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Investor protection: Towards additional EU regulation of investment funds?

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CHAPTER 4
US Investor Protection Law

4.1 INTRODUCTION

This chapter addresses the second research question of this book ('How are EU and US funds available to EU retail investors currently regulated relating to the protection of investors?') with respect to US law. It contains an analysis of the investor protection laws in place in the US that deal with the protection of investors with respect to fund management activities and apply to US funds in order to determine how retail investors investing in these funds are protected under US law.

As discussed in section 1.3.3[C], there are two basic levels of US law: federal law and state law. US federal law applies to the nation as a whole and to all US states whereas state laws are only in effect within that particular state.[1] State law can be divided into statutory law, generally focusing on company law issues, such as the right to vote at annual meetings, and state common law, including the conduct of business standards (fiduciary duties). As a rule, federal law supersedes state law, but with respect to the two core federal acts applying to US funds and fund managers, the 1940 Act and the Advisers Act, only provisions that conflict with any provision of the acts or rules or regulations of the acts are set aside (see section 1.3.3[D]. Thus, for the purpose of this research, both law types are relevant in determining the way in which investors in US funds are protected.

The structure of the remainder of the chapter is as follows. In the following paragraph, the two key structures of US funds under US federal law, i.e., registered and unregistered funds, are described (sections 4.2 & 4.3). In the following paragraph, the registration duty of the US fund manager will be assessed (section 4.4). Next, the chapter addresses the different types of investor protection rules under US (federal and state) law that affect the protection of (US and EU) investors in US funds. Similar to the

1. In addition, US (private) law can also be applied in other jurisdictions as a result of the application of principles and rules of private international law.

previous chapter on EU law, the investors protection rules applying to US funds are discussed thematically, divided into the five categories derived from the general conclusions contained in Chapter 2 that are relevant to US funds: (1) internal control systems, (2) leverage restrictions, (3) rules related to investor meetings, (4) transparency and disclosure rules, and (5) conduct of business rules (sections 4.5–4.9). Depositary (monitoring) rules will not be discussed in this chapter as US funds are not required by US law to appoint a depositary. Finally, the chapter will close with a conclusion (section 4.10).

4.2 REGISTERED FUNDS

Registered funds, defined as 'investment companies' in the 1940 Act, are required to register with the SEC under the 1940 Act and primarily invest in securities (thus *not* directly in real estate or other property).[2] They have been classified into three classes: (1) face-amount certificate companies (2) Unit Investment Trusts (UITs), and (3) management companies.[3] Face-amount certificate companies and UITs do not actively manage investment portfolios, whereas the third category does. Instead, they have fixed portfolios and, thus, usually pay a fixed amount of interest or dividend to investors.[4] Both groups represent only a small part of the total US fund industry.[5] Management companies constitute the largest group of investment companies and can be described as including all investment companies of which the shares are sold to the public and that are not face-amount companies or UITs.[6] Management companies can

2. Article 3(a)(1)(A) of the 1940 Act defines an investment company as 'any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities'.
3. Article 4 of the 1940 Act.
4. A face-amount certificate company is an investment company 'which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which have been engaged in such business and has any such certificates outstanding'. *See* Article 4(1) of the 1940 Act. Face-amount certificates of the installment type are debt securities that are backed by security interest on assets such as real property or other securities. Investors who hold such certificates are usually paid a fixed amount of periodic interest ('installments') and are refunded a definitive sum (the 'face-amount') of their certificates at a specified termination date. *See* Article 2(a)(15) of the 1940 Act. A UIT is an investment company 'which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust'. *See* Article 4(2) of the 1940 Act. UITs invest in a pool of equity securities and/or bonds and other fixed income securities and sells fractional undivided interests in that pool. They typically make a one-time 'public offering' of only a specific, fixed number of units and each UIT has a termination date at which the UIT will be terminated and dissolved. *See* Article 26 of the 1940 Act.
5. *See* with regard to face-amount certificate companies: http://www.sec.gov/divisions/investment/invcoreg121504.htm (accessed 13 Jan. 2011) (SEC states that there are only a few face-amount certificate companies), and for UITs, ICI, *2010 Investment Company Fact Book*, 9 (Total UITs assets by the end of 2009 were USD 38 billion, which was managed by 6,049 funds, a decrease in assets with almost 50% from 1995).
6. Article 4(3) of the 1940 Act and 2010 Investment Company Fact Book, p. 9 & 16 (The total number of management companies and their assets under management increased significantly since 1995, from 5,761 to 8,624 funds and USD 2,955 to USD 12,126 billion assets under management in 2009).

be further divided into open-end funds, also known as ‘mutual funds’, and closed-end funds and can have the status of a ‘diversified’ or ‘non-diversified’ company based on the composition of their assets.[7]

4.2.1 Open-End Registered Funds

To determine whether a management company is open-end or closed-end (and what type of regulation would apply), the SEC looks at whether or not the fund issues ‘redeemable securities’.[8] Diversified funds must invest at least 75% of its assets in cash, cash items (including receivables), Government securities, securities of other investment companies, and other securities that are limited in respect of any one issuer to an amount not greater in value than 5% of the companies’ NAV and to not more than 10% of the outstanding voting securities of the issuer. Consequently, there are four categories of management investment companies: (1) open-end diversified companies, (2) open-end non-diversified companies, (3) closed-end diversified companies, (4) closed-end non-diversified companies. The primary consequence of the non-diversified as opposed to the diversified status is that non-diversified funds will be required to disclose the general risks of their narrow portfolio selection in their prospectus.[9]

Additionally, it can be noted that open-end registered funds (mutual funds) may not invest more than 15% of their assets in illiquid securities so that they are able to meet investors’ redemption requests.[10] An asset is considered ‘illiquid’ if a mutual fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.[11] According to the SEC Division of Investment Management, certain derivative instruments will generally be illiquid under all or most market conditions. According to the division, ‘[t]his will more likely be the case if a derivative is designed to meet the needs of a particular investor’, as ‘[s]uch a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid’. With respect to

7. Article 5 of the 1940 Act.
8. *See* on when a fund is considered to issue redeemable securities section 2.6.2[B].
9. *See* on the prospectus disclosure requirements of US funds in general, section 4.8.1.
10. SEC, Revisions to Guidelines – Revision of Guidelines to Form N-1A, Release Nos. IC-18612, 33-6927, Federal Register Vol. 57, No. 55, 20 Mar. 1992, 9828.
11. SEC, Final Rule – Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Release No. IC-14983, Federal Register, Vol. 51, No. 55, 21 Mar. 1986, 9777. Futures and options that trade on a regulated exchange generally are treated as liquid instruments. The SEC has found ‘restricted securities’ (i.e., securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer) and securities of small businesses to be illiquid. *See* SEC, Final Rule – Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Federal Register Vol. 55, No. 83, 30 Apr. 1990, 17940 and SEC, Revisions to Guidelines – Revisions of Guidelines to Form N-1A, 9828. It can be noted that mutual funds that are regulated as MMFs under rule 2a-7 of the 1940 Act are subject to a 3% limitation in illiquid assets. *See* rule 2a-7(b)(5)(i) of the 1940 Act. In addition, rule 2a-7 imposes the general requirement on MMFs that such funds hold assets that are sufficiently liquid to meet reasonably foreseeable redemptions and minimum amounts of ‘daily liquid’ and ‘weekly liquid’ assets.

other derivative instruments, the division notes that their liquidity 'may vary depending on market conditions' and that '[a]n instrument that is liquid in one market environment may become illiquid in another market environment'. As a rule, however, the division states that 'the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or trustees'.[12]

4.2.2 Closed-End Registered Funds

Closed-end registered funds may also choose to redeem their shares in accordance with various rules adopted by the SEC permitting the repurchase of shares in certain limited circumstances.[13] In case fund shares may be redeemed, Article 22(e) of the 1940 Act requires that the redemption payments must be made within seven days, and the right of redemption can be suspended only in limited circumstances, such as when the NYSE is closed or when trading on that exchange is restricted. By contrast, MMFs, expect for government MMFs and feeder funds, are required to suspend redemptions for up to ten business days in a ninety-day period, if the fund's weekly liquid assets fall below 30% of its total assets and the fund's board of directors (including a majority of its independent directors) determines that imposing a gate is in the fund's best interests.[14]

4.2.3 Legal Structure

While the 1940 Act does not explicitly state that registered funds must have a specific legal structure, it does impose certain requirements that assume a corporate or trust form as typical structure, such as the requirement to have a board of directors consisting of multiple directors (whose function is to oversee the operations of the fund and review contracts with service providers) and rules on voting (e.g., the right of investors to elect directors, approve fee arrangements included in the investment

12. SEC Division of Investment Management, Letter to Chairman Levitt: Mutual Funds and Derivative Instruments, 26 Sep. 1994, 18–19. The letter be found at SEC's website: http://www.sec.gov/. Examples of factors that may be taken into account in determining liquidity trustees include: (1) the frequency of trades and quotes for the instrument, (2) the number of dealers wiling to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer. *Ibid*., 19. Many registered funds include a provision in their governing documents that allows the free transferability of swap transactions and other OTC derivatives or a right to break the transaction at an agreed price since inclusion of a transfer right or break right is consistent with prior SEC interpretations of when an instrument may be treated as liquid. *See* G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 17 Inv. Law. 19 (2010).
13. Rule 23c-1, 23c-2 and 23c-3 of the 1940 Act.
14. SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616, IA-3879, IC-31166, 23 Jul. 2014, 269–270. Weekly liquid assets include: cash, US Treasury securities, certain other Government securities with remaining maturities of sixty days or less, or securities that convert into cash within one week. *See ibid*, 815.

management contract, and approve fundamental investment policy changes).[15] Consequently, registered funds are, in practice, structured as either corporations or business trusts.[16] Most corporate funds are organized in Delaware or Maryland. Business trust funds are generally established in Massachusetts or Delaware.[17]

4.2.4 Capital Requirements

US registered funds, whether open- or closed-end or structured in the corporate or trust form (or any other legal form), are required to have a minimum capital of at least USD 100,000 in case they wish to make a public offering of shares or have made such an offering and, at the time of that offering, had a net worth of at least USD 100,000, which is the market value of assets owned by the fund minus the fund's liabilities.[18] However, in case the fund has made a public offering in the past, and at the time of that offering fulfilled the minimum capital requirement, it no longer has to meet the capital requirements set out in the 1940 Act.[19] Thus, the minimum net worth requirements of US registered funds is not an ongoing requirement (so assets may drop in value after the initial offering has been made). In this context, it is worth noting that the SEC has adopted a 'floating NAV' rule for institutional prime MMFs and liquidity fee and redemption gates for non-governmental MMF's, mainly because a capital buffer 'that was designed to absorb such large losses may be too high and too costly because the opportunity cost of [holding] this capital would be borne at all times even though it was likely to be drawn upon to any degree only rarely'.[20] With this reasoning, the SEC has met the concerns expressed by several market participants and the ICI that stated that '[t]he costs of added fees, assessments, and capital requirements could be substantial, and while their exact level is uncertain, it would not take much to increase the fees that investors in the largest regulated US funds currently pay'.[21]

15. Articles 16 (board of directors) and 13 (changes in investment policy) of the 1940 Act. With respect to fee arrangements set out in the management contract, investors are only permitted to approve the contract with the fund manager in which the compensation of the manager is described in case this power is not reserved to the board. The board furthermore has the duty to evaluate the fund's contract with the manager under certain conditions. *See* Article 15 of the 1940 Act.
16. Kirsch (ed.), *Mutual Fund Regulation,* 1–18. The LP form, although not excluded from the definition of investment companies in the 1940 Act, is not typically used as legal form for an investment company. The LP structure is generally adopted by funds that are offered in a manner that makes them eligible for exceptions to the definition of investment company in Articles 3(c)(1) and 3(c)(7) of the 1940 Act ('qualified-investors' and '100-investors' exceptions). The LP form may also not be suitable because of the fact that the general partner (often the fund's management) has unlimited personal liability, although in case the general partner is set up as a separate legal entity with limited liability (such as a limited liability company or corporation) liability is avoided.
17. *See also* section 1.4.
18. Article 14(a)(1) of the 1940 Act.
19. Article 14 (a)(2) of the 1940 Act.
20. SEC, Final Rule – Money Market Fund Reform; Amendments to Form PF, 672.
21. ICI, *Letter to the Secretariat of the Financial Stability Board: Assessment Methodologies for Identifying Non-bank Non-insurer Global Systemically Important Financial Institutions: Proposed*

Of all registered funds, open-end registered funds/mutual funds are the most commonly used type of funds.[22] The main reason for this is the fact that these funds offer professional portfolio management and flexibility regarding the purchasing and selling of shares because of the fact that they issue open-end shares.[23] The open nature of mutual funds also has the additional advantage that these funds are required by the 1940 Act to price their shares at least once a day in accordance with the NAV of their underlying portfolio.[24] Because mutual funds predominate among the funds that are registered, the remainder of the chapter will, with respect to registered funds, focus on this fund type. When referred to 'registered funds', it is thus meant to refer to mutual funds. However, if the regulations discussed apply specifically to MMFs or other types of open-end registered funds, not being mutual funds, these types of funds will be expressly mentioned. Additionally, reference is made to closed-end funds in case this is considered relevant or in case it would provide additional insight into the subject matter discussed.

4.3 UNREGISTERED FUNDS

Unregistered US funds can be defined, as their name indicates, as funds that are not required to register with the SEC and are therefore not subject to regulations under the 1940 Act.[25] They can be structured in many different ways, including the corporate, trust, and LP form. With respect to LPs, Delaware is often indicated as the leading

High-Level Framework and Specific Methodologies 31–32 (7 Apr. 2014). The letter can be found at ICI's website: http://www.ici.org/.

22. ICI, *2010 Investment Company Fact Book*, appendix A. ('The vast majority of investment companies are mutual funds, both in terms of number of funds and assets under management'). *See also* Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 1–17 ('[S]ince the 1980s, at least, most investment companies are open-end investment companies'). ICI data shows that closed-end funds are second in range in popularity after mutual funds (and ETFs) representing USD 288 billion of assets under management of the total USD 12.164 billion assets under management of the registered fund industry in 2010. ICI, *2010 Investment Company Fact Book*, 9 (total mutual funds (including ETFs) assets were USD 11,898 and UITs assets accounted for USD 38).
23. UITs also issue redeemable securities, but they do not offer professional management since they are unmanaged. *See* Article 4(2)(B) and (C) of the 1940 Act. The certificates of face-amount certificate companies do not qualify as redeemable securities under the 1940 Act as the holders of the certificates are not entitled to receive a pro rata share of the fund's net assets. Instead, they receive a fixed amount of interest on a periodic basis. According to the SEC Staff, face-amount certificate companies are also not allowed to issue redeemable securities next to face-amount certificates of the installment type, as this would qualify them as open-end company and thus, makes them subject to Article 18(f)(1) of the 1940 Act. This article prohibits open-end companies to issue senior securities, which the Staff qualifies face-amount certificates of the installment type to be. *See* R.H. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions*, 86.
24. Article 2(a)(41) of the 1940 Act and rules 2a-4 and 22c-1 of the 1940 Act.
25. However, similar to registered funds, unregistered funds and their managers are subject to a broad scale of other rules, including federal anti-fraud and anti-manipulation provisions, the prohibition on insider trading, certain reporting requirements relating to the ownership of equity securities, and state law (e.g., registration requirements, company law provisions and common law fiduciary duties).

market for establishing such a structure.[26] Unregistered funds are generally exempt under the 1940 Act special provisions Article 3(c)(1) and 3(c)(7) for non-public funds.[27] These articles are most often used by alternative funds, including hedge funds and private equity funds, although other funds (e.g., certain real-estate funds) may also rely on them. Specifically, they exempt an investment fund from the registration requirements when that fund has no more than 100 investors ('3(c)(1) fund')[28] or only qualified investors ('3(c)(7) fund')[29] and does not make or propose to make a public offering of its shares.

Next to the '1940 Act-registration', a fund may furthermore be required to register with the SEC and publish a prospectus under the 1933 Act, although an exemption also applies to non-public funds. A fund is exempt in case its offering is considered to be non-public is nature under Article 4(2) of the 1933 Act. For that reason, this rule is generally referred to as the 'private offering' exemption. Since the 1933 Act does not define what constitutes a public offering, courts have considered several factors to determine whether a public offering occurred, including the number of persons to whom the offering is made, the sophistication of these persons, the nature of the information disseminated and the manner of the solicitation.[30] As these factors are rather vague and unpredictable in application, most private placements of funds are made in accordance with the non-exclusive safe harbour contained in rule 506 of SEC Regulation D of the 1933 Act. Under this rule, an offer and sale of fund shares to an unlimited number of 'accredited investors' and a maximum of thirty-five non-accredited investors is permitted.[31] Rule 506 does not limit the dollar amount of

26. *See* section 1.4.
27. The 1940 Act also excludes a number of other entities from the definition of 'investment company' or specifically exempts them from regulation under the Act, including issuers primarily engaged in non-investment business (Article 3(b)(1) and (2)), underwriters, brokers and dealers in securities (Article 3(c)(2)), banks and certain other financial institutions (Article 3(c)(3), (4), (5), (6) and (11)), and companies designed to promote investment in small business (Article 6(a)(2)). *See* for an extensive analysis of these and other exceptions and exemptions Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Adviser*s, Ch. 6 and 7.
28. In case the investor is another fund, each investor in that fund is counted as an investor of a 3(c)(1) fund for the purpose of the 100-investor (or 100-owner) limit if the fund owns 10% or more of the 3(c)(1) fund's outstanding voting securities. *See* Article 3(c)(1)(A) of the 1940 Act.
29. Qualified investors (or, in the terminology of Article 2(a)(51) of the 1940 Act, 'qualified purchasers') include individuals who hold at least USD 5,000,000 in investments (as defined in rule 2a51-1 of the 1940 Act) and an entity that in the aggregate owns and invests on a discretionary basis not less than USD 25,000,000 in investments. For a complete definition of qualified purchaser see Article 2(a)(51) of the 1940 Act. Pursuant to rule 2a51-3 of the 1940 Act, a qualified purchaser also includes a company not meeting the above requirements as long as all of the beneficial owners of the securities of that company are qualified purchasers.
30. *See* for an overview of court cases considering this issue D.L. Hammer, *U.S. Regulation of Hedge Funds*, 114–115.
31. Rule 506(b)(2) of the 1933 Act. An 'accredited investor' refers to an individual whose net worth, or joint net worth with a spouse, exceeds USD 1 million or whose individual income exceeded USD 200,000 or whose joint income with a spouse exceeded USD 300,000 in each of the two most recent years and can be expected to meet that income in the current year. Similar to the definition of a qualified purchaser, an entity in which all of the equity owners are accredited investors is also an accredited investor. *See* rule 501(a) of the 1933 Act. It can be noted that in 2011, the SEC adopted amendments to the net worth standard for accredited investors to exclude

securities that can be offered, but rule 502(c) of the 1933 Act prohibits any offerings or sales of shares through general solicitation or advertising.[32]

4.4 REGISTERED/UNREGISTERED FUND MANAGERS

In addition to the registration requirements for funds, US fund managers may also be held to register with the SEC under the Advisers Act. Registered fund managers are subject to a number of rules and regulations, including, among others, anti-fraud provisions, disclosure obligations, restrictions on fee provisions, an advertising restrictions.[33] Fund managers that are prohibited from registering with the SEC generally must register with the state(s) in which they manage funds, unless they are exempt from the specific regulation under state law. State-registered fund managers are however still subject to Article 206 of the Advisers Act, which prohibits fraudulent conduct, and Articles 204A (the implementation of procedures designed to prevent the misuse of material non-public information), 205 (containing, among other things, prohibitions on the use of certain performance fee arrangements), 206(3) (disclosure obligation of transactions where the manager acts as principal for its own account) of the Advisers Act.

With respect to these rules, Article 205 of the Advisers Act is particularly noteworthy. Under this article, SEC-registered managers (and unregistered managers that are registered with a US state), unless exempted from registration under Article 203(b) of the Advisers Act,[34] are prohibited from receiving a performance-based fee from an open-end registered fund (mutual fund), unless the fee is structured to comply with four requirements: (1) the fee must be based on the funds NAV (thus not on the total return of the fund), (2) the NAV is averaged over a ‘specified period’, (3) the fee increases or decreases proportionately with the fund’s investment performance over a specified period, and (4) the fund’s investment performance relates to the investment record of an ‘appropriate index’ of securities prices.[35] Such a fee is also known as a ‘fulcrum fee’, i.e., a fee earned by the manager when the fund’s performance is equal

the value of an individual’s primary residence from the USD 1 million calculation. *See* SEC, Final Rule – Net Worth Standard for Accredited Investors, Release Nos 33-9287, IA- 3144, and IC-2981, 21 Dec. 2011. *See* for the term ‘qualified purchaser’ n. 29, *supra*.

