advisers Act) is subject to the standard of a prudent investor as described in the Restatement (Third) of Trusts and all other fund fiduciaries are subject to the standard of a prudent professional person in similar circumstances. At first sight, a fund manager seems to have to comply with a much higher standard than a trustee-director of a MBT fund, considering that he must act as an average manager instead of an average investor. The fund manager is held to act in accordance with a standard of behaviour that we would normatively expect of fund managers at the time that the activities took place. It can be argued that a fund manager would normally be expected to possess more knowledge and skill than an ordinary investor as a result of which the expectations of what an average manager would do under similar circumstances are also likely to be much higher than what can be expected of an average person.

However, US courts appear to have followed a different approach. The duty of care, as applied by US courts, has been often constrained by the business judgment rule. This rule stems from corporate law and holds the presumption that in making business decisions, the directors of a corporation acted on an informed basis, in good faith and in the best interest of the corporation.[304] Under this rule, a director will not be found liable even if the decision itself would not have been made by the average director.[305] The rule however does not apply in case no decisions are involved, the decision was uninformed, or in case there is a showing of a conflict of interest, fraud or other bad faith conduct, or gross negligence.[306] With respect to the duty to disclose material information to investors, which forms part of the duty of care, it follows from this that material information may only be withheld in case premature disclosure would influence a business decision, such as the signing of a contract. In case the disclosure is of no relevance to business decisions, such as the information contained in a (statutory or summary) prospectus, liability may be imposed for non-disclosure.[307]

303. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. Supr. 1985).
304. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Supr. 1984).
305. C. Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, The 48 Bus. Law. 1356–1357 (1993).
306. S.M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L Rev. 90 & 96 (2004), and E.S. Miller & T.E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?* 30 Del. J. Corp. L. 347 (2005). Gross negligence means reckless indifference to or a deliberate disregard of the shareholders, or actions which are bound to be unreasonable. *See Rabkin v. Philip A. Hunt Chemical Corporation*, 547 A.2d 963, 970 (Del. Ch. 1986).
307. M.I. Steinberg, *Securities Regulation: Liabilities and Remedies* 2–61 (Law Journal Press 2014).

Thus, the duty to disclosure pre-contractual information relevant to investors under the duty of care will often not be protected by the business judgment rule.

While the business judgment rule may also play a role with respect to the duty of loyalty,[308] the above shows that it is more closely related to the duty of care. By limiting application of the business judgment rule to decisions of negligence, the business judgment rule prevents liability claims for a breach of the duty of care involving negligence. Furthermore, due to the other exceptions, the rule limits the duty of care solely to the informed decision-making process and prevents liability when a decision was made in good faith.[309]

Although the business judgment rule has traditionally been developed in the corporate context, courts have explicitly expanded the rule to unincorporated businesses, including Delaware LPs and, under certain circumstances, Massachusetts business trusts.[310] Logically, the rule also applies to (the directors of) corporate funds. The question thus remains whether the rule should also apply to managers that do not also act as trustees, directors or general partners of funds. Considering the important role of fund managers in the fund industry and the undesirability to create differences in standards among managers, the business judgment rule ought to be, in my view, generally applied to all fund managers, irrespective of their legal status. In a similar way, the US Court of Appeal ruled this way in a bankruptcy case concerning an advisers conducting solely advisory functions by stating that 'courts do not interfere with advice by financial advisors when they: (1) have no personal interest, (2) have a

308. This is because the business judgment rule does not apply in the situation where a decision-maker has a conflict of interest. In other words, in case a decision can be considered reckless, irresponsible or irrational, which does not necessarily involves a conflict of interest, the business judgment rule applies. As most duties under the duty of loyalty arise in cases of conflicts of interests, the business judgment rule will often not apply. *See also* n. 310, *supra*.
309. *See Aronson v. Lewis,* 473 A.2d 805, 812 (Del. Supr. 1984) ('directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties') and Caremark International, Inc. Derivative Litigation, 698 A.2d 959, 967–968 (Del. Ch. 1996) ('[T]he business judgment rule is process oriented and informed by a deep respect for all good faith board decisions' (emphasis omitted)). Under Delaware corporate law, directors and officers are entitled to rely on the advice and recommendations of experts so long as such reliance is reasonable and in good faith. If there is reason to assume that the information presented by the expert is incorrect, such reliance is not reasonable and the duty of care not satisfied. *See* Article 141(e) DGCL.
310. *See*, e.g., *Halebian v. Berv*, 457 Mass. 620, n. 4 (Mass. Supr. 2010) (applying the business judgment rule in the derivative proceeding provisions of the Massachusetts Business Corporations Act to a mutual fund organized as a Massachusetts business trust because a business trust 'in practical effect is in many respects similar to a corporation'), In re Boston Celtics L.P. Litigation, 1999 WL 641902, 4 (Del. Ch. 1999) (stating that 'the business judgment rule generally protects the actions of general partners') and *Seaford Funding, L.P. v. M & M Associates II, L.P.*, 672 A.2d 66, 70 (Del. Ch. 1995). *See* however Miller & Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*? (arguing that it is inappropriate to apply the business judgment rule to unincorporated business organizations, unless the rule has been expressly applied into the organizing documents of the business).

reasonable awareness of available information after prudent consideration of alternative options, and (3) provide that advice in good faith' (notes omitted).[311]

Consequently, in my view, it can be concluded that all US fund fiduciaries are protected from personal liability for a breach of the duty of care under the business judgment rule, unless no business decision was concerned (i.e., pre-contractual disclosure), the decision was uninformed, the fiduciaries have engaged in fraudulent activity, intentional misconduct or misrepresentation, gross negligence or conflicting transactions. This also seems to be the rule under federal law.[312] Consequently, it appears that the only clear difference with respect to the duty of care between the prudence standard of a MBT trustee and other fund fiduciaries is the fact that MBT trustees have, under the Restatement (Third) of Trusts, an affirmative duty to diversify. However, this duty does not, as mentioned, create a definite duty of diversification of MBT investments as the scope of the duty may be limited in the trust agreement.[313] Thus, a fund fiduciary, irrespective of its legal nature, that follows the terms of the fund agreement and whose activities do not exceed the general activities of the average, similar fiduciary generally is not subject to a higher duty of care than other fund fiduciaries.

In this respect, however, it can be noted that registered funds have a federal duty to comply with the fundamental investment policies in the registration statement of the fund.[314] A registered fund that has declared that it will hold a diversified portfolio thus has a duty, under federal law, to diversify in accordance with Article 5(b) of the 1940 Act. The 1940 Act also places some restrictions on the investments of registered funds,

311. In re: United Artists Theatre Company, et al, 315 F.3d 217, 232–233 (3rd Cir. 2010). In this case, the Third Circuit looked to Delaware corporate law 'as a useful analogue' to determine whether the indemnification provision contained in a Ch. 11 debtors' retention agreement with a financial advisor which exempted the advisor from liability for its own ordinary negligence, was reasonable and, thus, permissible under the US Bankruptcy Code.
312. *See*, e.g., *Ash v. International Bus. Mach. Corp*, 353 F2d 491, 493 (3rd Cir. 1965) ('[A] stockholder's derivative action, whether involving corporate refusal to bring antitrust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way' (citing, among others, *Hawes v. City of Oakland*, 104 U.S. 450, 26 L.Ed. 827 (US Supr. 1881), *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (US Supr. 1917), and *Coast v. Hunt Oil Co.*, 344 U.S. 836, 73 S.Ct. 46, 97 L.Ed. 651 (5th Cir. 1985)).
313. *See* n. 292 and accompanying text, *supra*.
314. Article 13(a) of the 1940 Act. This article also provides that a registered fund may not borrow money, make loans, buy or sell real estate, or underwrite securities issued by other companies, may not change its investment objectives, may not change the nature of its business and cease acting as a registered fund, and may not change from a diversified form to an undiversified registered fund. There is no (implied) private right of action to enforce the provisions of Article 13(a) of the 1940 Act as the only provision of the Act that provides for an express private right of action is Article 36(b), which is limited to conduct related to the fees charged by registered funds. *See Northstar Financial Advisors, Inc. v. Schwab Investments*, 615 F.3d 1106, 1122 (9th Cir. 2010) (concluding that '[n]either the language of § 13(a), the structure of the [1940 Act], nor the statute's legislative history, including the addition of § 13(c), the Sudanese amendment, in 2007, reflect any congressional intent to create, or recognize a previously established, private right of action to enforce § 13(a). The job of enforcement remains exclusively with the SEC').

such as short selling shares,[315] the purchase of securities on margin, and the amount of leverage a fund may use.[316] Other federal rules related to the duty of care include investment due diligence and 'know your customer' (customer due diligence) rules.[317] Disclosure rules can also be found in federal laws, although unregistered Fund boards and directors of fund managers are not required to meet certain expertise or skill requirements, although funds and management companies will generally seek directors that are experienced in the field of finance and have the ability to read and assess financial reports and have a good reputation for integrity and professionalism.[318] Funds structured as a REIT or RIC are subject to additional federal (tax) rules, which may also include investment restrictions and diversification requirements.[319] These federal law duties will often contain a minimum of protection that is also required under the common law duty of care.

Furthermore, notwithstanding the preeminence of federal law, the common law duty of care may be, as has been mentioned above, limited or eliminated by the fund's charter or agreement, provided that the particular fiduciary acts in good faith and in

315. However, over the years, the SEC has been steadily relaxed the restrictions on short selling for open-end registered funds, making it easier for such funds to engage in short sales. *See* section 4.6.3. In addition, it can be noted that neither the 1940 Act nor the Advisers Act imposes restrictions on short selling by unregistered funds. However, in the aftermath of the financial crisis, the SEC adopted several rules to combat naked short selling that apply to all public company securities, including anti-fraud rule 10b-21 under the 1934 Act, which prohibits any person from submitting 'an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date'. *See* SEC, Final Rule: 'Naked' Short Selling Antifraud Rule, Release No. 34-58774, 14 Oct. 2008.
316. Article 12(a) and 18(a) of the 1940 Act. Article 12 also provides that a registered fund may not own a joint account that trades securities and may not purchase more than 3% of the outstanding voting stock of another registered fund. *See* Article 12(d)(1)(A) of the 1940 Act. As for Article 13(a) and the other provisions of the 1940 Act, it is viewed that investors do not have a private right of action to enforce this article. *See MeVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners L.P.*, 260 F. Supp. 2d 616, 622 (S.D.N.Y. 2003).
317. *See*, e.g., 31 CFR 131(b)(3) (customer identification programme for mutual funds), 31 CFR 131(b)(3) (customer information rules, 'know your customer', for mutual funds), SEC's Office of Compliance Inspections and Examinations (OCIE), Investment Adviser Due Diligence Process for Selecting Alternative Investments and their Respective Managers, 28 Jan. 2014 (referring to an fund manager's duty to perform due diligence of alternative investments pursuant to article 206(2) of the Advisers Act), and SEC No-Action Relief Under Broker-Dealer Customer Identification Rule (31 C.F R. § 103.122), 11 Jan. 2011 (allowing broker-dealers to treat registered fund managers as if they were subject to the anti-money laundering provisions, including the customer identification rules, provided that the broker-dealers reliance is reasonable upon the given circumstances and the manager has entered into a contract with the broker-dealer in which it agrees, among other things, that it has implemented the identification programme in a manner consistent with 31 U.S.C. 5318(h) added with Article 326 of the Patriot act (minimum standard for identifying customers), and will update the programme if necessary). The SEC's OCIE observations on the due diligence and no-action letter can be found at: http:// www.sec.gov/.
318. Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 2–29. The 1940 Act may disqualify certain directors to become a board member of a registered fund or fund manager. *See* Article 9(a) of the 1940 Act.
319. *See* section 2.7.3[A].

accordance with the governing documents of the fund.[320] However, in Delaware corporate law, courts appear to have exculpated directors from many traditional duties of care claims as they have increasingly placed such claims under the category of the duty of loyalty, which is not subject to exculpation.[321]

4.10 CONCLUSION

This chapter focused on assessing US law applying to funds protecting retail investors against misconduct by the fund manager. It began with discussing the key differences between US funds that are required to register with the SEC (registered funds) and funds that are not (unregistered funds). Furthermore, it has been assessed whether or not a US fund manager must undergo SEC registration. The core part of the chapter dealt with the investor protection rules applying to US fund (and their managers) that have been qualified as being most relevant to retail investors in Chapter 2, including: (1) rules related to the fund's internal control systems, (2) leverage restrictions, (3) rules aimed to secure investor rights in investor meetings, (4) transparency and disclosure rules, and (5) conduct of business rules. As noted (in section 2.8), depositary (monitoring) rules have not been assessed in this chapter for the simple reason that US law knows no such rules. With respect to the remaining rules, the following general conclusions can be made.

US registered funds and fund managers must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. Although exact policies and procedures are not defined by US law, the SEC has identified a number of areas that should be addressed by the compliance policies. These areas appear to cover similar areas as those required for EU funds, including fees, risks, conflicts of interest, and asset valuation. US law is highly principle-based on this matter, with the SEC exercising external supervisory control. Internal control with respect to the implementation and monitoring of the compliance policies of the fund and/or manager is done by the CCO. In addition, it can be noted that unregistered funds and fund managers are not required to implement compliance policies. Lastly, it is interesting to note that existing restrictions relating to the payment of performance-based fees to fund managers under the Advisers Act, which also influences their remuneration policy, do not apply to US fund managers (whether registered or not) managing registered closed-end funds and unregistered funds (see section 4.3).

Borrowing money is allowed by US law for registered open-end funds (mutual funds) to a maximum of 33% of their net assets and by registered closed-end funds to an unlimited extent, provided that, in case they issue debt or preferred shares, those shares are covered by a 300% or 200% asset coverage. Mutual funds and closed-end registered funds are furthermore permitted to invest in derivatives in case they take off-setting positions that would 'eliminate' the derivatives exposure and obviates the

320. A fund fiduciary cannot limit its liability for wilful misfeasance, bad faith, gross negligence or reckless disregard of the fiduciary duties of loyalty and care. *See* notes 238–240.

321. At least for corporate funds. *See* n. 238, *supra*.

need to segregate assets, or invest in derivatives that do not impose any payment obligations above the initial investment (i.e., premium), such as purchased stock options and leveraged inverse float rate notes. Unregistered funds are not subject to any restrictions regarding their leverage use.

Investor meetings are generally not held by US funds and even if they are held, a number of restrictions apply which limits the ability of investors to exercise their voting rights. Such restrictions include, among other things: the use of staggered boards, the inability to remove directors except for cause, difficulty to submit items to the agenda, short notice periods and plurality shareholder vote requirements. In addition, if the investor lives in a state other than the state where the shareholder meeting is held or abroad (as is the case for EU investors), it may be difficult to physically attend the meeting. Electronic/online voting and/or via proxy is allowed under US law, but do not provide for a real solution to this problem due to federal restrictions placed on proxy holders and the fact that it is at the sole discretion of the fund's board or general partner whether or not to allow such voting/online meetings to take place.

The transparency and disclosure obligation of US funds is centred around the duty to publish and provide investors with a prospectus and periodic reports. Registered funds are required to publish either a statutory prospectus (supplemented by additional information in the SAI) or a short summary prospectus and annual, half-yearly and quarterly reports. The prospectus contain detailed information on, among other things, the fund's investment objectives, strategies, performance, risks and costs, the purchase and sale of fund shares and payments to broker-dealers and other financial intermediaries. Unregistered funds relying on certain exemptions are not required to publish a statutory or summary prospectus and periodic reports, but must still provide investors with relevant (and similar) information based on US case law and the safe harbour provision provided in the 1933 Act, to the extent material to the investor. It follows from the assessment of the US law that the (statutory or summary) prospectus must be delivered to investors 'at the carrying or delivery' of the fund's shares. As a result, investors may receive the prospectus after they have purchased the fund's shares, although funds will often provide certain information beforehand to avoid liability on the basis of fiduciary law.

The conduct of business rules applying to US funds are placed in the context of the fiduciary duties of loyalty and care. The assessment of case law shows that state courts accept breach of state law fiduciary duties claims in case they find that a fiduciary relationship exists. In the case of investment funds, such a relationship exists between the manager and the fund and the internal board and the fund investors. In addition, federal fiduciary duties apply to all fund managers (whether registered or not) of registered and unregistered funds and fund directors of registered funds. With respect these duties, investors generally have no private right of action, except for a breach 'with respect to the receipt of compensation for services' in the case of registered funds. The duty of loyalty requires fund managers and boards to act in the best (or sometimes: sole) interest of the fund/investors when executing orders. In case of a conflict, the manager or board should either resolve the conflict, or pass on any profit accrued from the particular conflict to the fund/investors. In this respect, it is particularly interesting that disclosure of the conflict is also a way to 'resolve' the conflict (and prevent liability).

The duty of care focuses on the 'reasonable person standard', which translates as the duty of the manager/board to utilize the 'care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field'. It also includes prohibition to mislead investors and to provide full and fair disclosure of all material facts to existing and prospective investors, thus prior to the investment. The business judgment rule is inseparable from the duty of care and prevents liability when a decision was made in good faith, but it generally does not protect fund boards that have not provided pre-contractual information relevant to investors, such as the information contained in the prospectus of the fund. Next to these duties, federal law rules related to the duty of care also include, among other things, investment due diligence and 'know your customer' (customer due diligence) rules.

CHAPTER 5

Moving to a Level Playing Field of EU Investor Protection Regulation?

5.1 INTRODUCTION

This chapter will try to answer the third and final research question of this book: 'Is there is a level playing field between EU investors investing in EU funds and EU investors investing in US funds and if not, which rules should be adjusted?'. To this end, I will start with comparing the investor protection regulations discussed in Chapters 3 and 4. These rules have been categorized into six groups: (1) internal control policies, (2) leverage restrictions, (3) rules related to the exercise of voting rights at investor meetings, (4) transparency and reporting requirements, (5) conduct of business rules, and (6) depositary monitoring rules. Rules that have been considered to be of no or little relevance to the research topic, such as rules relating to the legal structure of a fund, are not discussed in this chapter. In the next paragraphs, the main differences between the EU and US rules applying to investment funds within each relevant (sub)group will be discussed (sections 5.2–5.7). After this, it will be considered whether these differences should lead to additional EU rules regarding the protection of retail investors in investment funds. To this end, I will firstly summarize the key differences in protection levels between EU investors investing in EU funds and EU investors investing in US funds (section 5.8). Since differences in protection levels cause distortions of competition, harmonization measures may be needed to create a 'level playing field' for investors and the fund industry. Potential harmonization measures may however only be adopted in case legal competence of the EU regulator exists, thus, in case the EU regulator has the ability to adopt such rules. Therefore, it will also be discussed whether or not there is a legal basis for the adoption of additional EU investor protection regulation (section 5.9).

5.2 INTERNAL CONTROL SYSTEMS

As set out in the previous two chapters, EU and US law require funds and their managers to implement various internal control systems to assess risks and ensure compliance with applicable rules and regulations. However, where the EU regulator mainly provides for detailed rules about which control policies should be implemented and what aspects should be taken into account when developing and monitoring these policies, US law takes a more principle-based approach.

Under US law, fund managers are required to adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act. Neither the Advisers Act nor the rules thereunder describe the exact policies that should be implemented, leaving it to the discretion of the manager which policies are appropriate for its business. The SEC has nevertheless stated that it expects the manager's policies and procedures to address, among other items, conflicts of interest, fees, best execution practices, and valuation procedures. The SEC furthermore requires registered funds to implement compliance procedures that include: protecting non-public information, complying with fund governance requirements, and preventing market timing. Furthermore, the 1940 Act imposes a number of more 'rule-based' requirements on funds related to internal control policies, including the requirement to adopt a written code of ethics containing detailed provisions on the administration and reporting of conflict of interests situations involving fund personnel,[1] and specific rules related to the fund's concentration policy, investment and fee restrictions. These rules require an adequate risk assessment to take place in order to identify and effectively manage the conflicts of interest risks and other compliance issues that may create risks.

EU law related to fund internal control policies is more rule-based orientated with principle-based elements and requires fund managers to implement a number of control policies, more specifically: conflicts of interest, risk management, liquidity, valuation, and remuneration policies. Although EU law starts off with the principle-based approach by requiring fund managers to, as a general rule, implement control systems and monitor their adequacy and effectiveness without specifying the exact policies for all funds, it also imposes a number of specific requirements on fund managers alongside these policies. For example, with respect to the risk measurement aspect of a UCITS' risk management process, UCITS are required to use an advanced risk measurement methodology, such as the VaR method, to calculate their global risk exposure. For UCITS with a complex risk profile, this process is supported by regular stress and back testing.

