Universiteit Leiden
The Netherlands

Investor protection: Towards additional EU regulation of investment funds?

Wegman, H.E.

Citation

Wegman, H. E. (2016, February 23). *Investor protection: Towards additional EU regulation of investment funds?*. Retrieved from https://hdl.handle.net/1887/38038

Version:	Corrected Publisher's Version
License:	Licence agreement concerning inclusion of doctoral thesis in the Institutional Repository of the University of Leiden
Downloaded from:	https://hdl.handle.net/1887/38038

Note: To cite this publication please use the final published version (if applicable).

Cover Page

The handle http://hdl.handle.net/1887/38038 holds various files of this Leiden University dissertation

Author: Wegman, Hanneke
Title: Investor protection : towards additional EU regulation of investment funds ?
Issue Date: 2016-02-23

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.

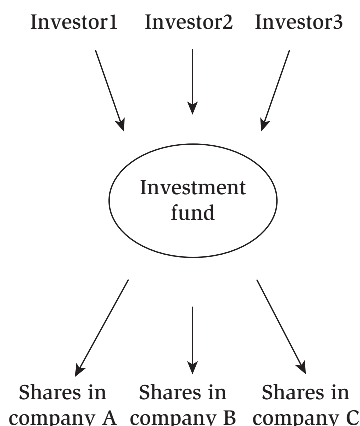
[C] General Definition

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.

---

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.

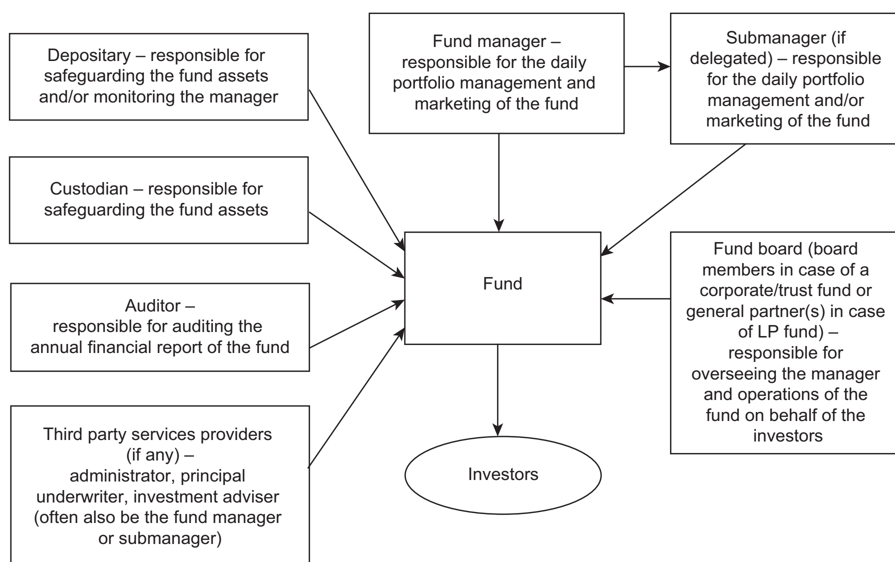
Other fund parties that provide services to the fund without any control functions include, among others, the administrator, principal underwriter, transfer agent, and investment adviser. The fund's administrator provides administration services to the fund, including accounting and pricing/valuation 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).

---

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

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]

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]

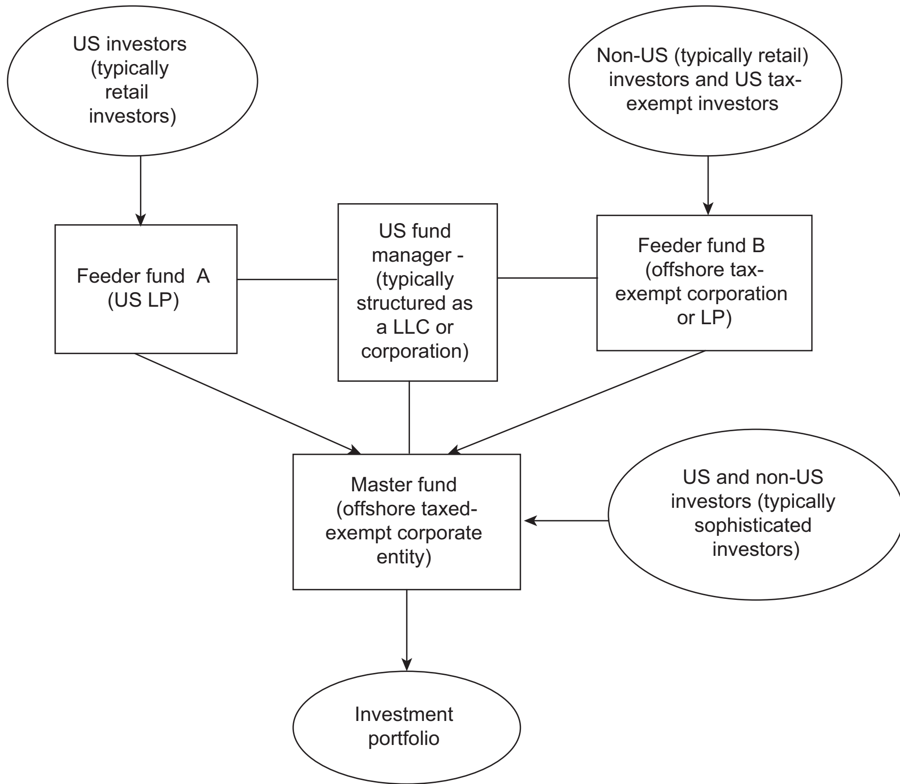
The master fund is generally structured as an offshore tax-exempt corporate entity that is treated as a tax transparent entity in order to ensure that both domestic and non-domestic investors profit from pass-through taxation at the master level.[248] Non-domestic investors that invest through a feeder 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.