32. Accordingly, a fund relying on the safe-harbour exemption of rule 506 Regulation D may not use cold calling (i.e., unsolicited phone calls), advertising, mass e-mails or spam, web sites or other similar forms of promotion to solicit investors or promote or solicit investment in the fund.
33. *See* Articles 205, 206 of the Advisers Act and rules 204-3 and 206(4)-1 of the Advisers Act.
34. Article 203(b) of the Advisers Act exempts any manager: (1) all of whose clients are within the same state as the manager’s principal business office, and that does not provide advice or issue reports about securities listed on any national securities exchange, (2) managers whose only clients are insurance companies, (3) any manager that during the previous twelve months has had fewer than fifteen clients, does not hold itself out generally to the public as an investment adviser, and does not act as an investment adviser to a registered fund or business development company, (4) any manager that is a charitable organization, or is employed by a charitable organization, and provides advice, analyses, or reports only to charitable organizations, or to funds operated for charitable purposes, and (5) manager to church employee pension plans.
35. Article 205(b)(2) of the Advisers Act.

to the index.[36] With respect to the second and third requirement, requiring averaging and payment over a specified period, the SEC finds that the calculation of the performance-based fee should use a measuring interval that is 'sufficiently long to provide a reasonable basis for indicating the adviser's performance' and suggests the use of at least a one year interval.[37] Rule 205-2 of the Advisers Act furthermore provides the possibility to pay fund manager's performance-based fees within this period in case (1) the variable performance component must be computed over a 'rolling period' and the fee is only payable at the end of each subperiod of the rolling period and (2) the fulcrum fee must be computed on the basis of the NAV averaged through the most recent subperiod or subperiods of the rolling period.[38] Lastly, Rule 205-1 of the Advisers Act provides that an appropriate index to which the performance should relate should be representative of the typical portfolio securities held by the fund and not be too narrow in scope. Registered/unregistered fund managers managing unregistered funds and registered closed-end funds are generally not subject to any rules related to the use of (performance-based) fees.[39]

Before 2010, managers of US funds were exempt from registration under the Advisers Act in case they have fewer than fifteen clients and investors in the US in 'private funds'.[40] However, as each private fund counted as one client, managers could form up to fourteen private funds, regardless of the total number of investors investing

36. Rule 205-2(a)(1) of the Advisers Act (defining a fulcrum fee to be the 'fee which is paid or earned when the investment company's performance is equivalent to that of the index or other measure of performance').
37. SEC, Factors To Be Considered in Connection With Investment Company Advisory Contracts Containing Incentive Fee Arrangements, Release No. IC-7113, 6 Apr. 1972, n. 12.
38. Rule 205-2(a)(2) of the Advisers Act (defining a rolling period to be 'a period consisting of a specified number of subperiods of definite length in which the most recent subperiod is substituted for the earliest subperiod as time passes').
39. Article 205(b)(4) and rule 205-3(a) of the Advisers Act (exempting private funds excepted from Article 3(c)(7) of the 1940 Act and clients with at least USD 750,000 under management with the fund manager or more than USD 1,500,000 of net worth or clients who are 'qualified purchasers' under article 2(a)(51)(A) of the 1940 Act. Private funds exempted from the 1940 Act under Article 3(c)(1) of that act are however not exempted from the performance-based fee restrictions. Also exempted are registered funds and clients having more than USD 1 million in managed assets and business development companies, if specific conditions are met, clients that are not US residents, and certain knowledgeable employees of the fund manager. *See* Article 205(b)(2)(B), (3), (5) and rule 205-3(a) and (d)(iii) of the Advisers Act.
40. Rule 203(b)(3)-1(a)(2) of the Advisers Act. The term 'private fund' is defined by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ('Dodd-Frank Act', Pub.L. 111-203, 124 Stat. 1376, H.R. 4173, enacted 21 Jun. 2010) and codified in Article 202(a)(29) of the Advisers Act, to mean 'an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act'. The definition covers hedge funds and private equity funds, including venture capital funds, and most real-estate funds. Prior to the Dodd-Frank Act, the definition was limited to manager of hedge funds, excluding managers of funds that have more than a two year 'lock-up', such as most private equity, venture capital and real-estate funds. Reason for this initial limitation was the fact that the SEC has not encountered significant enforcement problems with managers to such funds, in contrast to its experience with hedge fund managers. *See* SEC, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333, Federal Register, Vol. 69, No. 237, 10 Dec. 2004, 72074. In the Dodd-Frank Act, only managers of venture capital funds are exempted from registration under new Article 302(1) of the Advisers Act.

in the funds, without having to register with the SEC.[41] The Private Fund Act 2010 eliminated this exemption and also raised the dollar threshold for SEC registration from USD 25 million of total assets under management to USD 100 million (i.e., mid-sized manager exemption).[42] In addition, in the Act, Congress directed the SEC to create, among others, two new exemptions applying to: (1) managers managing solely venture capital funds (i.e., venture capital fund exemption), and (2) managers managing solely private funds with less than USD 150 million in assets under management in the US (i.e., small private fund exemption).[43] To this end, the SEC adopted final rules that implemented these exemptions.[44]

With respect to the first exemptions, Congress intended to distinguish managers of venture capital funds from the larger category of private equity funds.[45] Reason for this is the fact that venture capital funds are considered to, as opposed to private equity funds, not pose a systemic risk as they are generally not leveraged.[46] In implementing the exemption, the SEC has adopted a definition of a venture capital fund that is in line with the language previously used by the Congress to describe these funds.[47] The

41. Concerns about this lack of oversight led to the adoption of rule 203(b)(3)-2 in 2004 requiring fund managers to count each owner of a private fund for purposes of the 14 client-threshold and, subsequently, the requirement to register with the SEC. *See* SEC, Registration Under the Advisers Act of Certain Hedge Fund Advisers, 72075. However, this rule was vacated by the District Court of Colombia in 2006. *See Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).
42. Article 410 of the Private Fund Act and (new) Article 203A(a)(1) of the Advisers Act. However, the Private Fund Act shifts primary responsibility for their regulatory oversight to the state securities authorities by determining that a mid-sized fund manager is only prohibited from registration with the SEC if it is not required to be registered with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business or if registered, would not be subject to examination as an investment adviser by that securities commissioner, or if the fund manager is required to register in fifteen or more states. In addition, a mid-sized fund managers also will be required to register with the Commission if it can be qualified as an investment adviser to a registered investment company or business development company under the 1940 Act. *See also* Article 410 of the Private Fund Act.
43. Articles 407, 408, and 403(2) of the Private Fund Act. The Act also created exemptions and exclusions in addition to the three mentioned here. *See*, e.g., Articles 403 and 409 of the Private Fund Act (exempting fund managers to licensed small business investment companies and non-US managers with, among other things, less than USD 25 million in aggregate assets under management from US clients and investors and fewer than fifteen such clients and investors from registration under the Advisers Act and excluding family offices from the definition of 'investment adviser' under the Advisers Act).
44. SEC, Final Rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222, 22 Jun. 2011.
45. SEC, Proposed rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3111, 19 Nov. 2010, 10–12.
46. *Ibid.*, 11.
47. In summary, the rule defines a venture capital fund as a private fund that: '((i) holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings) ("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund (...)); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors

second, exemption enables a fund manager with USD 150 million or less assets under management to manage an unlimited number of private funds without having to register with the SEC.[48] As a result of this exemption in combination with the mid-sized manager exemption, managers of only private funds that hold between USD 100 and USD 150 million assets and managers of any fund, including private funds, with less than USD 100 million of assets under management in the US are exempt from federal registration. In case a manager manages solely private funds with between USD 100 and USD 150 million of assets under management, however, forms only one non-private fund, it would be required to register with the SEC.

4.5 INTERNAL CONTROL SYSTEMS

Rule 38a-1 of the 1940 Act and rule 206(4)-7 of the Advisers Act requires registered funds and registered fund manager to (1) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, (2) revise those policies and procedures each year for adequacy and effectiveness, and (3) designate a Chief Compliance Officer (CCO) to be responsible for overseeing and administering said policies and procedures. The rules do not prescribe the exact elements that the compliance policies and procedures should contain.[49] However, the SEC has stated that it expects fund managers and funds to, among other things and where relevant, identify risks and potential conflicts and implement policies to address those risks and conflicts.[50]

The rules furthermore do not state how funds should conduct compliance reviews or who should conduct them. As a result, funds have flexibility to design and carry out compliance reviews in a manner that best suits their particular circumstances.[51] They however do provide that the CCO should be involved in these reviews and imposes some general duties on the CCO with regard to its monitoring and reporting duties. Since US funds and their managers obtain a certain amount of freedom as regard to the adoption of compliance policies, these duties play an important role in regulatory enforcement and forms a keystone in the protection of investors with respect to internal control systems. Therefore, below, I will assess, in

redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company ("BDC")'. *See* SEC, Final Rule – Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than USD 150 Million in Assets Under Management, and Foreign Private Advisers, 9.

48. *Ibid.*, 75–76.
49. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA–2204, IC–26299, Federal Register, Vol. 68, No. 247, 24 Dec. 2003, 74716 (stating that 'funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements' and '[t]he policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred').
50. *Ibid.*, 74716–74717.
51. ICI, *Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedures*, December 2005, 2. This paper can be found at ICI's website: http://www.ici.org/.

addition to the rules related to the compliance policies of funds and fund managers, the duties of the CCO.

4.5.1 Compliance Policies

All US registered funds must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for the oversight of compliance by their service providers, including external managers.[52] A fund may apply this requirement in the manner best suited for its particular structure. It may, for example, adopt policies and procedures that solely cover the activities of the fund and would approve the policies of its service providers, but it may also adopt policies and procedures that covers the activities of its service providers (and would approve their policies). The fund's board is required to approve the fund's compliance policies. This approval must be based on a finding by the board that the policies are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers.[53] In this context, the SEC stated that the board must consider the following factors when determining whether to approve the policies: (1) the nature of the fund's exposure to compliance failures, (2) the adequacy of the policies and procedures in light of their recent compliance experiences, and (3) best practices used by other fund complexes.[54]

[A] Policies for US Fund Managers

Registered fund managers are also required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the manager and the manager's supervised persons.[55] A fund manager may take into account its specific nature, as a result of which, for example, small managers may adopt simpler policies than large managers. There is no board approval required, but the manager's policies must be, as is also the case for fund policies, annually reviewed and monitored by the CCO (see below).

In general, a fund manager should first identify its conflicts and other compliance factors creating risk exposure for the manager and its funds, after which it should design policies and procedures that address those risks. The policies should, as mentioned, vary from manager to manager, depending on factors as size and complexity of

52. Rule 38a-1(a)(1) of the 1940 Act. Service providers include fund managers, principal underwriters, administrators, and transfer agents. *See* SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74717, n. 28.
53. Rule 38a-1(a)(2) of the 1940 Act.
54. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74717.
55. Rule 206(4)-7(a) of the Advisers Act. Article 202(a)(25) of the Advisers Act defines a 'supervised person' as 'any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser'. The CCO is also a supervised person, *See also* article rule 206(4)-7(c) of the Advisers Act.

the manager's business, types of potential conflicts and types of funds managed and affiliated persons. The SEC has identified the following topics that should be addressed by the manager's compliance policies to the extent that they are relevant to the particular manager:

- Portfolio management processes, including investment allocation and consistency of the underlying portfolios held with the funds' investment objectives, disclosures to the funds managed, and applicable regulatory investment restrictions.
- Proprietary trading by the manager and the personal trading activities of the manager's personnel and policies on the prevention of insider trading.
- Trading practices, including best execution efforts, soft dollar arrangements, and the allocation of aggregated trades among funds.
- Disclosure accuracy, including information provided in Form ADV and other regulatory filings, fund account statements and advertisements.
- Custody of assets, including adherence to applicable requirements and the general safeguarding of the assets of the funds managed.
- Recordkeeping, including the timely creation and proper use of all required records.
- Privacy of information, including safeguarding fund information.
- Marketing, including the advertising of the manager's services and the use of solicitors.
- Portfolio valuation of client holdings, including the valuation of holdings and fees based on those valuations.
- Business continuity and disaster recovery plans, including efforts to address risks that might impact the continuity of the business, such as natural disasters or, in the case of a small manager, the death of the owner or key personnel.[56]

Although the exact policies and procedures are neither defined by the Advisers Act nor the SEC, the SEC has brought an enforcement action against an advisory firm that adopted a pre-packaged policies and procedures manual that did not adequately address the conflicts of interest unique to the firm's business.[57] The SEC thus expects fund managers to perform an adequate risk assessment and to implement and maintain compliance policies and procedures in accordance with this assessment and taking into account the areas mentioned in the SEC guidelines.

[B] Policies for US Funds

With respect to the compliance policies of registered funds, the SEC has stated that they should adhere to the same areas as those identified for fund managers, but added a number of areas:

56. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74716.
57. SEC, In the Matter of Consulting Services Group, LLC, Release No. IA-2669, 4 Oct. 2007.

- Valuation of funds shares, including the use of fair value prices for open-end funds and the methodology by which the fund determines the current fair value of portfolio securities.
- Processing of fund shares, including the segregation of investor orders received before open-end funds price their shares to ensure protection against late trading.[58]
- Identification of affiliated persons to prevent conflicting transactions such as self-dealing.
- Protection of non-public information, including preventing insider trading by the manager or any other person and other potential misuses of non-public information.
- Compliance with fund governance requirements, including safeguarding the election of a properly constituted board (with sufficient independent directors).
- The monitoring of investor trades or flows of money in and out of open-end funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing.[59]

Similar as for fund managers, registered funds must conduct a risk assessment in which they identify potential conflicts of interests and other compliance issues that may create risks for them. After this assessment, they must determine the specific policies and procedures which should be implemented in order to enable them to comply with the federal securities laws. However, although rule 38a-1 of the 1940 Act does not list the exact risks and the policies and procedures to be implemented by registered funds, by complying with the 1940 Act, a fund will have to address a number of risk areas, including credit risk, market risk and liquidity risk.[60] By complying with these rules, funds are already provided with a framework for developing compliance policies.[61]

58. The SEC however stated that simply having procedures designed to prevent late trading is not sufficient, but that a fund should also take 'affirmative steps to protect itself and its shareholders against late trading by obtaining assurances from its transfer agent that its policies and procedures are effectively administered'. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74719.
59. *Ibid.*, 74718–74720.
60. For example, the requirements set out in Article 22(e) of the 1940 Act regarding the suspension of redemptions seek to limit a fund's exposure to losses due to credit, market, and liquidity risks. In addition, SEC guidance allows open-end funds to invest 15% of their assets in illiquid assets, as a result of which 85% must be liquid. SEC, Revisions of Guidelines to Form N-1A, Release no. IC-18612, Federal Register, vol. 57, no. 55, 20 Mar. 1992, 9828. MMFs cannot acquire illiquid securities if, after the purchase, more than 5% of the fund's total assets would consist of illiquid securities. *See* Rule 2a-7(c)(5) under the 1940 Act. SEC guidance has further indicated that, in case more than 5% of a fund's net assets are exposed to derivative instruments and derivative-based transactions, the fund prospectus should include, among other things, the risks underlying the derivatives and the risks associated with the derivatives themselves, such as leverage, credit risk, market risk and liquidity risk. *See* G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 23.
61. S.H. Bier & M.A. Wolfe, *Risk Management Issues for Registered Investment Companies*, 16 Inv. Law. 10 (2009).

With respect to the valuation of shares, the 1940 Act however provides for additional guidance. Rule 2a-4(a)(1) and Article 2(a)(41)(B) of the 1940 Act determine that the underlying portfolio securities owned by the fund should be valued by using the 'market value method' when market quotations are readily available. When market quotations are not readily available, a fund must use fair values, as determined in good faith by the fund's boards of directors, to value its portfolio securities and other assets. Securities that are valued by the market value are classified by the SEC into two sub-types: (1) securities listed on or traded on a national securities exchange and (2) OTC securities. The valuation of the first category should be obtained through the last quoted sales price used. The valuation of OTC securities should be obtained through market quotations from broker-dealers or others.[62]

With respect to 'fair value method', the SEC determines that the fund's directors must satisfy that all appropriate factors relevant to the value of the securities or assets for which market quotations are not readily available have been considered and determine the method of arriving at the fair value of these securities or assets. According to the SEC, the current fair value of an issue of securities or assets being valued by the fund's board would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.[63] This valuation principle is also referred to as the current sale principle.[64] Methods which are allowed include, for example, methods that are based on a multiple of earnings, or a discount from market of a similar freely traded security.[65]

In this context, it can be noted that when a 'significant event' occurs, the fund must value the security pursuant to the fair value method and not the market value method.[66] However, the SEC did not establish specific criteria for determining when a significant event had occurred. The valuation policies and procedures established under rule 38a-1 of the 1940 Act should monitor the circumstances (i.e., valuation risks) that may necessitate the use of fair value prices, including significant events.[67]

62. SEC, Accounting Series Release No. 118, Release Nos. 40-6295, 33-5120, 34-0040, 23 Dec. 1970 (ASR 118), 19987–19988. The release can be found at SEC's website: http://www.sec.gov/.
63. *Ibid.*, 19988.
64. J.K. Smith, R.L. Smith & K. Williams, *The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6:2 Ford. J. Corp. & Fin. L. 429 (2001).
65. ASR 118, 19988.
66. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74718 (stating that funds may be required to fair value portfolio securities 'if an event affecting the value of the security occurs after the market closes but before the fund prices its shares'. According to the SEC, in these circumstances, 'a fund "must, to the best of its ability, determine the fair value of the securities, as of the time" that the fund prices its shares').
67. *Ibid.* ('[R]ule 38a-1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments'). According to ICI, significant events may include: 'events relating to a single issuer, such as corporate announcements on earnings; events relating to an entire market sector, such as significant governmental actions (e.g., raising interest rates); natural disasters that affect securities values, such as an earthquake; or

Furthermore, registered open-end funds must disclose to investors the circumstances under which the fund will use fair value pricing and the effects of using fair value pricing and the valuation procedures that they use in determining their NAV and the value of their investments.[68]

In addition to the above, reference can be made of three rules applying in specific circumstances regarding securities valuation. Firstly, in case of valuation of securities issued by controlled companies,[69] the board of directors may determine the value of such securities in good faith, provided that the value determined is not in excess of the higher market value of asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of the market value in the case of other controlled companies.[70] Secondly, in case of elimination of securities from the portfolio of the fund, rule 2a-2 of the 1940 Act provides that the valuation of such securities should give effect to the eliminations in accordance with one of the following methods: (1) the price of the specific certificate, (2) first in-first out, (3) last in-first out, or (4) average value. Thirdly, US funds that are required by state law to use another method of market value or fair value with respect to their securities are allowed to use this alternative method, provided that they state the facts and describe their methods and the facts justifying its adoption in their registration statement under Article 8 or in their reports under Article 30 of the 1940 Act (annual and semi-annual reports).[71]

Lastly, it is worth noting in this respect that funds and fund managers may also subject to certain written compliance policies under other US federal law provisions than rule 38a-1 of the 1940 Act. For example, rule 17j-1(c)(1) of the 1940 Act requires every registered fund (and each fund manager) to 'adopt a written code of ethics containing provisions reasonably necessary to prevent' certain persons affiliated with the fund, its manager or its principal underwriter from engaging in certain fraudulent manipulative, and deceptive actions with respect to the fund. Furthermore, MMFs are required to establish written procedures 'reasonably designed (…) to stabilize the money market fund's net asset value per share'.[72] With respect to fund managers, the Advisers Act requires registered fund managers to have a code of ethics that sets forth standards of conduct expected of manager personnel, addresses conflicts that arise from personal trading by the personnel, and to report their personal securities transactions, including transactions in any registered fund managed by the manager.[73]

significant fluctuations in domestic or foreign markets'. *See* ICI, *The Role of the Board* 3 (Fair Valuation Series 2006). ICI's document can be found at ICI's website: http://www.ici.org/.

68. Form N-1A, Items 11 and 23. Form N-1A can be found at SEC's website: http://www.sec.gov/.
69. *See* Article 2(a)(9) of the 1940 Act.
70. Article 2(a)(41) of the 1940 Act. A majority-owned subsidiary is defined in Article 2(a)(24) of the 1940 Act as 'a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority owned subsidiary of such a person'.
71. Rule 2a-1(a) and (c) of the 1940 Act.
72. Rule 2a-7(c)(7) of the 1940 Act.
73. Article 204A and rule 204A-1 of the Advisers Act.

4.5.2 CCO

Rule 38a-1(3) of the 1940 Act provides that registered funds must review at least annually the adequacy of their and their service providers' policies and procedures as well as the effectiveness of their implementation. A similar requirement applies to registered fund managers under rule 206(4)-7(b) of the Advisers Act. Furthermore, both registered funds and fund manager must appoint a CCO to administer the policies.

There is little guidance as to what the CCO's 'administering' role is, but the SEC has stated that the CCO must 'be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm' in order to detect potential compliance failures.[74] The broadest interpretation of this standard imposed by the SEC would result in a requirement of the CCO to be involved in the implementation (or overseeing the implementation) of the compliance policies of the fund and fund manager to monitor the activities of the business of the fund (and its service providers) and manager by testing, measuring and reviewing their performance for compliance with the federal securities laws. However, in practice, the role of the CCO in the reviewing process may vary among funds and managers and may depend on various factors, such as size of the fund and complexity of its strategies. So may a CCO of a small fund play a larger role in this process, while a CCO of a large fund will focus more on planning and coordinating the compliance reviews, and reviewing the results of tests and analyses performed by the fund manager or fund board.[75]

For registered funds, rule 38a-1 of the 1940 Act provides for a number of additional duties for CCO's with respect to their administrating role. It requires the CCO to at least annually provide a written report to the fund's board that addresses the operation of the fund's and its service providers' policies and procedure, any material changes in the policies and procedures since the last report, any material changes in the policies and procedures recommended in the annual review, and each material compliance matter that occurred since the last report.[76] The CCO must also meet separately with the independent directors at least annually.[77] The fund's board, including a majority of its independent directors, must approve the designation of the

74. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720.
75. ICI, *Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedure*, 2. It however does not by definition includes supervisory responsibilities. *See* SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720, n. 73 (stating that '[h]aving the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)-7 (or rule 38a-1) would not necessarily be subject to sanction by us for failure to supervise other advisory personnel').
76. A 'material compliance matter' is any compliance matter about which the fund's board of directors would reasonably need to know to oversee compliance, and that involves, without limitation: (a) a violation of the federal securities laws by the fund and any service provider (or any officers, directors, employees or agents thereof), (b) a violation of the policies and procedures of the fund and its service providers, or (c) a weakness in the design or implementation of the policies and procedures of the fund (or separate account) and its service providers. *See* rule 38a-1(e)(2) of the 1940 Act.
77. Rule 38a-1(a)(4)(iv) of the 1940 Act.

CCO and can remove the CCO at any time.[78] Furthermore, the rule imposes specific recordkeeping requirements. Among other things, funds are required to maintain any records documenting their annual compliance reviews as well as copies of the written compliance reports required to be provided by the CCO to the fund's board.[79] In addition, the SEC has indicated that the duties of the CCO (of either a fund or fund manager) go further than just reviewing and monitoring the compliance with federal securities laws, as it should also 'identify potential and actual conflicts of interest issues'.[80] With respect to fund managers, the SEC furthermore requires the CCO to report regularly to the risk management committee and to report violations to the Chief Executive Officer (CEO) and the board of directors of the manager.[81]

The annual compliance review should consider any compliance matters that arose during the previous year, any changes in the business activities of the fund managers, funds, the separate accounts, the principal underwriters, and their service providers or in the applicable regulations that might suggest a need to revise the policies or procedures.[82] In case a fund has an external manager, the CCO's role would be limited to oversight of the manager's compliance policies and providing advice to the fund board on the operation of the policies.[83] Although the rules only require annual reviews, the SEC has noted that the fund/manager should 'consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments'.[84] Consequently, funds and fund managers should put policies in place for determining when interim reviews may be advisable in light of the entity's ongoing risk assessment. This will require additional risk assessment by the risk management committee, CCO, and/or other personnel performing such assessments.