Furthermore, in addition to the requirement to implement remuneration policies, UCITS are subject to strict remuneration rules, with certain principle-based elements,[2] requiring them, among other things, to pay 50% of their variable part of the remuneration in financial instruments. UCITS management companies are also required to establish a hierarchically and functionally independent 'permanent risk management function' that is responsible for implementing the fund's risk management policies,

1. Rule 17j-1(c)(2) and (d) of the 1940 Act.
2. *See* section 3.4.5[A].

ensuring compliance with risk limits, advising on the risk profile of funds and, reviewing the valuation of the fund's assets. The AIFM Directive (and delegated regulation) provides for similar rules, although no risk measurement methodology is prescribed and the back- and stress-testing are mandatory for all AIFs. The EU approach of setting additional rules to be complied with, in addition to the principle-based rules on control policies, is in line with the general trend of European financial law to enhance regulation for financial institutions in response to the financial market crisis.[3] However, it runs the risk of not being able to accommodate sufficiently to new governance structures and leaves little discretion for fund managers to determine the (management, fee, risk, etc.) structure that suits them best. On the other hand, the more principle-based approach of the US regulator may lead to practical uncertainty. Maybe because of this, the SEC has however also moved to a more rule-based approach related to certain control policies, most notably with respect to the conflict of interests policies set out in the fund's code of ethics and the valuation of shares. Additionally, the 'regular' 1940 Act provisions impose a number of restrictions on registered funds that influence their risk profile and control policies, including the requirement to adopt a written code of ethics and restrictions on the payment of a performance-based fee by mutual funds. Furthermore, all registered funds are required to appoint a CCO to monitor and review the control policies, although this person does not have to be independent, as is the case for the permanent risk management function for UCITS and AIF.[4]

Overall, it can be concluded that there is not much difference between EU and US law relating to the requirement to implement, manage and review adequate internal control policies. However, there is one difference that stands out in this respect: the restrictions on the use of performance-based fees that are reflected in the fund's remuneration policy. Whereas EU funds are subject to a number of rules and restrictions regarding variable remuneration paid to their manager, only US mutual funds have some, 'minor' restrictions in this area (only allowing them to adopt a so-called fulcrum fee, see section 4.4). It can thus be concluded that the variable remuneration of EU funds is less 'free' than that of US funds.

Differences with respect to other internal control policies exist mainly with respect to the additional (rule-based) rules imposed on funds that aim to protect investors, such as risk measurement and oversight requirements. It follows from these

3. *See*, e.g., *Report of the High-Level Group on Financial Supervision in the EU* 13 (25 Feb. 2009) ('The de Larosière Report') (stating that 'the present crisis results from the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight' and that 'changes in regulation (…) are required to strengthen financial stability and the protection of customers so to avoid – if not the occurrence of crises, which are unavoidable – at least a repetition of the extraordinary type of systemic breakdown that we are now witnessing').
4. The CCO must be an individual person responsible for administrating the fund's policies and procedures. At the manager's level, the CCO must be a 'supervised person'. Supervised persons includes 'any partners, officers, directors (or other persons occupying a similar status or performing similar functions), or employee of an investment advisers, or other persons who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser'. *See* Article 202(25) of the Advisers Act.

rules that EU law, in particular with respect to UCITS, is much more detailed and is therefore likely to be providing, at first sight, a higher level of protection to investors than US law. In case an EU investor invests in a US (registered or unregistered) fund, the fund manager of that fund will however have to comply with the internal control rules set out in the AIFM Directive, unless the fund manager can use an exemption. The internal control policies implemented by these funds should therefore comply with the same basic principles as those adopted by EU AIFs. However, different levels of protection may exist between the two main traditional fund types, i.e., UCITS and US mutual funds, as regard their risk measurement. Whereas UCITS are required to use a set risk measurement methodology, most notably the VaR or commitment method, which are considered to be 'adequate' by the EU regulator,[5] US mutual funds are not subject to such a requirement under either US law or the AIFM Directive, although they may use similar risk methodologies.[6] However, since US mutual funds have similar characteristics as UCITS (i.e., open-end funds primarily focusing on the retail market and subject to very detailed regulations), it would be sensible to require them to use methodologies similar to those used by UCITS in order to prevent potential differences and enhance comprehensibility and comparability of investments in UCITS and US 'UCITS-like' funds. In my view, this would not result in an imposition of excessive costs for the fund industry (and subsequent regulatory avoidance and/or high costs for investors) since many US mutual funds may already use a (similar form) of the VaR method currently applying to UCITS[7] and because the implementation of a new risk measurement method would not entail high costs. The costs involved are mostly costs in relation to the adoption of the risk measurement method for all mutual funds offered in the EU. Once made, no significant additional work and expenses or additional costs are incurred for the fund manager. Consequently, the benefits for investors of imposing UCITS risk measurement methodologies on US mutual funds, i.e., improving comparability for the benefit of investors, which may increase investor confidence and investments, outweigh, in my view, the potential extra costs for the fund industry.

5.3 LEVERAGE RESTRICTIONS

With respect to leverage restrictions, different rules among the different EU fund structures and between EU and US funds apply. When using the term 'leverage' in a broad meaning, i.e., encompassing both risk exposure and borrowing rules, it can be

5. Recital 10 of the preamble to the UCITS IV Directive.
6. *See* C. Alexander, *Market Risk Analysis, Value at Risk Models* 7 (John Wiley & Sons 2009) ('Today there is no universal risk metric for the portfolio management industry but it is becoming more and more common to use benchmark VaR and its associated risk metrics such as expected shortfall'), K. Simons, *Risk-Adjusted Performance of Mutual Funds*, 1998 New England Economic Review 36 (1998) ('In recent years, Value at Risk has gained prominence as a risk measure' for mutual funds) and R.Tehrani, S.M. Mohammadi & N.S. Nejadolhosseini, *Value at Risk as a Tool for Mutual Funds Performance Evaluation*, 7:10 International Business Research 16 (2014) ('Following the lead from both regulators and large international banks during the mid-1990s, almost all financial institutions now use some form of VaR as a risk metric').
7. *Ibid.*

noted that only the UCITS Directive provides for substantial restrictions on both areas. Where UCITS are subject to limitations on the amount of money they can borrow (maximum 10% of their assets on a temporary basis or to acquire property for own use, or 15% in case allowed by their home Member State), risk spreading and exposure rules ('5/10/40 Rule' and other risk exposure rules, including global exposure limit of 210%),[8] several restrictions on their eligible assets, among which the prohibition on short selling (both 'covered' and 'uncovered'), and restrictions on the use of derivatives,[9] AIFMs are only subject to leverage disclosure requirements.[10]

US mutual funds are subject to fewer than UCITS as they can borrow money from any person in case it is temporarily or from US banks in case there is an asset coverage at all times of at least 300%. This asset coverage translates into a 33% borrowing restriction of their net assets, where UCITS are faced with a 10% (or 15%) limit. Additionally, mutual funds have greater discretion to increase their risk exposure via derivatives and short selling practices than UCITS.[11] With respect to the use of derivatives, US mutual funds should only meet a 100% coverage requirement (if applicable) and the relevant risk spreading rules[12] set out in the 1940 Act, e.g., the requirement no more than 15% of their assets may be invested into illiquid assets.[13]

8. *See* section 3.4.2.
9. *See* sections 3.2.1, 3.2.2 & 3.5.
10. See section 3.5. AIFMs have to provide information to investors in the pre-contractual phase on, among other the things, 'the maximum level of leverage' which they are entitled to employ on behalf the AIF. The actual amount of leverage employed should be disclosed periodically to investors, at least at the same time as the annual report is made available, thus after the investment has been made. *See also* section 3.7.4.
11. *See* section 4.6.2.
12. Other risk spreading rules for US mutual funds include, among others, (i) the requirement that they may only invest 3% of the outstanding voting stock of another fund, (ii) purchase securities issued by another registered fund representing more than 5% of the investing mutual fund's total assets, and (iii) purchase securities issued by funds that in the aggregate represent more than 10% of the mutual fund's total assets. *See* Article 12(d)(1) of the 1940 Act. Mutual funds that furthermore declare themselves as being 'diversified' are furthermore required to invest more than 75% of the value of its total assets in cash and cash items (including receivables), government securities, securities of other registered funds, and other securities that are limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the fund and to not more than 10% of the outstanding voting securities of the issuer. *See* Article 5(b) of the 1940 Act.
13. UCITS are not allowed to invest into illiquid assets at all, although the definition of the term 'liquid assets' under the UCITS Directive is broader than that used for mutual funds under the 1940 Act. For example, under the UCITS Directive, financial derivatives are qualified as 'liquid assets' (whether traded on a regulated market or OTC) provided that certain conditions related to the underlying of the derivative, the counterparties and reliability and verifiability of OTC derivatives, and, in case of derivatives on indices, the transparency and rebalancing of the indices, are met. By contrast, in the US, only derivatives traded on regulated markets are generally qualified as being liquid, although other derivatives may also be considered liquid assets depending on market conditions, including, among other things, the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security. In general, OTC derivatives transactions are considered to be illiquid, but may be treated as liquid by fund boards that have included a provision in their governing documents that allows the free transferability of the transaction or a right to break the transaction at an agreed price since inclusion of a transfer right or break right is consistent with prior SEC interpretations of when an instrument may be treated as liquid.

US closed-end funds are provided with even more freedom as regards their leverage exposure. They are allowed to borrow capital from US banks or issue single class of debt or preferred shares to leverage their portfolios, provided that the issuance of those shares is covered by a 300% or 200% asset coverage. Furthermore, the 'restrictions' placed on mutual funds regarding investments in derivatives also apply to registered closed-end funds. Since US registered funds that are offered to EU investors are not subject to additional leverage restrictions under EU law (the AIFM Directive provides none), the should only have to adhere to US law, provided that their shares are also offered to US investors.

Unregistered US closed funds and EU AIFs are not subject to any borrowing and derivative exposure limits. With respect to AIFs, it can be noted that the AIFM Directive requires AIFs to periodically disclose their derivatives exposure to investors. However, when comparing the above rules relating to the use of leverage, US law appears to be less restrictive with respect to registered (open and closed-end funds) as opposed to EU law applying to UCITS. Thus, it provides for less investor protection on this matter in case US registered funds are being offered to EU investors as opposed to UCITS. However, there are indications that the SEC intends to adopt new rules restricting, among other things, the use of derivatives by mutual funds, and imposing stress-testing requirements on these funds.[14] These rules will meet the EU regulator's investor protection standard in case they 'limit the maximum potential exposure relating to derivative instruments so that it does not exceed the total net value of the [fund's] portfolio', require the 'risks and commitments' arising from the derivative exposure to be 'measured and monitored on an ongoing basis', and impose a duty on the funds to describe 'their strategies, techniques and investment limits governing their derivative operations'.[15] It would therefore make sense for EU regulators to await these rules and, when adopted, assess their practical consequences before imposing any EU rules on the use of leverage by US mutual funds that are offered to EU investors.

5.4 INVESTOR MEETINGS

Investor meetings of investment funds are subject to a number of restrictions and limitations under both EU and US law. While the Shareholder Rights Directive establishes requirements in relation to the exercise of investor rights at investor meetings, the directive only applies to listed EU funds. In addition, it allows Member States to restrict minority retail investors from placing items on the agenda and does not provide adequate rules on the consistency or readability of information regarding the agenda items that are up for voting. Moreover, UCITS, whether listed or not, may be excluded from the scope of the directive. US funds that are not listed can eliminate the possibility of (general or special) meeting of investors under state law in their

14. The SEC is seeking public comments on the use of derivatives by registered funds, which initiative may result in more regulations regarding investments in derivatives by such funds. *See* also section 4.6.3.
15. Recital 43 of the preamble to the UCITS Directive.

governing instrument. Only Delaware corporate funds are required to hold a meeting in case a director is elected, which is generally either once a year or often even less.[16]

In both systems, it is apparent that even if a meeting is held, investors may not attend it due to practical problems (e.g., late notice periods, share blocking or record dates, and the availability of timeless and adequate information when shares are hold via an intermediary) or limitations in their ability to change certain matters as a result of quorum requirements, the issuance of non-voting shares and/or restrictions on the matters that can be voted on. The main difference between the systems relates to the removal of directors. In most EU fund jurisdictions, directors can be removed at any time (with no cause) by a simple majority vote, while in the typical US fund states (Delaware, Maryland and Massachusetts), directors can only be removed for cause (e.g., disclosure of corporate secrets or embezzling funds)[17] or in intentional wrong-doing, not mere negligence, gross negligence or recklessness.[18]

In both the EU and US, investors may be enabled to vote by proxy or electronically, or attend a virtual investor meeting. These instruments will effectively remove some of the practical problems in connection with annual/special meetings, especially for EU investors investing in other EU funds than their country of residence or in US funds. However, while the EU regulator provides safeguards for investors with respect to proxy voting for listed funds that are subject to the Shareholder Rights Directive (e.g., enabling investors to issue a proxy by electronic means and requiring the fund to place the proxy form on its website or send it to investors at no costs), US federal securities law effectively restricts the use of proxy entities to solicit votes from investors due to cumbersome requirements imposed on the form and content of the proxy statement required when soliciting votes.[19]

Electronic voting is permissible under both systems, but it is left to the discretion of the board of directors of a fund whether or not to allow this way of voting. Virtual meetings are also allowed, but they have only actually been implemented into the laws of Denmark and a number of US states in which many funds are established, including Delaware and Maryland.[20]

In conclusion, both EU and US funds are offered with substantial freedom whether or not to hold investor meetings (although in the EU, most corporate funds are required to hold at least one investor meeting (the annual meeting) a year – see section 3.6.1) and, if a meeting is held, to decide on the issues that can be voted upon. In addition, investors may be faced with a number of practical restrictions or limitations in their ability to exercise their voting rights and to decide on certain fundamental

16. Depending on whether or not the fund is subject to the 1940 Act, has implemented the ‘two-third’ federal law provision in its charter and has more than three classes of directors. *See* section 4.7.1.
17. D. Kershaw, *Company Law in Context: Text and Materials* 229 (Oxford U. Press 2012). Kershaw concludes from case material that a director’s misbehaviour must involve some form of impropriety and that poor corporate performance alone would not provide for ‘cause’.
18. Article 3303(a) of the Delaware Code.
19. By contrast, the Shareholder Rights Directive does not impose any requirements on the content and form of the proxy form that should be provided to shareholders prior to the meeting.
20. *See* sections 3.6.4 & 4.7.3.

matters (e.g., record dates and quorum requirements). However, although this conclusion might appear to be somewhat disappointing, investors in (EU and US) funds may not be interested in exercising their voting right, but are more inclined to 'vote with their feet' in case of disappointing returns or mismanagement.[21] For this reason, I believe that investors are more in need of comparable and consistent information that can help them to compare fund performances, risks and costs, than the ability to effectively exercise their voting rights at investor meetings. Thus, the right to vote or participate at meetings has, in my view, little relevance in the context of investor protection of investment funds within the meaning of this research.

5.5 TRANSPARENCY AND DISCLOSURE RULES

In this paragraph, the transparency and disclosure rules applying to funds under EU and US law as discussed in Chapters 3 and 4 will be analysed and compared within each stage. In these chapters, these rules have been divided into pre-contractual disclosure requirements and ongoing disclosure requirements.

Generally, all funds, whether EU- or US-based regardless of their legal structure and regulatory status, are subject to mandatory pre-contractual and ongoing disclosure requirements. So UCITS are held to provide investors with a KII and, on request, a prospectus, annual report, and half-yearly reports. Furthermore, AIFMs must provide certain initial investor information to investors before they invest in an AIF, usually in the form of an AIFM prospectus and the annual report, as well as certain going disclosures regarding their liquidity, risk and leverage exposure. However, in this respect, it can be noted that some Member States allow AIFs to be marketed within their jurisdiction to small, retail investors on the basis of their national law, which may include more stringent disclosure requirements than those applicable under the AIFM Directive.[22] In this research, however, only the rules following from the AIFM Directive will be assessed.[23] US registered funds should provide investors with a statutory or summary prospectus at or before the carrying or delivery of the fund's shares. Upon request, they should provide investors with the SAI containing additional information about the fund, which may also be published on the fund's website. Furthermore, they should provide investors with annual, half-yearly, and quarterly reports. Lastly, US unregistered funds will generally give investors the same information as contained in the statutory prospectus for open-end registered funds.[24]

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21. The mechanism of investors to 'vote with their feet' is also considered to be more important in relation to investment funds, in particular open-end funds, as opposed to regular stock companies, as it may directly reduce the size of the funds in case investors redeem their shares. *See* Duong, *Essays on Agency Conflicts in Mutual Funds*, 2.
22. Article 43 of the AIFM Directive permits Member States to allows AIFMs to market AIFs to retail investors within their jurisdiction. They may 'may impose stricter requirements on the AIFM or the AIF than the requirements applicable to the AIFs marketed to professional investors in their territory in accordance with this Directive'.
23. *See* also section 2.7.5.
24. They are not obliged to provide this information on the basis of statutory law, but are held to do so on the basis of US case law or in order to comply with the exemption provided in Regulation D of the 1933 Act. *See* section 4.8.

However, whereas both EU and US laws place a number of disclosure requirements of funds, the timing and methods of the delivery of the mandatory information may differ among funds. An important difference between EU and US law relates to the timing of delivering of information. While EU law requires the information to be provided before investing into a fund, US law enables funds to give the information once the investment has already been made ('at the carrying or delivery' of the shares).[25] US funds may thus suffice by providing investors with a copy of the prospectus after they invested, although investors may generally request the information before making an investment decision. In addition, US funds will often provide certain information beforehand to avoid liability claims on the basis of fiduciary law.[26]

In Table 5.1, an overview is presented of the various types of information that EU and US funds should provide to EU investors before and after they invest into the fund and the time frame for providing ('delivering') the information to investors. See also Tables 3.1, 3.2 & 4.1. In general, it can be concluded that despite the differences that may appear at first sight regarding the timing of the delivery of the information, in practice, there will be not much difference when an EU investors invests in an EU or US fund in this respect. Pre-contractual information is generally provided to investors prior to the investment and ongoing information periodically or continuously. Furthermore, the methods of delivery used by EU and US funds are also much alike: either the fund's website (with a notification to investors) suffices, or a paper or electronic copy may be provided (sometimes upon investors' request).

Table 5.1 Timing and Methods of Delivery of Information: EU versus US Funds

	UCITS	*AIFs*	*US Registered Funds*	*US Unregistered Funds*
Timing of delivery or publication	– Prospectus and KII: prior to the investment. – Annual and half-yearly reports: periodically.	– Prospectus: prior to the investment. – Annual report: prior to the investment and periodically – Liquidity/risk/leverage disclosure: periodically. – Conflicts of interest disclosure: continuously, as often as needed.	– Statutory prospectus or summary prospectus: no later than the delivery of the shares, but generally prior to the investment. – SAI: delivery not required. – Annual, half-yearly and quarterly reports: periodically	– Statutory prospectus or summary prospectus: not required, but similar information as contained in the statutory prospectus is provided no later than the delivery of the shares, but generally prior to the investment. – SAI: not required. – Annual, half-yearly and quarterly reports: not required.

25. Article 5(b)(2) of the 1933 Act.
26. Such a claim may be based on the common law concept of the duty of care. *See* section 4.9.4[B].

	UCITS	*AIFs*	*US Registered Funds*	*US Unregistered Funds*
Method(s) of delivery or publication	– Prospectus and KII: website with consent or other durable medium, paper copy on request. – Annual and half-yearly report: in any manner specified in prospectus and KII, paper copy on request.	– Prospectus: any method (website, electronically, etc.). – Annual report: any method (website, electronically, etc.). – Liquidity/risk/leverage disclosure: annual report. – Conflicts of interest disclosure: website or any other durable medium.	– Statutory prospectus: upon request in paper or electronically. – Summary prospectus: website and electronically upon request. – Annual, half-yearly and quarterly reports: upon request in paper or electronically or, when relying on rule 498 of the 1933 Act, on the fund's website and electronically upon request.	– No methods of delivery are prescribed.

Although the delivery of the information is not so different when EU investors invest in EU or US funds, the way in which fund shares are distributed to these investors may have an impact on the information that the investor receives. In addition, the information contained in the different documents may also differ from each other, resulting in different kinds of investor protection levels. In the following paragraphs, these issues will be further discussed.

5.5.1 Means of Distribution

As this research focuses on the protection of EU investors in funds, a distinction should first of all be made between EU funds and US funds that are being offered to them. When EU funds are being directly (by the fund manager or an intermediary) offered to EU investors, the disclosure requirements mentioned in Table 5.1 regarding UCITS and AIFs will apply. US funds offered to US investors are subject to the disclosure requirements set out in this table applying to US registered or unregistered funds. However, when a (EU or non-EU) fund manager directly offers US fund shares in the EU, it should, in addition to applicable US law, comply with the disclosure requirements set out in the AIFM Directive for non-EU AIFs. As a consequence, EU investors that wish to invest in US funds will be handed over with at least the pre-contractual information that should be disclosed under the AIFM Directive by AIFMs. In addition, the fund manager must provide investors with the annual report prior to the investment and on an ongoing basis, and give ongoing/continuous information on the liquidity, risk and leverage exposure and conflicts of interest of the fund. In this respect, it must be noted that only EU 'professional' retail investors can invest directly in US funds.[27] Furthermore, the additional AIFM rules do not apply in case the manager is exempt from the AIFM directive.