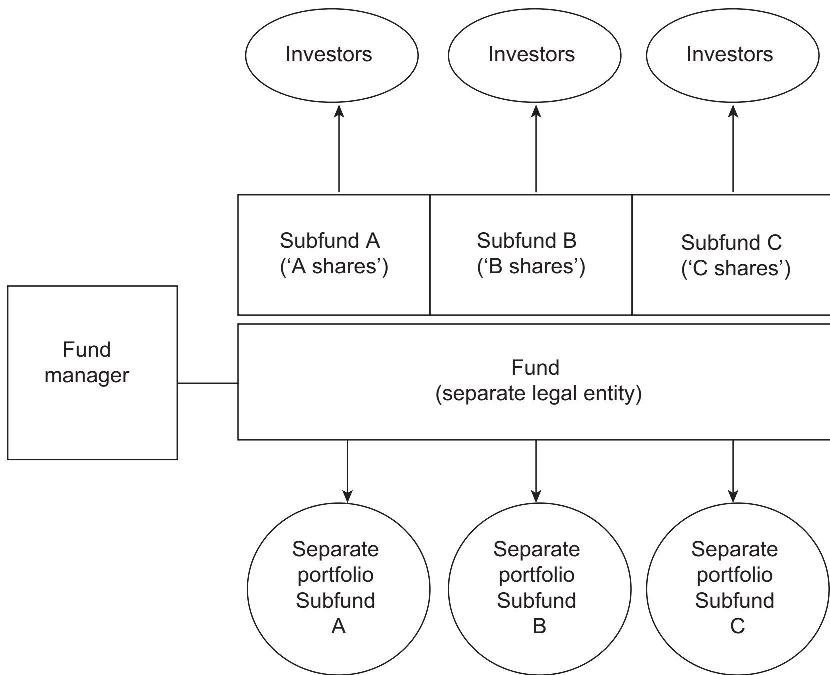
While an umbrella structure can be singly employed, it can also be combined with the master-feeder structure and/or the fund of funds structure. This may be useful when a fund family wishes to offer multiple investment strategies to investors and also wants to profit from the tax benefits offered by 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



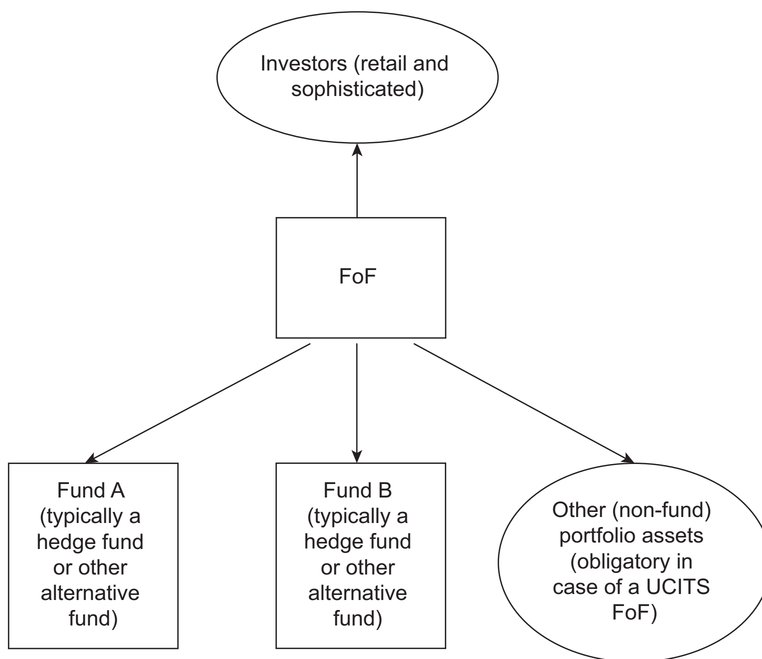
2.6.5 Fund of Funds Structure

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.