The annual review must be formalized and documented and the documents retained for SEC inspection for a period of five years after the end of the fiscal year in which the review was conducted.[85] With respect to these inspections, the SEC has noted that it will be looking at whether a proper 'culture of compliance' is in place by assessing whether there are adequate checks and balances, internal controls and supervisory structure that make it more likely that ethical behaviour will be the norm within the entity, and communication of its culture of compliance to those outside the firm.[86]

78. Rule 38a-1(a)(4)(i) and (ii) of the 1940 Act.
79. Rule 38a-1(d) of the 1940 Act.
80. SEC, In the Matter of RS Investment Management Inc., et al., Rel. No. IA-2310, 6 Oct. 2004, under 28.
81. *Ibid.*
82. SEC, Final Rule – Compliance Programs of Investment Companies and Investment Advisers, 74720.
83. *Ibid.*, 74722.
84. *Ibid.*, 74720.
85. Rule 38a-1(d)(2) of the 1940 Act and Article 204-2(a)(17)(ii) of the Advisers Act.
86. Frankel & Schwing, *The Regulation of Money Managers: Mutual Funds and Advisers*, 9-126.14.

4.6 LEVERAGE RESTRICTIONS

As mentioned by the Committee of Federal Regulations of Securities in 2010, leverage that is embedded in many derivatives, has presented issues concerning how US funds should appropriately use derivatives, how they should disclose the related risks, and how the positions should be treated under applicable law.[87] Investors may understand the risks associated with an investment in a fund that uses leverage. As a result, regulatory authorities, including the SEC, focus on restricting the use of leverage by funds offered to retail investors and imposing disclosure obligations on funds to make investors aware of the risks involved in funds that expose their portfolio to significantly high levels of leverage.[88]

The 1940 Act imposes certain leverage restrictions on registered funds. Article 18(f)(1) of the 1940 Act prohibits open-end funds from issuing or selling so-called senior securities and provides that they may only borrow from US banks subject to a 300% asset coverage requirement (including the amount borrowed), i.e., direct leverage is allowed up to 33.33% of a fund's total net assets,[89] at all times that the borrowing is outstanding. Senior securities are defined in Article 18(g) of the 1940 Act as 'any bond, debenture, note or similar obligation or instruments constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends'.

Closed-end registered funds are subject to less restrictive provisions as they may issue or incur debt under Article 18(a), (c) and (e) of the 1940 Act: (1) through issuance of a single class of debt, so long as the fund maintains an asset coverage ratio of at least 300% and the debt is subject to specified restrictive covenants, (2) through issuance of one class of senior ('preferred') stock, so long as the fund maintains an asset coverage ratio of at least 200% and the preferred stock is subject to specified restrictive covenants, (3) by borrowings from a US bank or through a privately arranged financing, (4) for the purpose of refunding or a plan of reorganization subject to certain requirements. Both open-end and closed-end funds are allowed to issue temporary, short-term loans of up to 5% of the fund's total assets with any person. A loan is presumed to be for temporary purposes if it is repaid within sixty days and is not extended or renewed.[90]

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87. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 6 Jul. 2010, 4. The report can be found at the American Bar Association's website: http://apps.americanbar.org/.
88. *Ibid.*, 11 & 40.
89. For example, an open-end funds that has USD 2 million of net assets and borrows USD 1 million from a bank, its total net assets is USD 3 million of which 1 million is loaned (33%). 'Asset coverage' is defined in Article 18(h) of the 1940 Act to mean, with respect to a class of senior security representing an indebtedness of an issuer, the ratio that the value of the total assets of an issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer.
90. Article 18(g) of the 1940 Act.

4.6.1 Application of Article 18 of the 1940 Act

With regard to these leverage restrictions, the SEC has issued a general statement of policy on the application of Article 18 of the 1940 Act for registered funds.[91] In this statement, the SEC addressed three types of transactions: (1) reverse purchase agreements, (2) firm commitment agreements, and (3) standby commitment agreements,[92] but emphasized that it 'intended to address generally the possible economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices' specifically discussed in the release'.[93] For purposes of Article 18 of the 1940 Act, the SEC stated that 'all contractual obligations to pay in the future for consideration presently received' fall under the scope of this article.[94] Further, the SEC stated that 'trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18'.[95] Consequently, engagements by (open-end or closed-end) registered funds in 'senior securities transactions' involving derivatives that create third party obligations (indebtedness), e.g., futures, forward contracts, written options (and securities-lending transactions, e.g., short sales) are covered by Article 18 of the 1940 Act, whereas investments in derivatives that do not impose any payment obligations above the initial investment (i.e., premium), such as purchased stock call options and leveraged inverse floating rate notes, are not.[96]

As a rule, the SEC determined that it would not treat the three transactions discussed as creating senior securities if funds segregates or 'cover' their obligations by establishing a segregated account equal in value to its obligations under the transaction holding only liquid assets, such as cash, US government securities, other appropriate high grade debt obligations or, according to a later no-action letter, equity and

91. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, Release No. IC-10666, Federal Register, Vol. 44, No. 83, 27 Apr. 1979.
92. Reverse purchase agreements involves the purchase of securities with the agreement to sell them at a higher price at a specific future date. In firm commitment agreement, the fund agrees to buy securities at a future date, stale price, and fixed yield. The standby commitment agreement is a delayed delivery agreement in which the fund contractually binds itself to accept delivery of securities with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. *Ibid.*, 25129–25131.
93. *Ibid.*, 25128.
94. *Ibid.*, 25131.
95. *Ibid.*
96. This follows from the fact that the SEC has focused on providing guidance as to the issuing of senior securities rather than on limiting the use of derivatives. When a fund buys a stock call option, it has the right (not the obligation) to purchase a specified number of shares of the underlying stock at the given strike price on or before the expiration date of the contract. To obtain this option, the fund pay an initial fee (called a premium) to the seller of the option. Inverse floating rate notes are instruments on which the rate paid increases as market floating rates declines. In leveraged inverse floating notes, the rate paid on the note is typically set by doubling the swap rate (fixed rate) in effect at the time the contract is signed, and subtracting the floating reference index rate for each payment period. *See* G. Gastineau & M. Kritzman, *Dictionary of Financial Risk Management* 266 (3th ed., John Wiley & Sons 1999).

non-investment grade debt, provided the assets are liquid.[97] The SEC explained that allocating assets into a segregated account would: (1) function as a practical limit on both the amount of leverage undertaken by a fund and the potential increase in the speculative character of the fund's outstanding shares, and (2) assure the availability of adequate funds to meet the obligations arising from such activities.[98]

4.6.2 Exemptive Relieves

After this statement, the SEC applied the standards in a number of exemptive relieves, no-actions letters and guidelines with regard to several derivative instruments and other leveraged transactions, including future contracts, commodity options, futures, and short selling.[99] The main questions that the SEC addressed in these documents relate to the amount of assets the fund must segregate with respect to these instruments. For example, with respect to futures, the SEC determined that an open-end registered fund must segregate liquid or other qualifying assets equal to (1) the purchase price of the futures contract, if the fund is long the positions or (2) an amount that, when added to the amounts deposited with a futures commission merchant, or broker as margin, equals the market value of the instruments or currency underlying the futures contract, if the fund is short the positions.[100]

In addition, short selling (both 'covered' and 'uncovered') is allowed in case the fund maintains in a segregated account on its books an amount that, when combined with the amount of collateral (not including short sale proceeds) deposited with the broker in connection with the short sale, equals the current market value of the security sold short.[101] In many cases, segregation of short selling is accomplished in case the fund physically posts liquid assets as collateral. Furthermore, the SEC approved 'off-setting exposure' to derivatives, i.e., entering into a position that fully off-sets its exposure on a derivative or short position, as a means by which a registered fund avoids violation of Article 18 of the 1940 Act.[102] With this approval, the SEC in fact

97. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25129 and SEC No-Action Letter, Merrill Lynch Asset Management L.P., 2 Jul. 1996. The no-action letter can be found at SEC's website: http://www.sec.gov/.
98. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25132.
99. *See* for an analysis of these no-action letters, G. Bullitt et al., *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 15–16 and Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 13–15.
100. *Ibid.*, 15.
101. SEC No-Action Letter, Robertson Stephens Investment Trust, 24 Aug. 1995, 3 and SEC Letter to fund CFOs, 7 Nov. 1997 (further relaxing the rules to allow funds to designate securities as segregated assets solely on the fund records and not on the fund's custodian's records). The no-action letter and SEC's Letter to the fund CFOs can be found at SEC's website: http://www.sec.gov/.
102. SEC No-Action Letter, Dreyfus Strategic Investing, 30 Mar. 1987. According to SEC, this would effectively eliminates the derivatives exposure and obviates the need to segregate assets to comply with the prohibition on senior securities contained in article 18(f) of the 1940 Act. For example, the SEC clarifies that a fund that has sold a put option could cover its position by selling short the instrument or currency underlying the put option at the same or a higher

confirmed that registered funds could use derivatives for investment purposes, although it did not make fully clear what constitutes an 'offsetting' transaction.[103]

4.6.3 Disclosure

According to the SEC, every registered fund that uses leveraged transactions and derivatives should disclose its investment trading strategies and how it segregates the amount of assets in order to avoid issues under Article 18 of the 1940 Act and to comply with Article 8(b)(1) of the 1940 Act. This article requires for general disclosure of a fund's issuance of senior securities and borrowings to the SEC.[104] In addition, it has written a letter on the issue providing registered funds with 'immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them'.[105] However, with respect to open-end registered funds, it can be noted that the document generally used for these disclosures (Form N-1A) does not call for such disclosures.[106] In this context, it can be noted that, in 2011, the SEC issued a concept release to seek public comment on a wide range of issues raised by the use of derivatives by funds regulated under 1940 Act.[107] The results of the consultation may be reason for the SEC to change the regulatory environment regarding the use of derivatives for registered funds by adopting more derivative disclosure rules, but also restricting the use of such instruments, and/or limiting the amount of economic exposure created by a fund's investment in derivative.[108]

price than the strike price of the original put). *Ibid.*, 9. The no-action letter can be found at SEC's website: http://www.sec.gov/.

103. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 19 (stating that the SEC did not address matters as 'pegged currencies, substantially correlated offsetting positions, different counterparties, and the like').
104. SEC, General Statement of Policy – Securities Trading Practices of Registered Investment Companies, 25132 & n. 18.
105. SEC, *Letter from Barry D. Miller, Associate Director, Office of Legal Disclosure, SEC, to Karrie McMillan, Esq., General Counsel of the ICI: Derivatives-Related Disclosures by Investment Companies* 1 (30 Jul. 2010). The letter can be found at SEC's website: http://www.sec.gov/.
106. Committee on Federal Regulation of Securities, American Bar Association's Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, 15, n. 27. Instructions 1 of Item 9 of Form N-1A only requires the disclosure of 'any policy, practice, or technique used by the Fund to achieve its investment objectives' and Item 9(c) requires the fund to '[d]isclose the principal risks of investing in the Fund, including the risks to which the Fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, or total return').
107. SEC, Concept Release – *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Release No. IC-29776, 31 Aug. 2011.
108. In fact, according to the Wall Street Journal of 7 Sep. 2014, the SEC is already preparing new rules that :(1) limits the use of derivatives by registered funds that sell shares to small investors, (2) requires internal policies and procedures for risks exposed by the use of derivatives, (3) enhances derivative disclosures, (4) mandates that funds have a resolution plan and (4) imposes enhanced stress-testing requirements. A. Ackerman, *SEC Preps Mutual Fund Rules*, The Wall Street Journal (7 Sep. 2014).

4.7 INVESTOR MEETINGS

Investor meetings are often not held by funds established in the US.[109] US law does provide for rules requiring funds to hold an investor meeting, but this requirement is subject to a number of limitations.

4.7.1 Elimination of Investor Meetings

Firstly, it can be noted that most US funds can eliminate the possibility of an investor meeting or may choose to not establish such meetings in their governing instruments.[110] However, Article 16(a) of the 1940 Act requires US registered funds to hold an annual meeting in two-third of the director elections.[111] Besides this, only funds listed on a US stock exchange, such as the NYSE, and Delaware corporate funds are required to hold annual meetings.[112] However, in the case of Delaware corporate funds, it is only required to hold a meeting when a director is elected, which is generally either once a year or often even less, depending on whether or not the fund is subject to the 1940 Act, has implemented the 'two-third' federal law provision in its charter and has more than three classes of directors. With respect to Delaware corporations, it is furthermore provided that the failure to hold an annual meeting does not affect otherwise valid corporate action or causes a forfeiture or dissolution of the corporation.[113] Thus, unless an investor meeting must be held on the basis of federal law or stock exchange rules, the board of directors of a Delaware corporate fund may have little incentive to hold an annual meeting. Next to annual meetings, a fund may also hold a special, or extraordinary, meeting. In Delaware and Maryland, investors are

109. *See*, e.g., J.A. Haslem, *Mutual Funds: Risk and Performance Analysis for Decision Making* 69 (Blackwell Publishing 2003) (stating that only few mutual funds hold shareholders meetings) and Jones, More & Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 453 (stating that 'after 1974 investment companies in trust form commonly omit the requirement to hold an annual meeting').
110. Article 2-105(b)(1) of the Maryland Corporate Code, Maryland Corporations and Associations Code Ann. § 1-101 et seq. (noting that for corporations registered under the 1940 Act an annual meeting is not required, except for the case that a director is to be elected), Articles 1 and 2 of the Massachusetts Voluntary Association Statute (codified in Ch. 182 of the Massachusetts General Laws Ann.) (providing that an annual meeting must only be held if it is required by trust agreement, or any amendment thereof), Article 3806(b)(5) DBTA (stating that the governing instrument may, but is not required to, set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on) and Article 17–302(c) of the Delaware Revised Uniform Limited Partnership Act (DRULPA), Del. Code Ann. tit. 6, § 17–101 et seq. (*ibid.*).
111. Article 16(a) of the 1940 Act ('No person shall serve as a director of a registered investment company unless elected (…) by the holders of the outstanding voting securities (…), at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in anywise legal manner if immediately after filling such vacancies at least two-third of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities at an annual or special meeting').
112. Article 302.00 of the NYSE Listed Company Manual and Article 211(b) DGCL. The manual can be found at NYSE's website: http://www.nyse.com/.
113. Article 211(c) DGCL.

permitted to call for a special meeting, but that right is often limited or eliminated by the fund.[114]

It appears that, in most cases, fund directors can thus quite easily avoid difficult questions and attempts of investors to overrule a prior decision or to be otherwise critical towards directors by not holding investor meetings. However, in this respect, it is important to note that even if a meeting is held, investors are often unable or unwilling to attend. Meetings may be held at places that are inconvenient for investors to attend or they are held at too short notice.[115] As generally known, attendance is also often low when no investor or group is able to exercise effective control over the management, which is the case when shares are widely dispersed among many small (retail) investors. Furthermore, when shares are held in the name of an intermediary, not the investors but the intermediary, as the record holder of the shares, has the authority to attend (and to vote at) meetings, although it generally solicits voting instructions from the underlying investors.[116] In addition, it can be noted that institutional investors are often not interested in attending investor meetings at all since they generally exercises influence on the fund's management through an investment committee or green lighting committee.[117]

114. Article 2-502(b) of the Maryland Corporate Code (stating that only a shareholder or group of shareholders representing 25% of the votes can call a special meeting, which threshold can be raised in the articles to maximum 50%) and 211(d) DGCL (noting that a special meeting can only be called by any person or group of persons if they are authorized to do so in the certificate or bylaws). *See also* R. Daines & M. Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. Econ. & Org. 96 (2001) (stating that approximately 24% of the sample corporations at the time of the IPO stage prohibit shareholders from calling a special meeting and that even when shareholders are permitted to call such a meeting, specified percentage of outstanding shares are usually needed to do so).

115. Only corporate funds are required by law to provide a written notice not less than ten (in Delaware) or thirteen days (in Maryland) and not more than sixty days before the date of the meeting. *See* Article 222(b) DGCL and 2-511(c)(i) of the Maryland Corporate Code. Other types of US funds should set forth procedures relating to the notice of a meeting in their fund agreement. If no such procedures are included in the fund agreement, there is no requirements on full and timely notice of annual/special meetings.

116. The voting rights of bank nominees are typically restricted by contractual arrangements with their clients and NYSE-registered brokers that act as nominees for their client only have 'discretionary' authority to vote at an annual meeting of US public companies if the following two conditions are met: (i) the subject matter of the vote has been deemed 'routine' by the NYSE, and (ii) the broker has not received voting instructions by the tenth day preceding the meeting date (rule 452 and Article 402.08 of the NYSE Listed Company Manual). Examples of non-routine matters include any contested proposal, merger proposals, the issuance of shares exceeding more than 5% of the outstanding shares and any proposal to materially amend an investment management contract between a fund manager and an investment company (Article 402.08(B) of the NYSE Listed Company Manual and Supplementary Material 1.1 to rule 452). *See also* generally A.L. Goodman & J.F. Olson (eds.), *A Practical Guide to SEC Proxy and Compensation Rules* 10-8 – 10-10 (4th ed., Aspen Law & Business 2007). Noteworthy in this respect is a recent amendment to rule 452, which became effective on 1 Jan. 2010, making uncontested director elections also non-routine matters under the rule, although elections at registered investment companies are explicitly exempted from the rule.

117. The 1940 Act does not impose requirements on the composition of any board committee. In the case of an audit committee, however, registered funds typically maintain an committee consisting of solely independent directors in compliance with rule 32a-4 of the 1940 Act in order to avoid shareholder ratification of a fund's independent accountant under rule 32a-2 of the 1940 Act.

4.7.2 Voting Obstacles

Secondly, when an investor meeting is held and a (retail) investor *does* attend the meeting, he will often be faced with a number of obstacles to voting. With respect to the election of directors, the general rule under US law is that investors of registered funds are entitled to elect their directors in accordance with Article 16 of the 1940 Act.[118] However, in the US, directors of corporate funds, whether registered or not, are generally elected by a plurality shareholder vote. A plurality shareholder vote means that nominees for available directorships who receive the highest number of affirmative votes are elected irrespective of how small the number of affirmative votes is in comparison to the total number of shares voted (i.e., all affirmative votes and withholding votes).[119]

Under this voting system, shareholders cannot vote against a director nominee. This means that in case of an uncontested election (only one nominee), they may only vote for a nominee or withhold, which only has a symbolic effect. As an extreme example, a nominee could be elected as a director with one affirmative vote and several million withholding votes and abstentions. Investors in US funds that are publicly held companies under the 1934 Act, usually registered funds,[120] can, however, nominate their own director nominees. However, they may only do so through proxy contests in which an investor must, at its own expenses, prepare, file with the SEC and disseminate its own proxy statement to solicit votes.[121] In practice, the fund's independent directors or its nominating committee, which typically also consists of solely independent directors, selects and nominates new directors.[122]

Other obstacles derived from US corporate law related to directors include the common use of staggered boards (i.e., a board that is made up of different classes of directors which are elected at different times for multiple years),[123] the inability to

118. Article 16 of the 1940 Act provides that 'no person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding securities of such company'.
119. Article 216(1) DGCL and Article 2-404(d) of the Maryland Corporate Code. The plurality vote-rule can be changed by charter (in Maryland) or bylaw (in both Maryland and Delaware) amendment, but it is very difficult for an investor to pass such an amendment. *See* notes 127-129 and accompanying text, *infra*.
120. Publicly held companies are companies (including LPs and business trusts) that are required by the 1934 Act to register their shares because of an offering to the public as described in the 1933 Act. In general, unregistered funds make use of the private offering exemption provided in the 1933 Act and are therefore not deemed to be 'public funds'. *See also* section 4.3.
121. *See* rule 14a-1 to 14b-2 of the of the 1934 Act. Under the SEC's adopted rule 14a-11 of the 1934 Act, shareholders who have owned at least 3% of the company's voting power for at least three years and who do not have a control intent would be allowed to include director nominees in the company's proxy statement unless they are prohibited from doing so by either state law or the company's governing documents. However, the rule was vacated by the District Court of Colombia in 2011. *See Business Roundtable et al v. Securities and Exchange Commission*, 647 F.3d 1144 (D.C. Cir. 2011).
122. Most fund groups do not have a formal nominating committee, but the independent directors perform the same function. *See* Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 4-30.2.
123. Board members of a staggered board are usually appointed for a period of three years. Under Article 16(a) of the 1940 Act, a fund is allowed to have a maximum of five classes, provided that

remove directors except for cause,[124] and difficulty to submit items to the agenda, including the item whether or not to remove directors.[125] When comparing registered with unregistered US funds, it can be noted that in an unregistered LP or trust fund, directors are not appointed by the investors or subject to replacement by them, except in extraordinary circumstances.[126] Thus, investors' involvement into the board composition of these funds will even be lower than in the case of registered funds (and unregistered corporate funds).

In addition to the right to elect or remove directors, the right to vote on fundamental matters, such as mergers and charter amendments, is also limited. Generally, investors are not able to propose fund transactions or charter amendments themselves, or to modify those proposed by directors, but can only vote in favour or against amendments proposed by the directors.[127] Investors in corporate funds however do usually have the right to amend the bylaws of the corporation, but the value

at least one class expires each year. Most funds with staggered boards however have three classes. *See* Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 12–44. If the number of directors is evenly divided among the classes, it will thus take at least two annual meetings before a majority investor could remove the majority of directors.

124. Article 141(k)(1)and 141(d) DGCL. This feature is common among Delaware corporations, including corporate funds, and effectively prevents shareholders to remove directors during their term.

125. Delaware's and Maryland's corporate statutes do not provide for a right for shareholders to place items on the agenda. However, under rule 14a-8 of the 1934 Act, shareholders in US public companies, who have at least 1% of the shares or USD 2,000 in market value for at least one year may submit proposals to the company requesting that items be put to a shareholder vote at the company's next annual or special meeting. However, in addition to the thresholds that must be met, the shareholder proposal rule permits a number of exclusions, such as the 'ordinary business exclusion', allowing the exclusion of proposals that deal with day-to-day matters and the 'election exclusion', permitting a corporation to exclude a proposal from its proxy statement if 'the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election'. *See* rule 14a-8(i)(7) and (8). In 2009, the SEC's proposed amendments to rule 14a-8(i)(8), which would narrow the election exclusion and require a company to include a proposal to amend its governing documents regarding nomination procedures or election disclosure provisions if submitted by a certain, qualifying shareholder (see for the proposed rule http://www.sec.gov/rules/proposed/2009/33-9046.pdf, accessed 29 Sep. 2014).