Let us take a closer look at these exempted AIFMs. It follows from the assessment in Chapter 3 that the de minimis exemption is a relevant exemption of the AIFM Directive. The exemption applies to AIFMs managing EU or non-EU AIFs that have no more than EUR 100 or EUR 500 (in case of AIFs that are unleveraged) million assets under management. As stated in section 5.3, US registered funds are offered with considerable freedom in entering into derivative transactions and borrowing money and unregistered funds face no restrictions at all. As a consequence, when offering shares in the EU, they will often be considered to be 'leveraged' for the purpose of the AIFM Directive. AIFMs offering US funds with a net worth of EUR 100 million or more in the EU are thus subject to the AIFM Directive and the disclosure requirements set out in it.

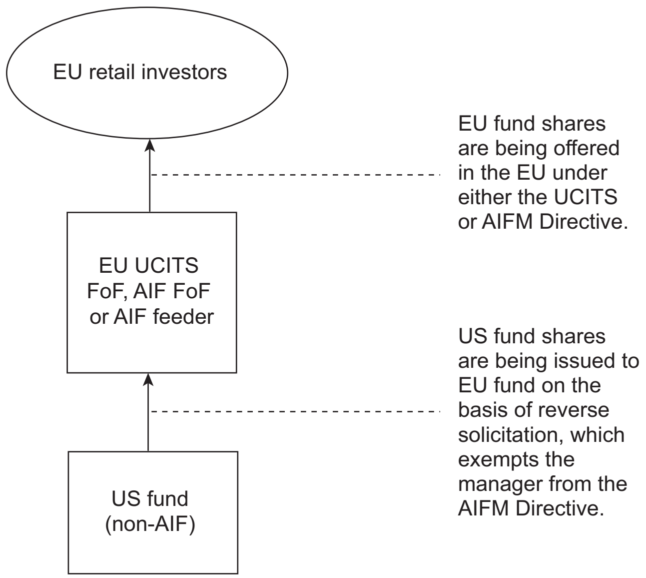
However, some US AIFMs, most notable US hedge fund managers, may stop actively marketing their shares in the EU and only sell shares through 'reverse solicitation', in which case the investor initiates the contact with the fund rather than the fund with the investors.[28] Reason for this will be to prevent applicability of the AIFM Directive. In such a situation, the manager does not offer US fund shares in the EU as a result of which it is not subject to the AIFM Directive. For these fund managers, the use of FoF or master-feeder structures may offer a valuable possibility to reach EU retail investors.

For example, in case an EU UCITS or AIFM Directive-compliant FoF invests in a US non-compliant hedge fund through reverse solicitation, EU retail investors are provided with indirect access to the hedge fund through the EU FoF (see Figure 5.1).[29] As the US hedge fund offers shares to the EU FoF relying on the reverse solicitation exclusion, it is not required to obtain a license under the AIFM Directive. In this structure, investors in the EU FoF will only obtain pre-contractual and ongoing information about the EU fund, although the manager is obliged to also disclose some details about the underlying US fund to the investors (see section 5.5.2). In case the EU FoF is however also excluded from EU law, for example because it is an AIF that falls

27. Including high-net worth individuals and individuals with significant and relevant work experience. *See also* section 2.2.3[A].
28. The definition of 'marketing' in Article 4(1)(x) of the AIFM Directive only encompasses direct or indirect offering or placement of AIF shares at the initiative of the AIFM or on behalf of the AIFM, thereby excluding 'reverse solicitation'. *See also* section 2.2.1.
29. *See* E. Cusworth, *No Warm EU Welcome for US Hedge Funds*, Financial News (24 Apr. 2014) (stating that '[m]any US hedge funds are choosing to stop marketing their products in Europe rather than comply with the Alternative Investment Fund Managers Directive' and 'the AIFMD could create a significant opportunity for the beleaguered European fund of hedge funds industry. An AIFMD-compliant fund of funds would be able to leverage its in-depth industry knowledge to access non-compliant US managers through reverse solicitation').

below the de minimis threshold,[30] investors may not receive any information about both the US fund (as well as the EU FoF or feeder). In this context, it can be noted that master-feeder structure will only be an option for EU AIFs since feeder UCITS may only invest in masters that are also subject to the UCITS Directive (see section 2.6.3).

Figure 5.1 US Fund Investing in EU Fund through Reverse Solicitation



In addition to the indirect offering of US fund shares, EU funds may also be offered via another (FoF or feeder) fund to EU investors. In such as case, investors would, similar to the EU FoF/feeder-US fund construction, only receive information about their investment in the FoF, and not, or to a limited extent, information about the underlying fund. It follows from all this that EU investors receive different types of information in relation to investment funds, depending on whether or not they would like to invest in a UCITS, AIF or US registered or unregistered funds and depending on whether or not the investment concerns a direct investment in the fund or an investment via another fund. In the next paragraphs, the various types of information that should be provided to EU investors before and after their investment as discussed in Chapters 3 and 4 will be compared. In order to find out which information EU retail investors receive when investing in funds, irrespective of the way in funds the fund shares are being distributed, I will look at both direct investments in EU/US funds as well as indirect investments via EU FoFs or feeders.

30. AIFMs that fall below the threshold are not subject to a license requirement but only to an obligation to register and thereby only limited reporting obligations apply.

5.5.2 Pre-contractual Disclosure Requirements

Suppose that EU 'professional' retail investors investing in a US fund receive the US fund's prospectus before they invest into the fund,[31] would they be provided with more sufficient information to base their investment decisions on than EU retail investors investing in EU funds? And would this also be the case compared to EU retail investors investing into US funds through an EU fund (FoF or feeder)?

To answer these questions, the content of the different initial disclosure documents should be analysed. However, in this respect, the following two comments can be made. Firstly, for UCITS, I will only look at the KII and for AIFs, the AIF prospectus. Although UCITS (and AIFs in case they are subject to the Prospectus Directive) may also be required to publish a prospectus, the KII and investor disclosure document are more likely to be read by investors before they make their investment decision due to the simple fact that they must be provided *prior* to an investor subscribing for shares. Furthermore, they can also be assumed to be providing more accessible and therefore better readable and understandable information than a lengthy and complex prospectus.[32] The same can be argued for the annual report that AIFs must provide on a pre-contractual basis. While technically also a pre-contractual information document (it must be provided by the AIFM to investor prior to the investment, see section 3.7), the level of details contained in it would make it generally unsuitable to serve as information document to base investment decision on. This may be especially the case for retail investors, including, for the purpose of the research, both individual (small) investors and professional (high-net worth or experienced) individual investors.[33]

Secondly, I will only look at disclosure requirements relating to certain areas, namely: [A] performance, [B] risk, and [C] cost disclosure. In general, investment decisions are based on two parameters, the expected return and risk.[34] As a result, investors will primary be interested in information on the fund's past performance, the expected costs and the risks associated with investing in a particular fund. In particular retail investors should be at least sufficiently informed on the potential benefits, risks

31. Either directly or via an intermediary.
32. Consumer research indicates that retail investors have difficulty assessing long, complex documents like a prospectus. By contrast, the shorter form, such as the UCITS KII (former: simplified prospectus) 'should be designed to be investor-friendly and should therefore represent a source of valuable information for the average investor'. *See* recital 15 to the UCITS III Management Company Directive.
33. The latter group may qualify as 'professional investors' to which AIFMs may offer AIF shares on the basis of the AIFM Directive. However, the term 'retail investors' is defined in section 1.3.1 as all individual investors, whether financially sophisticated or possessing skills in the financial field or not. Thus, individuals that invest in AIFs that are qualified as 'professional investors' under the AIFM Directive, are considered to be retail investors for the purpose of this book.
34. F. Reilly & K. Brown, *Investment Analysis and Portfolio Management* 183 (Cengage Learning 2011) (referring to the Markowitz's portfolio model that is based on several assumptions regarding investor behaviour, under which the assumption that 'a single asset or portfolio of assets is considered to be efficient if not other asset or portfolio of assets offers higher expected return with the same (or lower) risk or lower risk with the same (or higher) expected return').

and costs of a particular investment fund in order to make an informed investment decision and compare products.[35] Below, these three areas will be further analysed.

[A] Performance

Fund performance under the KII includes a bar chart showing ten years (or five in specific cases) of annualized performance history (calculated following the calendar year). The chart must also be accompanied with several (warning) statements.[36] The initial investor information required under the AIFM Directive should only provide information on the historical performance of the AIF. There are no rules relating to the reporting period or 'look-back period', as a result of which the fund manager may choose to report from the first year in which the fund has showed a good performance or may choose to disclose the results of only the last financial year to investors.[37] Furthermore, while structured UCITS, i.e., UCITS which are linked to price changes or other conditions of financial assets, indices or other UCITS portfolios, typically total return swaps, are held to disclose prospective scenarios of performance (what if?-scenarios),[38] are AIFMs only required to disclose *historical* performance results to investors.

Since investors in structured UCITS are considered 'to gain a better understanding of the merits and limits of a structured UCITS when provided with answers to "what if?" questions', the question can be raised why AIFs, which may also be linked to indices or other portfolios and thereby can be considered 'structured', are not subject to similar requirements? The only reasonable explanation for this can be found in the fact that the AIFM Directive and its underlying rules and regulations are aimed to be proportionate in view of the risks posed by AIFMs and the nature and complexity of the industry. Consequently, as stated by the Commission, 'any intervention is targeted and does not go beyond what is necessary in order to achieve the objectives'.[39] Considering that the AIFM Directive aims 'to provide for an internal market for AIFMs and a

35. *See* Impact assessment on the PRIP proposal, 13 ('The purpose of these [retail product] disclosures is typically to ensure comprehension of products including their specific risks and costs, and, in some cases, to enable investors to better compare between products') and OISCO, *Consultation Report – Principles on Point of Sale Disclosure* 7 (2009) ('Retail investors seem to be asking the following questions: how much can I make (returns); how much can I lose (risk); and how much does it cost (fees)').
36. Including a warning about the limited value of the bar chart, a brief indication of charges which have been included or excluded, an indication of the year that the UCITS came into existence and an indication of the currency in which past performance has been calculated. *See* Article 15(5) of Commission Regulation No. 583/2010.
37. Anson, *Handbook of Alternative Assets,* 183 (stating that '[b]ecause hedge fund managers hold the option of when to reveal their historical performance, it is reasonable to expect that they will disclosure their performance when their results look most favorable'). Under the AIFM Directive, hedge funds offering shares in the EU are however currently required to disclose some historical performance data, but this may lead to funds to only start disclosing after they have become successful.
38. Article 36(1) of Commission Regulation No. 583/2010 and CESR's guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS.
39. Impact assessment on the Commission Delegated Regulation on AIFMs, 5.

harmonised and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs',[40] additional performance disclosure requirements were most likely be considered to be not proportionate.[41]

To measure the performance of a fund, the assets of the fund should be valued. AIFMs (and UCITS) are required to adopt valuation policies and value their assets which should be applied consistently, but there are no requirements relating to the methods of valuation that may be used. In particular, valuation of unrealized, illiquid investments can be problematic for private equity and hedge funds, and leads to potential differences in practice.[42] While UCITS are subject to similar rules, the CESR has provided guidance as to which factors should be taken into account when valuing 'illiquid' assets, including the volume and turnover in the instrument and the bid and offer prices over a period of time. Furthermore, since UCITS are also generally less 'illiquid' in nature as opposed to AIFs (due to the investment restrictions imposed on them by the UCITS Directive), it can be reasonably concluded that investors of UCITS are better protected against malpractices or misleading fund performance representations than investors of AIF.[43]

With respect to US funds that are being directly offered to EU retail investors, the above applies relating to AIFs (unless an exemption applies). In case of a US open-end fund that has also provided the statutory or summary prospectus before the investment takes place, investors will receive the performance figures for each of the last ten calendar years (or for the life of the fund if less than ten years). If the fund has annual returns for at least one calendar year, it should provide a table showing the fund's: (A) average annual total return, (B) average annual total return (after taxes on distributions), and (C) average annual total return (after taxes on distributions and

40. Recital 4 to the AIFM Directive.
41. Although investors might well be interested in this information. For example, a study performed in 2008 by EDHEC Risk and Asset Management Research Centre finds that 'hedge fund managers think that information on risk-adjusted returns is relatively more important to investors', while investors 'stress the relevance of information on past returns and excessive risks'. EDHEC Risk and Asset Management Research Centre, *Hedge Fund Reporting Survey* 7 (November 2008). The report can be found at: http://www.edhec-risk.com/.
42. In general, there are four valuation methods that can be used to value companies: (1) discounted cash flow method, (2) comparable company method, (3) comparable transaction method and (4) market-based approach. The alternative fund industry generally uses the discounted cash flow method, which is a method which projects the expected cash flows over a given period, estimating the terminal value at the end of the period, so as to project the company's at that point in time, and then discounting cash flows at a discount rate that factors in the company's cash-flow risk. As the pricing of illiquid assets are more difficult than liquid assets, it could lead to different interpretation as to the cash flow realizations relating to these assets. Furthermore, if there is a high distress probability, the outcome of the discounted cash-flow valuation will overestimate the company and its share value, even if the cash flows and the discount rates have been correctly estimated. *See* F. Stefanini, *Investment Strategies of Hedge Funds* 194–195 (John Wiley & Sons 2006).
43. Although it can be noted that AIFs are required to disclose to investors, in the pre-contractual investor disclosure document, the valuation model used, including the reason for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them, and the limitations of the model-based valuation shall be appropriately documented. Furthermore, before being used, the model must be validated by a person with sufficient expertise who has not been involved in the process of building that model. *See* Articles 23(1)(g) of the AIFM Directive and 68(1) and (2) of the Commission Delegated Regulation on AIFMs.

redemption).[44] The table also should show the returns of an appropriate broad-based securities market index.[45] These requirements are to a large extent similar to the performance bar chart required for UCITS in the KII.[46] In case of a US closed-end fund, only the last year's operating performance per share is disclosed in the statutory prospectus.[47]

Thus, EU retail investors investing directly (or via an intermediary) in US open-end funds will generally receive similar information relating to the past performances of the funds as investors in UCITS, provided that they have actually received a statutory or summary prospectus (or another document providing similar information in the case of a US unregistered open-end fund)[48] at the pre-contractual stage. It can be noted that these investors will most likely receive more information on past performances than investors investing into US closed-end funds, which should only disclose the last year's performance, and EU AIFs, which are only required to provide some historical performance results.

However, in case an EU retail investor invests into a US fund through an EU (FoF or feeder) fund, he will in principle receive no past performance information about the underlying US fund since the EU fund is only required to disclose on the costs, risks and/or investment strategies of the funds in which it invests.[49] In case the EU fund is a UCITS FoF, it will only have to include in the KII: (1) a brief explanation on how the underlying funds are selected, (2) a narrative description of the risks posed by the underlying funds, and (3) a reflection of the entry/exit fees and ongoing charges levied by the underlying funds in its own ongoing charges figure.[50] AIF FoFs or feeders must only include in its prospectus: (1) where the underlying funds or master is established and (2) all the fees and costs directly or indirectly paid by investors, including fees paid to underlying funds.[51] However, since the same information rules apply to EU FoFs or feeders that invest in another EU fund, there is no difference in level of protection between indirect investment in EU funds and US funds.

44. Form N-1A, Item 4(b)(2)(ii).
45. *Ibid*. A fund may include, in addition to the required broad-based securities market index, information on one or more other indexes. If an additional index is included, disclose information about the additional index in the narrative explanation accompanying the bar chart and table is required (e.g., by stating that the information shows how the fund's performance compares with the returns of an index of funds with similar investment objectives). *See* Form N-1A, Item 4, Instruction 2.
46. Article 15 of Commission Regulation No. 583/2010.
47. Form N-2, Item 4(1).
48. *See* section 4.8.
49. Investors, in particular passive retail investors, will generally also not look for this information themselves. Furthermore, they generally do not known which information is missing as this assumes that they would both look beyond the information they receive from the fund manager of the EU fund (or their intermediary) and understand the complexity of the fund structure used.
50. Articles 28–30 of Commission Regulation No. 583/2010.
51. Article 23(1)(a) and (i) of the AIFM Directive.

[B] Risks

Pre-contractual risk disclosure by UCITS occurs through the 'the risk and reward profile' section included in the KII. In this section, UCITS are required to include the SRRI, a description of the SRRI's main limitations, and the risks materially relevant to the fund which are not adequately captured by the SRRI. While it is questionable whether the adoption of the SRRI is a success,[52] it provides investors with at least a uniform tool to compare the risk profile of different UCITS. Investors in AIFs are only provided with a (narrative) description of the risks employed. In this context, it is interesting to note a research commissioned by the European Commission and performed by IFF Research Ltd and YouGov, in which the content of the KII was tested among UCITS investors (including both retail and institutional investors) across various EU Member States. According to this research, investors in general appear to prefer the SRRI over a narrative description of the risks, as they 'found it easier to understand than the purely narrative description'.[53] More particularly, the SSRI is being viewed as more 'user-friendly' and therefore more appropriate. However, more detail on the fund in the accompanying explanation of the indicator as well as more detail on how the categories are distinct, may be, according to the report, useful.[54]

AIFMs must disclose for each AIF its manages or markets in the EU, a description of the 'techniques it may employ and all associated risks', 'the types and sources of leverage permitted and the associated risks' and 'the maximum level of leverage the AIFM [is] entitled to employ on behalf of the AIF'.[55] Since the initial investor disclosure document is form-free, no risk indicator nor any other requirement on how the risks should be described applies. The AIFM Directive mainly focuses on the requirement for AIFMs to implement policies and procedures to implement to identify, monitor and manage risk, i.e., risk management policies, and the establishment of a permanent and independent risk function.

As part of the risk management policy, the AIFM must assess the current risk profile of the AIF, which must be disclosed periodically to investors (but not pre-contractually).[56] The risk profile should be consistent with the risk limits that have been set in accordance with the AIFM Directive.[57] These risk limits should cover, at least: (1) market risks, (2) credit risks, (3) liquidity risks, (4) counterparty risks and (5) operational risks.[58] The description of the associated risks in the AIF prospectus will often cover the same risks as those included in the risk profile of the AIF, although

52. *See* section 3.7.1[B].
53. IFF Research and YouGov, *UCITS Disclosure Testing Research Report – Prepared for European Commission*, 11.
54. *Ibid.*, 87. For example, when presented with a scale of risk from 1 to 7, 42% of investors thought that a risk rating of 1 (the safer end of the scale) meant that their investment would be largely unaffected by any widespread financial turmoil and 18% could not answer the question (despite the fact that the explanation of what the numbers meant said that 'a category 1 fund is not a risk-free investment'). *Ibid.*, 76.
55. Article 23(1)(a) of the AIFM Directive.
56. Article 23(4)(c) of the AIFM Directive.
57. Article 39(1)(b) of the Commission Delegated Regulation on AIFMs.
58. Article 44(2) of the Commission Delegated Regulation on AIFMs.

some risks may not be described in case they are considered to be not 'associated' with the activities of the fund. Also, different risks categories may be combined into one category or may be named differently than the names used in the risk profile of the AIF, which may result in investor confusion.

With respect to leverage, the main reason for requiring AIFMs to disclose their exposure lies in the fact that leverage can create systemic risk.[59] However, as a secondary reason, it also magnifies the impact of risks for investors, as a result of which investor disclosure is required.[60] In the initial disclosure document, the general types and sources and maximum level of leverage permitted and restrictions on the use of leverage, are to be disclosed. AIFMs are however not required to disclose in this document the amount of leverage employed by the fund. This information, including any change in the maximum level of leverage that may be employed, should be disclosed to investors 'regularly', but not per se in the initial document.[61]

EU 'professional' retail investors that invest directly in US funds will thus receive the narrative risk information as required by the AIFM Directive in the AIF prospectus, whether they are financially sophisticated or not. In addition, when provided with a summary/statutory prospectus a US open-end fund beforehand, they are provided with a narrative description which 'summarize[s] the principal risks of investing in the Fund, including the risks to which the Fund's portfolio as a whole is subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, and total return'.[62] In addition, the prospectus should disclose that loss of money is a risk of investing in the fund.[63] In case the fund is a diversified fund, it should describe the effect of non-diversification (e.g., disclose that, compared with other funds, the fund may invest a greater percentage of its assets in a particular issuer), and summarize the risks of investing in a non-diversified fund.[64] US closed-end funds are required to 'discuss the principal risk factors associated with investment in the [fund] specifically as well as those factors generally associated with investment in a company with investment objectives, investment policies, capital structure or trading markets similar to the [fund]'.[65] In addition, they should disclose the annual rate of interest payments or dividend payments on senior securities (leverage exposure).[66]

It follows from these rules that the pre-contractual risk disclosure by US funds more closely resembles the AIF disclosure style than the risk/reward section of the KII for UCITS (description risk/risk factors and leverage exposure in case of a closed-end

59. Recital 49 of the AIFM Directive ('Given that it is possible for an AIFM to employ leverage and, under certain conditions, to contribute to the build up of systemic risk or disorderly markets, special requirements should be imposed on AIFMs employing leverage').
60. Impact assessment on the Commission Delegated Regulation on AIFMs, 10.
61. Article 23(5) of the AIFM Directive.
62. Form N-1A, Item 4(b)(1)(i).
63. *Ibid*. This requirement does not apply to MMFs, which have to, instead, state that '[a]n investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency' and that '[a]lthough the Fund seeks to preserve the value of your investment at USD 1.00 per share, it is possible to lose money by investing in the Fund'. *See* Form N-1A, Item 4(b)(1)(ii).
64. Form N-1A, Item 4(b)(1)(iv).
65. Form N-2, Item 8(3)(a).
66. Form N-2, Item 8(3)(b).

fund). Consequently, when an EU retail investor invest directly into a US mutual fund, it will receive risk information in a different style (in a narrative form), whereas they would receive the SSRI-style of risk disclosure when investing directly into a UCITS, the EU counterparty of the US mutual fund. The question can be raised whether this difference in regulation is severe enough to advise the EU regulator to adopt additional regulations in this respect. At first sight, I believe that this is not the case since the information content that is given to investors is merely the same under both regimes. The information is however provided in different forms. Furthermore, the costs incurred in developing new information documents is generally considered to be high.[67] However, it can also be argued that investors benefit highly from more comparable information about different retail funds. In section 5.8, I will get into more detail on this issue.

