Investor protection: Towards additional EU regulation of investment funds?

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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.