126. Article 3303(a) of the Delaware Code provides that a fiduciary is subject to removal by a court of competent jurisdiction for wilful misconduct, which is defined as 'intentional wrongdoing, not mere negligence, gross negligence or recklessness'.

127. Generally, fundamental corporate changes, such as mergers and similar transactions and charter amendments must be proposed by the directors. *See* with respect to Delaware and Maryland corporate funds, 251(b), (c) (mergers), 271(a) (sale of substantially all assets), 275(a) (dissolution), 242(b)(1) (charter amendments) DGCL and 3-105(b) (mergers and transfer of assets), 3-403(b) (dissolution), and 2-602(a) (charter amendments) of the Maryland Corporate Code. Investors may be able to put an agenda item up for voting proposing a charter amendment or fundamental change, but such a proposal is only a non-binding suggestion to the board. *See* rule 14a-8(i)(1) note to paragraph of the 1934 Act and n. 125, *supra*. A Delaware corporate fund may amend its certificate of incorporation without submitting such amendments to its shareholders for approval (unless otherwise expressly required by its certificate of incorporation) to: (1) change its name, (2) delete historical references to its incorporator, initial board of directors or initial subscriber for shares, or (3) delete provisions in any amendment to its certificate of incorporation effecting a change, exchange, reclassification, subdivision, combination or cancellation of stock if such change, exchange, reclassification, subdivision, combination or cancellation has become effective. *See* Article 242(a) DGCL.

and effect of such an amendment is highly questionable[128] and directors may have a concurrent (or even exclusive) power to do so.[129] In addition, a quorum of shareholders that must be represented at an annual meeting in order to make a valid decision may be required.[130]

With regard to fundamental transactions, it can furthermore be noted that not all transactions can be voted on by investors. So do investors in Delaware corporate funds, for example, not have the opportunity to vote on asset purchases and funds organized as business trusts are generally not required to receive investor approval before being acquired by another fund. However, with respect to the latter, it can be noted that in case of a merger between registered funds, rule 17a-8(a)(3) of the 1940 Act provides that the investors of the acquired fund have the opportunity to vote on the merger.[131] In connection with this, unless federal law thus provides otherwise, the voting rights of investors or a particular class or group of investors may even be totally eliminated with respect to any matter related to the fund (including the election of directors). This possibility is not just restricted to corporate funds: LP and business trust fund

128. For example, in *C.A., Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. Supr. 2008), the Delaware Supreme Court found that the proposed bylaw amendment that would compel the corporation to reimburse a shareholder, or group of shareholders, for reasonable expenses incurred in a proxy contest adopted by the shareholders of C.A., Inc., 'would violate the prohibition, which our decisions have derived from Article 141(a) [of the DGCL], against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders' (*ibid*., 240). As a result of this decision, some academics and practitioners have concluded that a proposed shareholder bylaw amendment will be invalid if it attempts to curb the substantive power of the board. *See*, among others, R.B. Thompson*, Delaware's Disclosure: Moving the Line on Federal-State Corporate Regulation*, 1 U. Ill. L. Rev. 188–189 (2009), J. Antignani, *Note: Delaware to the Rescue: A Proper Exercise of Deference by the SEC and the Future Implications of CA, Inc. v. AFSCME*, 3 Brook. J. Corp. Fin. & Comm. L. 431 (2009). This also follows from Article 109(a) DGCL, which states that the bylaws cannot be inconsistent with the law or the charter and rule 14a-8(i)(1) note to paragraph of the 1934 Act, permitting the company to exclude a shareholder proposal, e.g., a proposal to amend bylaws, if it 'is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization'.
129. Articles 109(a) DGCL (charter may confer power to amend bylaws on directors) and 2-109(b) of the Maryland Corporate Code (power to amend bylaws is provided to the shareholders, unless the charter or bylaws reserve this right to the directors).
130. Article 216 DGCL (charter may specify the number of voting shares that must be represented at a meeting in order to constitute a quorum. In no event, however, may a quorum consist of less than one-third of the shares outstanding) and 2-506(2) and (3) of the Maryland Corporate Code (charter may consist a quorum 'to approve any matter which properly comes before the meeting', which 'may not be less than one-third of the votes entitled to be cast at the meeting').
131. Investor approval is however not required in case: (1) the investment policy of the acquired fund that under Article 13 of the 1940 Act could not be changed without a vote of a majority of outstanding voting securities is not materially different from the policy of the acquiring fund, (2) the management contract is not materially different, (3) the acquired fund's independent directors who are elected by the investors comprise the majority of the independent directors of the acquiring fund, and (4) any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the acquiring fund in accordance with rule 12b-1 are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the acquired fund pursuant to such a plan.

structures may also have non-voting shares.[132] In addition, under US state law, the board of a US fund (irrespective of its legal structure) is generally allowed to set a record date.[133] This may further restrict the number of fund investors who are able to vote at the meeting.

4.7.3 Electronic Voting

In addition to the voting obstacles mentioned above, it can be that that if the investor lives in a state other than the state where the shareholder meeting is held or abroad (as is the case for EU investors), it may be difficult, if not impossible, to physically attend the meeting. Electronic voting is more convenient and could solve many practical issues for investors.

Investors in Delaware/Maryland corporate funds are permitted to vote by mail, e-mail or any other means of remote communication. However, this is at the sole discretion of the board of directors.[134] In a similar way are corporate virtual meetings regulated.[135] Limited partner meetings of Delaware LP funds can also be held online and voting in such meetings occurs electronically if the partnership agreement is silent on this issue.[136] However, when a limited partners meeting is held at a physical location, it is not possible to vote by electronic means, unless the partnership agreement provides otherwise.[137] Similar rules apply to funds organized as Delaware and Massachusetts business trusts.[138]

In addition to electronic voting and virtual meetings, proxy voting may also be possible. This allows investors to vote in the meetings of US funds through someone else without having to physically attend the meeting. However, heavy federal proxy regulation applying to registered funds has made it considerably difficult and expensive for (large) investors of such funds or other proxy entities to solicit votes from other

132. Article 302(a) DRULPA ('A partnership agreement may provide for classes or groups of limited partners having such relative rights, powers and duties as the partnership agreement may provide') and Article 3805(4) DBTA (providing that the trust instrument '[m]ay grant to [or withhold from] all or certain trustees or beneficial owners, or a specified class, group or series of trustees or beneficial owners, the right to vote').
133. Articles 213(a) DGCL, 2-511(a) of the Maryland Corporate Code, 17-405(a) DRULPA and 3806(5) DBTA. The board of a corporate fund established in Delaware or Maryland cannot require shares to be held more than sixty days before the meeting and the record date can also not be set less than ten (in Delaware) or thirteen (in Maryland) days before the meeting.
134. Articles 211(a)(2) DGCL and 2-502.1(a) of the Maryland Corporate Code.
135. Articles 211(a)(1) DGCL (2002) and 2-503(b) of the Maryland Corporate Code (2003).
136. Article 302(e) DRULPA ('Unless otherwise provided in a partnership agreement, meetings of limited partners may be held by means of conference telephone or other communications equipment').
137. Article 302(e) DRULPA ('Unless otherwise provided in a partnership agreement, on any matter that is to be voted on by limited partners, the limited partners may vote in person or by proxy, and such proxy may be granted in writing, by means of electronic transmission or as otherwise permitted by applicable law').
138. Article 3806(f) and 3806(f)(2) DBTA and the Massachusetts Voluntary Association Statute (statute does not state any requirement to hold physical annual meetings or to vote physically).

investors for an annual or special meeting, which may have resulted in investors either voting in line with the fund's management recommendations or not voting at all.[139]

The above shows that electronic/online voting and/or via proxy is allowed under US law, but that these ways of voting are, at this moment, far from ideal. The fact that it is up to the fund's directors to decide whether or not to allow electronic voting or to switch to a virtual meeting undermines the involvement of investors in this. With respect to virtual meetings, there are also some concerns regarding the safeguarding of investor rights. So may investors not be able to communicate with each other during the meeting and there are no guarantees that their questions will be answered.[140] But more importantly than this, virtual meetings in general appear to be lacking popularity.[141] As a result of all this, most (EU and non-EU) investors in US funds are likely to be currently unable to vote electronically or to attend (and vote at) online meetings. With respect to proxy voting in a registered fund, it can be noted that although this is generally allowed, there are regulations that may hinder it.

4.8 TRANSPARENCY AND DISCLOSURE RULES

Transparency and disclosure requirements imposed on US funds can have their basis in both state and federal law. As for state law, Delaware corporate law for example provides investors in corporate funds with the right to inspect the fund's books and records.[142] A similar inspection right is usually available to limited partners in a LP fund and investors in Maryland funds and trust funds.[143] However, this right is generally very limited and often even non-existent as investor must comply with several statutory requirements impeding the effectiveness of this right.[144] Nevertheless,

139. J. Velasco, *Taking Shareholder Rights Seriously*, 41 UC Davis Law Review 615–616 (2007). The main obstacle related to proxy solicitation is preparing the necessary proxy materials relating to registered shares in accordance with the requirements specified in Schedule 14A to Regulation 14A of the 1934 Act. Other than investors, the management of a fund can use the company's resources to cover these costs. As of July 2007, however, soliciting persons can furnish proxy materials to shareholders by posting them online (see 17 CFR Parts 240, 249 and 274 available at http://www.sec.gov/rules/final/2007/34-55146.pdf, accessed 29 Sep. 2014). Although this rule eliminated the printing and delivery costs of the proxy materials, it has not eliminated the significant preparation and campaigning costs.

140. Van der Krans, *The Virtual Shareholders Meeting: How to Make it Work?*, 35.

141. *Ibid.*, 34 and E. Boros, *Virtual Shareholder Meetings*, 8 Duke L. & Tech. Rev. 7 (2004).

142. Article 220 DGCL. This article provides that a shareholder may inspection (and copy) a corporation's share ledger, a list of its stockholders, and its 'other books and records', including its subsidiary's books and records, so long as: (a) the parent corporation has possession and control of the records sought, or (b) the parent could obtain them through the exercise of control over the subsidiary – at least when the subsidiary has no legal right to deny its parent access to its records.

143. Articles 3819 DBTA, 17-305 DRULPA, and 2-512 and 2-513 of the Maryland Corporate Code.

144. For example, Delaware's corporate statute requires that a demand is made in writing, under oath, and directed to the corporation's registered office in Delaware or to its principal place of business. Furthermore, an investor making a demand must specify the documents sought and state the purpose of his demand, which must reasonably related to his interests as a shareholder. An investor must also make sure that the documents requested are appropriate to meet the stated purpose of the inspection. To this end, the investor must provide sufficient evidence of a credible basis that actual mismanagement or wrongdoing has occurred. *See*

federal law already requires a large amount of information to be provided to investors, regardless of whether the fund is registered or not. Furthermore, fund managers are also subject to certain disclosure rules.

Disclosure Requirements for US Registered Funds

In the pre-contractual phase, US registered funds are required to publish either a statutory or summary prospectus under the 1933 Act and 1940 Act.[145] The statutory prospectus is supplemented by the Statement of Additional Information (SAI), and both documents are part of a registration form with the SEC under the registration requirements of the 1933 and 1940 Act (usually Form N-1A).[146] If the fund is an open-end fund that chooses to rely on rule 498 of the 1933 Act, a shorter, simple version summary prospectus would suffice.[147] Ongoing disclosures that US registered funds should make to investors include annual, half-yearly, quarterly reports, and the publication of the fund's NAV.

Disclosure Requirements for US Unregistered Funds

Unregistered funds relying on the private offering exemption of Article 4(2) of the 1933 Act are not required to publish a statutory or summary prospectus and periodic reports, but must still provide investors with relevant information based on the *SEC v. Ralston Purina Co*. case in order to be exempt from Article 5 of the 1933 Act.[148] According to US Supreme Court, disclosure of information should be the 'kind of information that the [1933] [A]ct would make available in the form of a registration statement'.[149] Funds relying on the safe harbour provision provided in Regulation D of the 1933 Act must deliver the same kind of information to non-accredited investors as would be required in a statutory prospectus under the registration form that the fund would be entitled to use in case of registration under the 1933 Act, to the extent material to the investor.[150]

Article 220(b) DGCL and *City of Westland Police and Fire Retirement System v. Axcelis Technologies, Inc.*, WL 3086537, 4 (Del. Ch. 2009). Furthermore, in a Maryland corporation, only an investor (or group of investors) holding 5% of the outstanding securities of the corporation for six months has a statutory right to inspect the books and records of the corporation, including the share ledger. *See* Article 2-513(a) of the Maryland Corporate Code.

145. Article 5(a) of the 1933 Act and Article 8(a) of the 1940 Act.
146. The SEC has designated Form N-1A as the form of registration statement for open-end funds that are required to register under the 1933 and 1940 Act. *See* Form N-1A, General Instruction B.1. Closed-end registered funds must file Form N-2, which to a large extent requires similar information to be provided. Form N-2 can be found at the SEC's website: http://www.sec.gov/.
147. Rule 498(b) of the 1933 Act permits open-end funds to satisfy their prospectus delivery obligations under the 1933 Act by sending or giving key information directly to investors in the form of a summary prospectus.
148. 346 U.S. 119 (8th Circ. 1953).
149. *Ibid.*, 125–126. Furthermore, in absence of proof that an investor has access to such information, the issuer must, according to the US Supreme Court, provide the 'full and fair disclosure' afforded by registration with the SEC and deliver a statutory prospectus containing information necessary to enable potential investors to make an informed investment decision. *Ibid.*, 124.
150. Rule 502(b)(1), (2)(A) and (B) of the 1933 Act.

The information provided by such funds to accredited investors is unclear.[151] However, in practice, most unregistered funds will provide investors with at least the same information as provided by the statutory prospectus as it is commonplace for such funds to disclose their investment policies and goals, subscription and redemption policies, conflict of interests, and other information to investors that is material to their decisions to invest.[152] In any case, a fund that is subject to Regulation D would be wise to disclose all relevant information to potential investors to avoid potential fiduciary liability under state law (as discussed in section 4.9). Finally, unregistered funds are not required to publish their NAV, although they usually will do so on a regular basis.

Disclosure Requirements for US Fund Managers

US registered funds managers have to disclose various information to the funds they manage containing all the information included in Part 2 of Form ADV, the registration form used to register with the SEC.[153] This information should thus only be disclosed to the fund itself, not the investors in the fund.[154] However, Form ADV is published on SEC's website, as a result of which investors can access the information if they actively seek for it.[155] Furthermore, fund managers that manage or trade 'commodity pools' and are required to register as Commodity Pool Operators (CPO) or Commodity Trading Advisors (CTAs) must deliver to investors a disclosure document.[156] This document contains information about, among other things, the risks of the commodity pool, fees and expenses, actual or potential conflicts of interest, and information on the assets and past performance of the pool.[157] However, most CPO's and CTA's are exempted

151. SEC, Interpretive Release on Regulation D, Release No. 33-6455, 3 Mar. 1983, n. 26. Rather, the regulation provides that in certain instances the exemptions from registration will not be conditioned on a particular content, format or method of disclosure. Regulation D however does require a fund to provide investors with the exhibits required to be filed with the registration statement, among which include the fund's articles or certificate of incorporation and bylaws and management agreements. *See* rule 502(b)(2)(iii) of the 1933 Act and Form N-1A, Item 28. Funds that make an offering to accredited investors must also deliver to those investors the financial statements that would be required in a registration statement filed with the SEC under the 1933 Act. *See* rule 502(b)(2)(i)(B)(3). Non-accredited investors must be provided with certain financial statements under rule 502(b)(2)(i)(B)(1) and (2) of the 1933 Act.
152. Hammer et al., *U.S. Regulation of Hedge Funds*, 161 (stating that '[h]edge funds ordinarily should satisfy this requirement by providing each offeree with a private offering memorandum that discloses the required information').
153. Rule 204-3 of the Advisers Act. The information is not required to be delivered to, among others, clients who are registered funds or business development companies and the management contract meets the requirements of Article 15(c) of the 1940 Act (requiring the management contract with the fund to be approved by the majority of independent directors). *See* rule 204-3(b)(2).
154. According to the SEC, a 'client' in the case of a hedge fund, private equity fund or other (private or non-private) investment fund is the fund itself and not the ultimate investors. SEC, Final Rule: Amendments to Form ADV, 47, Release No. IA-3060, 28 Jul. 2010, n. 192 (referring to the Goldstein-case, in which the Court of Appeals for the D.C. Circuit stated that the 'client' of an fund manager managing a hedge fund is the fund itself, not an investor in the fund).
155. SEC, Final Rule: Amendments to Form ADV, 25, n. 90.
156. A pooled investment fund is a commodity pool under the CEA if it trades or invests in commodity interests, including, among other instruments, futures contracts and commodity options. *See* Article 4.10(d) of the Commodity Exchange Act, 7 U.S.C. §§1, et seq. (CEA).
157. Article 4.24 and 4.25 of the CEA.

from registration or provided with partial relief from certain disclosure requirements, including the disclosure document for investors, provided that the commodity pool is offered only to 'qualified eligible participants'.[158]

Timing and Method(s) of Delivery

Both the statutory and summary prospectus must be delivered directly to investors at or before the carrying or delivery of the fund's shares. As 1933 Act does not require delivery of a prospectus until the 'carrying or delivery' of the purchased security, this may occur after the sale. As a result, while technically classified as pre-contractual information, investors may receive (and read) the information post-sale. The statutory prospectus must be delivered in paper or electronically with investors' consent and the summary prospectus should be published on the fund's website and provided to investors electronically upon request.[159] In this respect, it can be referred to rule 159 of the 1933 Act. This rule imposes liability on them for losses suffered by investors, if, at the time of the sale, the information investors had received included either untrue statements of a material fact or omitted to state material facts necessary in order to make the statements made not misleading at the time of sale. This means that a prospectus which is provided to the investor at the time of sale that includes modifications, amendments or corrections to the information that was previously available, will not be considered for determining whether the issuer or other offering participant is subject to liability under the 1933 Act. Accordingly, all material information will have to be available to an investor before the time of sale. However, despite the fact that this rule is technically applicable to (corporate) funds, both the sector and the SEC has not applied it to the sale of fund shares.[160] Consequently, point-of-sale delivery of a fund's (statutory or summary) prospectus remains sufficient to meet the prospectus delivery requirements under the 1933 Act. However, it can be noted that liability may arise from fiduciary law (see section 4.9). As a result, most funds will

158. Articles 4.14(a)(8)(i)(D) and 4.7(b)(1) of the CEA. Article 4.13(a)(3) of the CEA generally provides for exemption from CPO registration if the interests in the commodity pool are exempt from registration under the 1933 Act and are offered only to qualified eligible participants which include qualified purchasers as defined under the 1940 Act, accredited investors or knowledgeable employees, and the commodity pool's aggregate initial margin and premiums attributable to commodity interests do not exceed 5% of the liquidation value of the commodity pool's portfolio.
159. Rule 498(e) and (3) of the 1933 Act (summary prospectus). With respect to the statutory prospectus, SEC guidance typically requires affirmative consent from individual investors, to send or give a prospectus by electronic means. Online delivery via the fund's website may be, according to the SEC, allowed under certain circumstances, for example if explicit consent is given that also covers the specific electronic medium or media (e.g., Internet website, PDF or other programme necessary to download the prospectus) that may be used for delivery. *See* SEC Interpretation – Use of Electronic Media, No. 33-7856, 28 Apr. 2000.
160. M.A. Bancroft, *One Act and Two Scenes: The Securities Act and Delivery of Mutual Fund Prospectuses*, 17 Inv. Law. 3 & n. 5 (2010). Article 913 of the Dodd-Frank Act authorized the SEC to require pre-sale disclosure by brokers and other financial intermediaries to retail investors regarding the investment objectives, strategies, risks, costs and any compensation received by them with respect to any investment the intermediary recommends, including mutual fund shares. As of the date of the manuscript of this book, the SEC has requested comments on pre-sale disclosures to investors but has not yet proposed any rules.

provide the information in time to information and, in case of a summary prospectus, point out to investors where to find it on their website.

Annual and half-yearly reports should be transmitted to investors within sixty days after the end of the fiscal period for which the report is being prepared.[161] Quarterly reports should be transmitted within sixty days of the end of the first and the third quarter.[162] All periodic reports must be filed with the SEC within ten days after the transmission date.[163] Furthermore, the most recent reports should be sent to investors on request (in paper or electronically with investors' consent) or, in case the fund relies on rule 498 of the 1933 Act, published on the fund's website.[164]

In Table 4.1, the key information disclosure requirements of US registered is set out. It shows whether the information should be provided to investors pre-contractually or after the fund's shares are sold, the timing and methods of delivery or publication of this information to (potential) investors. It can be noted that the disclosure requirements applying to fund managers are not included in the tables since they require fund managers to disclosure certain information to the funds, not investors.[165] Furthermore, the disclosure requirements for US unregistered funds are also not included since these funds are not subject to any disclosure requirements under federal statutory law. However, as noted above, they will generally provide investors with similar information as that contained in the statutory prospectus for registered funds to avoid liability based on fiduciary law or in order to comply with Regulation D of the 1933 Act (in case of offerings to non-accredited investors).[166] In addition, they will publish their NAV on their website.

161. Form N-CSR, General Instruction A. Form N-CSR can be found at the SEC's website: http://www.sec.gov/.
162. Form N-Q, General Instruction A, Article 30(e) of the 1940 Act and rules 30e-1 and 30b1-5 of the 1940 Act. Form N-Q can be found at the SEC's website: http://www.sec.gov/.
163. Article 30(b)(2) of the 1940 Act.
164. Articles 5(b) and rules 498(e) and 430(b)(2) of the 1933 Act. Online delivery may also be allowed for fund's not relying on rule 498 of the 1933 Act under certain circumstances. *See* SEC Interpretation – Use of Electronic Media and n. 159, *supra*.
165. *See* n. 154 and accompanying text, *supra*.
166. *See* n. 152, *supra*.