When a UCITS FoF invests in a US fund, it should provide investors with a narrative description of the risks posed by the US fund, which description may not be much different from the description set out in the prospectus of the US fund. However, in case an EU retail investor invests in a US fund though an AIF, no information about the risks of the fund is to be provided in the pre-contractual phase, as the AIFM must only disclose information about the costs of its underlying funds.[68] For UCITS FoFs and AIF FoFs/feeders investing in other EU funds, the rules are equivalent, as a result of which the way in which investors are protected when investing indirectly in EU funds and US funds is the same (thus: no distortion of the level playing field in this respect).

[C] Costs

The costs in respect to UCITS are disclosed through the charge figures in the charge section of the KII. It includes three separate figures of charges that are to be paid by the investors for running and distributing the UCITS (i.e., entry and exit fees (max. in %), ongoing charges (in %), and performance-based fees (in %). The section must also contain a reference to the fund's prospectus for more information, a statement that the charges are maximum figures and that investors in some cases might pay less, a statement that the entry and investor can find out the actual entry and exit charges from their intermediary, and a statement that the ongoing charges figure is based on the last year's expenses and that this figure may vary from year to year where this is the case.[69] Lastly, it must contain a general statement about the importance of charges, which makes it clear that the charges paid are used to pay the costs of running the UCITS, including the costs of marketing and distributing the UCITS, and that these charges reduce the potential growth of the investment.[70]

AIFMs should disclose all fees and expenses directly (i.e., entry/exit fees and dilution costs) or indirectly (all other costs levied at the fund level) paid by investors.

67. *See* on this matter with respect to the furnishing of a prospectus, M. Sabine, *Corporate Finance*, Ch. 5(II) (2nd ed. Butterworths 1993).
68. *See* n. 50, *supra*.
69. Articles 11(1) and 14 of Commission Regulation No. 583/2010.
70. Article 11(2) Commission Regulation No. 583/2010.

As the AIFM Directive is not specific on the format of information to be provided, different disclosure documents may be used containing different information. So may some AIFMs provide for a charge table in their AIF prospectus, while others may only provide for a description of the fees and expenses that the fund incurs and will refer to their website or annual reports for an overview of the charges and expenses of the previous year. A quick scan of some investor disclosure documents of AIFs managed by large AIFMs (including J.P. Morgan and Blackrock) shows that they appear to use two different methods to disclose their costs to investors in the investor disclosure document: (1) by including a separate category containing a (brief) description of the fees and expenses with a reference to the annual report and/or the website of the fund and/or (not often) a chart table encompassing the amount of fees (in %), (2) by splitting the information on fees and expenses into different item categories (e.g., auditor, depositary, management, etc.), in which a reference to the annual report and/or the website of the fund or the amount of fees (in %) charged are disclosed. In any case, investors in AIFs will generally not be provided with cost information in an accessible and comparable format and may not have received the information before they invest in the fund (as they will have to actively look for it themselves in the fund's annual reports and/or on its website).

Although the investor disclosure document is technically handed to investors before they invest in the fund, the information relating to the fees and expenses of the fund is provided in a layered approach, i.e., supplementing the information with additional and more detailed information either upon request or through additional supplementary material attached or linked to the disclosure document.[71] Investors, in particular professional investors, yet still individual investors allowed to invest in AIFs, may find it difficult to locate the information about the potential costs in these documents and, even if they have found it, may not properly interpret the information included in the documents. Furthermore, AIFMs are not required to, as opposed to UCITS, clarify that the costs mentioned in the disclosure document are maximum fees which can vary (higher or lower) or might be lower (in case of entry/exit fees). Consequently, investors may have difficulty in understanding the cost information provided to them correctly and information may be buried from them through the layered approach or the fee-splitting of costs in the investor disclosure document.

US funds offered directly in the EU under the AIFM Directive will have to provide their European investors with the initial investor disclosure document including the above mentioned information. Thus, the same considerations as described for EU-based AIFs apply. When investors however also receive the summary or statutory prospectus of the fund under US law, they are provided with a fee table setting forth the direct fees (i.e., entry/exit fee, sales charge on reinvestments, redemption fee, exchange fee, and account fee) and the indirect fees (i.e., management fees, including performance-based fees, interest payments on borrowed funds, 12b-1 fees, and other

71. *See also* OISCO, *Consultation Report – Principles on Point of Sale Disclosure*, 12.

expenses) paid by investors.[72] The entry fee is stated as a percentage of the public offering price of the shares, the exit fee are most often assessed as a percentage of assets, and the redemption fee for open-end end funds is listed as a percentage of amount redeemed.[73] The entry/exit and redemption fee should be set as a maximum percentage that the fund can charge investors. The indirect costs percentages ('annual operational costs') should be based on amounts incurred during the fund's most recent fiscal year.[74]

The prospectus should furthermore include an expense illustration example showing the costs an investor would incur for different time periods when investing USD 10,000 in the fund at a 5% return each year with equal annual operating expenses.[75] The example does not reflect entry/exit fees on reinvested dividends. The fee table must also contain a statement that transaction costs paid by the fund when buying or selling securities are not included. Instead, the portfolio turnover rate of the most recent fiscal year should be disclosed.[76] However, when the fund is an open-end feeder fund, the prospectus should reflect the aggregate expenses of the feeder fund and the master fund in a single fee table.[77] US FoFs and closed-end feeder funds should include a subcaption to the annual operational costs section of the table disclosing the fees and expenses incurred indirectly by the fund as a result of investment in one or more 'acquired funds', i.e., public funds.[78]

When comparing the US rules to the KII cost disclosure requirements applying to UCITS, it becomes clear that both sets of rules are very much alike (similar cost categories and disclosure method). The main differences relate to the expense illustration example (not mandatory for UCITS, but required for US registered funds under Forms N-1A and N-2) and the disclosure of fees charged by underlying funds in case of a FoF (disclosed within a UCITS' own ongoing charge figure as opposed to a separate disclosure line in case of a US fund investing in 'public' FoFs). However, these differences can, in my view, not be considered severe and important enough to propose additional regulation for UCITS on these matters to protect investors. This is mainly

72. Form N-1A, Item 3 and Form N-2, Item 3(1). Closed-end funds are however not required to disclose an exit fee, redemption fee, exchange fee, and account fee and open-end funds are not required to disclose interest payments on borrowed funds (as they are not allowed to borrow money).
73. Form N-1A, Item 3.
74. Form N-1A, Item 3(f)(iv).
75. Form N-1A, Item 3 and Form N-2, Item 3(1).
76. Form N-1A, Item 3 and Form N-2, Item 4(1). A fund's portfolio turnover rate measures the percentage of its holdings a fund sells and replaces, or turns over, in a year. A US open-end MMF may omit the portfolio turnover rate. *See* Form N-1A, Item 3, Instruction 5. Closed-end funds are required to disclose the portfolio turnover rate in the financial highlights item instead of the fee table.
77. Form N-1A, Item 3, Instruction 1(d)(i).
78. Form N-1A, Item 3, Instruction 3(f)(i) and Form N-2, Item 3(10a). An 'acquired fund' means 'any company in which the Fund invests or has invested during the relevant fiscal period that (A) is an investment company or (B) would be an investment company under section 3(a) of the Investment Company Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7))'. *Ibid*. Consequently, non-public funds, including most hedge funds and private equity funds, will be excluded from this definition. *See* section 4.3.

because of the fact that the scope of these duties for US funds is very limited. The illustration expense example is a highly simplified example that uses assumed figures, which runs the risk of being not realistic and over-reliance by investors. The requirement for US FoF's to include a separate disclosure line in their charges table is limited in relevance due to the fact that investments in 'non-public' funds, including, among others, most hedge funds and private equity funds, are excluded from its scope. Because of these limitations, I believe that the benefits of imposing these requirements on UCITS would be disproportionate low compared to the costs of the UCITS industry of complying with them.

In case an EU UCITS FoF invests in a US fund, the fees charged by the US fund are disclosed in the ongoing charges figure of the UCITS' KII. This combined figure does not state, as opposed to the separate line required in the fee table of US FoFs, the management fees incurred by the US fund. Consequently, there is a risk that investors may not be aware of this additional layer of costs in case this is not properly disclosed to them by the UCITS FoF and/or the intermediary through which they buy the UCITS' shares. As the IOSCO has put it, '[i]nvestors should be made aware that investing through a fund-of-funds structure means that, in effect, two sets of fees are payable on the investment. This could be helpfully illustrated by an example showing the total amount of fees payable from the investors' money'.[79] EU AIFs investing in US funds should disclose the fees paid to their underlying funds in the initial investor disclosure document, but they may do so by only disclosing the total aggregated percentage or amount of costs and fees payable by investors and/or by simple referring to the website of the US fund and/or its annual report of the previous year.[80] Similar as to the performance and cost disclosure, there is no difference between EU funds investing in US funds and EU funds investing in other EU funds as regards the cost disclosure related to the underlying fund. Consequently, there is no difference in protection level, as a result of which no gap in the level playing field for EU investors can be identified.

5.5.3 Ongoing Disclosure Requirements

Every fund that offers its shares in the EU is held to provide investors with an annual report. In addition, UCITS and US registered funds should also publish half-yearly reports, and US registered funds are held to also publish quarterly reports. Period reports contain detailed financial and operational information of the fund, including information on the directors and fund, the fund manager's report, the NAV and number of shares in circulation, the financial statements, including the fund's, balance sheet, statements of investments and portfolio changes, profits and loss account (including the fund's remuneration) and notes to the statements, director's report, custodian's report, auditor's report, a summary of the financial data, performance data and several

79. IOSCO, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Fund-of) Hedge Funds*, 9.
80. Article 23(1)(i) of the AIFM Directive.

ratios (e.g., TERs and portfolio turnover rates).[81] Because of the extensive list of information that should be included in such reports, they are often very long (often over 100 pages) and include many sections. In addition, much information, in particular the financial statements, contain highly technical information which is difficult to understand for the average investor. Similar as for prospectuses, it can be argued that, even if investors have found the information they need, annual reports are often considered to be too complex for retail investors to analyse and process, and to use in a rational way.[82] Moreover, as periodic reports are provided to investors after they have made an investment decision, they cannot be regarded as documents that are used by investors to make informed judgments about whether or not to buy particular securities. By contrast, they may even serve as a means for the fund manager to protect itself against potential liability claims as opposed to the protection of investors.[83]

However, despite these remarks, it can be concluded that EU funds and US funds will to a large extent be required to disclose similar, and equally complex, information in their periodic reports, so that investors will 'benefit' from a relatively equal protection level. Of course, there are some differences in disclosure requirements that can be noted here. An example is cost disclosure. UCITS FoFs that invest in US funds must disclose the strategies of the US fund and the maximum proportion of management fees charged both to the UCITS itself and to the US funds.[84] In other words, actual aggregate management fees at both levels have to be disclosed in the UCITS annual report. On the other hand, AIFs FoFs/feeders are only required to disclose information on the total amount of fees and costs incurred by the fund in their annual reports, which includes the fees paid to underlying fund(s).[85] Thus, they are only required to disclose the management fees at one level to EU investors: the FoF or feeder level. When comparing these rules, it can be concluded that with respect to indirect investments in funds, investors in UCITS FoFs receive more adequate cost information about the underlying fund investments than investors in AIF FoFs or feeders. Nevertheless, there are no differences in this respect when the EU FoF/feeder invests in a US or EU fund. For comparison reasons, the level of protection that EU investors enjoy in EU and US funds regarding this issue appears to be the same.

81. Annex I, Schedule B to the UCITS Directive and Articles 22(2) of the AIFM Directive, 107 of the Commission Delegated Regulation on AIFMs, and 30(b) to 30(e) of the 1940 Act and the rules thereunder.
82. *See*, e.g., M.C. Thomsett, *Annual Reports 101*, 2 (AMACOM/American Management Association 2007) (stating that '[t]he highly technical accounting and analytical language and footnotes in the annual report are often of very little use to anyone who has not had an accounting education') and, with respect to disclosure requirements in general, Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform,* 51 ('The inability of less sophisticated retail investors to understand and use information rationally serves to limit (…) the usefulness of mandatory disclosure requirements').
83. *See* F.H. Easterbrook & D.R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 705 (1984) (stating that 'broad disclosure rules are very effective in reducing risk in exchange for minor alterations of firms' disclosures') and Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform,* 52 ('the risk of information overload is even more acute today as the risk of liability for failure to disclose has increased since corporate scandals of the early 2000s').
84. Articles 50(1)(e)(iii) and 55(3) of the UCITS Directive.
85. Article 22(2)(e) of the AIFM Directive.

Besides periodic reports, some funds are also required to disclose continuous information to investors. The only continuous disclosure requirement for UCITS concerns the publication of their NAV at least twice a month.[86] Other mandatory disclosures do not exist, but this does not prohibit UCITS to publish promotional materials for marketing purposes. In addition, the directive sets forth a number of subordinate rules applying in specific situations, such as the requirement that index-tracking UCITS must include a prominent statement drawing attention to their investment policy in their marketing communications.

AIFMs are subject to a number of other periodic and continuous disclosure requirements. They are required to disclosure to investors, in case they are leveraged, the maximum level of leverage they employ and total amount of leverage of the relevant AIF. In addition, they should disclose their NAV and any special arrangements they are subject to arising from their illiquid nature, their risk profile, and risk management systems. AIFMs may provide this information in their terms and conditions, through general website disclosures, or as part of the AIF's prospectus or offering document, as long as the information is published -as a minimum- at the same time the annual report is published.[87] AIFMs therefore enjoy considerable flexibility in how they provide the required disclosures, with the only limitation that changes to the maximum leverage employed new special arrangements should be disclosed to investors immediately.[88]

US registered funds are not subject to investor-related continuous disclosure obligations, besides the daily publications of the NAV in case the fund is open-end,[89] as they are only required to publish annual, half-yearly and quarterly reports (and various pre-contractual information –see above). US unregistered funds however have no obligation to publish periodic reports, although certain financial information will generally be available to investors via the fund's or fund manager's website. However, when US funds are being offered in the EU, they will generally do so under the AIFM Directive, as a result of which the AIFM continuous disclosure rules apply, or via another EU FoF or feeder (see section 5.5.1). In the latter case, there is also no difference in investor protection level between EU and US funds that can be identified. The EU FoF or feeder will provide similar 'ongoing' information to investors about the underlying EU funds and the US funds.

5.6 CONDUCT OF BUSINESS RULES

UCITS management companies and AIFMs are, through the conduct of business rules set out in the UCITS and AIFM Directive, placed under the fiduciary duty of loyalty and care. US fund managers are subject to similar duties under state common law and/or federal law. In addition, under US law, fund directors, trustees and general partners are also subject to fiduciary duties towards the fund and the investors.

86. Article 76 of the UCITS Directive.
87. Articles 108 and 109 of the Commission Delegated Regulation.
88. Articles 108(3)(b) and 109(1) of the Commission Delegated Regulation on AIFMs.
89. Rule 2a-4(a)(2) of the 1940 Act.

In addition, it must be noted that fund managers generally only owe fiduciary duties towards the funds they manage. The UCITS and AIFM Directives explicitly state this, although they are required to treat all investors of the funds they manage fairly (see also below). Under US law, this rule also applies. Reason for this can be found in common law which specifies that the fund is the direct client of the manager and thus is the principal in the fiduciary agency relationship. As a result, the fund (represented by its internal board), and not the investors, must take the steps required to enforce any such claims. However, since many board members have a personal financial interest in remaining on good terms with the fund manager, even though this may not be in the interest of investors, there is a risk that the fund board will not file suit against the manager in case of a breach of fiduciary duty. The same applies to the fiduciary duties imposed on fund managers under the Advisers Act, although these duties generally cannot be enforced in private actions.[90] In the following two subparagraphs, the main differences between the two conducts of business duties of loyalty and care under EU and US law are discussed.

5.6.1 The Duty of Loyalty

The principal duty of loyalty encompasses a number of subduties, most notably the duty to act in the best interest of the fund, the duty of confidentiality, and the duty of disclosure. In general, EU law requires fund managers to treat all investors fairly, although preferential treatment of investors is allowed under the AIFM Directive, as long as this is properly disclosed.[91] In addition, some Member States may consider different treatment of investors to be ‘fair’ if this is disclosed prior to investors.

This standard for minimal disclosure also applies to the best execution standard, i.e., the requirement establish, monitor and review an execution policy that applies to the trading decisions of the fund with a view to obtain the best possible result of investors. The fund manager must determine the objectives, investment policy and risks specific to the UCITS or AIF, the characteristics of the order, the characteristics of the financial instruments that are the subject of that order, and the characteristics of the execution venues to which that order can be directed.[92] However, the manager is only required to establish an execution policy, obtain prior consent of the fund, and disclose appropriate information about that policy to investors.[93] There are no requirements for investor consent or demonstration of compliance to investors.[94]

90. *See* section 4.9.
91. So may AIFMs provide certain ‘seed’ investors with better terms, such as preferential fees, than those investing later in the AIF subject to disclosure of the different treatment.
92. Articles 25(2) and 26(2) of Directive 2010/43/EU and 27(2) and 28(2) of the Commission Delegated Regulation on AIFMs.
93. Articles 26(2) of Directive 2010/43/EU and 28(2) of the Commission Delegated Regulation on AIFMs.
94. UCITS management companies and AIFMs are only required to obtain prior consent of the fund (which is represented by its board). They should demonstrate that they have executed orders on behalf of the UCITS/AIF in accordance with the manager’s execution policy, but it is not clear to whom they should demonstrate this. This duty will be most likely interpreted as a duty to demonstrate best execution at the request of the fund.

In addition, in order to comply with the duty of best execution, fund managers are left with substantial latitude over how the concept is defined. In general, the best execution standard does not require fund managers to determine whether they achieve with each order the best possible result for each fund, but merely that the order is executed in accordance with the execution policy adopted.[95] The policy should however be monitored and annually reviewed by the fund manager and, where appropriate, corrected.[96]

US registered fund managers are also subject to the duty to adopt a best execution and allocation policy under SEC rules, which policies should be reviewed and monitored by the CCO. They are not required to disclose these policies as the Advisers Act only states that they should establish them. The SEC Staff has however outlined a number of situations under which the manager should disclose its practice to their fund clients, e.g., when participating in soft dollar arrangements, when orders are not aggregated, and when exercising potential conflicting transactions.[97] In addition, each fund manager is required to disclose all material conflicts of interest, or potential conflicts of interest, to its clients under Article 206 of the Advisers Act. When the fund manager acts as a principal in a transaction with a fund client, he must disclose the arrangement and the conflicts of interest in this practice (in writing) and also obtain the fund's consent for each transaction prior to the time that the trade settles.

Considering these rules, it can be argued that the US disclosures regarding conflicts in relation to order execution provides in general terms for at least the same level of disclosure as the broad EU rule of disclosing all 'appropriate information to investors'. A difference that can be noted is the fact that UCITS management companies and AIFMs should disclose information about their execution policy to the fund (by obtaining its consent) *and* investors, while US fund managers are only required to disclose best execution practices to the fund.[98] However US registered funds are required to provide such information in the SAI, which can be obtained by investors upon request (and may often be published on the fund's website).[99] Similar to the EU best execution standard, US law does not require fund managers to always achieve the best possible result for individual funds. They satisfy their best interest obligation by executing the order on a consistent basis in accordance with their execution policy, subject to annual review.[100]

95. *See also* Van Setten, *The Law of Institutional Investment Management*, 260 (stating that '[t]he duty to obtain best execution (…) is a duty to use skill and care in the design and implementation of execution processes, rather than a duty to obtain a quantitative result').
96. Articles 25(4) of Directive 2010/43/EU and 27(4) and (5) of the Commission Delegated Regulation on AIFMs.
97. SEC Staff, *Division of Investment Management and Office of Compliance Inspections and Examinations, Information for Newly-Registered Investment Advisers*, http://www.sec.gov/divisions/investment/advoverview.htm, accessed on 14 December 2014.
98. This is also in line with US common law, which identifies the fund as the principal and the fund manager as the agent in the agency relationship.
99. *See* section 4.8.1.
100. Rule 206(4)-7(a) of the Advisers Act requires fund manager to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. Rule 206(4)-7(b) of the Advisers Act requires that an annual review of the policies should be conducted. Rule 206(4)-7 does not prescribe how fund managers should conduct

Under the duty of confidentiality, information that is given in circumstances where such a duty applies cannot normally be used without the provider's consent. EU law has codified this duty by requiring fund managers to establish procedures to safeguard the security, integrity and confidentiality of information. In the US, the duty of confidentiality has a basis in both common and federal law. The common law duty applies to directors and the federal law duty to fund managers. The federal law duty is embedded in Article 206 of the Advisers Act.