Table 4.1 Information and Delivery Requirements for US Registered Funds

	Statutory Prospectus	*Summary Prospectus*	*SAI*	*Annual Report*	*Half-Yearly and Quarterly Reports*	*NAV Disclosure*
Type of information	Pre-contractual information	Pre-contractual information	Pre-contractual	Ongoing information	Ongoing information	Ongoing information
Timing of delivery or publication	No later than the delivery of the fund's shares.	No later than the delivery of the fund's shares.	Delivery is not required, the SAI is published as part of the registration statement with the SEC.	Annually, no later than sixty days following the end of the financial year.	Semi-annually or quarterly, no later than sixty days following the end of the period to which it relates.	Once a day at the close of the NYSE or, in case of a closed-end fund relying on rule 23c-3 of the 1940 Act, no less frequently than weekly and daily on the five business days preceding a repurchase request deadline.[167]

167. *See* section 2.6.2.

Method(s) of delivery or publication	In paper or electronically with investors' consent and/or provided via intermediaries or, in case the fund relies on rule 498 of the 1933 Act, by sending (by the fund or an intermediary) a direct link to the document on the fund's website.[168]	On the fund's website and electronically upon request and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	Upon request in paper or electronically with investors' consent, or, in case the fund relies on rule 498 of the 1933 Act, on the fund's website and free of charge.	No requirements apply. Most funds publish their NAV in the daily newspaper and on their website.

Below, the different pre-contractual and ongoing information requirements will be discussed in more detail.

168. Rule 498(e) the 1933 Act. Access must be free of charge, at the website address specified on the cover page or the beginning of the summary prospectus. The statutory prospectus must be accessible at or before the time that the summary prospectus is sent. The current versions of must remain on the website for at least ninety days after the date that the fund's securities are delivered. However, failure to comply with this rule does not result in a violation of the requirement of delivery of a prospectus to investors under the 1933 Act. Rule 498(f)(5). *See* with respect to the requirement of US intermediaries to send the statutory prospectus to investors, rule 15c2-8(b)-(d) of the 1933 Act.

4.8.1 Pre-contractual Disclosure Requirements

The summary prospectus for open-end registered funds must meet several content requirements, which requires the fund to provide the key information included in Items 2 through 8 of Form N-1A.[169] This key information comprises the following components: a risk/return summary, including information about the fund's investment objectives, strategies, performance, risks and costs (consisting of a fee table, expense illustration example, and the fund's average assets holding period), certain information about the purchase and sale of fund shares and payments to broker-dealers and other financial intermediaries, and tax information.[170] US FoFs must include an additional line in their fee table which shows the fees charged by the funds in which they invest. Feeder funds must include a single fee table in their prospectus for the master fund and state that the fee table and costs example reflect the expenses of both the feeder and master funds.[171] Furthermore, it has been expressly stated by the SEC that the summary prospectus must use clear, jargon-free language (plain English) and that the information is provided in a standardized form.[172] There is furthermore no set requirement related to the length of this prospectus, but the SEC expects it to be 'on the order of three or four pages'.[173]

Similar to a summary prospectus, all information provided in the statutory prospectus must be presented in a 'clear, concise and understandable manner' and must be drafted in compliance with the SEC's plain English writing principles by using,

169. Rule 498(f)(4) of the 1933 Act.
170. Form N-1A, Items 2-8. The summary prospectus must also include on the cover page of the prospectus or at the beginning of the prospectus certain general information about the fund and an exchange ticker symbol. An exchange ticker symbol is a short abbreviation used to identify a particular publicly traded security and is applied as a tool of obtaining information about that security and its movement. Symbols with five letters ending in X are exchange ticker symbols of mutual funds. A mutual fund is also required to include its exchange ticker symbol on the cover pages of the statutory prospectus and SAI. *See* rule 498(b)(1)(ii) of the 1933 Act and items 1(a)(2) and 14(a)(2) of Form N-1A.
171. Form N-1A, Item 8, Instructions 3(f) and 1(d)(i). Fund of funds and feeder funds are not required to disclose specific information about the funds they invest in, but they must describe the strategy to invest in a particular type of security, the risks of those strategies, and the policies and procedures with respect to the disclosure of the fund's portfolio securities, including other funds. *See Ibid.*, Items 4(a) and 16(a).
172. SEC, Enhance Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Release Nos. IC-28584 & 33-8998, 13 Jan. 2009, 14. *See also* Form N-1A, General Instruction B.4.(c) ('The plain English requirements of rule 421 under the Securities Act [17 CFR 230.421] apply to prospectus disclosure in Part A of Form N-1A. The information required by Items 2 through 8 must be provided in plain English under rule 421(d) under the Securities Act'). Rule 421(d)(2) lists the following plain English principles: (1) short sentences, (2) definite, concrete, everyday words, (3) active voice, (4) tabular presentation or bullet lists for complex material, wherever possible, (5) no legal jargon or highly technical business terms, and (6) no multiple negatives.
173. *Ibid.*, 24. For a multi-fund prospectus, this three to four page length guideline applies separately to the summary prospectus for each fund.

for example, short sentences, the active voice and everyday words.[174] The fund's statutory (or summary) prospectus may include pictures, charts or other design into the prospectus, but this design may not be misleading as is the case for all information provided to investors.[175] Besides a 'summary section', which is a comparable equivalent of the summary prospectus discussed above, the statutory prospectus must contain additional information about virtually all aspects included in the summary section and about, among other things, its share distribution arrangements, the pricing procedures, redemption and purchasing of fund shares, financial conditions and capital structure.[176] Both the statutory prospectus and summary prospectus must be current upon first use and updated annually.[177]

The SAI document goes further into detail on the matters discussed in the statutory prospectus. For example, the fund's SAI must describe its conflicts of interest policies and actual material conflicts of the fund manager, allocation policies, its policies with respect to the issuing of senior securities, borrowing of money/leverage (including the purpose for which the money will be used), underwriting securities of other issuers, concentrating investments in a particular industry or group of industries, purchasing or selling real estate or commodities, making loans and any other policy that the fund deems fundamental or that may not be changed without investor approval.[178] Furthermore, the fund must disclose in the SAI the total amount of fees paid for investment management and other services and the structure and method of determining the compensation received by the portfolio manager(s) of the fund, including salary, bonuses, deferred compensation and pension and retirement plans.[179] For each type of management compensation, the SAI must also describe the criteria on which that type of compensation is based. However, the actual amount of fees that are paid out of the fund assets to portfolio managers is not required to be disclosed in the SAI.[180]

Generally, in the SAI, the fund may expand on any information it discloses in the prospectus if it finds the information to be of interest to some investors.[181] However,

174. Form N-1A, General Instruction B.4(c) and rule 421(d)(1) and (2) of the 1933 Act. *See also* n. 172, *supra*.
175. Rule 421(d)(3) of the 1933 Act. *See* n. 185, *infra*.
176. Form N-1A, Items 1-13 and 23.
177. Article 10(a)(3) of the 1933 Act generally requires that when a prospectus is used more than nine months after the effective date of the registration statement, the information in the prospectus must be as of a date not more than sixteen months prior to such use. The effect of this provision is to require mutual funds to update their prospectuses annually to reflect current cost, performance, and other financial information.
178. Form N-1A, Items 16(c), (f), 20(a) and 21.
179. Form N-1A, Items 19 and 20(b).
180. Form N-1A, Item 20(b), Instruction 2. In the statutory prospectus, the fund must outline the compensation of each portfolio manager as a percentage of the fund's average net assets or, if the fee is not based on a percentage of the fund's assets (e.g., a performance-based fee), the basis of the compensation. *See* Item 10(a)(ii).
181. Form N-1A, General Instruction C.2.(b).

duplication of information is prohibited, unless it is necessary to make the SAI comprehensible as a document independent of the prospectus.[182] The third part of the registration statement includes other information which must be filed with the SEC, including the articles of incorporation or trust agreement of the fund and its bylaws, the investment management contract and underwriting and custodian/depository agreements, rule 12b-1 fee plans,[183] and codes of ethics adopted by the fund under rule 17j-1 of the 1940 Act.[184]

All information that a fund discloses to investors in connection with the sale and purchase of its shares, whether contained in the summary or statutory prospectus, the SAI or other information document, must not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[185] Rule 10b-5 of the 1934 Act creates liability for such statements or omissions made by the 'maker' of the prospectus. It must be noted that the fund manager, although often the one who creates the fund and also creator of the fund's information documents, is not liable for misstatements in these documents under US federal law. In 2011, the US Supreme Court rendered in the Janus case that a manager of a fund is not liable for misleading statements in the sponsored fund's prospectus because not the manager, but the fund itself, represented by the board of directors, board of trustees or general partner (which is often also the fund manager), as the one with 'ultimate authority' over the statements and thus the 'maker' of such statements, provided that the fund is considered a separate legal entity.[186] Applying this theory to unregistered funds, which are often LPs or business trusts, it can be concluded that the manager will often not be liable as these entities are considered legal entities, although the

182. *Ibid*.
183. Registered funds are allowed to charge either a monthly or annual flat fee or asset-based fee (i.e., a fee based on the total amount of assets under management) based on rule 12b-1 of the 1940 Act to compensate portfolio managers or other third-party service providers for providing marketing and distribution services to the fund (known as '12b-1 fees'). Any plan entered into by the fund under rule 12b-1 must be disclosed to the SEC. Information about 12b-1 fees is also disclosed in the fund's summary prospectus or summary section. *See* Form N-1A, Item 3.
184. Form N-1A, Item 28. Under rule 17j-1 of the 1940 Act, every registered fund, other than a money market fund or a fund that does not invests in covered securities, and each manager of and principal underwriter for the fund, must adopt a written code of ethics containing provisions reasonably necessary to prevent the directors, officers or other affiliated persons to the fund, manager or principal underwriting from defrauding the fund or from making any untrue statement of a material fact to the fund or omitting to state a material fact or from engaging in any manipulative practice with respect to the fund (see under (b) and (c)). The SAI must provide a brief statement disclosing whether the fund and its manager and principal underwriter have adopted codes of ethics under rule 17j-1 and whether these codes of ethics permit personnel subject to the codes to invest in securities, including securities that may be purchased or held by the fund. *See* Form N-1A, Item 17(e).
185. Article 10(b) of the 1934 Act.
186. *Jones Capital Group, Inc., et al. v. First Derivative Traders*, 564 U.S. –, 131 S. Ct. 2296, at. 5–12 (US Supr. 2011). To 'make' a statement, the Court held, literally means only to actually 'make' a statement – but does not embrace drafting, preparation, or anything else.

Massachusetts business trust may lack legal personality in some state jurisdictions in certain situations.[187]

4.8.2 Ongoing Disclosure Requirements

Ongoing disclosure requirements applicable to US funds include the requirement to provide annual reports. In both Delaware and Maryland, corporate funds are required to submit an annual report to the Secretary of State in connection with the payment of corporate franchise or other taxes.[188] The information included in this report consists of the name and location of the fund and its directors and tax due. More specific information includes the total number of shares and the par value of the shares of a Delaware corporate fund, and, in the case of a corporate fund located in Maryland, the fund's balance sheet and the sources of property owned by the corporation.[189]

In addition to a state report, registered funds are required to file annual, half-yearly, and quarterly reports under the Article 30(b)–30(e) of the 1940 Act and the rules thereunder with the SEC and their investors.[190] Information required in these reports include detailed financial information and information about, among other things, the funds' investment performance, portfolio holdings, total amount of fees and costs and proxy votes for the current reporting period. Furthermore, investors should also be informed about the location of each upcoming shareholder meeting that will be held during the period covered by the periodic reports, including a brief description of the matters voted upon at the meeting.[191] In light of these periodic requirements, it is noteworthy that many funds are also subject to certain audit and reporting requirements that follow from the Sarbanes-Oxley Act of 2002.[192] Although the Act is primarily

187. *See* on the legal status of trust funds section 2.7.3[A].
188. Article 502 DGCL and 11-101 of the Tax Property Article of the Maryland Code.
189. Article 502(a) DGCL and the Maryland Personal Property Form. The Maryland form can be found at http://www.dat.state.md.us/.
190. *See* rules 30b1-1 (semi-annual report for registered management investment companies), 30b1-2 (semi-annual report for totally owned registered management investment company subsidiary of registered management investment company, 30b1-3 (transition reports), 30b1-4 (report of proxy voting record), 30b2-1 (filing of reports to stockholders), 30d-1 (filing of copies of reports to shareholders), and 30e-1 (reports to stockholders of management companies) of the 1940 Act.
191. Rule 30e-1(b) of the 1940 Act. It can however be noted that directors of funds may simply suffice by providing a brief summary of the proposed action, which means that they can leave out many details as regard the specific action subject to approval in the notice. State law also does not provide additional protection to investors in this respect. *See*, e.g., Article 251(c) DGCL (requiring that the notice to shareholders in case of approval of a merger should contain either a copy of the merger agreement or (only) a brief summary thereof). On the other hand, unregistered LP funds are often not required to notice the business to be discussed at, nor the purpose of, any shareholder meeting at all. *See* Article 302(c) DRULPA (providing that the partnership agreement may, but is not required to, provide provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any limited partners).
192. Pub.L. 107-204, 116 Stat. 745, enacted 30 Jul. 2002.

intended to apply to public companies, several of its provisions related to control and reporting also affect registered funds. So requires Article 301 of the Sarbanes-Oxley Act, which amended the 1934 Act, that directors who serve on a public's company's audit committee must be 'independent' and responsible for selecting and overseeing the fund's external independent auditor. However, in practice, this requirement was already implemented by virtually all registered funds in order to comply with rule 32a-4 of the 1940 Act.[193]

Rule 32a-4 of the 1940 Act also requires that a fund's audit committee has the responsibility to oversee the fund's accounting and auditing process. Other duties of the audit committee include, among other things: overseeing, or assisting the board in overseeing, the fund's compliance with laws and regulations relating to accounting and financial reporting, internal controls over financial reporting, and the independent audits, and overseeing the quality and integrity of the fund's financial statements and the independent audits thereof.[194] The Sarbanes Oxley Act furthermore contains two certification requirements in Articles 302 and 906 that apply to registered funds.[195]

Article 302 requires a separate certification requirement for chief executive officer and chief financial officer of public companies. More specifically, these officers must personally certify, to the best of their knowledge, that each periodic report of the company filed under the 1934 Act[196] does not contain any untrue statements of material fact or omit any material facts to make the statements in the report not misleading, and that the financial statements and information in the reports represent in all material respects the financial condition and results of the operation of the company.[197] Article 302 also provides that the officers make certifications as the company's internal controls.[198] The certification of Article 906 is required only in periodic reports that contain financial statements and states that the report fully complies with SEC rules and that it fairly presents the financial condition and results of

193. *See* n. 117, *supra*.
194. Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 4–28.
195. Other provisions of the Sarbanes Oxley Act requiring improved financial disclosures and mandating changes in governance do not apply to investment funds as existing federal securities regulations applying to funds were considered to be already sufficient at the time of the adoption of the Act. *See* H.E. Bines & S. Thel, *Investment Management Law and Regulation* §2.04[A] (Aspen Publishers 2004).
196. In accordance with Article 13(a) or 15(d) of the 1934 Act. Under Articles 13(a) and 15(d) of the 1934 Act, companies with registered publicly held securities on a national securities exchange that are of a certain size and companies that have filed a registration statement under the 1933 Act that has become effective are 'reporting companies' under the 1934 Act meaning that they must disclose continuously by filing annual reports, quarterly reports, and reports when certain events occur. Information in these reports includes information about the company's officers and directors, the company's line of business, audited financial statements, the management discussion and analysis section (in which the company's management discusses the prior year's performance and plans for the next year), and audited financial statements. Mutual funds are required to file their periodic reports on Form N-CSR. *See* rule 30d-1 of the 1940 Act. Form N-CSR can be found at the SEC's website: http://www.sec.gov/.
197. Article 302(a)(2) and (3) of the Sarbanes Oxley Act.
198. Article 302(a)(4) of the Sarbanes Oxley Act.

operations of the company.[199] Both articles have been implemented by the SEC with respect to registered funds in rule 30a-2 of the 1940 Act.[200]

4.9 CONDUCT OF BUSINESS RULES

Under US law, the standards of conduct of business are known as fiduciary duties imposed on fiduciaries when they do business with investors. Historically, the concept of fiduciary duties stems from common law, which can be described as the part of the law that refers to all case law developed by courts.[201] Today, fiduciary duties also arises from state statutory law and, most notably, US securities law. State statutes frequently impose statutory fiduciary standards upon corporate officers and directors, which generally require them to act in good faith and in the best interest of the corporation. These statutes often form the basis of a claim or defence for breach of fiduciary duty. At the federal level, the Advisers Act created a fiduciary standard for fund managers, which is embodied in the overreaching principles derived from the anti-fraud provisions in Article 206 of the Act.[202] This fiduciary duty applies to all managers, whether

199. Since the periodic reports of mutual funds (on Form N-CSR) contain financial statements, both Articles 302 and 906 of the Sarbanes Oxley Act apply. Although the certification statement of Article 906 is almost similar to a part of the 302-statement, there are some (minor) differences. First, where Article 302 requires the separate statement of each officer, Article 906 does not require separate certifications from the officers so that the certifications could be consolidated into a single statement signed by both officers. Second, other than Article 302, Article 906 does not include the qualifying language 'based on the officer's knowledge', although in practice, this phrase will often be included in the 906-certification as well.
200. A CEO or CFO signing a false certification potentially could be subject to an SEC enforcement action for violating Article 13(a) of the 1934 Act and private actions under Article 10(b) of the 1934 Act and rule 10b-5 thereunder. A false certification also may have liability consequences under Articles 11(a) and 12(a)(2) of the 1933 Act where the annual report is incorporated by reference into a registration statement.
201. *See*, e.g., *Roland International Corp. v. Najjar*, 407 A.2d 1032, 1036 (Del. Supr. 1979) (stating that the duty did not arise from the statute, but from 'long-standing principles of equity [which are] superimposed on many sections of the Corporation Law'). The term common law is also often used to indicate the difference between a common law and a civil law legal system (i.e., a system based on the legal precedence of court decisions as opposed to only written, codified law), to describe judge-made laws in the absence of statutory law, and to refer to all law in a broad sense (statutory and case law) in England and the American colonies before the American Revolution. *See also*, e.g., J.H. Merryman, *On the Convergence (and Divergence) of the Civil Law and the Common Law*, 17 Stan. J. Intl. L. 358 (1981) (stating that 'all national legal systems of the Western world are members of two great legal families: the Romanic Civil Law and the English Common Law'), J.S. Kaye, *State Courts at the Dawn of a New Century: Common Law Courts Reading Statutes and Constitutions*, 70 N.Y. L. Rev. 5 (1995) ('The common law is, of course, lawmaking and policymaking by judges'), and F.W. Hall, *The Common Law: An Account of Its Reception in the United States*, 4 Vand. L. Rev 791–825 (1951) (discussing the adoption of English common law in the original American colonies).
202. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (US Supr. 1962) (stating that '[t]he Investment Advisers Act of 1940 […] reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship' (quotation marks omitted)) and *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d. 622, 644 (E.D. Va. 2003) ('§ 206(2) [of the Advisers Act] is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers').

registered or not.[203] In addition, the 1940 Act imposes certain fiduciary duties on managers, directors and other affiliated persons of registered funds. Investors can bring forth a claim for breach of these duties on the basis of Article 36(b) of the 1940 Act, although they can only do so 'with respect to the receipt of compensation for services'.[204] This phrase has been interpreted by courts to mean that the services provided must stand in a reasonable relationship to the compensation paid.[205]

As regards the fiduciary duties derived from the Advisers Act, it is worth noting that there is generally no private right of action.[206] The fiduciary duties thereunder are thus not enforceable by individual investors. The SEC interprets and applies the fiduciary provisions of Article 206 of the Advisers Act and the accompanying rules through enforcement proceedings against individual investment advisers, including fund managers.[207] Other duties imposed on registered fund managers by the Advisers Act, such as requirements relating to registration, disclosure, advertising, the custody of client assets, and duty to adopt a code of ethics, are also enforced by the SEC in case the fund manager in question is registered or otherwise is subject to a particular provision or rule. While investors in registered funds are thus limited in their possibilities to enforce a federal fiduciary duty, they may be able to bring actions

203. The language of Article 206 of the Advisers Act prohibits *any* adviser, thus whether registered or not, to 'engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client'.

204. And such a claim can only be brought by investors derivatively. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (US Supr. 1984) (interpreting the language and legislative history of Article 36(b) of the 1940 Act). In this respect, it can also be noted that investors generally do not have a private right of action under Article 36(a) of the 1940 Act for breach of fiduciary duty against managers for general misconduct as this right appears to be restricted to the SEC. *See Stegall v. Ladner*, 394 F.Supp.2d 358, 371 (D. Mass. 2005) (no private right of action under Article 36(a) for breach of fiduciary duty against managers for misconduct) and *Mutchka v. Harris*, 373 F.Supp.2d 1021, 1026–1027 (C.D. Cal. 2005) (noting that Congress's inclusion of an express right of action for Article 36(b) but not for Article 36(a) 'suggests that omission of an explicit private of right to enforce other rights was intentional' (quotation marks omitted)).

205. *See*, e.g., *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923, 928 (2nd Cir. 1982) (stating that, for purposes of Article 36(b), a plaintiff-shareholder must show that the fund manager charged a fee 'so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining') and *Jones v. Harris Associates*, L.P., No. 08-586 (US Supr. 2010) (affirming the Gartenberg standard).

206. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, at 24 (US Supr. 1979) (holding that 'there exists a limited private remedy under [Article 215(b) of] the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable').

207. *See* for an overview of SEC enforcement actions for breach of Article 206 of the Advisers Act, SEC, *Staff Study on Investment Advisers and Broker-Dealers* 22–46 (January 2011) and for interpretations of article 206 by the SEC, *Ibid*. and SEC No Action Letter, Heitman Capital Management, LLC, 12 Feb. 2007 (SEC provided guidance as to whether the use of a hedge clause, i.e., a contractual provision limiting an fund manager's liability to gross negligence, reckless disregard, wilful misconduct or bad faith, would be a violation of the anti-fraud provisions of Article 206(1) and (2) of the Advisers Act) and SEC, *Interpretation of Section 206(3) of the Investment Advisers Act of 1940* (17 Jul. 1998) The SEC study, no-action letter, and interpretation can be found on SEC's website: http://www.sec.gov/.

against fiduciaries under (statutory or common) state law. Both the 1940 Act and the Advisers Act do not pre-empt this possibility.[208]

In general, state courts accept breach of fiduciary duties claims in case they find that a fiduciary relationship between two or more parties exists. In the case of an investment fund, a fiduciary relationship may exist between the manager and the fund and the internal board and the fund.[209] Below, these different possible fiduciary relationships will be discussed, after which the specific duties that may arise out of these relationships will be described. In examining the scope of the fiduciary duties, I will focus on the duties derived from state law, as a claim for breach of a fiduciary duty is generally based upon this law type. In addition, fiduciary duties have, as mentioned, common (state) law origins and have formed the main source of federal duties. This has been affirmed by the US Supreme Court in the Capital Gain case,[210] in which the Supreme Court stated that a fiduciary relationship originates in the common law of fraud and that Congress was, in enacting the Advisers Act, aware of the developments in this area of law.[211] However, where appropriate, it will be referred to federal obligations imposed by federal law.