In both the EU and US, the duty of confidentiality may conflict with the duty to act in the best interest of investors. This may be the case if, for example, the fund manager manages multiple funds. A decision of the fund manager that is in the interest of one fund (e.g., to sell portfolio securities), could be disadvantageous for the other fund in case the manager uses that information by deciding the exact opposite (to buy the securities) at the same point in time. While on the one hand the duty to act in the best interest imposes a positive duty to act in a beneficiaries' best interest, it also imposes the negative obligation to refrain from doing anything that would injure a beneficiary, independent whether or the action would benefit another beneficiary. As a consequence, the duty of confidentiality prevails in case a fund manager possesses information related to investment decisions of one fund that, when used, would harm that fund but benefits another fund.[101]

The duty of disclosure can be viewed as a secondary duty which arises when a fiduciary has failed to avoid conflicts of interests or finds himself or herself in an avoidable conflict. Under both EU and US law, a fund manager has been provided with the option to disclose to the fund both actual and potential conflicts of interest that may affect the manager's service to the fund. So requires the UCITS and AIFM Directive fund managers to implement conflict of interest policies that identify conflict of interest situations, such as transactions with affiliates of the fund manager and soft dollar arrangements, and assesses the potential risks of damage to the fund's interests or its investors. When the manager cannot avoid the conflict and the measures set out in the policy do not prevent the risk of damage to the interest of investors, both the fund board (or the senior manager) and investors must be informed about this fact. The fund board is furthermore provided with the task to ensure that the manager in any case acts in the best interest of the fund. When the board is thus of the view that, despite the disclosure, the fund manager does not act in the best interest of the fund it is obliged to take 'any necessary decision' in this respect, e.g., terminate, if possible, the management contract. However, besides of the fact that fund boards often have a financial stimulus to keep the manager, the contract may also provide a provision that

compliance reviews or who should conduct them. It only provides that the CCO is responsible for 'administering the policies and procedures' adopted, which duty may be limited to planning and coordinating of the compliance reviews, and reviewing the results of tests and analyses performed by others. As a result, fund managers have ample flexibility to design and carry out compliance reviews in a manner that best suits their particular circumstances.

101. According to Spangler, investment management contracts will generally provide for a provision, i.e., a hedge clause, that permit this type of activity or reduce the scope of the best interest standard. *See* Spangler, *Investment Management – Law and Practice*, 381–382. However, a hedge clause that eliminates the best interest standard completely is prohibited by securities law and may result in administrative sanctions from securities authorities.

limits this option, making it subject to a sixty or ninety days written notice period. Since transactions are made on a daily basis, this will often be far too late to be able to serve effectively the fund's interest. US common law requires fund managers to fully disclose actual and potential conflicts to the fund (not the investors).

Similar to EU law, the US common law duty of loyalty restricts absolute unfair behaviour (whether disclosed or not) that violates the general best interest standard, such as self-dealing transactions which are not performed on an arm's-length basis. The reasonableness of such transactions should however be evaluated by the fund's board, being the beneficiary of the manager. In addition, US federal law provides for a number of provisions that prohibits certain self-dealing transactions and soft dollar arrangements and requires fund manager to disclose all material conflicts of interest, or potential conflicts of interest, to the funds they manage that arise during the management relationship.[102] Registered funds and fund managers should also implement conflict of interest policies to identify and address the conflicts related to their business practice.[103]

The above shows that, despite the different approaches, the duty of loyalty has been applied in the EU and the US in very similar ways. In short, fund managers must adhere to the best interest standard, although in some occasions the standard is set aside in case it conflicts with the duty of confidentiality or when a particular conflicting situation has been properly disclosed. A difference in this context relates to the recipient of this disclosure. US law only requires a fund manager to disclose conflicts to the fund itself, whereas UCITS management companies and AIFMs should disclose their conflicts to the fund and the investors. However, US registered funds are required to disclose the allocation policy in their SAI,[104] as a result of which this difference cannot be observed to be significant.

5.6.2 The Duty of Care

The duty of care can be summarized as a duty to exercise the special skills and expertise to take reasonable measures to prevent harm to the person or persons to which the duty is owed. The EU regulator has codified this duty by imposing two standards on fund managers: (1) that they must be of sufficient good repute and experienced, and (2) should perform adequate due diligence in the selection of their portfolio investments. US law imposes a broader requirement on fund boards and managers, referring to the prudent investor rule for fund boards of MBT funds and the prudent professional

102. Article 17(a) of the 1940 Act generally prohibits a fund affiliate – such as the fund manager – from borrowing money or other property from, or selling or buying securities or other property to or from, the fund or any company that the fund controls. Articles 17(e)(1) of the 1940 Act and 28(e) of the 1934 Act prohibit a fund affiliate to receive compensation when purchasing or selling property for a registered fund, except when the manager has received, in return, qualifying research or brokerage services from its broker(s). Article 206(3) of the Advisers Act imposes a fiduciary duty on the fund manager to disclose all material actual and potential conflicts of interest and principal or agency transactions to their fund clients.
103. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74716–74717.
104. *See* section 4.8.1.

person rule for all fiduciaries. Under these rules, the fiduciary is either required to act as a prudent investor, with a focus on maximizing the return of the overall investment portfolio, or to act in a way that any other professional fiduciary would in similar circumstances. In order to be able to meet these standards, the fiduciary should possess the necessary skills required to perform its services. If he does not possess such skills, he should not act.[105] In addition, under the US common law duty of care, fund fiduciaries are also obliged to not mislead investors and to provide them with all material information to the extent relevant to the investor. As a result, US funds will generally be inclined to provide investors with pre-contractual information prior to the investment, even if they are not required to do so under US federal law.[106] This however does not pose a difference with EU funds, as both UCITS and AIFMs are subject to several pre-contractual disclosure requirements (see section 5.5.2).

Both EU and US law do not specify which skills a manager (or board director) should reasonably possess, leaving it up to the particular (national) securities authority to determine whether or not a fund manager or board meets this standard. In the US, however, federal law provides for a list determining which persons are deemed to be ineligible to act as a director of a fund board or an employee or director of a fund manager for a registered fund, including any person who has been convicted of 'any felony or misdemeanour involving the purchase or sale of any security' or 'any person who, by reason of misconduct, is permanently or temporarily' prohibited to act as, among others, employee of a registered fund or fund manager.[107] EU Member States have however adopted similar rules into their national law.[108]

Investment due diligence should be performed by fund managers under both EU and US law. However, where the UCITS and AIFM Directive places a clear duty on fund managers to establish policies on due diligence and to implement 'effective arrangements for ensuring that investment decisions on behalf of the UCITS/AIF are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS/AIF',[109] US common law imposes no such duty on fund managers. Instead, fund managers will generally perform due diligence when selecting their portfolio securities in order to avoid a breach of the general anti-fraud provision of Article 206(2) of the Advisers Act, which prohibits any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. The SEC's OCIE declared that a fund managers' due diligence process must determine whether their investments: (1) meet the funds' investment objectives, and (2) are consistent with the

105. Spangler, *The Law of Private Investment Funds*, 87.
106. As is the case for US unregistered funds, see section 4.8.
107. Article 9(a)(1) and (2) of the 1940 Act. A person who is ineligible under Article 9(a) of the 1940 Act may file an application with the SEC for an exemption under Article 9(c) of the 1940 Act. The SEC is required to grant this exemption if the prohibitions, 'as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application.'
108. *See* section 2.7.4[B].
109. Article 23(3) of Directive 2010/43/EU and 18(3) of the Commission Delegated Regulation on AIFMs. AIFMs must furthermore comply with additional rules related to the monitoring of 'assets with limited liquidity' and are precluded from entering into transactions with unregulated entities.

investment principles and strategies that were disclosed to the fund clients.[110] In addition, while technically not required under federal law, many of the fund managers examined had written, formal due diligence policies and procedures or guidance in place.[111] In case a fund manager has disclosed its due diligence policy it to its fund clients, it should adhere to it or risk an enforcement action of the SEC for a violation of Article 206(2) of the Advisers Act.[112]

In conclusion, as with regard to the duty of loyalty, the application of the duty of care appears to be very similar under both EU and US law. While US law provides for list requiring when directors of funds and fund managers are eligible, EU Member States imposes similar rules under national law. In addition, EU law imposes a clear duty on fund managers to establish investment due diligence policies, but US fund managers will generally also adopt such policies to avoid a breach of US federal law. However, under both frameworks, funds are provided with substantial freedom as to how to interpret and implement these rules in their own policies and governing rules.

5.7 DEPOSITARY MONITORING RULES

Depositary monitoring rules, including *ex-post* controls on, among other things, subscription/redemption orders and the compliance with the applicable law and investment policies of the fund, and *ex-ante* cash monitoring, can only be found in EU law. US law does not require funds to appoint a depositary (only a custodian). As a result, it can be easily concluded that EU law provides investors with more protection in this area than US law. However, in case a fund manager offers a US fund in the EU, the fund manager will be subject to appoint a depositary with monitoring duties under the AIFM Directive. By contrast, in case an exemption to the AIFM Directive applies or when a US funds is being offered in the EU though reverse solicitation via another, EU-based UCITS/AIF FoF or AIF feeder,[113] a depositary at the US level is not required. The depositary appointed for the EU FoF or feeder only has monitoring duties towards the EU FoF or feeder, not any underlying US (or EU) fund.

As has been discussed above relating to transparency and disclosure requirements (in section 5.5.1), this method of accessing the EU market may increase in

110. SEC's OCIE, *Investment Adviser Due Diligence Process for Selecting Alternative Investments and Their Respective Managers*, Risk Altert, Vol. IV, Issue 1, 28 Jan. 2014, 1–2. The Risk Alert can be found at SEC's website: http://www.sec.gov/.
111. *Ibid.*, 7–8. However, the SEC's OCIE observed that some managers did not include in their annual review a review of their due diligence policies and procedures for such investments and that managers' disclosures sometimes included misleading statements or statements that appeared to be unsubstantiated or deviated from actual practices.
112. *See*, e.g., SEC, In the Matter of Hennessee Group LLC and Charles J. Grandante, Release No. IA-2871, 22 April 2009 (finding that Hennessee Group and Gradante failed to conduct two of the five elements of the due diligence review that they had represented to their clients they would undertake and, additionally, failed to adequately respond to information that they received, which suggested that the identity of the fund's outside auditor was in doubt and that there existed a potential conflict of interest between one of the fund's principals and its purported outside auditor).
113. A UCITS can only invest in US funds via the FoF structure, as UCITS feeders are only allowed to invest in UCITS masters. *See* section 2.6.3.

popularity due to the adoption of the AIFM Directive. Considering the main overall investor protection aim of the depositary oversight duties and specific intend to 'avoid the possibility of fraudulent cash transfers',[114] it can be reasonably concluded that EU investors investing in EU funds receive more 'depositary' monitoring protection than EU investors investing in US (AIF-exempted) funds or US funds offered through EU FoF/feeders. So should this lead to more EU regulation? In other words: should US (AIF-exempted) funds offering their shares directly to EU investors be required to appoint an depositary-like entity with similar monitoring duties as the EU depositary? Similarly, should EU FoFs or feeders be required to only invest in US funds that have appointed such an entity? To determine this, a cost-benefit review of the potential requirements is needed. To this end, it must be assessed whether the benefits for investors outweigh the additional cost burden on the fund industry when imposing such rules. In the following section, I will describe how this assessment should, in my view, work out.

5.8 CONCLUSION

The previous paragraphs provide for a comparative analysis of the scope and limits of EU and US investor protection rules that have been discussed in Chapters 3 and 4. These rules have been categorized into six categories (internal control systems, leverage restrictions, rules regarding investor meetings, transparency and disclosure rules, conduct of business rules, and depositary monitoring rules) which have been further broken down into a number of subcategories. With respect to these categories, the main similarities and differences regarding these key investor protection rules under EU and US law have been summarized in Table 5.2.

Table 5.2 Key Investor Protection Rules: EU versus US Law

Internal control policies
– EU law imposes more far-reaching restrictions on funds than US law applying to mutual funds related to internal control policies, including, most notably, remuneration restrictions regarding the use of variable fees for all funds and UCITS risk measurement methodologies. – Fund managers of all EU funds should establish adequate internal control policies, whereas, under US law, only fund managers of US registered funds should establish such policies.

114. European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, COM(2012) 350 final, 3 Jul. 2012, 6.

Leverage restrictions
– US law offers US mutual funds broader possibilities to use leverage than UCITS. – US closed-end registered funds are subject to minor leverage restrictions and US unregistered funds and AIFs are not restricted by law in this respect.
Investor meetings
– Both EU and US law provide significant freedom to funds to hold investor meetings and to restrict the right to vote of investors at those meetings in a number of ways.
Transparency and disclosure rules
– The pre-contractual performance disclosure by US open-end funds is generally similar to that provided to investors in UCITS. US closed-end funds and AIFs must both provide only limited performance disclosure on the last year's performance (US closed-end funds) or some historical performance results (AIFs). – The pre-contractual risk disclosure by US funds more closely resembles the AIF disclosure style than the risk/reward section of the KII for UCITS. – The pre-contractual cost disclosure by EU and US funds is similar in many ways as only minor differences with respect to the disclosure of fees charged by underlying funds in case of a FoF exist. – EU and US law provide to a large extent similar ongoing information requirements regarding periodic reports of funds. – AIFs are subject to a number of additional periodic and continuous disclosure requirements, including liquidity, risk, and leverage exposure disclosure and conflicts of interest disclosure. Similar ongoing disclosure rules do not apply to UCITS and US funds.
Conduct of business rules
– EU and US law apply the duty of loyalty and care in very similar ways, requiring to perform best execution, disclose conflicts of interest, hire skilled managers, and to establish an investment due diligence policy. – With respect to the duty of loyalty, EU fund managers are required to disclose conflicts of interest of the fund manager and its allocation policy to investors, whereas US fund manager should only disclose these aspects to the fund, although the SAI provided by US registered funds upon request also provides for this information. – In the US, the duty of care also encompasses the duty for all US funds (registered and unregistered) to not mislead investors and provide them with all material information prior to the investment. This is not included in the duty of care under the UCITS and AIFM Directive, although a similar duty follows directly from the pre-contractual disclosure requirements set out in these directives.
Depositary monitoring rules
– EU law requires funds to appoint a depositary that has certain monitoring duties. US law does not require such an entity to be appointed, nor does it place any monitoring duties on another third party providing services to the fund.

Table 5.2 shows that there are many similarities between EU and US investor protection law in relation to the activities of fund managers. However, there are four differences that can be pointed out. Firstly, with respect to the internal control policies,

the main difference between the EU and US rules concerns the fact that EU law requires UCITS to use a predetermined risk methodology (the VaR or commitment method for non-structured UCITS and the VaR, commitment or any alternative method that meets ESMA guidelines for structured UCITS), whereas US law does not impose such rules on US mutual funds. Thus, when US mutual funds are being offered to EU investors, they are free to choose the methodology by which they measure their risk exposure, although they are likely to use 'mainstream' risk methodologies that are much alike those used by UCITS. However, since US mutual funds have similar characteristics as UCITS (i.e., open-end funds primarily focusing on the retail market and subject to very detailed regulations), it would be sensible to require them to use UCITS methodologies in order to prevent potential differences and enhance comprehensibility and comparability of investments in UCITS and US 'UCITS-like' funds (see also section 5.2).

Secondly, it follows from Table 5.2 that US law offers US mutual funds broader possibilities to use leverage than UCITS. As a result, when EU retail investors invest in US mutual funds, they may be exposed to a higher level of (unwanted) risk than investors investing in UCITS. This could lead to the conclusion that additional regulation is needed in this respect. However, there are indications that the SEC intends to adopt new rules restricting, among other things, the use of derivatives by mutual funds, and imposing stress-testing requirements on these funds.[115] It would therefore make sense for the EU regulator to await these rules and, when adopted, assess their practical consequences before imposing any EU rules on the use of leverage by US mutual funds that are offered to EU investors.

Thirdly, while the pre-contractual disclosure requirements under EU and US law are largely the same (besides some differences related to the disclosure of risks – see Table 5.2), this conclusion is somewhat misleading. It does not take into account the fact that the way in which fund shares are distributed to investors, i.e., directly or indirectly, via a FoF or feeder fund, influences the level of information provided to investor prior to the investment.[116] This will result in investors acquiring more or less pre-contractual information when they invest in either an EU fund or a comparable US fund. These differences can be summarized as follows.

In case US funds shares are being offered directly in the EU, the fund manager is technically only required to provide the pre-contractual AIF prospectus to its EU 'professional' retail investors under the AIFM Directive. The US prospectus disclosure document must only be provided to US offerings (thus: US investors) and, additionally, it may be provided after the sale of the fund shares has taken effect.[117] Since the AIF prospectus document is subject to less detailed requirements than the KII (i.e., it is form-free and no risk indicator, charge table and performance reporting period or 'look-back period' is prescribed),[118] it can be argued that investors receive a lower level of protection, or at least less comparable information, when they invest in US AIFs instead of UCITS. Thus, in case a US mutual fund is offered to EU investors, these

115. *See* section 4.6.
116. *See* on these distribution forms also section 5.5.1.
117. *See* section 4.8.
118. *Cf*., sections 3.7.1[B] & 3.7.3.

investors may make a less-informed investment decision than in case they would invest in a UCITS with comparable characteristics.

The difference in information level would imply that some regulation is appropriate to solve this problem in order to achieve a level playing field between EU investors when investing in investment funds. For instance, the AIFM Directive could be amended requiring US AIFs with UCITS characteristics, including US mutual funds, to provide investors with a KII or KII-like document instead of an AIF prospectus. Another solution can be found in requiring US mutual funds to provide the prospectus they are required to publish under US law to investors before they have made their final investment decision. However, when comparing the main differences in information content between the US prospectus for mutual funds and the KII, only the risk disclosure requirements stand out (i.e., US law imposes an 'AIF risk disclosure style' as opposed to the risk/reward section included in the KII). It could therefore be argued that the US prospectus document overall provides investors with similar information as the KII, as a result of which there is no need to impose the KII rules on these funds. By contrast, however, it could also be argued that all information provided to investors about investment funds should be easily comparable and understood by investors in order to support informed decision-making and that, therefore, the risk disclosure style (as well as other aspects of disclosure) should also be similar among comparable funds.[119] Consequently, a similar form of disclosure is equally important, perhaps even more important, for investors in terms of comparability of funds and accessibility of information. Moreover, with respect to the risk disclosure difference, it can be noted that since the disclosure style in the KII is generally preferred among investors over a 'narrative risk description',[120] the first solution (imposing the KII requirements on US mutual funds), would be most feasible.

However, as a result of such additional rules, some US mutual funds may choose to not offer their fund shares directly to EU investors due to the significant cost burden imposed on them if such rules were to be adopted, although US fund managers are generally interested in selling mutual funds in the EU.[121] As a result, they may choose to offer their funds via the EU FoF or feeder-route as discussed in section 5.5.1. They may also choose to establish a UCITS for this purpose.[122] The first situation would

119. Willemaers, *The EU Issuer-disclosure Regime: Objectives and Proposals for Reform,* 213 ('Fund disclosure, together with investment products disclosure, should therefore take particular account of the decision-making process, the relevance, comprehensibility and timeliness of disclosure and the ability of individuals to use the information and to compare it with similar information from other funds').
120. *See* n. 52 and accompanying text, *supra*.
121. *See* on costs involved with the furnishing of a KII, n. 159 and accompanying text. *infra*. *See* on the attractiveness of the EU market for US fund managers, ICI, *Market Access for Regulated Fund Managers in the United States and the European Union* 1 (October 2013) ('U.S. firms are interested in selling regulated funds in Europe and elsewhere' and 'European markets have been attractive because they potentially offer large, continent-wide markets of retail investors, the type of investors for whom regulated funds are particularly appropriate'). The ICI document can be found at ICI's website: http://www.ici.org/.
122. *Ibid.*, 20 ('In considering the current fund regulatory regime in the European Union, the most effective way for a U.S. manager of regulated funds to obtain access to the European market as a whole is to establish funds in the EU under the UCITS Directive').

result in regulatory avoidance by the US mutual fund industry. Consequently, the costs of additional regulation could outweigh the benefits for investors. However, in my view, this is not the case, because of the following factors.

In case a US fund is not directly marketed to EU investors, but offered via an EU FoF or feeder fund, no past performance information and, in case of a AIF FoF or feeder, information on the risks of the fund is to be provided in the pre-contractual phase.[123] In addition, UCITS FoFs should only disclose a combined charge figure in the KII, which does not explicitly state the management fees charged by the underlying US fund, and AIF FoFs or feeders may, in addition to a combined charge figure, choose to not include this information in the investor document but only refer to their website.[124] However, the same, limited amount of information is also provided in case an investor invests in an EU fund via an EU FoF or feeder. Thus, no different level of protection exists between EU investors investing in EU FoFs/feeders that invest in EU funds and those investing in EU FoFs/feeders that invest in US funds that would justify regulatory action at the EU level.

However, it can still be argued that the EU regulator should enhance disclosure requirements for UCITS FoFs investing in US funds. Reason for this might be the fact that small retail investors are able to invest in US funds that are normally not directly available to them (such as hedge funds and private equity funds) through a UCITS FoF structure.[125] The EU regulator might need to address this issue to ensure that investors will receive at least sufficient information about underlying fund investments. For example, this could be done by imposing more detailed performance, risks and cost disclosure requirements relating to underlying fund investments in the KII of UCITS FoFs. However, such requirements should then also be imposed on UCITS FoFs investing in *EU* (hedge funds and private equity) funds, considering that the same basic argument can be used, i.e., that small retail investors should be provided with sufficient information on underlying fund investments. It can be questioned whether the costs of such regulation imposed on the fund industry would outweigh the benefits for investors. Moreover, UCITS FoFs may only invest up to 30% of their assets in non-UCITS (including US funds) and only 10% in one single (UCITS or non-UCITS) fund. Because of these restrictions, the relevance of such regulations for investors would be limited. Moreover, it can be noted that more disclosure than currently required under the UCITS Directive may not necessarily result in a higher level of investor protection, as it may merely function as a disclaimer for fund manager to prevent any liability for any loss arising from the investment.

123. *See* section 5.5.2[B].
124. *See* section 5.5.2[C].
125. Retail investors with a net worth above EUR 500,000, but below USD 1 million, may also be offered with the possibility to access certain US unregistered hedge funds and private funds through EU AIFs FoFs that would otherwise not be available to them due to the accredited investor standard of USD 1 million imposed by these funds. However, since these investors may have direct access to EU hedge funds and private equity funds with similar investment features under the AIFM Directive, stricter requirements on the ability of EU AIFs to invest in US funds is, in my view, not necessary.

Further restricting the ability of UCITS to invest in other funds might also be a possibility, but this would limit FoF investment possibilities for retail investors. In addition, it would likely result in a competitive disadvantage between UCITS FoFs and other investment funds that provide investors with a comparable yield to similar investments, such as structured or index UCITS or listed AIF shares.[126] Moreover, high-net-worth and 'professional' retail investors have direct access to AIFs and Member States may also permit AIFMs to market AIFs to retail investors within their territory. Due to this expected declining competitiveness of the UCITS FoF industry, placing more restrictions on the investments of UCITS FoFs in AIFs would not be feasible (and disproportionate).

Alternatively, since most small retail investors will buy UCITS shares, including UCITS FoF shares, through a MiFID 2 intermediary, it may be more preferable to strengthen investor protection through enhancing the conduct of business rules for intermediaries. For example, this could be achieved by imposing the suitability and appropriateness test on all services related to investment funds (including execution-only services) under MiFID 2.[127] Furthermore, the suitability test itself could be amended by, for instance, requiring MiFID 2 intermediaries to ask a predetermined set of questions about the investment to make sure that investors understand all risks and costs related to the underlying funds in which a UCITS invests. However, such additional rules for intermediaries will increase the costs for the intermediary industry. This will most likely result in higher fees for intermediation services to be paid by investors and higher retail commissions charged to fund manager. This makes the purchase of UCITS shares through an intermediary more expensive, which may decreases the number of intermediaries offering UCITS shares to retail investors. In addition, it can be noted the forthcoming PRIIP rules, if applied to UCITS, may also enhance the ability of retail investors to understand the costs of underlying funds of UCITS FoFs as the disclosure document will contain information on the direct and

126. This was also noted with respect to alternative funds in the context of the adoption of the UCITS IV Directive and before the adoption of the AIFM Directive. *See* Report of the Expert Group on Investment Fund Market Efficiency: Report to the Commission 2 (July 2006) ('UCITS increasingly compete with other investment products such as unit-linked life insurance contracts, investment certificates and structured products and other collective investment schemes for long-term investment. Although there are differences in product features, performance, risk, regulation and tax, these alternative vehicles are increasingly attracting investors'). The report can be found at the Commission's Internal Market website: http://ec.europa.eu/internal_market/.

127. Currently, MiFID 2 intermediaries are required to perform suitability assessments when providing investment advisory or discretionary portfolio management services to a private investor. When performing only execution-only services, MiFID 2 requires the intermediary to apply the appropriateness test, i.e., to assess whether the investor has the knowledge and experience to understand the risks involved in the transaction for the sale of any investment product or service. However, when performing execution-only services with respect to non-complex instruments, including UCITS, at the initiative of the investors, it is not necessary to determine appropriateness. Under MiFID 2, structured UCITS are however considered to be 'complex' and would thus fall within the scope of the appropriateness test. *See* Article 25(4)(a)(iv) of the MiFID 2.

indirect costs of the product.[128] However, the downside of the KID is that the production of KIDs for each UCITS will be a time consuming and costly process and not yet clear whether UCITS will be required to disclose more costs under the KID than the current KII.[129]

In line with this, it may also be feasible to impose a suitability test on UCITS management companies that are directly offering UCITS FoF shares to retail investors. Such a test could be drafted in accordance with the suitability test included in the proposed ELTIF Regulation for long-term AIFs. Under the proposed regulation, a fund manager must establish and employ a specific internal process to determine whether a particular ELTIF is suitable for the distribution to retail investors.[130] In addition, when directly offering an ELTIF to retail investors the ELTIF manager would be required to obtain information regarding the retail investor's knowledge and experience in the investment field relevant to the ELTIF, the retail investor's financial situation and his/her investment objectives.[131] Lastly, the proposed regulation requires the fund manager and any distributor to ensure, in case a potential retail investor's financial instrument portfolio does not exceed EUR 500,000, that the investor does not invest an aggregate amount exceeding 10% of his portfolio, provided that the initial amount invested is at least EUR 10,000.[132] However, similar to the above mentioned option, such additional rules would place a significant high cost burden on UCITS, without significant advantages for investors. MiFID 2 intermediaries through which UCITS shares are generally bought by EU retail investors are already responsible to ensure that the investment is suitable for retail investor by conducting the suitability and/or appropriateness test. Thus, in my view, such additional rules should not be adopted.

Fourthly and lastly, the EU depositary monitoring rules do not apply in case a US fund offers its shares in the EU on the basis of an exemption of the AIFM Directive or in case its shares are being offered via an EU FoF or feeder fund through reverse solicitation. In the latter case, the fund manager is also exempt from complying with the (depositary) rules set out in the AIFM Directive. Since the key aim of the monitoring of the depositary is to protect investors and to minimize the risk of loss or diminution of the cash assets because of the detection of fraud, deficient administration/management, inadequate records or negligence, it may be adequate to also require US funds offered in the EU to appoint a depositary (or another third party entity with similar duties). However, in case a US fund is offered in the EU via a EU FoF or feeder, the lack of legal jurisdiction of the EU regulator over the fund poses a problem. This problem can be 'solved' by requiring the EU FoF or feeder to only invest in underlying funds that have appointed a similar entity with equivalent monitoring duties. However,

128. The obligation to produce the KID however falls on the 'manufacture' of the PRIIP, which is the UCITS and not the intermediary offering the shares.
129. *See* also section 3.7.1[B]. Whether or not the PRIIP rules should by applied to UCITS is also a political question. In general, there is a trend among (national and EU) regulators towards to shorter the disclosure for retail investors. More information on costs than currently provided under the UCITS KII will be in contradiction with this trend.
130. Article 23a(1) of the ELTIF Proposal.
131. Article 23b of the ELTIF Proposal.
132. Article 24(1a)(ac) of the ELTIF Proposal.

as also noted above with respect to whether or not to enhance pre-contractual transparency rules for UCITS FoFs, the relevance of such regulation would be very low considering the investment restrictions imposed on UCITS FoFs (e.g., they can only invest up to 30% of their assets in non-UCITS). Furthermore, such a rule would likely result in a competitive disadvantage of *UCITS FoFs v. other UCITS* that provide investors with similar (indirect) access to US funds, such as index-tracking or structured UCITS. Consequently, adjusting the regulations in this regard would, in my view, not be feasible.

This leaves the question whether EUAIF FoF/feeders investing in US funds should become subject to 'underlying' depositary monitoring regulation. These funds may invest all of their assets in underlying US funds. In this context, it should be noted that imposing the EU (AIFM) depositary rules on (underlying) US funds would give rise to considerable costs for the fund industry.[133] These underlying US funds will have to hire a depositary with the role of which is to not only safe keep the assets of the fund, but also to monitor cash flows and provide oversight. Depositaries will pass on most of their costs to the fund manager, which will in turn pass on the increased costs on to the funds and, ultimately, investors. While this may result in EU AIF FoFs/feeders to stop investing in US funds (or US funds to stop market their shares via EU funds), the benefit for investors, i.e., an independent additional layer of controls to the fund manager, is so large that I believe that for this group of funds, imposing such a rule would be appropriate. Moreover, it can also be argued that if such a rule is not adopted, the FoF/feeder structure remains an easily accessible way for US fund managers to sell US funds in the EU without having to adhere to any EU rules, which would help them to avoid EU law (more particularly, the AIFM Directive) from applying (instead of combating regulatory avoidance). Furthermore, as noted by Ernst & Young, the height of the costs for fund managers to appoint a depositary with AIFM duties may turn out lower than expected as it will depend on the current custody-relationship of the manager. So will 'increases in custody and depositary charges (…) be less noticeable if these are part of a bundle of services provided by one prime broker or custody bank'.[134] Consequently, 'a number of new models (…) [may] emerge as prime brokers and asset servicers package and price their services in different ways'.[135]

5.9 LEGAL BASIS

It follows from the above paragraph that there are three types of investor protection rules that are to be addressed by the EU regulator to create a level playing field between

133. *See* Ernst & Young, *Viewpoint, AIFMD: get ready for European depositary reform* 2-3 (March 2012). For this survey, depositaries were asked to estimate the increase in their total service charges, including liability premiums and capital charges. Depending on whether or not the depositary liability regime is strictly enforced and includes liability for the entire sub-custody chain including unaffiliated agents, they estimated the additional cost burden to be 10-25 basis points (a rise of about half of current estimated custody charges) or even 100-150 basis points (a four- or five fold increase in the current charges). The document can be found at: http://www.ey.com.
134. *Ibid.*, 3.
135. *Ibid.*

EU investors of investment funds: (1) risk measurement requirements, (2) pre-contractual disclosure requirements, and (3) depositary monitoring rules. As discussed, the first type of regulation should address the risk methodologies used by US mutual funds that are directly offered in the EU to 'professional' retail investors under the AIFM Directive to measure their risk exposure and includes the imposition of UCITS risk measurement methodologies on these funds. The second improvement relates to the UCITS KII or 'KII-like' disclosure requirements for these funds. The third improvement related to the imposition of a requirement on EU AIF FoFs and feeders to only invest in underlying US funds that have appoint a depositary or other entity with monitoring duties that are equivalent to those adopted under the AIFM Directive. To determine whether these rules may be adopted by the EU regulator, it should be firstly determined if there is a legal basis granted by EU law to do so.

When looking at the three investor protection standards that should perceivably be applied to either US mutual funds solely (risk measurement and pre-contractual requirements) or EU AIFs (depositary monitoring rules for 'underlying US funds') offered directly in the EU, it can be noted that they concern funds offered by funds managers that fall within the scope of the AIFM Directive. Thus, it would be reasonable to assess the possibilities to amend this directive and/or the rules and regulations thereunder. In general, EU investment fund regulation, including the AIFM Directive (and the UCITS Directive), has been based on Article 53(1) TFEU concerning the freedom of establishment and the freedom to provide services.[136] In addition, EU rules may be based on the general 'internal market' TFEU provision, Article 114(1) TFEU. These two potential legal bases will be discussed below.

5.9.1 Article 53(1) TFEU

As mentioned, in the area of EU fund law, the legal competence of the EU regulator has been based on Article 53(1) TFEU. Article 53(1) TFEU relates to the introduction of provisions aimed to facilitate the effective exercise of the freedom of establishment and the freedom to provide services in the EU.[137] According to the ECJ, this provision is directed towards reconciling the freedoms 'with the application of national professional rules justified by the general good, in particular rules relating to organization, qualifications, professional ethics, supervision and liability, provided that such application is effected without discrimination'.[138] As such, coordinating directives, aimed at seeking harmonization of national (Member States) law concerning the taking up and pursuit of activities of investment funds to facilitate freedom of establishment and provision of services can be based on this article.

136. *See* the opening considerations in the preamble to both directives. Article 62 TFEU extends Article 53 TFEU to services.
137. L. Dragomir, *European Prudential Banking Regulation and Supervision: The Legal Dimension* 70 (Routledge 2010).
138. ECJ, Reference for a preliminary ruling, *Jean Thieffry v. Conseil de l'Ordre des Avocats A la Cour de Paris*, Case 71/76, [1977] ECR 765, section 12.

Under the freedom of establishment, fund managers are free to set up branches in another Member State than its home Member State or Member State of reference. Under the freedom to provide services, a fund manager may conduct its activities in another Member State than its home Member State or Member State of reference. Accordingly, restrictions imposed under national law that obstruct the exercise of these freedoms should be eliminated (by adopting coordinating laws). Such restrictions concern all national measures 'liable to hinder or make less attractive the exercise of fundamental freedoms'.[139]

With respect to the AIFM Directive, current national private placement regimes existing for AIFMs may hinder the marketing of AIFs in the EU.[140] In addition, Member States may also apply additional rules on non-EU AIFs (instead of AIFMs), effectively making the marketing of such funds in the EU less attractive. In this respect, it can be referred to recital 10 of the AIFM Directive stating that:

> [t]he fact that a Member State may impose requirements additional to those applicable in other Member States on AIFs established in its territory should not prevent the exercise of rights of AIFMs authorized in accordance with this Directive in other Member States to market to professional investors in the Union certain AIFs established outside the Member State imposing additional requirements and which are therefore not subject to and do not need to comply with those additional requirements.

National rules for the marketing of AIFs to 'professional' retail investors effectively restrict the access to the market of AIFMs wishing to sell AIF shares in the EU. With respect to national private placement regimes, differences may arise regarding, among other things, the regulatory provisions that are disapplied, such as the prospectus disclosure requirement, the definition of investors entitled to invest in de private offering entity, local disclosure requirements, and marketing and promotion restrictions.[141]

The above mentioned restrictions would justify amending the AIFM Directive on the basis of Article 53(1) TFEU with a view of facilitating the freedom of establishment and the freedom to provide services. Since uniform rules concerning the protection of investors can be seen as a precondition for the functioning of the internal market for funds, such amendments could include, among other things, the imposition of

139. *See*, e.g., the Dassonville and Cassis de Dijon rulings (ECJ Cases 8/74, [1974] ECR 837 and 120/78, [1979] ECR 649. However, '[o]bstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements,' i.e., 'requirements [that] serve a purpose which is in the general interest and such as to take precedence over the requirements of the free movement of goods, which constitutes one of the fundamental rules of the Community'. Cassis de Dijon case, sections 8 & 14. This rule is also known as the rule of reason.
140. Articles 36(2) and 42(2) of the AIFM Directive allows Member States to impose stricter rules on AIFMs marketing AIFs in the EU than the minimum rules set out in Articles 36(1) and 42(1) of the AIFM Directive. This provision however only concerns AIFs which are marketed to investors without a passport under a national private placement regime. However, these regimes are likely to be abolished in 2018.
141. Commission of the European Communities, Commission Staff Working Document, Impact Assessment Report Private Placement, SEC(2008) 2340, 18 Jul. 2008, 12–13.

UCITS-like risk measurement, KII rules and depositary monitoring rules on underlying fund investments on AIFs marketed directly in the EU to 'professional' retail investors.[142]

However, it can be argued that since the EU regulator has explicitly excluded the marketing of AIFs to retail investors and AIF regulation from the scope of the directive and intends to terminate national private placement regimes applying to AIFMs, any national measures affecting AIFs or AIFMs would not be an argument to justify the amendment of the directive.[143] Moreover, in case of such harmonization, it might be more sensible to adopt these rules in a separate EU measure. This could be in the form of a directive based on Article 53(1) TFEU, but adopting a regulation might be more appropriate.

In the case of a directive, the process of transposition gives considerable leeway to the Member States because the form and method of implementation of directives is left to the Member States, regulatory difference may exist among Member States.[144] By contrast, regulations are directly applicable, which means that their effectiveness does not depend on transposition by the Member States. In this respect, the Commission has indicated on several occasions that, although many of the EU rules are based on directives, 'replacing directives with regulations can, when legally possible and politically acceptable, offer simplification as they enable immediate application and can be directly invoked before courts by interested parties'.[145] The adoption of a directive instead of a regulation may therefore not only be a legal obligation, but also a strategic political choice. In addition, the level of detail and complexity of the new rules may be more appropriate to a regulation.[146]

5.9.2 Article 114(1) TFEU

EU rules may, in addition to Article 53(1) TFEU (see above), also be based on the general internal market provision TFEU, i.e., Article 114(1) TFEU. Article 114(1) TFEU

142. Moloney, *How to Protect Investors: Lessons from the EC and the UK,* 10 and note 52 (referring to the MiFID rules under which investor protection has become a function of EU law in its own right).
143. Furthermore, the scope of the freedom of establishment is further limited by the fact that it only provides a right to EU AIFMs, and thus not to non-EU AIFMs. *See* ECJ Case C-299/02, *Commission v. Netherlands*, [2004] ECR I-9761, section 16 ('the right to freedom of establishment is guaranteed (…) to companies formed in accordance with the legislation of a Member State and having their registered office, central administration or principal place of business within the Community').
144. *See*, e.g., ECJ Case 363/85, *Commission v. Italy*, [1987] ECR 1733, section 7.
145. Commission of the European Communities, A Europe of results – applying community law, COM (2007) 502 final, 5 Sep. 2007, 5, note 12 and Commission of the European Communities, Commission Staff Working document, Instruments for a modernized single market policy, SEC(2007) 1518, 20 Nov. 2007, 24.
146. Similarly, the Commission has also chosen the regulation as most appropriate legal form for harmonizing the rules on venture capital, social entrepreneurship, and long-term funds. *See* the EuVCF and EuSEF Regulations and the ELTIF Proposal.

authorizes the EU regulator to adopt 'approximation'[147] measures with the purpose of establishing the internal market. Such measures can follow different approaches, ranging from full harmonization with national deviation completely excluded or only allowed within the limits of safeguard clauses, to minimum harmonization, which establish minimum standards but allow for more stringent national measures. Furthermore, as this article speaks of 'measures', the EU law adopted on the basis of this provision not only includes directives, but also all other measures mentioned in Article 288 TFEU, including regulations.[148]

In order to determine whether UCITS-like rules for risk measurement, pre-contractual disclosure (KII) for US mutual funds and 'underlying' depositary rules for EU AIFs FoFs/feeders investing in US funds to EU 'professional' retail investors can be adopted on the basis of Article 114(1) TFEU, they must be, following the Tobacco Advertizing I case, 'intended to improve the conditions for the establishment and functioning of the internal market and must genuinely have that object, actually contributing to the elimination of obstacles to the free movement of goods or the freedom to provide services, or to the removal of distortions of competition'.[149] Thus, Article 114(1) TFEU provides legal competence to the EU regulator in two circum-stances: (1) to cure diversity between national laws to the exercise of the fundamental freedoms or (2) to eliminate distortions of competition. In both instances, the overall aim of the measures must be the establishment and functioning of the internal market.

Regarding the first circumstance, it follows from Tobacco Advertizing I case that the mere finding of disparities between national rules and the abstract risk of obstacles to the exercise of the fundamental freedoms is insufficient to choose Article 114(1) TFEU as a legal basis.[150] With respect to the second circumstance the same judgment states that EU measures intended to eliminate distortions of competition must be appreciable in order to justify the use of Article 114(1) TFEU.[151] With 'appreciable' is meant that the distortions of competition may not be considered to be small distortions of competition, which generally include all distortions in relation to which the benefits of intervention do not outweigh the costs.