4.9.1 The Fiduciary Relationship

In general, a fiduciary relationship is a relationship in which one person has a duty to act for the benefit for another on matters within the scope of the relationship.[212] The two core fiduciary relationships under common law are the agency and trust relationships. An agency relationship is created when one person, the 'principal', agrees that

208. *See* section 1.3.3[D].
209. In addition to fund managers and directors, brokers (i.e., a person or entity in the business of selling or buying securities for the account of others) selling funds may also stand in a fiduciary relationship to their clients and thus owe fiduciary duties to them. Brokers are generally not considered 'fiduciaries' under federal law, but state common law imposes several fiduciary duties on them. *See*, e.g., *Paine Webber, Jackson & Curtis, Inc. v. Adams,* 718 P.2d. 508 (Colo. 1986) and *Duffy v. King Cavalier*, 215 Cal. App.3d 1517 (Cal. App. 1989). As a result of the Dodd-Frank Act, however, the SEC has submitted to Congress a staff study recommending a uniform fiduciary standard of conduct for brokers, similar to the standard currently applied to advisers under the Advisers Act, when those brokers provide personalized investment advice about securities to retail investors. *See* SEC, *Staff Study on Investment Advisers and Broker-Dealers*. If adopted, the fiduciary status of brokers will also be recognized by federal law. In this book, however, the fiduciary duties of brokers will not be discussed separately as they fall outside the scope of this research.
210. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (US Supr. 1962).
211. *Ibid.*, 193–195. The Supreme Court also ruled 'that Congress codified the common law [of fraud in the Advisers Act] "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels' and that, therefore, Congress 'did not intend to require proof of intent to injure and actual injury to the client'. Under common law, some form of intent is generally required, although intent to cause harm is only of importance with respect to punitive damages. In this context, the Supreme Court mentioned that, under common law, 'it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself; it is only necessary that he intend action in reliance on the truth of his misrepresentations'. *See Ibid.*, 192, n. 39.
212. *Burdett v. Miller*, 957 F.2.d 1375, 1381 (7th Cir. 1992).

another person, the ‘agent’, shall act on his behalf and subject to the his control, and the agent consents so to act.[213] In essence, in an agency relationship, the principal has, expressly or impliedly, authorized the agent to perform activities on his behalf. An agent may not exceed the scope of its authority and must comply with the principal’s instructions in connection with the agency contract.[214] A trust relationship is the relationship in which legal title to the property resides in one person, the ‘trustee’, who has the duty to deal with the property for the benefit of one or more others, the ‘beneficiary’ or ‘beneficiaries’.[215] Thus, a trustee is the legal owner of the trust’s property and makes decisions as to what to do with the property, whereas the agent is no legal owner and must perform his activities within the terms of the mandate given by the principal.

With respect to fund managers, either agency or trust law governs the activities of the manager.[216] Looking at the definition of a trustee, it can be concluded that in case the legal title of the fund property is vested with a manager who holds it on behalf of the investors in the fund, the manager can be qualified as a trustee. Under US law, the legal title to the fund’s property is held by the individual trustees jointly comprising the trust board in the case of a trust fund, the partnership if the fund is an LP fund or by the corporation in a corporate fund.[217] It is thus not in the hands of the manager of the fund nor the directors individually, the board of directors of a corporate fund or the partners of a LP fund. However, it can be argued that the board of directors of a corporate fund and the general partner of an LP hold the ‘equitable title’ to the underlying fund, as the only function of the corporation or the partnership is to hold the legal title on behalf of the directors, respectively general partner for the benefit of the investors.[218]

213. Restatement (Third) of Agency, American Law Institute, 2006, § 1.01 (‘Agency is the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act’). *See also* Restatement (Second) of Agency, American law Institute, 1958, § 1. While Restatements do not have binding authority, courts throughout the US have widely adopted the principals set out in the Restatements into their common law judgments.
214. Van Setten, *The Law of Institutional Investment Management*, 83.
215. Restatement (Third) of Trusts, American Law Institute, 2007, § 2 (‘A trust (…) is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee’). *See also* Restatement (Second) of Trust, American Law Institute, 1959, § 2.
216. Bines & Thel, *Investment Management Law and Regulation*, §2.02[A] (stating that ‘[t]ogether, agency and trust law cover every investment management service for which an investment manager expressly or impliedly has any discretion to act on behalf of and bind a client or beneficiary’).
217. Rounds & Dehio, *Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal Structures*, 490. *See also* Article 3805(f) DBTA (‘Except to the extent otherwise provided in the governing instrument of the statutory trust, legal title to the property of the statutory trust or any part thereof may be held in the name of any trustee of the statutory trust, in its capacity as such, with the same effect as if such property were held in the name of the statutory trust’) and Article 203 of the Uniform Partnership Act (UPA) of 1997 (‘Property acquired by a partnership is property of the partnership and not of the partners individually’). The UPA can be found at: http://www.nccusl.org/.
218. *Ibid.*, 493–494 (noting that ‘in equity the corporate entity is merely a custodial trustee, as nominee as it were, with each director-trustee having a direct equitable duty to act solely in the

Consequently, the individual directors of a corporate fund and the general partner of a LP fund may be viewed by courts as trustee-like fiduciaries, although they are technically not.

When determining whether or not a fund manager can be qualified as a trustee under common law, a distinction should be made between manager and externally managed funds.[219] In case the fund is internally managed, the manager would function as individual fiduciary trustee of the fund investors in case the fund is organized as a business trust. In case the board of trustees consist of multiple trustees, it is one of the members sitting on the board.[220]

Such an external manager can either operate under a separate management contract or act as a managing trustee, director or general partner of the fund. In the first case, the manager invests on behalf of the fund under the terms and conditions of the management contract between the fund and the manager. In that case, the relationship between the fund and the manager can be qualified as an agency relationship, in which the manager represents the agent and the fund the principal. In the latter situation, i.e., the manager is (one of) the fund's trustee(s), director(s) or general partner(s), the external manager operates on the basis of the trust agreement, the fund's charter and bylaws, or the partnership agreement, which in fact represents the 'management contract' between the manager and the fund. The manager then qualifies as a fiduciary trustee in case he (individually or jointly) holds the legal title to the fund property, which will only be the case when, as mentioned above, he is a trustee board member of a trust fund.[221]

In addition, it can be noted that in case the external manager qualifies as an 'investment adviser' under Article 2(a)(20) of the 1940 Act, which will often be the case,[222] he is required to work under contract pursuant to Article 15 of the 1940 Act, which also dictates several items in connection with the contract.[223] With respect to fiduciary duties, both the manager that operates as an agent and the manager-trustee

interests of the (…) fund investors' and 'that there are actually two trusts: the corporate nominee trust and the directors' trust, with the latter containing beneficial interest in the former').

219. *See also* Ch. 2 for these structures.
220. Registered funds are required to have multiple trustees which together comprise the board of directors of the fund, consisting of both dependent (which can be the manager) and independent director (which cannot be the manager). Such a requirement does not exist for unregistered trust funds, so only these funds can also have one trustee (which can be the manager) on the basis of the 1940 Act.
221. *Ibid.*
222. Article 2(a)(2) of the 1940 Act includes among the definition of an investment adviser, among others, 'any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company'.
223. Article 15(a) of the 1940 Act requires shareholder approval of investment management contract and determines that the contract must prescribe all compensation to be paid under the contract. This article, in combination with Article 15(c), also provides that the contract may continue for more than two years only if it is 'specifically approved at least annually by the board of directors' who are not parties to the contract or interested persons of any such party. Article

are subject to fiduciary duties imposed under state law (in addition to possible federal duties). However, it is important to note that where a manager-trustee owes fiduciary duties directly to the fund investors, an (external) manager-agent generally only owes such duties to the fund (being the direct client of the manager).

As mentioned in the beginning of this paragraph, next to manager, the internal fund board members may also be fiduciaries. Courts have applied the label 'fiduciary' to, among others, directors of corporations, trustees of business trusts and general partners of LPs.[224] These parties are considered to be subject to fiduciary duties in nature as the underlying relationships are referred to as legal fiduciary relationships or fiduciary relationships 'as a matter of law'.[225] As such, these relationships are, similar to an agency/trust relationship, of the 'general'-type. In my view, individual board members of a fund may also qualify as 'trustee' under common law in case they jointly hold the legal title of the fund property, which is the case with respect to the board of trustees of a trust fund.[226] At any rate, the internal board members owe fiduciary duties to the fund investors. These duties include the duty to supervise the external manager.[227]

In line with this, the 1940 Act requires that the independent directors of a registered fund must approve the management contract and other contracts with service providers who may or may not be affiliated with the manager. In this context, it is also provided that the directors of a registered fund have the duty to request, and the manager to provide, any information that may be necessary to evaluate the terms of the contract of the manager.[228] In addition, directors have a number of other duties under federal law related to a fund's operation.[229] Based on the above, it can be

15(a) finally states that the contract must provide a termination clause, which allows the contract to be terminated at any time by either the board of directors or by vote of the majority of shareholders.

224. *See Smith v. Van Gorkom,* 488 A.2d 858, 872 (Del. Supr. 1985) ('In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders'), *Loft, Inc. v. Guth*, 23 Del.Ch. 255, 270, 5 A2d 503 (Del. Supr. 1939) ('While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders'), In re USA Cafes, L.P. Litigation, 600 A.2d 43, 49 (Del. Ch. 1991) ('The theory underlying fiduciary duties is consistent with recognition that a director of a corporate general partner bears such a duty towards the limited partnership'), *Cargill, Inc. v. JWH Special Circumstance*, LLC, 959 A.2d 1096, 1111 (Del. Ch. 2008) ('[U]nless the Trust Agreement or the [Delaware business trust] Act "otherwise provides", existing trust law applies, including default fiduciary duties provided by statute or common law').
225. *Davion v. Williams,* 352 So. 2d 804, 807 (Miss. Supr. 1977).
226. By contrast, the relationship between any type of internal fund board and the fund investors cannot qualify as a relationship of agency, as the specific features of agency, i.e., the complete right of control of the principal over the agent and the duty of the agent to turn over all profits and benefits to the principal, are absent. *See*, e.g., P.D. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 Hous. Bus. & Tax J. 309–310 (2008) (stressing that the existence of the 'agency problem' between shareholders and the board of directors in a corporation 'has led some people to [mistakenly] refer to the shareholders as "principals" and boards as "agents" of the shareholders').
227. Kirsch, *Financial Product Fundamentals: Law – Business – Compliance*, 6–13.
228. Article 15(c) of the 1940 Act.
229. For example, directors have the duty to select the fund's independent accountants, to approve multiple classes of voting stock, to approve mergers within the same fund complex, to approve the fund's plan for distribution, to approve depository arrangements, to approve, and monitor

concluded that both the fund manager and individual the board members of a fund's internal board stand in a fiduciary relationship with either the fund (in case of the external manager) or the fund and its underlying investors (in case of the board members), which gives rise to certain fiduciary duties.

4.9.2 Fiduciary Duties

Although there is no uniform standard to determine which specific duties are encompassed in the term 'fiduciary duties', the two cornerstone duties traditionally applied by US courts are the duty of loyalty and the duty of care.[230] In addition to the duty of loyalty and the duty of care, two other duties have emerged over the past years in common law: the duty of disclosure and the duty of good faith. Although US courts traditionally have recognized these duties as being part of a fiduciary's duties, recent case law suggest that they should be seen as an application of the duties of loyalty and care.[231] For this reason, these subduties will be discussed, where appropriate, within the context of the key duties of loyalty and care.

Before turning to the two duties, the following note can be made. In general, common law duties do not require a contract to be created, as they may arise out of any relationship where both parties understand that a special trust or confidence has been reposed.[232] Thus, although funds generally contract with an external manager, this is not required to impose fiduciary duties as they are imposed by the law, and the fiduciary cannot negotiate around them.[233] However, it should be mentioned that state

compliance with, the fund's code of ethics, and to monitor trades with affiliated funds. *See* Articles 32(a), 18(f)(3), 17(j), 17(a) and rules 12b-1 and 17(f)(4), 17(j)(1), 17(a)(8), and 17(a)(7) of the 1940 Act.

230. *See*, e.g., T. Frankel, *Fiduciary Duties as Default Rules,* 74 Or. L. Rev. 1226–1227 (1995) and J.H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L. J. 642 (1995).

231. *See*, e.g., *Malpiede v. Townson*, 780 A.2d 1075, at 1086 (Del. Supr. 2001) ('We begin by observing that the board's fiduciary duty of disclosure (…) is not an independent duty but the application in a specific context of the board's fiduciary duties of care, good faith, and loyalty'), In re Walt Disney Company Derivative Litigation, 907 A.2d 693, at 745, n. 400 (Del.Ch. 2005) ('The Delaware Supreme Court [in *Malpiede v. Townson*] has been clear that outside the recognized fiduciary duties of care and loyalty (and perhaps good faith), there are not other fiduciary duties. In certain circumstances, however, specific applications of the duties of care and loyalty are called for, such as (…) the duty of candor or disclosure'), In re Transkaryotic Therapies, Inc., 954 A.2d 346, at. 357 (Del. Ch. 2008) ('Although usually labeled and described as a duty, the obligation to disclose all material facts fairly when seeking shareholder action is merely a specific application of the duties of care and loyalty'), *Stone v. Ritter*, 911 A.2d 362, at 369–370 (Del. Supr. 2006) ('The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element[,] i.e., a condition, of the fundamental duty of loyalty').

232. T. Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 817 (1983) ('[The] classification [of a relationship] as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties intended the legal consequences of such a relation').

233. Although some authors, referred to as the 'contractualists', argue otherwise. *See*, e.g., Langbein, *The Contractarian Basis of the Law of Trusts*, 658 ('Loyalty and prudence, the norms of trust fiduciary law, embody the default regime that the parties to the trust deal would choose

statutory law may provide rules that enable fund fiduciaries to limit their liability for breach of a fiduciary duty by a provision in the fund's governing instrument or management contract, also referred to as 'hedge clause'.[234] This effectively imposes only a contractual default rule on fiduciaries. For example, Article 1101(d) of DRULPA permits a partner's duties, including fiduciary duties, to be 'expanded or restricted or eliminated' by the partnership agreement. A similar provision is contained in the Delaware Limited Liability Company Act (DLLCA) and the DBTA.[235] Delaware corporations may eliminate the liability of directors for monetary damages for breach of fiduciary duty, although they may not do so as regard the duty of loyalty.[236] However, Delaware law does not seem to enable corporate fiduciaries to eliminate any fiduciary duty completely as it also provides that the liability of a director may not be restricted 'for any transaction from which the director derived an improper personal benefit'.[237]

In addition and more importantly, federal law limits the possibility to use of hedge clauses by fund directors and managers. In the case of registered funds, any hedge clause in the fund's governing instrument or contract with the manager limiting the board's or manager's duties for conduct that constitutes 'wilful misleading, bad faith, or gross negligence', is prohibited.[238] Thus, under federal law, the liability of a registered fund's board or manager can only be limited in cases where there is no wilful misconduct or gross negligence on the side of the board respectively the manager. This is also the rule under state statutory and common law.[239] In addition, a provision that purports to limit the board's or manager's liability may be prohibited under the

at the criteria for regulating the trustee's behavior (...)') and F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* 427 (Harvard University Press 1991) ('a "fiduciary" relation is a contractual one (...)'). *See also* Frankel, *Fiduciary Duties as Default Rules*, 1211–1212 (stating that 'most fiduciary rules constitute default rules', but also that beneficiaries 'may only waive fiduciary duties owed to them if they follow a two-step procedure', consisting of: (1) a clear notice of the beneficiaries that they can no longer rely on the fiduciary with respect to the waived duties and (2) sufficient information provided by the fiduciary to enable beneficiaries to make an informed decision regarding the waiver). Despite these views, courts generally find that fiduciary duties arise irrespective of a contract saying otherwise. *See*, e.g., *Meinhard v. Salmon,* 249 N.Y. 458, 164 N.E. 545 (NY Supr.), in which the NY Supreme Court applied fiduciary rules despite the exclusion of certain rights by contract.

234. *See* SEC, *Staff Study on Investment Advisers and Broker-Dealers*, January 2011, 43.
235. Article 1101(c) of the DLLCA (Del. Code Ann. tit. 6, ch. 18, § 101 et seq.) and 3806(c) DBTA. However, in these cases, the parties may not eliminate the 'implied contractual covenant of good faith and fair dealing'. This obligation applies under Delaware law to all contracts 'and requires that contracting parties refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party from receiving the fruits of the contract' (*See Kelly v. Blum,* 2010 WL 629850,13 (Del. Ch. 2010)). Although the obligation of the implied covenant may not be eliminated by contract, Delaware courts are reluctant to infer implied obligations in a contract. Moreover, courts will not use the implied covenant obligation to override express provisions of an agreement. *See* P.M. Altman & S. M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing under Delaware Law*, 60 The Business Lawyer 1485 (2005).
236. Article 102(b)(7)(i) DGCL.
237. Article 102(b)(7)(iv) DGCL.
238. Articles 17(h) and (i) of the 1940 Act.
239. *See* n. 234, *supra*. A hedge clause that limits a fiduciary's liability entirely would also constitute a breach of the duties of loyalty and care that fund managers and board members owe under common law.

Advisers Act.[240] And even if such a provision is permitted, it can be argued that the provision must be at least appropriately disclosed to clients/investors.

4.9.3 The Duty of Loyalty

The most commonly used expression of the duty of loyalty under US law can be found in the case of *Meinhard v. Salmon*.[241] In this case, the New York Court of Appeals stated that '[a] trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior'.[242] This formulation has become the standard formulation used by US courts in applying the duty of loyalty, which has also been defined as the 'duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so'.[243] In essence, the duty of loyalty means that a fiduciary is held to act honestly, with utmost good faith and with a view to the best interest of the beneficiaries. As a result, this duty has also been described as a duty of 'unselfishness'.[244] While it is clear that the duty of loyalty is about constraining self-interested behaviour of a fiduciary, US law requires a fiduciary to comply with a number of subduties that in order to act in accordance with this duty of loyalty. These subduties can be divided into [A] the duty to act in the interest of investors, [B] the duty of disclosure, and [C] the duty of confidentiality. These subduties will be discussed below.

240. The Advisers Act make it unlawful to waive a manager's liability for actions concerning wilful misconduct or gross negligence as such actions are in violations of the anti-fraud provisions. In addition, in case a fund manager uses a hedge clause that would limit his liability to acts of wilful misconduct or gross negligence, the Advisers Act may also be violated. The SEC Staff has determined that whether or not this is the case depends on 'the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client'. *See* SEC No-Action Letter, Heitman Capital Management, LLC, 12 Feb. 2007, 4. In any case, fiduciary duty waivers, especially open-end waivers, may not be enforceable in court. *See* for a discussion of the interpretation of fiduciary duty waivers in partnership agreements, L.E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927 (2004) (stating that '[o]n the one hand, the courts have concluded that limited partners need some protection against open-ended waivers whose effects the partners cannot fully evaluate at the time on the agreement. On the other hand, the courts have recognized the strong practical reasons for enforcing fiduciary duty contracts in LPs and the implications of the parties' having deliberately selected an entity form that serves specific business functions and that notoriously permits freedom of contract').
241. *See* n. 233, *supra*.
242. *Ibid.*, 546.
243. Restatement (Second) of Trust, American Law Institute, 1959, §170, comment a. *See also* Restatement (Third) of Trusts, § 78 and Restatement (Third) of Agency, § 8.02 ('An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position') and 8.04 ('Throughout the duration of the an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors').
244. L.E. Ribstein, *Fiduciary Duty in Contracts in Unincorporated Firms*, 54 Wash. & Lee L. Rev. 542 (1997).

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

Best Interest Rule

The duty to act in the interest of investors stems from the general obligation under the duty of loyalty to exercise good faith. The term 'good faith' is often used in the context of fiduciary duties to describe the requirement of a fiduciary to act in the interest of the beneficiaries as to all matters connected with the fiduciary relationship.[245] Agents are, however, allowed to act in their own interest, provided that they also act in the interest of the beneficiaries and the agent's interests are not placed above the beneficiaries' (or principals') interests.[246] This rule can be referred to as the 'best interest rule' or 'best interest standard', i.e., the duty to ensure that principals' best interest are served when executing orders. The best interest rule enables an agent to undertake transactions in which he has a (potential) conflict of interest as long as the transaction was also undertaken in the best interest of the beneficiary.[247] For example, an external manager-agent of a fund is permitted to switch some or all of the fund's assets which may give him some benefit (such as a commission), but may also benefit the fund in terms of asset diversification or return expectations. The rule also applies to directors of corporate funds, trustees of Delaware business trust funds, and general partners of Delaware LP funds.[248]

245. *See*, e.g., L.E. Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L. J. 671(2010) (stating that the Delaware Supreme Court's decision in Revlon 'demonstrates the use of good faith to define the core mandate of loyalty, which is to act solely in the interest of the corporation and its stockholders') and D.A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context,* 25 Wake Forest L. Rev. 24 (1990) ('[A]s applied to the decisions of corporate directors, good faith focuses on directors' position as fiduciaries obliged to serve the interests of others').
246. Restatement (Third) of Agency, § 8.01, comment b.
247. M.L. Fein, *The Fiduciary Duty of Securities Brokers and Investment Advisers: Sole Interest or Best Interest?, An Analysis of the Administration's Proposal*, Paper prepared for Federated Investors, Inc., 2009, 17–18 (2009). Available at SSRN ('One alternative [to the sole interest standard] is a "best interest" standard whereby an investment firm is required to act in the best interest rather than sole or exclusive interest' and '[a] "best interest" standard would be similar to the standard reflected in the duty of loyalty imposed on agents under state agency law').
248. J.H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L. J. 958–959 (2005). The Uniform Statutory Trust Entity Act of 2009 (USTEA), the most recent product of the NCCUSL in the area of business entity legislation, applies the corporate 'best interest rule' rather than the more restrictive trust law 'sole interest rule' to Delaware business trusts. *See* Article 505 of the USTEA and the comment to Article 505 of the USTEA. The USTEA can be found at: http://www.uniformlaws.org/. Furthermore, Delaware Courts have often applied the corporate law fiduciary duties to general partners of Delaware LPs, including the best interest standard. *See*, e.g., *Boxer v. Huskey Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981) ('[The] fiduciary duty of partners is often compared to that of corporate directors'), In re Boston Celtics L.P. Litigation, 1999 WL 641902, 4 (Del. Ch. 1999) ('[I]t is well settled that, unless limited by the limited partnership agreement, the general partner of a Delaware limited partnership and the directors of a corporate General Partner who control the partnership, like directors of a Delaware corporation, have the fiduciary duty to manage the partnership in the partnership's interests and the interests of the limited partners' and that '[a]s a result, Delaware law requires the general partners of limited partnerships to exercise due care and to act in the best interest of the partnership and the limited partners').

Under the Advisers Act, fund managers are also required to act in the best interest of their clients.[249] Thus, when a manager falls under the definition of 'investment adviser' of the Advisers Act, he is subject to this standard, irrespective of the standard that would have applied under common law (and irrespective of whether or not he is registered).

Sole Interest Rule

With respect to a trustee of a business trust fund based on common law instead of statute (i.e., the Massachusetts business trust, 'MBT'), the rule is somewhat different. A trustee is required to manage the assets of the beneficiaries in the *sole* interests of the beneficiaries.[250] This 'sole interest rule' or 'sole interest standard' is a formulation of the strict duty of loyalty in common trust law.[251] The standard applies to all common law trustees, expect for trustees that qualify as investment advisers under the Adviser Act, which are subject to the federal prevailing best interest standard.[252]

The sole interest rule precludes transactions where the trustee has any interest in the transaction whatsoever, regardless of whether or not the beneficiaries of the MBT also benefit from it. The rule would, for instance, prohibit an MBT fund's trustee to undertake transactions between the fund and an affiliated entity or person (i.e., an entity in which the trustee is a director, general partner, agent or employee, an entity or person that controls one or more of such outside entities, or an individual who is a general partner, principal or employer of the trustee). Furthermore, there is a potential conflict when a trustee of a MBT would receive asset-based or performance-based

249. SEC, In re Arleen W. Hughes, Release No. 34-4048, 18 Feb. 1948 ('The very function of furnishing investment counsel on a fee basis (…) cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests').
250. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?,* 931 ('[The] "sole interest" rule is widely regarded as "the most fundamental" rule of trust law' (notes omitted)).
251. Restatement (Second) of Trusts, § 170(1) and Restatement (Third) of Trusts, American Law Institute, 2007, § 78(1). The Restatements appear to exclude business trusts from their coverage by stating that 'the business trust is a business arrangement that is best dealt with in connection with business associations'. *See* Restatement (Third) of Trusts, § 1, comment b. However, the Uniform Trust Code of 2000 (last amended in 2005) (UTC), the first codification of the law of trusts in the US, also applies to trusts that have a business or commercial purpose to the extent that neither the trust instrument nor other legislation displace the UTC's provisions. *See* comment to Article 102 of the UTC. Thus, the common law of trusts set out in the Restatements and the UTC applies to all trusts arising under the common law, including those that have a business purpose, to the extent that the common law is not displaced by the trust instrument or by specialized legislation. With respect to statutory business trusts, e.g., the Delaware business trust, Article 105 of the USTEA states that the common law of trusts supplements the USTEA, but only to the extent not modified or displaced by the USTEA or the governing instrument. Article 505 of the USTEA modifies the fiduciary duties of the trustee of a statutory trust, which are drawn from corporate law.
252. Consequently, in case an external manager holds the legal title of a trust fund's assets, the best interest rule does not apply, while an internal trust board is subject to the sole interest standard.

compensation. The most commonly used remuneration arrangements by a trust fund, whether the trustee is a separate legal entity or not, are asset-based fees.[253] Such fees may incline the trustee to overvalue the assets in the fund or to attract more assets than would be in the interests of the investors.

Conflict of Interest: Sole Interest or Best Interest

Whether a fund fiduciary is required to act in the sole or best interest of investors, conflicting transactions and remuneration policies are very common in the fund industry, including funds organized as MBTs. An external manager managing multiple funds may be faced with several potential conflicts of interest relating to the allocation of limited time and attention and investment opportunities, pursuit of different investment strategies, selection of brokers/dealers, variation in compensation and related business opportunities, such as distribution or recordkeeping. For example, with respect to the use of different strategies, the manager may determine that an investment opportunity is appropriate for only some of the funds for which he exercises investment responsibility, or may decide that certain funds should take differing positions with respect to a particular security. In these cases, the manager may place separate transactions for one or more funds or accounts which could affect the market price of the security or the execution of the transaction, or both, to the detriment or benefit of one or more other funds and/or accounts. Internal fund managers that sit on a number of different boards are faced with similar problems.[254]

Another conflicting situation specifically related to fund managers occurs when a manager manages or advises more than one client. In such a case, he may be faced with the risk that when he acts in the interest of one client, he would harm another fund (i.e., not act in the best interest of this client, but something less). As a result, for example, a conflict arises when the manager has a client relationship with a company's pension fund and has to vote on the shares that the fund he manages holds in that company or when the manager has a commercial relationship with a company in which the fund hold shares in the event of a takeover bid on that company. Other potential conflicting transactions result from possible beneficiary incentives of the manager, which may form a motivation to favour certain funds in which he has an interest or in which its affiliates have interests. For example, potential conflict of interest issues arise in situations where the manager is affiliated with a broker through which clients' transactions will be traded or the manager compensates a third party for referring a client or in exchange for services, i.e., soft dollar arrangements.[255]

253. As a result of the restrictions placed on the use of performance-based fees by registered managers, most registered managers charge large asset based fees. *See* J. Golec, *Regulation and the Rise In Asset-Based Mutual Fund Management Fees*, 26 J. Fin. Res. 19 (2003).
254. A.B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 82 (2005) ('Some have questioned whether a director who sits on eighty or one hundred boards can effectively monitor the activities of each'). In addition, directors may have competing interests between the fund they owe a duty of loyalty to and some other person or entity.
255. According to US federal law, soft dollar arrangements are permissible provided that the manager receives qualifying research or brokerage services from its broker(s). *See* Article 28(e)

As mentioned, fiduciaries of funds also have a conflict of interest if they are able to exercise significant influence on the amount they receive as compensation for their services/management. This involves both performance-based fees and asset-based fees. The conflict arises because a fiduciary may be inclined to overvalue the fund's assets (or performance) to gain a higher fee. Furthermore, as fund fiduciaries can hide such fees from investors by deducting them from fund assets before distributing earnings to the investors, investors are often unable to effectively monitor the amount of fees being withheld from each payment. In both instances, (state and federal) statutory law do not provide investors with sufficient tools to change these arrangements, although they are able to put forward a breach of federal fiduciary duty claim stating that the fees are 'excessive' under Article 36(b) of the 1940 Act.[256] With respect to internal directors' fees, it might be possible to amend the fund agreement or bylaws to change the fee structure/fee height established in these documents. However, as mentioned, this right is usually very limited.[257] Additionally, as the originators of the fund are typically either the future board members (in case of an internally managed fund) or the manager (in case of an externally managed fund), the original directors' fee is generally determined by the manager or the directors themselves. In any case, the first investors of the fund will have no influence on this. With respect to the external manager's fee, the fund's board has the responsibility to negotiate this fee with the manager. However, the manager, often also the initial shareholder of the fund, will typically be the one who appoints the first internal officers and directors of the fund.[258] Of course, when the fund's directors owe their appointment to the manager, and perhaps also perform a function at the office of the manager, they will be less inclined to bargain a lower fee in the management contract for the benefit of the investors.

As a consequence of the potential for conflicts of interest, strict application of the sole interest rule would be impossible to maintain in practice. However, the sole interest rule is not that stringent as it may appear at first sight. Trust common law provides that conflict of interest transactions are allowed when specifically authorized beforehand by law or court order, by the trust instrument, or with informed, expressed consent of all beneficiaries.[259] In addition, compensation arrangements are also permissible under trust common law provided that they are fair and properly disclosed to the beneficiaries.[260] Since fund managers will generally fall under the best interest rule of the Advisers Act, this rule only has limited value as it only applies to fund directors, trustees and general partners which are not also manager of the fund.

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of the 1934 Act. Conduct outside of the safe harbour of Article 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities law, most notably under the 1940 Act and the Advisers Act.

256. *See* notes 204 & 205 and accompanying text, supra.
257. *See* section 4.7.2.
258. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 152–153.
259. Restatement (Third) of Trusts, § 78, comment c.
260. *Ibid*. and Restatement (Third) of Trusts, § 78, comment c(4) (noting that '[t]he strict prohibitions against transactions by trustees involving conflicts between their fiduciary duties and personal interests do not apply to the trustee's taking of reasonable compensation for services rendered as trustee').

By contrast, the best interest standard has high relevance in the context of US funds. This standard indicates that fiduciaries, including fund managers, are allowed to perform conflicting transactions provided that the beneficiaries benefit from the transactions, even if the fiduciary also benefits or may benefit. Overlaps of interests are thus allowed. In case of a conflict, it is, however, not always clear whether there is mutual advantage between the relevant parties. As a result, the rule that has been developed to deal with this problem is that in (potential) conflict of interest situations, the fiduciary should either resolve the conflict, or, in the case there is no resolution, pass on any profit the manager accrues from the particular conflict to the beneficiaries.[261] In any case, disclosure of the conflict is required (see below).

[B] The Duty of Disclosure

One of the most important ways of resolving a conflict of interest, which follows from both US trust and agency law, is disclosure.[262] With respect to internal corporate fund officers and directors, this viewpoint has also been accepted by US courts. For example, in *Underwood v. Staffor*, the New York Court of Appeals held that officers and directors possess fiduciary obligations toward the corporation and its shareholders, and must show 'full disclosure and fair dealing' to the shareholders when a conflict of interest arises.[263] Other state courts have ruled in similar ways.[264] Other than other trustee fiduciaries, however, internal corporate fund officers and directors do not need the consent of the beneficiaries in a conflict situation: mere disclosure is sufficient. This

261. Restatement (Third) of Trusts, § 205 (1992) and Restatement (Third) of Agency, § 8.02, 8.03 and 8.06.
262. Restatement (Third) of Trusts, § 83 comment c ('[T]rustee has affirmative duty to disclose relevant information'). This duty to disclose exists even if the trustee is acting in a personal capacity. Restatement (Third) of Trusts, § 78(3) ('Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter'). Restatement (Third) of Agency, § 8.06 ('Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 does not constitute a breach of duty if the principal consents to the conduct, provided that: (a) in obtaining the principal's consent, the agent: (i) acts in good faith, (ii) discloses all material facts that the agent knows has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship'). Courts have affirmed this duty. *See*, e.g., *Regnery v. Meyers*, 679 N.E.2d 74, 79 (Ill. App. Ct. 1997) ('It is well settled that a trustee owes the highest duty to his beneficiary to fully and completely disclose all material facts relating to dealings with the trust') and *Ziswasser v. Cole & Cowan, Inc.*, 210 Cal. Rptr. 428, 429–430 (Cal. Ct. App. 1985) ('It almost goes without saying that the general fiduciary duty owed by the agent to his principal includes the duty to make a full and complete disclosure to him of all material facts which the agent knows and which might influence the principal with respect to the transaction and his willingness to enter into it').
263. *Underwood v. Stafford*, 155 S.E.2d 211, 212–213 (N.C. App. 1967).
264. *See*, e.g., *Kapushion v. Colorado W. Packers, Inc.*, 701 P.2d 625, 627 (Colo. App. 1985) (listing the full and fair disclosure of all material facts as one requirement for a director contracting with the corporation).

indicates that the duty of disclosure is relevant in the context of both the sole interest and the best interest standard, although the evidential burdens in court proceedings differ between the two standards.[265] In other words, full and accurate disclosure of actual and potential conflicts by a fiduciary is an important aspect of acting in good faith and thereby of the duty of loyalty.

When a fund fiduciary intends to conduct a potentially conflicted transaction, he should, in order to avoid a breach of the duty of loyalty and a possible claim thereof, make sure that he provides all material facts related to that transaction to the fund and/or its investors before he initiates the transaction. Such disclosures must be made before the fiduciary relationship is created (in the investment management contract or the fund agreement, i.e., the trust agreement/corporate charter/LP agreement) as well as after the relationship has started and an actual or potential conflict arises. However, it should be noted that a fiduciary remains under an immutable duty to always act fairly and in accordance with the interests of beneficiaries, regardless of the whether a conflict of interest has been disclosed. This means that a fiduciary is not allowed to provide misrepresentations or false or incomplete statements,[266] to engage in self-dealing transactions which are not performed on an arm's-length basis,[267] or otherwise act opportunistically to the detriment of the primary beneficiary or beneficiaries (i.e., 'the duty of fair dealing').[268]

265. Under the sole interest standard, a conflicted transaction is void unless the trustee acquires consent of the beneficiaries (or the conflict has been authorized by law, trust agreement or court order – see n. 259, *supra*) and, of course, the trustee has acted fairly towards the beneficiaries. This rule, also known as 'no further inquiry' rule, makes all self-dealing transactions entered into by the trustee that are not allowed under trust law per se voidable by the beneficiaries, requiring no proof that such transactions were unreasonable or harmful. As a result, a trustee is unable to defend a breach-of-loyalty case by proving that a conflicted transaction was undertaken in de best interest of the beneficiaries, while other fiduciaries, subject to the best interest standard, may do so. *See* Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?,* 931–932.
266. M.A. Eisenberg, *The Duty of Good Faith in Corporate Law,* 31 Del. J. Corp. L. 39, n. 102 (2006) (citing several court cases relating to the duty of full and fair disclosure of corporate fiduciaries). It can be noted that a knowingly false statement (i.e., fraud) may give rise to liability under federal securities law (rule 10b-5 of the 1934 Act).
267. When parties are not dealing at arm's length, i.e., not upon an equal footing, the transaction is considered to be, in the eyes of the law, not performed in good faith and, consequently, in conflict with the duty of loyalty. *See also* V. Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 632 (1997) ('Fairness in corporate law fiduciary terms is said to embody limits on the consensual allocation of gains to management or controller from self-aggrandizing conduct by reference to arm's length bargains or the market' (notes and quotation marks omitted)).
268. The duty of fair dealing requires a fiduciary to manage the assets of the beneficiaries for the good of the beneficiaries, not for their own private, personal gain or for the advantage of third parties. It is thus consistent with the concept of fiduciary behaviour as traditionally applied to require arm's-length dealing. This duty traditionally stems from contract law, although, in contract law, fair dealing and good faith are placed side-by-side, as though fair dealing is something in addition to good faith. *See* Restatement (Second) of Contracts, American Law Institute, 1997, § 205 ('Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement'). In corporate law, 'fairness' has two basic aspects: fair dealing and fair price. Together, these two aspects are generally referred to as the 'entire fairness test'. *See Weinberger v. UOP,* Inc. 457 A.2d 701, 711 (Del. Supr. 1983) (explaining the entire fairness test and its two aspects as follows: 'The former [fair dealing]

It can be noted that under federal law, an officer, director, manager or other affiliated person[269] to a registered fund is prohibited to perform certain transactions in view of the potential conflicts of interest that may exist. For example, Article 17(a) of the 1940 Act generally prohibits affiliated persons of a registered fund from borrowing money or other property from, or selling or buying securities or other property to or from, the fund or any company that the fund controls, although the SEC can approve reasonable, fair transactions that do not involve overreaching and are consistent with the fund's investment policy and other requirements of the 1940 Act.[270] Thus, similar to state common law, any form of self-dealing that is not performed on an arm's length basis is prohibited under federal law, without exemption from the SEC. Furthermore, Article 17(e)(1) of the 1940 Act makes it unlawful for an affiliated person of a registered fund, acting as its agent, to accept 'from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale' of property, including securities, by such fund (i.e., soft dollar arrangements).[271]

In addition, under Article 206 of the Advisers Act, a fund manager has a federal fiduciary duty to disclose all material conflicts of interest, or potential conflicts of

embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness [fair price] relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. (…) However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness'). The entire fairness test only applies in case the directors' conduct does not qualify for the business judgment rule, which involves, among other things, conflict of interest situations. *See* DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 16.

269. Article 2(a)(3) of the 1940 Act.

270. Article 17(b) of the 1940 Act. Furthermore, certain rules under the 1940 Act provide specific exemption of the prohibition set out in Article 17(a) of the Act. For example, rule 17(a)(2) provides that the purchase, sale or borrowing transactions occurring in the usual course of business between affiliated persons of registered investment companies is permissible, provided that: (1) the transactions involve notes, drafts, time payment contracts, bills of exchange, acceptance or other property of a commercial character rather than of an investment character, (2) the buyer or lender is a bank, and (3) the seller or borrower is a bank or is engaged principally in the business of installment financing. Other exemptions include, among others, transactions with fully owned subsidiaries, transactions with portfolio affiliates, transactions between affiliated registered funds, and transactions with certain sub-manager affiliates. *See* rule 17(a)(3), (6), (7), and (10) of the 1940 Act.

271. However, it can be noted that soft dollar arrangements are allowed in case they are used for services that are included in the 'safe harbour' list of Article 28(e) of the 1934 Act, including research or brokerage services. *See* n. 255, *supra*. Other restrictions on affiliate transactions also may be relevant depending on the particular trading practice or situation. The most notable are Article 17(d) and 17(e)(2). Article 17(d) of the 1940 Act restricts an affiliated person of a registered fund from participating in or effecting a transaction in connection with any joint enterprise or other joint arrangement in which the company or a company controlled by that company is a participant. Article 17(e)(2) limits the remuneration an affiliated person can receive when effecting securities transactions as a broker for a registered investment company to not more than 1% of the purchase or sale of the securities.

interest, to its fund clients that arise during the management relationship.[272] Article 206(3) of the Advisers Act requires that fund managers must also disclose the principal or agency transactions that they are conducting to their fund clients.[273] However, it must be kept in mind that mere compliance with the information specified in these documents may not fully satisfy the disclosure obligations required under the common law duty of loyalty (or even the federal fiduciary duty of the 1940 and Advisers Act). As such, the specific disclosure requirements set out in federal law establishes only a minimum level of disclosure. More disclosure required by fiduciary law does not undermine the applicability of the specific federal disclosure requirements of the 1940 and Advisers Act and thus does not conflict with these requirements.

[C] The Duty of Confidentiality

Next to the aforementioned duties of acting in the best or sole interests of the investors and disclosure, the last subduty required by the duty of loyalty is the duty of a fiduciary to retain the confidentiality of confidential information.[274]

Confidential information is information that is explicitly deemed confidential by the fund, as well as information that appears to be confidential from its nature.[275] An important problem that particularly may arise with respect to the duty of confidentiality is the issue of conflicting duties. For example, a director that serves as a trust fund manager and also sits on the board of a corporation may learn of confidential information from the corporation that would be beneficial or detrimental to the fund. For example, if the director at a certain moment learns that the corporation is in financial trouble and the trust fund he manages holds shares in the capital of the corporation, is he bound to sell the shares of the fund? Selling the shares would be beneficial to the fund, but may drive the price of the shares of the corporation down, which would harm the other shareholders in the corporation in their ability to sell their shares at a certain profit.

Apart from possible federal insider dealing prohibitions, the general rule in fiduciary law is that the fiduciary must refrain from causing harm. This generally holds

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272. SEC, *Staff Study on Investment Advisers and Broker-Dealers*, 22 (citing the Capital Gains case).
273. Article 206(3) of the Advisers Act makes it unlawful for any fund manager, directly or indirectly ‘acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction’. Thus, it imposes a prior consent requirement on a fund manager that acts as principal in a transaction with a client, or that acts as broker (i.e., an agent) in connection with a transaction for, or on behalf of, a client. *See* SEC, *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*.
274. Restatement (Third) of Agency, § 8.05.
275. *Ibid.*, comment c (distinguishing two types of confidential information, namely ‘any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others’ and ‘confidential information [that an agent has acquired] in the course of the agency relationship that does not have competitive or other economic value’, such as information about the principal’s health, life history, and personal preferences).

that the fiduciary has no positive duty to act in a conflict of duties situation.[276] In the above example, this would support the view that the director should not sell the shares.

4.9.4 The Duty of Care

[A] Prudence Standard

The traditional formulation of a fiduciary's duty of care is the duty of a fiduciary to make only investments that a prudent investor would make with his own property. This standard of prudence derives from trust law and traces back to the *Harvard College v. Amory* case of 1830.[277] In this case, it was held that a trustee has an obligation to 'observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested'.[278] Although the general concept of the duty of prudence remained unchanged since the Amory case, the Restatement (Third) of Trusts of 1992 redefined this duty into an obligation to invest 'as a prudent investor would',[279] thereby changing the Armory 'prudent man rule' into the 'prudent investor rule'. The Restatement formed the model for the Uniform Prudent Investor Act (UPIA), drafted by the NCCUSL in 1994, which sets out a similar prudence standard.[280]

In essence, the Restatement and the UPIA transformed the prudent investing standard generally applicable to trustees of MBT funds (*not* Delaware business trusts)[281] from a rule based on avoiding speculation and preserving capital into a rule based on the so-called modern portfolio theory.[282] The modern portfolio theory is an investment theory which focuses on the investment portfolio as a whole instead of the individual assets in isolation and aims at maximizing the return of the portfolio for a given amount of risk or minimizing the risk for a given level of expected return.[283] In general, the modern portfolio theory brought about three main changes in the prudence standard applicable to trustees, including trustees of MBTs.

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276. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 149 (concluding after having performed an extensive analysis of case law that '[t]he principal's first claim is that the fiduciary must refrain from causing harm; a claim to the performance of positive acts is secondary').
277. *Harvard College v. Amory,* 26 Mass. 446, 9 Pick. 446, 1830 WL 2554 (Mass. Supr. 1830).
278. *Ibid.*, 461.
279. Restatement (Third) of Trusts, § 227.
280. UPIA, prefatory note ('This Act draws upon the revised standards for prudent trust investments promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992)') and Article 2(a) of the UPIA. The UPIA can be found at: http://www.uniformlaws.org/.
281. Delaware business trusts are subject to a different standard pursuant to Article 505(b) of the USTEA ('A trustee shall discharge its duties with the care that a person in a similar position would reasonably believe appropriate under similar circumstances').
282. UPIA, prefatory note ('[The] changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as modern portfolio theory' (quotation marks omitted)).
283. The theory was introduced by Markowitz in the Journal of Finance in 1952. *See* H.M. Markowitz, *Portfolio Selection,* 7 J. Fin. 77–91 (1952).