Can the potential new rules thus for AIFMs be based on either of (or both of) these two circumstances and therefore be adopted as an EU measure? Firstly, when examining the justification of removing divergences between national laws to the

147. With the reference to approximation measures in Article 114(1) TFEU is meant that the measures require all of the Member States to make changes to their domestic law to ensure that whatever set of rules was agreed at the EU level would be incorporated into national law. *See* C. Twigg-Flesner, A *Cross-Border-Only Regulation for Consumer Transactions in the EU: A Fresh Approach to EU Consumer Law* 11 (Springer Science & Business Media 2011). Consequently, EU measures that take effect alongside the law of a Member State without changing its content, do not effect an approximation of the laws of the Member States. *See* Vossestein, *Modernization of European Company Law and Corporate Governance: Some Considerations on Its Legal Limits*, 133–134.

148. Other EU measures include decisions, recommendations and opinions. *See* for the difference between a directive and a regulation, section 5.9.1.

149. ECJ Case C-378/98, *Germany v. Parliament and Council,* [2000] ECR 1I-8419 ('the Tobacco Advertizing I case'), section 84.

150. *Ibid.*

151. *Ibid.*, section 106.

exercise of the fundamental freedoms, it can be noted that it is necessary that the measure actually contributes to this purpose as the mere 'abstract risk' of such obstacles is not sufficient. As mentioned above, while disparities between the national placement regimes for AIFMs may currently exist, these regimes will most likely be abolished in 2018. When the national private placement regimes are abolished, fund managers marketing EU and non-EU AIFs in the EU will have to comply with the AIFM Directive and additional national rules places on AIFMs are no longer allowed. However, Member States remain free to impose national rules at the AIF level on EU or non-EU AIFs marketed within their jurisdiction. As a result, it can be concluded that additional EU (risk measurement and pre-contractual disclosure) rules applying to US mutual funds and 'underlying' depositary monitoring rules for EU AIFs FoFs or feeders offered in the EU, can likely be justified as a method of actually contributing to the elimination of obstacles to the free movement of establishment and to provide services.

Secondly, with respect to the justification that the EU rules should remove appreciable distortions of competition, Tobacco Advertizing I case rules that, similar as the first justification underlying Article 114(1) TFEU, such distortions may not be based on the sole need to eliminate obstacles. What is required is that they must actually contribute to remove distortions in competition. In the Tobacco Advertizing I case, the potential distortions related to differences in national advertising regulations, which were, according to the ECJ, not substantial and could thus not be justified on the basis of Article 114(1) TFEU.[152] If AIFMs market AIFs investing in US funds or US mutual funds to EU 'professional' retail investors under the AIFM Directive, they will face different national rules relating to the marketing of such funds under (current) private placement regimes and/or (future) national marketing rules applying to AIFs. These rules distort the free competition of AIFMs marketing (US) funds in the EU.

In order to rely on the justification for EU law to remove distortions in competition, the distortions should be, as mentioned, 'appreciable'. In general, this is the case when they involve substantial economic disadvantages of the firms concerned, by which is meant investment, operating, or production costs.[153] Thus, not every distortion in competition can form a basis for EU regulation. The ECJ did not provide much guidance as to when a particular distortion involves 'substantial investment, operating, or production costs' as it only briefly highlighted the differences of the fact of the case at hand which gave rise to its judgment. For example, in the Tabacco Advertizing I case, it ruled that existing differences between national advertising regulations, did not constitute appreciable distortions since the advantages on competition were 'remote and indirect' in terms of economies of scales and the profits encountered.[154] Consequently, the ECJ ruled in relation to the validity of the Tobacco Advertising Directive that the distortions were not such that they would justify using Article 114 TFEU as a

152. The Tobacco Advertizing I case, section 109.

153. Vossestein, *Modernization of European Company Law and Corporate Governance: Some Considerations on Its Legal Limits*, 139 (referring to the *Tabacco Advertizing I and Ireland v. Parliament and Council* (C-301/06, [2009] ECR I-593) cases).

154. The Tobacco Advertizing I case, section 109. According to the ECJ, the distortions were not comparable to distortions of competition caused by differences in production costs, such as those which resulted in the adoption of the Directive on titanium dioxide industry. *Ibid*.

legal basis for the adoption of the directive.[155] Even though, as the ECJ acknowledged, the distortions could justify for the prohibition of certain forms of sponsorship on the basis of Article 114 TFEU, they could not justify for an outright ban of all types of sponsorships by tobacco products.[156]

As to potential additional rules for AIFMs marketing US mutual funds and EU AIFs FoFs/feeders in the EU to 'professional' retail investors, it should be determined whether the mentioned competitive disadvantages of AIFMs are substantial in terms of economies of scales and the profits encountered. In my view, it can be argued that these disadvantages are substantial as the national rules differ in many ways. In this respect, it has been noted by the Commission that the regulatory inconsistencies arising from these regimes 'may preclude cross-border private placement'.[157] Furthermore, in other cases, 'the offeror may have to bear a high administrative burden and/or may be severely restricted in the types of deal that can be privately placed'.[158]

However, when harmonizing the rules for such AIFMs by imposing UCITS-like risk measurement rules, pre-contractual disclosure (KII) rules, and restrictions on investments in underlying US funds regarding on them, it can be argued that this would create substantial, disproportional additional costs for them. The calculation of risk exposure comes with a number of disclosure requirements relating to the methodology used, the leverage employed (in case of use of the VaR method) and the reference portfolio (in case of the use of the VaR relative method).[159] Furthermore, disclosure costs also have to be made by US mutual funds when they are required to publish KII-like information or (more advisable for comparability reasons) a KII document to investors before they invest in the fund.[160] With respect to the requirement placed on EU AIFs FoFs and feeders to only invest in US funds that have appointed a depositary with AIFM-like monitoring duties, this can also be argued as this would effectively require the AIF to investigate the policies and procedure of the its underlying funds and corresponding (depositary) monitoring function.

By contrast, it can also be argued that such rules strike the appropriate balance between enhancing the internal market (and investor protection) and costs for the industry since it would make products better comparable for retail investors (and more 'trustworthy', i.e., constituting an EU-wide 'brand' for retail AIFs). In this context, it can be referred to the EuVCF, EuSEF and, most notably, the (proposed) ELTIF Regulations. In the ELTIF proposal, the Commission simple states that the choice for a regulation 'strikes the appropriate balance between the public interest at stake and the

155. *Ibid.*, section 111.
156. *Ibid.*
157. Commission of the European Communities, Commission Staff Working Document, Impact Assessment Report Private Placement, 13.
158. *Ibid.*
159. *See* section 3.4.2.
160. The costs of the KII requirements for the UCITS industry, which already had to publish a simplified prospectus before the requirements took effect, increased by 7.5%. European Commission, Commission Staff Working Document, Summary of the Impact Assessment on the proposed UCITS IV Directive and implementing directives, SEC(2010) XXX final, 6. This document can be found at http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2010/sec_2010_0811_en.pdf, last accessed on 29 Sep. 2015.

cost-efficiency of the measure' proposed.[161] Apparently, the Commission takes the view that sector-specific measures applying to AIFs meet the principles of subsidiarity and proportionality, i.e., they cannot be regulated sufficiently by Member States and are not disproportionate.[162]

It thus follows from the above that adopting an EU regulation requiring AIFMs to use predetermined risk measurement methodologies and provide pre-contractual 'KII' disclosure similar to UCITS and requiring EU AIF FoFs/ feeders to restrict underlying US fund investment to funds that have appointed an entity with monitoring duties equivalent to those required for the AIF depositary, can be based on Article 114(1) TFEU. In line with this, it may be also logical to create a separate category of AIFMs marketing US mutual funds to small retail investors on the basis of an EU passport subject to similar risk measurement and KII rules. This would effectively partly eliminate Article 43 of the AIFM Directive allowing Member States to allow AIFs to be marketed to retail investors within their jurisdiction under equivalent AIFM rules or more stricter rules (although these rules may not be stricter than those applicable to domestic funds). However, in order to conclude this, more research as regards the national AIFM retail regimes and their functioning would be necessary.

161. The EuVCF, EuSEF and (proposed) ELTIP Regulations are also based on Article 114 TFEU. *See* the opening considerations in the preamble the (proposed) regulations.
162. Explanatory Memorandum to the ELTIF Proposal, 9. *See* in a similar way, Explanatory Memorandum to the EuVCF Proposal, COM(2011) 860 final, 7 Dec. 2011, 5 and Explanatory Memorandum to the EuSEF Proposal, COM(2011) 862 final, 7 Dec. 2011, 8. However, these regulations do not impose additional disclosure requirements on EuVCF's and EuSEF's since these funds are only allowed to be sold to professional investors as defined by MiFID/the AIFM Directive (whereas ELTIF's may also be sold to small retail investors). *See* for these principles, Article 5(3) and (4) of the EU Treaty (Consolidated version of the Treaty on European Union, OJ C 326, 26 Oct. 2012, 13).

Chapter 6
Conclusion

This book is about the protection of European retail investors in investment funds. More specifically, the central question is whether there is a level playing field between EU investors investing in EU funds and EU investors investing in US funds and if not, if the EU regulator should adopt additional investor protection rules applying to investment funds on a legal basis granting the EU competence to act in this area. Accordingly, this book addresses three questions: (1) which key features of investment funds in relation to the activities of fund managers are relevant to the issue of the retail investor protection, (2) how are EU and US funds available to EU retail investors currently regulated relating to the protection of investors, and (3) does this protection provide for a level playing field between investors investing in EU funds and investors investing in US funds and if not, is there a legal basis for the EU regulator to adopt additional regulation in this area?

The main conclusions may be summarized as follows. Firstly, as to the essential fund features of the different fund types available to EU retail investors, the following features appear to have the largest impact on the protection of investors against mismanagement, fraud, excessive risk-taking, and other unwanted activities by fund managers: (1) how the fund manager is regulated, (2) the monitoring duties of the depositary, (3) the issuance of fund shares, (4) fees and costs, and, to a lesser extent, (5) operational structures and investment strategies. Other features, such as the duties of the fund board, the requirement to appoint a custodian and auditor, and the specific legal structure in which the fund is organized, are of less importance to the issue at stake. The role of the fund board, custodian and auditor in investor protection is limited due to potential personal interests (i.e., board directors), or limited monitoring duties (i.e., custodian and auditor). The legal structure in which a fund is established is of less relevance to this research since national law applying to the structure mostly concern fiscal and liabilities issues and protection against bankruptcy risk instead of protection against investor protection issues that this research focuses on. Most regulations affecting the protection of investors in investment funds with respect to these issues stem from supranational or federal law which arises irrespectively of the legal form chosen. National law may however continue to be relevant in the context of investor rights that are derived from (national/state) company law.

Of the key fund parties, the fund manager appears to be the most important party. In general, not the fund board (of directors or trustees) or general partner manages the fund, but an external fund manager operates as single director or partner of the fund. EU and US rules applying to fund managers that are relevant in the context of investor protection include, among other things, internal control policy, (fee) transparency, and conduct of business requirements. Furthermore, funds regulated by EU law are required to appoint a depositary with a number of oversight duties and the duty to monitor the fund's cash flows, with a view to protect investors from fraudulent and negligent behaviour by the fund manager.

With respect to the shares that are issued by funds, the right to vote at investor meetings can be particularly noted. By exercising this right, investors can express their dissatisfaction with the way in which the fund is managed. In this context, it can be particularly referred to requirements for conducting an investor meeting of investors and restrictions on the exercise of the voting rights of investors at these meetings.

A number of investor protection issues that are relevant in the context of the research topic may arise from a fund's fee structure. It can lead to excessive payments to managers and to incentive conflicts that may contribute to mismanagement or misappropriation of the fund manager. Besides regulating the height of the remuneration of the fund manager, the high impact of fees on investor returns justifies adequate transparency of fees and control systems to ensure this disclosure and compliance to the applicable remuneration rules.

A fund can be either open- or closed-end and may use the master-feeder, umbrella or FoF structure. Furthermore, different investment strategies with different risk levels (leverage exposure) attached to them may be used. While the features of these structures and strategies may give rise to a number of investor protection issues, mainly related to transparency and risk exposure, they by themselves does not raise such issues, as they can be viewed as a consequence of the structure or strategy used. Accordingly, when assessing investor protection regulations concerning these issues, the particular operational structure adopted and the specific strategies employed should be taken into account.

Secondly, as to how EU and US funds available to EU retail investors are currently regulated relating to the protection of investors, the book analyses both EU law and US law applying to funds and their managers. From the assessment of the key fund features, it follows that investor protection regulations applying to funds and fund manager that aim to protect investors against misconduct by the fund manager should focus on six categories of rules: (1) internal control systems, (2) leverage restrictions, (3) rules related to the right to vote in investor meetings, (4) transparency and disclosure rules, (5) rules applying conduct of business standards, and (6) depositary monitoring rules.

EU and US law regarding internal control policies for funds are quite similar. Under both frameworks, fund managers should establish various internal control policies in order to monitor and manage the internal affairs of the fund and to appropriately identify and address risks. However, in case an EU investor invests in a

US (registered or unregistered) fund, the fund manager of that fund (i.e., AIFM) will have to comply with the internal control rules set out in the AIFM Directive. Other than UCITS management companies, AIFMs are not required to use a predetermined risk methodology (such as the VaR or commitment method for non-structured UCITS). Thus, when US mutual funds are being offered to EU investors, they are free to choose the methodology by which they measure their risk exposure. This creates a difference in the level of investor protection between EU and US retail funds (i.e., UCITS and US mutual funds). Furthermore, in my view, the benefits for investors of imposing UCITS risk measurement methodologies on US mutual funds, i.e., improving comparability for the benefit of investors, which may increase investor confidence and investments, outweigh the potential extra costs for the fund industry.

At the EU level, the UCITS Directive places a number of restrictions regarding the use of leverage on UCITS which aim to protect investors. US registered funds that attract retail investors are subject to fewer rules than UCITS, although there are indications that the SEC intends to adopt new rules restricting the use of derivatives by registered open-end funds (mutual funds). US unregistered funds and AIFs are not restricted by law in this respect.

With respect to the exercise of investors' voting rights at investor meetings, both EU and US law reach similar results. Although EU and US funds may only hold meetings in limited circumstances and restrict the rights investors may exercise at these meetings, fund investors often do not attend such meetings as they generally 'vote with their feet' and move to the next fund in case of disappointing results and/or mismanagement.

Regarding transparency and disclosure requirements, two types of information is provided to fund investors: (1) pre-contractual information and (2) ongoing information. Pre-contractual information requirements are clearly present in both EU law than in US law. However, when taking the way in which fund shares are distributed to EU retail investors, some differences can be noticed. A fund manager that markets US mutual fund shares directly to EU 'professional' retail investors should supply an AIF prospectus under the AIFM Directive. Since this document is subject to fewer requirements than the KII provided by UCITS, it can be concluded that investors will generally receive a lower level of protection, or at least less comparable information, when they invest directly in a US mutual fund instead of a UCITS. The difference in information level implies that some regulation is appropriate to solve this problem. The cost-benefit analysis related to this issue has shown that the benefits for investors (i.e., receiving easily comparable and understandable information) outweigh the additional cost burden for the fund industry.

When a US fund is not directly marketed to EU investors, but via an EU FoF or feeder fund, no past performance information, clear and accessible cost disclosure about the underlying management fees and, in case of a AIF FoF or feeder, information on the risks of the fund is to be provided to investors in the pre-contractual phase. However, the same, limited amount of information is also provided in case an investor invests in an EU fund via an EU FoF or feeder. Thus, no different level of protection exists between EU investors investing in EU FoFs/feeders that invest in EU funds and those investing in EU FoFs/feeders that invest in US funds.

It can be argued that the EU regulator should enhance disclosure requirements for UCITS FoFs or restrict the ability of UCITS to invest in other (EU and US 'alternative') funds for investor protection reasons. However, in my opinion, such rules should not be adopted due to the limited impact of the rules, a (disproportionate) costs burden on the fund industry without significant advantages for investors, and competitive disadvantages for UCITS FoFs as opposed to investment funds that provide investors with a comparable yield to similar investments, such as structured or index UCITS or listed AIF shares. Furthermore, strengthening investor protection through enhancing the conduct of business rules for MIFID 2 intermediaries or imposing a suitability test directly on UCITS management companies that are directly offering UCITS FoF shares to retail investors, may also be a viable option to increase investor protection. However, both options have been set aside due to a potential increase in intermediary's costs (and a subsequent decrease in the number of intermediaries offering UCITS shares to EU retail investors) and (disproportionate) high costs for UCITS, without significant advantages for investors.

With respect to ongoing disclosures, it can be concluded that EU and US funds will to a large extent be required to disclose similar information in their periodic reports. With respect to indirect investments in funds, however, investors in UCITS FoFs receive more adequate cost information about the underlying fund investments than investors in AIF FoFs or feeders. Nevertheless, there are differences in this respect when the EU FoF/feeder invests in a US or EU fund and, therefore, for the purpose of this research, no need for additional regulation in this respect. Other ongoing disclosures include NAV publications, and, with respect to AIFMs, liquidity, risk, leverage and conflicts of interest disclosure. Despite these additional rules for AIFMs, no difference in investor protection level should be addressed in this respect. Since US funds that are being directly offered in the EU under the AIFM Directive are subject to the AIFM continuous disclosure rules, no difference emerges between EU investors investing in EU AIF and EU investors investing in US funds. In case the US funds is offered via another EU FoF or feeder, there is also no difference in investor protection level between EU and US funds as the EU FoF or feeder will provide similar 'ongoing' information to investors about the underlying EU funds and the US funds.

The conduct of business rules under EU and US law identify two main duties that apply to fund managers and, in the case of US funds, fund directors: (1) the duty of loyalty and (2) the duty of care. Both duties have been applied in very similar ways, requiring to perform best execution, to hire skilled managers, and to establish an investment due diligence policy. However, under the duty of care, a difference arises. While under the US common law duty of care, fund manager are obliged to not mislead investors and to provide them with all material information to the extent relevant to the investor prior to the investment, the EU duty of care does not impose such an obligation on fund managers. This however does not pose a real difference with EU funds, as fund managers marketing funds in the EU are subject to several pre-contractual disclosure requirements under either the UCITS or AIFM Directive. In addition, US funds offered directly to EU investors will generally also be offered under the AIFM Directive, as a result of which the fund manager will have to comply with the duty to disclose this information to investors under the AIFM Directive.

Depositary monitoring rules, including *ex-post* controls on, among other things, subscription/redemption orders and compliance with the applicable law and investment policies of the fund, and *ex-ante* cash monitoring, can only be found in EU law. US law does not require funds to appoint a depositary (only a custodian). When a fund manager offers a US fund in the EU, the fund manager will be subject to appoint a depositary with monitoring duties under the AIFM Directive. By contrast, in case an exemption to the AIFM Directive applies or when a US funds is being offered in the EU though reverse solicitation via another, EU-based UCITS/AIF FoF or AIF feeder, a depositary at the US level is not required. This latter issue could be tackled by required the EU FoF or feeder to only invest in underlying funds that have appointed as similar or other entity with equivalent monitoring duties. However, as also noted with respect to whether or not to enhance pre-contractual transparency rules for UCITS FoFs, the relevance of such regulation would be very low considering the current investment restrictions imposed on UCITS FoFs (e.g., they can only invest up to 30% of their assets in non-UCITS). Furthermore, such a rule would likely result in a competitive disadvantage of *UCITS FoFs v. other UCITS* that provide investors with similar (indirect) access to US funds, such as index-tracking or structured UCITS. Consequently, adjusting the regulations in this regard would not be feasible. As a result, only EU AIF FoF/feeders investing in US funds should become subject to 'underlying' depositary monitoring regulation. While this may result in EU AIF FoFs/feeders to stop investing in US funds (or US funds to stop market their shares via EU funds), the benefit for investors, i.e., an independent additional layer of controls to the fund manager, is so large that I believe that imposing such a rule on EU AIF FoFs/feeders would be appropriate. Moreover, it can also be argued that if such a rule is not adopted, the FoF/feeder structure remains an easily accessible way for US fund managers to sell US funds in the EU without having to adhere to any EU rules, which would help them to avoid application of the AIFM Directive instead of combating regulatory avoidance behaviour.

Thirdly, as to whether additional EU investor protection rules are needed with a view of ensuring a level playing field for EU investors in investment funds, it has been concluded from the comparison between EU and US investor protection law applying to investment funds that there is, surprisingly, little difference between the two frameworks. Nevertheless, three types of investor protection rules might be addressed by the EU regulator in this context: (1) risk measurement requirements applying to US mutual funds that are directly being offered in the EU to 'professional' retail investors under the AIFM Directive and (2) pre-contractual disclosure requirements applying to those US mutual funds, and (3) 'underlying' depositary monitoring duties for AIFs FoFs or feeders investing in US funds.

The first type of regulation should address the risk methodologies used by US mutual funds offered in the EU to measure their risk exposure and includes the imposition of UCITS risk measurement methodologies on these funds. The second regulation relates to the UCITS KII or 'KII-like' disclosure requirements for these funds. The third regulation relates to the imposition of a requirement on EU AIF FoFs and feeders to only invest in underlying US funds that have appointed a depositary or any other entity with monitoring duties that are equivalent to those adopted under the AIFM Directive.

Since the legal basis of the AIFM Directive is formed by Article 53(1) TFEU relating to the freedom of establishment and to provide services, it would make sense to base amendments to the directive on this provision. Current national rules for the marketing of AIFs to 'professional' retail investors and national private placement regimes may justify amending the AIFM Directive on the basis of Article 53(1) TFEU with a view of facilitating the freedom of establishment and the freedom to provide services. However, as the AIFM Directive intends to terminate current AIFM national private placement regimes, the more logical (and practical) regulatory form may be adopting a separate regulation for a specific category of AIFMs marketing US mutual funds to EU retail investors and EU AIF FoFs and feeders investing in US funds.

Such a regulation can be adopted on the basis of Article 114(1) TFEU, which provides legal competence to the EU regulator in two circumstances: (1) to cure diversity between national laws to the exercise of the fundamental freedoms or (2) to eliminate distortions of competition. Adopting a regulation in order to harmonize the rules for AIFMs by: (1) imposing UCITS or UCITS-like risk measurement and pre-contractual disclosure (KII) rules on AIFMs marketing US mutual funds to EU 'professional' retail investors and (2) requiring EU AIF FoFs/ feeders to restrict underlying US fund investment to funds that have appointed an entity with monitoring duties equivalent to those required for the AIF depositary, can likely be justified as a method of actually contributing to the elimination of obstacles to the free movement of establishment and to provide services and to eliminate appreciable distortions between AIFMs marketing US mutual funds in the EU and EU AIF FoF and feeders that invest in US funds. In line with this, similar rules for AIFMs offering US mutual fund shares to EU small retail investors might also be feasible (effectively partly eliminating current national AIFM retail regimes), although more research should be done regarding the current national regimes and their functioning before such a conclusion can be drawn.

Samenvatting

Dit proefschrift behandelt de vraag of er een *level playing field* is tussen Europese beleggers die beleggen in EU-beleggingsinstellingen en Europese beleggers die beleggen in Amerikaanse beleggingsinstellingen en, als dit niet het geval is, of de Europese wetgever aanvullende regelgeving zou moeten aannemen op basis van het Verdrag betreffende de werking van de Europese Unie ('VwEU'). Om tot een antwoord te komen op deze vraag komen de volgende deelvragen aan bod: (1) Welke kenmerken van beleggingsinstellingen met betrekking tot de activiteiten van fondsmanagers zijn van belang voor de bescherming van beleggers? (2) Hoe zijn EU- en Amerikaanse beleggingsinstellingen die worden aangeboden aan Europese particuliere beleggers gereguleerd op het gebied van beleggersbescherming? (3) Zorgt deze regelgeving voor een *level playing field* voor beleggers die in EU- en Amerikaanse beleggingsinstellingen beleggen en zo niet, biedt het VwEU een juridische basis voor aanvullende Europese regelgeving op dit gebied?

Met betrekking tot de eerste deelvraag ('Welke kenmerken van beleggingsinstellingen met betrekking tot de activiteiten van fondsmanagers zijn van belang voor de bescherming van beleggers?'), kan worden geconcludeerd dat de volgende fondskenmerken de grootste invloed hebben op de bescherming van beleggers: (1) de regulering van de fondsmanager, (2) de toezichthoudende functie van de bewaarder ('*depositary*') op de fondsmanager, (3) de deelnemingsrechten in beleggingsinstellingen en het daarbij behorende stemrecht, (4) de kostenstructuur van beleggingsinstellingen, inclusief de vergoedingen aan de fondsmanager, en, in beperkte mate, (5) de operationele structuur (open-of closed-end, FoF, master-feeder en/of de paraplustructuur) en beleggingsstrategieën van beleggingsinstellingen. Andere kenmerken, zoals de taken van het fondsbestuur, de verplichting om het vermogen te bewaren bij een apart bewaarder ('*custodian*'), de accountantscontrole van de financiële verslaggeving en de specifieke rechtsvorm van een beleggingsfonds, zijn voor het beschermingsniveau van beleggers in beleggingsinstellingen minder relevant. Dit komt door potentiële conflicterende belangen bij bestuurders, het gebrek aan toezicht op het fondsmanagement door de *custodian* en de accountant, en het feit dat nationale regelgeving die van toepassing is op fondsstructuren zich voornamelijk richt op aansprakelijkheidsregels, fiscaliteit en de bescherming van beleggers tegen het risico op faillissement (in plaats van de beschermingsonderwerpen waar dit onderzoek zich op richt).

Voor de tweede deelvraag ('Hoe zijn EU- en Amerikaanse beleggingsinstellingen die worden aangeboden aan EU-particuliere beleggers gereguleerd op het gebied van beleggersbescherming?'), zijn de EU- en Amerikaanse regels die gelden voor (de managers van) beleggingsinstellingen en die bijdragen aan de bescherming van beleggers geanalyseerd. Op basis van de kenmerken van beleggingsinstellingen die van belang zijn voor de bescherming van beleggers, zijn de volgende zes categorieën van regelgeving geselecteerd: (1) interne controle procedures, (2) restricties op het gebied van het gebruik van *leverage* (hefboomwerking), (3) regels gerelateerd aan het recht om te stemmen, (4) transparantie en informatievoorschriften, (5) regelgeving inzake deugdelijk beheer en (6) de toezichttaken van de *depositary*.

Met betrekking tot de interne controleprocedures zijn er in het algemeen weinig verschillen tussen de EU- en Amerikaanse regelgeving voor beleggingsinstellingen waar te nemen. Beide gaan uit van een '*principle-based*' benadering waarbij richtlijnen voor de procedures en de controle van deze procedures zijn vastgesteld en geven derhalve ongeveer een gelijk beschermingsniveau aan beleggers. Indien een EU-particuliere belegger echter rechtstreeks belegt in Amerikaanse geregistreerde beleggingsinstellingen met een open-end karakter ('*mutual funds*'), bestaat er wel een verschil in beschermingsniveau. In een dergelijk geval dient de manager van het Amerikaanse *mutual fund* namelijk alleen te voldoen aan de vereisten uit de AIFM-Richtlijn, waarin, anders dan in de ICBE-Richtlijn voor ICBE's, geen vastgestelde methoden voor risicometing zijn opgenomen. Dit creëert een ongelijk speelveld tussen EU- en Amerikaanse fondsen voor particuliere beleggers (ICBE's en *mutual funds*). Naar mijn mening zijn de voordelen van het verplicht stellen van ICBE-methoden voor risicometing voor Amerikaanse *mutual funds*, namelijk verbetering van de vergelijkbaarheid tussen beleggingsinstellingen en versterking van het vertrouwen van beleggers, groter dan de potentiële extra kosten voor de beleggingsinstellingenindustrie.

ICBE's zijn onderhevig aan diverse restricties op het gebied van het gebruik van *leverage* (door middel van derivaten of geleend geld). Voor Amerikaanse *mutual funds* gelden minder strenge eisen op dit gebied, maar de SEC is van plan om dit in de toekomst aan te scherpen conform het EU-model. Tussen overige Amerikaanse beleggingsinstellingen en AIFs zijn geen verschillen; beide typen beleggingsinstellingen zijn vrij in hun gebruik van *leverage*.

Wat betreft de stemrechten van beleggers in (jaarlijkse of tussentijdse) vergaderingen van beleggers, is gebleken dat de Europese en Amerikaanse regels op veel punten dezelfde restricties opwerpen. EU- en Amerikaanse beleggingsinstellingen zijn slechts in bepaalde gevallen verplicht een dergelijke vergadering te houden en er kunnen diverse beperkingen kunnen worden opgeworpen door het fondsbestuur die (de uitoefening van het) stemrecht van beleggers bemoeilijken. Hoewel het stemrecht van beleggers in beleggingsinstellingen dus beperkt is, kan worden opgemerkt dat beleggers er ook vaak voor kiezen om te 'stemmen met hun voeten', oftewel de deelnemingsrechten te verkopen, in plaats van deel te nemen aan de vergadering indien ze ontevreden zijn over het management van de beleggingsinstelling.

Transparantie- en informatievoorschriften die gelden voor beleggingsinstellingen kunnen worden onderverdeeld in (1) precontractuele transparantievoorschriften en (2) doorlopende transparantievoorschriften. Precontractuele transparantievoorschriften zijn in gelijke mate terug te vinden in EU- en Amerikaanse regelgeving. Er bestaat echter een verschil op het punt van beleggersbescherming indien een Amerikaans *mutual fund* rechtstreeks wordt aangeboden aan EU-'professionele' *retail* beleggers (individuele beleggers met veel vermogen of beleggerservaring). In een dergelijk geval dient de fondsmanager alleen een AIF-prospectus te verstrekken. Omdat dit document aan minder (gedetailleerde) voorschriften gebonden is dan het precontractuele informatiedocument ('KII') voor ICBE's, kan worden aangenomen dat beleggers minder bescherming of in ieder geval minder vergelijkbare informatie krijgen wanneer zij rechtstreeks beleggen in Amerikaanse *mutual funds* dan wanneer zij beleggen in vergelijkbare ICBE's. Dit verschil in informatieniveau impliceert dat aanvullende regelgeving op dit gebied wenselijk is. De kosten-batenanalyse met betrekking tot dit onderwerp laat eveneens zien dat de voordelen voor beleggers, namelijk het verkrijgen van begrijpelijke en vergelijkbare informatie, opwegen tegen de extra kosten voor de beleggingsinstellingenindustrie.

Indien een Amerikaanse beleggingsinstelling wordt aangeboden in de EU via een EU-beleggingsinstelling (FoF of *feeder*), hoeft er geen informatie verstrekt te worden over de in het verleden behaalde resultaten, de onderliggende managementkosten en, in geval van een AIF-FoF of *feeder*, de risico's van de Amerikaanse beleggingsinstelling. Echter, dezelfde, beperkte informatievoorschriften gelden ook indien een EU-beleggingsinstelling belegt in een andere EU-beleggingsinstelling. Er is dus geen verschil in beschermingsniveau tussen EU-beleggers die in EU-beleggingsinstellingen beleggen via EU-FoFs/*feeders* en EU-beleggers die in Amerikaanse beleggingsinstellingen beleggen via dergelijke structuren.

Betoogd zou echter kunnen worden dat, met het oog op beleggersbescherming, de Europese wetgever de informatieverplichtingen voor ICBE-FoF's zou moeten aanscherpen of de mogelijkheden voor ICBE's om in andere (EU- en Amerikaanse 'alternatieve') beleggingsinstellingen zou moeten beperken. Naar mijn mening is dergelijke regelgeving niet wenselijk gelet op reeds geldende restricties en de (disproportionele) kostenverzwaring en concurrentienadelen die dit voor de ICBE-industrie zou meebrengen. Andere mogelijkheden om het beschermingsniveau te verhogen zijn het versterken van de regels voor MiFID 2 tussenpersonen inzake het beoordelen van de geschiktheid of passendheid van de beleggingsinstelling voor de belegger en het verplicht stellen van het uitvoeren van een vergelijkbare geschiktheidstest voor ICBE-managers. Beide opties kunnen echter eveneens terzijde worden gelegd gelet op de onwenselijke extra kosten voor beleggers bij het inschakelen van een tussenpersoon (wat een mogelijke afname van het aantal tussenpersonen dat ICBE's aan particuliere beleggers aanbiedt tot gevolg kan hebben) en de (disproportionele) kostenverzwaring voor ICBE-managers.

De doorlopende transparantieverplichtingen waar EU- en Amerikaanse beleggingsinstellingen aan dienen te voldoen in hun periodieke rapportages is voor een groot deel gelijk. Met betrekking tot indirecte beleggingen in beleggingsinstellingen, valt het op dat beleggers in ICBE-FoF's meer adequate informatie over de kosten van de onderliggende fondsbeleggingen krijgen dan beleggers in AIF- FoF's of *feeders*. Echter, aangezien dit voor zowel EU-FoF's/*feeders* die in EU-beleggingsinstellingen beleggen als voor EU-FoF's/*feeders* die in Amerikaanse beleggingsinstellingen beleggen geldt, is er vanuit het oogpunt van dit onderzoek geen noodzaak voor aanvullende regelgeving op dit gebied. Hetzelfdegeldt voor de aanvullende doorlopende informatieverplichtingen voor AIF's. Amerikaanse beleggininstellingen die rechtstreeks in de EU worden aangeboden zullen dit doorgaans doen onder de AIFM-Richtlijn. Hierdoor is er geen verschil tussen EU-beleggers die in een EU-AIF beleggen en EU-beleggers die in een Amerikaanse (AIF) beleggingsinstelling beleggen. Wanneer een Amerikaanse beleggingsinstelling wordt aangeboden via een EU-FoF of *feeder* is er ook geen verschil in beschermingsniveau omdat EU-FoF's en *feeders* dezelfde doorlopende informatie aan beleggers moeten verstrekken over hun beleggingen in EU als over hun beleggingen in Amerikaanse beleggingsinstellingen.

Fondsmanagers dienen zich onder het EU- en Amerikaanse recht te houden aan twee centrale gedragsregels: (1) de loyaliteitsplicht en (2) de zorgplicht. De twee rechtstelsels passen deze plichten grotendeels op dezelfde wijze toe. Beleggingsinstellingen worden verplicht om ervoor zorg te dragen dat zij een zo goed mogelijk resultaat behalen ('*best execution*'), geschikte fondsmanagers aannemen en voldoende onderzoek ('*due diligence*') verrichten naar hun beleggingen. Met betrekking tot de zorgplicht is er wel een verschil tussen het EU- en Amerikaans recht waar te nemen. Onder het Amerikaanse *common law*-systeem dient de aan de belegger verstrekte informatie duidelijk en niet misleidend te zijn en moet alle relevante informatie verstrekt worden voorafgaand aan de belegging. De EU-zorgplicht bevat een dergelijke verplichting niet. In de praktijk zorgt dit echter niet voor veel problemen aa ngezien fondsmanagers die beleggingsinstellingen in de EU aanbieden onderworpen zijn aan gelijksoortige precontractuele informatieverplichtingen onder de ICBE- of AIFM- Richtlijn. Fondsmanagers die Amerikaanse beleggingsinstellingen rechtstreeks aanbieden aan EU- beleggers zullen veelal verplicht zijn om dergelijke, tijdige informatie te verstrekken aan beleggers onder de AIFM-Richtlijn.

De toezichttaken die de *depositary* dient uit te voeren op beleggingsinstelling, inhoudende *ex-post* controle op de orderuitvoering en of de fondsmanager zich houdt aan de toepasselijke interne documenten en de wet- en regelgeving, en *ex-ante* controle van de kasstromen, is alleen terug te vinden in het EU-recht. Het Amerikaanse recht kent geen verplichting voor beleggingsinstellingen om een *depositary* of andere entiteit met dergelijke taken aan te nemen (alleen een *custodian* met een bewaarfunctie). Echter, wanneer een fondsmanager een Amerikaanse beleggingsinstelling in de EU aanbiedt, zal hij verplicht zijn een dergelijke entiteit met toezichttaken aan te stellen onder de AIFM-Richtlijn. Deze verplichting geldt niet indien er sprake is van een uitzondering op toepassing van de AIFM -Richtlijn of indien de beleggingsinstelling wordt aangeboden op eigen initiatief van de belegger ('*reverse solicitation*') via een EU- (ICBE/AIF) FoF of *feeder*. Deze laatste ontwijkingsmogelijkheid kan worden aangepakt door EU-FoF's of *feeders* te verplichten om alleen te beleggen in andere beleggingsinstellingen indien deze een *depositary* of andere entiteit met gelijksoortige toezichttaken hebben aangenomen. Naar mijn mening heeft een dergelijke regel voor ICBE-FoF's relatief weinig invloed aangezien ICBE's reeds onderworpen zijn aan diverse restricties met betrekking tot beleggingen in andere beleggingsinstellingen. Daarnaast zou dit kunnen leiden tot een (onwenselijk) concurrentienadeel van ICBE-FoF's ten opzichte van andere ICBE's die beleggers gelijksoortige (indirecte) toegang tot Amerikaanse beleggingsinstellingen verschaffen, zoals indexvolgende en gestructureerde ICBE's. Resteert de mogelijke 'onderliggende' *depositary* verplichting voor EU-AIF-FoF's/*feeders*. Hoewel deze regel tot gevolg zou kunnen hebben dat EU-AIF-FoF's/*feeders* niet meer in Amerikaans beleggingsinstellingen zullen beleggen (of dat Amerikaanse beleggingsinstellingen hun deelnemingsrechten niet meer zullen aanbieden via EU-beleggingsinstellingen), is het te behalen voordeel voor beleggers, namelijk een extra beschermingslaag ter controle van de fondsmanager, dusdanig groot dat een dergelijke regel naar mijn mening gerechtvaardigd is. Bovendien kan worden betoogd dat indien een dergelijke regel niet zou worden ingevoerd, de FoF/*feeder*-structuur een makkelijke toegang biedt voor fondsmanager tot ontwijking van de *depositary* beschermingsregels uit de AIFM- Richtlijn.

Ten derde, met betrekking tot de laatste deelvraag ('Zorgt deze regelgeving voor een *level playing field* voor beleggers die in EU- en Amerikaanse beleggingsinstellingen beleggen en zo niet, biedt het VwEU een juridische basis voor aanvullende Europese regelgeving op dit gebied?'), valt het op dat er weinig verschil is tussen de EU- en Amerikaanse beleggersbeschermingsregels die van toepassing zijn op beleggingsinstellingen. Niettemin zijn er drie typen beschermingsregels waar de EU-wetgever zich op zou kunnen richten vanuit de *level playing field*-gedachte: (1) risicometingsmethoden voor Amerikaanse *mutual funds* die rechtstreeks in de EU aanbieden aan 'professionele' r*etail* beleggers onder de AIFM-Richtlijn, (2) precontractuele transparantievoorschriften voor dergelijke Amerikaanse *mutual funds* en (3) 'onderliggende' *depositary* toezichttaken voor EU-AIF-FoF's of *feeders* die in Amerikaanse beleggingsinstellingen beleggen.

De eerste categorie regelgeving heeft betrekking op ICBE-achtige risicometingsmethoden voor Amerikaanse *mutual funds* die worden aangeboden in de EU. De tweede categorie regelgeving ziet op KII of KII-achtige precontractuele transparantievoorschriften naar het ICBE-voorbeeld voor dergelijke Amerikaanse *mutual funds*. De derde categorie heeft betrekking op de verplichting voor EU-AIF-FoF's en feeders om alleen te beleggen in onderliggende Amerikaanse fondsen die een *depositary* hebben aangesteld of een andere entiteit met gelijksoortige toezichttaken als de toezichttaken opgenomen voor de *depositary* in de AIFM-Richtlijn.

Gelet op het feit dat de AIFM-Richtlijn is gebaseerd op artikel 53 lid 1 VwEU met betrekking tot de vrijheid van vestiging en dienstverlening, zouden aanpassingen aan deze richtlijn eveneens gebaseerd kunnen worden op deze bepaling. De bestaande huidige nationale marketingregels voor AIF's en de nationale regelingen voor onderhandse plaatsingen kunnen de voorgestelde aanpassingen ook rechtvaardigen. Echter, omdat de AIFM-Richtlijn de uitdrukkelijke intentie heeft om de nationale regelingen voor onderhandse plaatsingen op termijn af te schaffen, is het logischer om een aparte verordening aan te nemen voor AIFM's die Amerikaanse *mutual funds* en EU-AIF's-FoFs/*feeders* die in Amerikaanse beleggingsinstellingen beleggen aanbieden.

Een dergelijke verordening kan worden gebaseerd op artikel 114 lid 1 VwEU. Artikel 114 geeft de EU-wetgever de bevoegdheid om een maatregel te nemen indien daarmee (1) verschillen in nationale wetgeving gelet op de fundamentele vrijheden worden opgeheven of (2) concurrentieverschillen verdwijnen. Een EU-verordening gericht op de harmonisatie van de regels voor AIFM's door (1) ICBE- of ICBE-achtige risicometingsmethoden en precontractuele (KII) transparantievoorschriften voor te schrijven voor AIFM's die Amerikaanse *mutual funds* aan EU-'professionele' *retail* beleggers aanbieden en die (2) AIF FoF's of *feeders* die in Amerikaanse beleggingsinstellingen beleggen verplicht om een aparte entiteit met '*depositary*'-achtige toezichttaken conform de AIFM-Richtlijn aan te nemen, is naar mijn mening een gerechtvaardigde manier om obstakels in de vrijheid van vestiging en dienstverlening en concurrentieverschillen tussen AIFM's die die Amerikaanse *mutual funds* en EU-AIF's die in Amerikaanse beleggingsinstellingen beleggen op te heffen. In deze lijn zou ook kunnen worden betoogd dat het wenselijk is een aparte categorie AIFM's onder een EU-paspoort die Amerikaanse *mutual funds* aan EU-particuliere beleggers aanbieden te creëren. Dit zou in feite een (gedeeltelijke) opheffing van de huidige nationale '*retail*' regimes voor AIFM's. Meer onderzoek naar deze regimes is echter nodig voordat een dergelijke conclusie kan worden getrokken.

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