First, both the Restatement and the UPIA adopted an active duty to diversify trust investments. Although under the former Restatement, courts had already recognized this duty, the scope of it was narrow as trustees were not allowed to perform investments that were deemed to be 'speculative'.[284] The second change imposed by both the Restatement (Third) of Trusts and the UPIA is the possibility for trustees to diversify their investments among any type of investment, irrespective of the risk nature of that investment.[285] This duty to diversify is not absolute: in case the trustee reasonably determines that the trust, under special circumstances, is better served without diversifying, it is considered prudent to not do so.[286]

The official comment to the UPIA gives two examples of such situations: first, when the tax costs of selling low-basis securities would outweigh the gain from diversification, and second, when there is a wish that the trust retains a family business.[287] It is apparent that with respect to investment funds, only the first situation is relevant. In addition, it can be noted that a MBT trustee also cannot be held to this duty if both prudent risk management and impartiality can be satisfied without doing so, or in case it would violate the purposes of the trust.[288] The UPIA provides a non-exclusive list of factors that the trustee must consider as a part of its investment decision-making process, such as economic conditions, inflation, and taxes, as well as the beneficiary's needs and resources. For example, REITs and RICs (and other funds designed to improve tax conditions) that are organized as MBTs should consider how certain investment decisions would influence their favourable tax status before making a particular decision relating to this issue.

A trustee also must consider the portfolio's expected return, an asset's role within the overall portfolio, and, if applicable, an asset's special relationship to the trust or its beneficiaries.[289] Consequently, if a trustee decides to invest the trust's assets in a non-diversified portfolio, the trustee must have considered these factors set out in the UPIA and have concluded that there are no 'special circumstances' present. Because of this, it has been argued that the Restatement and the trust laws of many jurisdictions

284. Under the Restatement (Second) of Trusts, it appeared that any investment in equity was considered speculative, unless such an investment was in a company 'with regular earnings and paying regular dividends which may reasonably be expected to continue'. *See* Restatement (Second) of Trusts, § 227, comment a and m ('The trustee does not use due care in making an investment unless he makes an investigation as to the safety of the investment and the probable income to be derived therefrom' and '[t]he purchase of shares of preferred or common stock of a company with regular earnings and paying regular dividends which may reasonably be expected to continue is a proper trust investment if prudent men in the community are accustomed to invest in such shares when making an investment of their savings with a view to their safety').

285. Restatement (Third) of Trusts, § 90(b) and Article 3 UPIA *See also* the comment to Article 2 UIPA ('The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments').

286. *Ibid*.

287. *See* the comment to Article 3 UPIA.

288. Restatement (Third) of Trusts, § 90, comment g and Article 2 UPIA.

289. Article 2(c) UPIA.

provide a rather poorly duty to diversify as it can be relatively easily set aside in the trust instrument with reference to the trust purpose presented in the instrument.[290]

The third and last change that the Restatement and the UPIA made is the revision of the traditional rule that prohibited trustees from delegating management functions.[291] This was not allowed under the old rule.[292] However, a variety of 'special purpose state statutes' already reversed the non-delegation rule for investments.[293] This reform is thus a general codification of what was already practice in most state trust laws.

The Restatement's duty of prudence requires a trustee of a MBT fund to exercise 'reasonable care, skill, and caution' in the administration of the trust.[294] This general standard of reasonable care also, in a broad sense, applies to other fund fiduciaries.[295] However, the above mentioned prudence standard as well as the specific duties that arise out of the duty of care may differ among fund fiduciaries. With respect to managers-agents, the Restatement (Third) of Agency has described an agent's duty of care as a duty to act with 'the care, competence, and diligence normally exercised by agents in similar circumstances'.[296] The prudence standard for fund managers appears to be how other managers would act in similar circumstances instead of how a prudent investor would act. A similar description of a fund manager's duty of care can be found in federal law, which prevails over the prudent investing standard for common law trustees.[297]

290. E.C. Halbach, *Trust Investment Law in the Third Restatement,* 77 Iowa L. Rev. 1179 (1992) ('The diversification requirement is not inflexible in any event, and the discussion recognizes that the duty to diversify may be further relaxed by authorization in the instrument, particularly in light of special objectives of the settlor and special opportunities or difficulties presented to the trust').
291. Restatement (Third) of Trusts, § 90, comment j ('In administering the trust's investment activities, the trustee has power, and may sometimes have a duty, to delegate such functions and in such manner as a prudent investor would delegate under the circumstances') and Article 9(a) UPIA ('A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances').
292. Restatement (Second) of Trusts, § 171.
293. J.H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. R. 652 (1996).
294. Restatement (Third) of Trusts, § 77(2).
295. *See*, e.g., Restatement (Third) of Agency, § 8.08 ('Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances'), Article 505(b) Uniform Statutory Trust Act ('[I]n exercising the powers of trusteeship, a trustee shall act in good faith and in a manner the trustee reasonably believes to be in the best interests of the statutory trust'), and *Smith v. Van Gorkom*, 488 A.2d 858, 872–873 (Del. Ch. 1985) ('[A] [corporate] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty').
296. Restatement (Third) of Agency, § 8.08.
297. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (US Supr.) ('Courts have imposed on a fiduciary [,which the Congress recognized Capital Gains to be,] an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts", as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients' (notes omitted)). . *See also* n. 249, *supra*. A breach of this fiduciary duty constitutes a violation of the anti-fraud provisions (Article 206) of the Advisers Act. It is not entirely clear whether the US Supreme Court in Capital Gains distinguishes a fund manager's common law fiduciary duty from its

The accepted standard is that a manager is under the duty to utilize the 'care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field'.[298] The same standard applies to the internal board of a corporate fund and the trustee of Delaware business trust.[299] Thus, for these fiduciaries, the degree of care, knowledge and skill expected of the average professional person or entity alike should be looked at to discover the fiduciary's standard of care. In fulfilling the duty of care of a fund manager it is thus expected that the manager meets the standard of care applicable to the profession of performing management services to funds.

In this context, industry standards and codes of conduct will be relevant factors to take into account. US courts will generally use these as an indication of what would be expected of fund managers in respect of care exercised. However, they are not conclusive and courts will not always accept industry practice as the benchmark for determining whether a fund manager's duty of care is fulfilled. It may well be that a court will not find a fund manager liable for failing to comply with unduly high industry standards. On the other hand, a manager might be held liable even though he complied with the industry standard. This may especially be the case when the applicable code of conduct sets out minimum requirements a fund manager member is expected to achieve.[300] In addition, it can be noted that the standard of care may change over time along with the expectations that come with the duty of care due to law changes and the development of new services and products.[301]

Lastly, it is important to note that as part of the duty of care, both the fund manager and fund board must employ reasonable care to avoid misleading funds/ investors. For registered fund managers, this also follows from rule 206(4)-1 of the Advisers Act, which states that a fraudulent practice within the meaning of Article 206(4) of the Advisers Act includes any advertisement 'which contains any untrue statement of a material fact, or which is otherwise false or misleading'. Under common law, this duty also requires funds managers and boards to provide full and fair disclosure of all material facts to fund clients/investors and prospective clients/ investors, thus prior to the investment.[302] Whether 'all material information' is

federal duty under the Advisers Act. However, the Court rejected the idea that the Advisers Act prohibitions on fraud and deceit are constrained by principles of common law. *See* the Capital Gains case, note. 6.

298. *Erlich v. First Nat. Bank of Princeton*, 505 A.2d 220, 291 (NJ Super. 1984).

299. In re Walt Disney Company Derivative Litigation, 907 A.2d 693, 749 (Del. Ch. 2005) ('The fiduciary duty of due care requires that directors of a Delaware corporation use that amount of care which ordinarily careful and prudent men would use in similar circumstances' (quotation marks omitted)) and n. 280, *supra*.

300. Under federal law (rule 204A-1 of the Advisers Act), a SEC-registered fund manager is required to adopt and enforce a written code of ethics which set forth a standard of business conduct. While the code of ethics must reflect the adviser's fiduciary obligations and those of its supervised persons, and must require compliance with the federal securities laws, it would have to contain only minimum provisions.

301. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 193 (US Supr.) ('The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue').

302. *Smith v. Van Gorkom*, 872.

provided is determined by the quality of the information, the advice considered by the manager/board, and whether the manager/board had 'sufficient opportunity to acquire knowledge concerning the problem before acting'.[303] Generally, facts are 'material' if a reasonable investor would consider them to be important.

[B] Business Judgment Rule

It follows from the prudence standard that a MBT fund trustee (*not* qualifying as an 'investment adviser' under the Advisers Act) is subject to the standard of a prudent investor as described in the Restatement (Third) of Trusts and all other fund fiduciaries are subject to the standard of a prudent professional person in similar circumstances. At first sight, a fund manager seems to have to comply with a much higher standard than a trustee-director of a MBT fund, considering that he must act as an average manager instead of an average investor. The fund manager is held to act in accordance with a standard of behaviour that we would normatively expect of fund managers at the time that the activities took place. It can be argued that a fund manager would normally be expected to possess more knowledge and skill than an ordinary investor as a result of which the expectations of what an average manager would do under similar circumstances are also likely to be much higher than what can be expected of an average person.

However, US courts appear to have followed a different approach. The duty of care, as applied by US courts, has been often constrained by the business judgment rule. This rule stems from corporate law and holds the presumption that in making business decisions, the directors of a corporation acted on an informed basis, in good faith and in the best interest of the corporation.[304] Under this rule, a director will not be found liable even if the decision itself would not have been made by the average director.[305] The rule however does not apply in case no decisions are involved, the decision was uninformed, or in case there is a showing of a conflict of interest, fraud or other bad faith conduct, or gross negligence.[306] With respect to the duty to disclose material information to investors, which forms part of the duty of care, it follows from this that material information may only be withheld in case premature disclosure would influence a business decision, such as the signing of a contract. In case the disclosure is of no relevance to business decisions, such as the information contained in a (statutory or summary) prospectus, liability may be imposed for non-disclosure.[307]

303. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. Supr. 1985).
304. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Supr. 1984).
305. C. Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, The 48 Bus. Law. 1356–1357 (1993).
306. S.M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L Rev. 90 & 96 (2004), and E.S. Miller & T.E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?* 30 Del. J. Corp. L. 347 (2005). Gross negligence means reckless indifference to or a deliberate disregard of the shareholders, or actions which are bound to be unreasonable. *See Rabkin v. Philip A. Hunt Chemical Corporation*, 547 A.2d 963, 970 (Del. Ch. 1986).
307. M.I. Steinberg, *Securities Regulation: Liabilities and Remedies* 2–61 (Law Journal Press 2014).

Thus, the duty to disclosure pre-contractual information relevant to investors under the duty of care will often not be protected by the business judgment rule.

While the business judgment rule may also play a role with respect to the duty of loyalty,[308] the above shows that it is more closely related to the duty of care. By limiting application of the business judgment rule to decisions of negligence, the business judgment rule prevents liability claims for a breach of the duty of care involving negligence. Furthermore, due to the other exceptions, the rule limits the duty of care solely to the informed decision-making process and prevents liability when a decision was made in good faith.[309]

Although the business judgment rule has traditionally been developed in the corporate context, courts have explicitly expanded the rule to unincorporated businesses, including Delaware LPs and, under certain circumstances, Massachusetts business trusts.[310] Logically, the rule also applies to (the directors of) corporate funds. The question thus remains whether the rule should also apply to managers that do not also act as trustees, directors or general partners of funds. Considering the important role of fund managers in the fund industry and the undesirability to create differences in standards among managers, the business judgment rule ought to be, in my view, generally applied to all fund managers, irrespective of their legal status. In a similar way, the US Court of Appeal ruled this way in a bankruptcy case concerning an advisers conducting solely advisory functions by stating that 'courts do not interfere with advice by financial advisors when they: (1) have no personal interest, (2) have a

308. This is because the business judgment rule does not apply in the situation where a decision-maker has a conflict of interest. In other words, in case a decision can be considered reckless, irresponsible or irrational, which does not necessarily involves a conflict of interest, the business judgment rule applies. As most duties under the duty of loyalty arise in cases of conflicts of interests, the business judgment rule will often not apply. *See also* n. 310, *supra*.

309. *See Aronson v. Lewis,* 473 A.2d 805, 812 (Del. Supr. 1984) ('directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties') and Caremark International, Inc. Derivative Litigation, 698 A.2d 959, 967–968 (Del. Ch. 1996) ('[T]he business judgment rule is process oriented and informed by a deep respect for all good faith board decisions' (emphasis omitted)). Under Delaware corporate law, directors and officers are entitled to rely on the advice and recommendations of experts so long as such reliance is reasonable and in good faith. If there is reason to assume that the information presented by the expert is incorrect, such reliance is not reasonable and the duty of care not satisfied. *See* Article 141(e) DGCL.

310. *See*, e.g., *Halebian v. Berv*, 457 Mass. 620, n. 4 (Mass. Supr. 2010) (applying the business judgment rule in the derivative proceeding provisions of the Massachusetts Business Corporations Act to a mutual fund organized as a Massachusetts business trust because a business trust 'in practical effect is in many respects similar to a corporation'), In re Boston Celtics L.P. Litigation, 1999 WL 641902, 4 (Del. Ch. 1999) (stating that 'the business judgment rule generally protects the actions of general partners') and *Seaford Funding, L.P. v. M & M Associates II, L.P.*, 672 A.2d 66, 70 (Del. Ch. 1995). *See* however Miller & Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*? (arguing that it is inappropriate to apply the business judgment rule to unincorporated business organizations, unless the rule has been expressly applied into the organizing documents of the business).

reasonable awareness of available information after prudent consideration of alternative options, and (3) provide that advice in good faith' (notes omitted).[311]

Consequently, in my view, it can be concluded that all US fund fiduciaries are protected from personal liability for a breach of the duty of care under the business judgment rule, unless no business decision was concerned (i.e., pre-contractual disclosure), the decision was uninformed, the fiduciaries have engaged in fraudulent activity, intentional misconduct or misrepresentation, gross negligence or conflicting transactions. This also seems to be the rule under federal law.[312] Consequently, it appears that the only clear difference with respect to the duty of care between the prudence standard of a MBT trustee and other fund fiduciaries is the fact that MBT trustees have, under the Restatement (Third) of Trusts, an affirmative duty to diversify. However, this duty does not, as mentioned, create a definite duty of diversification of MBT investments as the scope of the duty may be limited in the trust agreement.[313] Thus, a fund fiduciary, irrespective of its legal nature, that follows the terms of the fund agreement and whose activities do not exceed the general activities of the average, similar fiduciary generally is not subject to a higher duty of care than other fund fiduciaries.

In this respect, however, it can be noted that registered funds have a federal duty to comply with the fundamental investment policies in the registration statement of the fund.[314] A registered fund that has declared that it will hold a diversified portfolio thus has a duty, under federal law, to diversify in accordance with Article 5(b) of the 1940 Act. The 1940 Act also places some restrictions on the investments of registered funds,

311. In re: United Artists Theatre Company, et al, 315 F.3d 217, 232–233 (3rd Cir. 2010). In this case, the Third Circuit looked to Delaware corporate law 'as a useful analogue' to determine whether the indemnification provision contained in a Ch. 11 debtors' retention agreement with a financial advisor which exempted the advisor from liability for its own ordinary negligence, was reasonable and, thus, permissible under the US Bankruptcy Code.
312. *See*, e.g., *Ash v. International Bus. Mach. Corp*, 353 F2d 491, 493 (3rd Cir. 1965) ('[A] stockholder's derivative action, whether involving corporate refusal to bring antitrust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way' (citing, among others, *Hawes v. City of Oakland*, 104 U.S. 450, 26 L.Ed. 827 (US Supr. 1881), *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (US Supr. 1917), and *Coast v. Hunt Oil Co.*, 344 U.S. 836, 73 S.Ct. 46, 97 L.Ed. 651 (5th Cir. 1985)).
313. *See* n. 292 and accompanying text, *supra*.
314. Article 13(a) of the 1940 Act. This article also provides that a registered fund may not borrow money, make loans, buy or sell real estate, or underwrite securities issued by other companies, may not change its investment objectives, may not change the nature of its business and cease acting as a registered fund, and may not change from a diversified form to an undiversified registered fund. There is no (implied) private right of action to enforce the provisions of Article 13(a) of the 1940 Act as the only provision of the Act that provides for an express private right of action is Article 36(b), which is limited to conduct related to the fees charged by registered funds. *See Northstar Financial Advisors, Inc. v. Schwab Investments*, 615 F.3d 1106, 1122 (9th Cir. 2010) (concluding that '[n]either the language of § 13(a), the structure of the [1940 Act], nor the statute's legislative history, including the addition of § 13(c), the Sudanese amendment, in 2007, reflect any congressional intent to create, or recognize a previously established, private right of action to enforce § 13(a). The job of enforcement remains exclusively with the SEC').

such as short selling shares,[315] the purchase of securities on margin, and the amount of leverage a fund may use.[316] Other federal rules related to the duty of care include investment due diligence and 'know your customer' (customer due diligence) rules.[317] Disclosure rules can also be found in federal laws, although unregistered Fund boards and directors of fund managers are not required to meet certain expertise or skill requirements, although funds and management companies will generally seek directors that are experienced in the field of finance and have the ability to read and assess financial reports and have a good reputation for integrity and professionalism.[318] Funds structured as a REIT or RIC are subject to additional federal (tax) rules, which may also include investment restrictions and diversification requirements.[319] These federal law duties will often contain a minimum of protection that is also required under the common law duty of care.

Furthermore, notwithstanding the preeminence of federal law, the common law duty of care may be, as has been mentioned above, limited or eliminated by the fund's charter or agreement, provided that the particular fiduciary acts in good faith and in

315. However, over the years, the SEC has been steadily relaxed the restrictions on short selling for open-end registered funds, making it easier for such funds to engage in short sales. *See* section 4.6.3. In addition, it can be noted that neither the 1940 Act nor the Advisers Act imposes restrictions on short selling by unregistered funds. However, in the aftermath of the financial crisis, the SEC adopted several rules to combat naked short selling that apply to all public company securities, including anti-fraud rule 10b-21 under the 1934 Act, which prohibits any person from submitting 'an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date'. *See* SEC, Final Rule: 'Naked' Short Selling Antifraud Rule, Release No. 34-58774, 14 Oct. 2008.
316. Article 12(a) and 18(a) of the 1940 Act. Article 12 also provides that a registered fund may not own a joint account that trades securities and may not purchase more than 3% of the outstanding voting stock of another registered fund. *See* Article 12(d)(1)(A) of the 1940 Act. As for Article 13(a) and the other provisions of the 1940 Act, it is viewed that investors do not have a private right of action to enforce this article. *See MeVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners L.P.*, 260 F. Supp. 2d 616, 622 (S.D.N.Y. 2003).
317. *See*, e.g., 31 CFR 131(b)(3) (customer identification programme for mutual funds), 31 CFR 131(b)(3) (customer information rules, 'know your customer', for mutual funds), SEC's Office of Compliance Inspections and Examinations (OCIE), Investment Adviser Due Diligence Process for Selecting Alternative Investments and their Respective Managers, 28 Jan. 2014 (referring to an fund manager's duty to perform due diligence of alternative investments pursuant to article 206(2) of the Advisers Act), and SEC No-Action Relief Under Broker-Dealer Customer Identification Rule (31 C.F R. § 103.122), 11 Jan. 2011 (allowing broker-dealers to treat registered fund managers as if they were subject to the anti-money laundering provisions, including the customer identification rules, provided that the broker-dealers reliance is reasonable upon the given circumstances and the manager has entered into a contract with the broker-dealer in which it agrees, among other things, that it has implemented the identification programme in a manner consistent with 31 U.S.C. 5318(h) added with Article 326 of the Patriot act (minimum standard for identifying customers), and will update the programme if necessary). The SEC's OCIE observations on the due diligence and no-action letter can be found at: http:// www.sec.gov/.
318. Robertson, *Fund Governance: Legal Duties of Investment Companies Directors*, 2–29. The 1940 Act may disqualify certain directors to become a board member of a registered fund or fund manager. *See* Article 9(a) of the 1940 Act.
319. *See* section 2.7.3[A].

accordance with the governing documents of the fund.[320] However, in Delaware corporate law, courts appear to have exculpated directors from many traditional duties of care claims as they have increasingly placed such claims under the category of the duty of loyalty, which is not subject to exculpation.[321]

4.10 CONCLUSION

This chapter focused on assessing US law applying to funds protecting retail investors against misconduct by the fund manager. It began with discussing the key differences between US funds that are required to register with the SEC (registered funds) and funds that are not (unregistered funds). Furthermore, it has been assessed whether or not a US fund manager must undergo SEC registration. The core part of the chapter dealt with the investor protection rules applying to US fund (and their managers) that have been qualified as being most relevant to retail investors in Chapter 2, including: (1) rules related to the fund's internal control systems, (2) leverage restrictions, (3) rules aimed to secure investor rights in investor meetings, (4) transparency and disclosure rules, and (5) conduct of business rules. As noted (in section 2.8), depositary (monitoring) rules have not been assessed in this chapter for the simple reason that US law knows no such rules. With respect to the remaining rules, the following general conclusions can be made.

US registered funds and fund managers must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. Although exact policies and procedures are not defined by US law, the SEC has identified a number of areas that should be addressed by the compliance policies. These areas appear to cover similar areas as those required for EU funds, including fees, risks, conflicts of interest, and asset valuation. US law is highly principle-based on this matter, with the SEC exercising external supervisory control. Internal control with respect to the implementation and monitoring of the compliance policies of the fund and/or manager is done by the CCO. In addition, it can be noted that unregistered funds and fund managers are not required to implement compliance policies. Lastly, it is interesting to note that existing restrictions relating to the payment of performance-based fees to fund managers under the Advisers Act, which also influences their remuneration policy, do not apply to US fund managers (whether registered or not) managing registered closed-end funds and unregistered funds (see section 4.3).

Borrowing money is allowed by US law for registered open-end funds (mutual funds) to a maximum of 33% of their net assets and by registered closed-end funds to an unlimited extent, provided that, in case they issue debt or preferred shares, those shares are covered by a 300% or 200% asset coverage. Mutual funds and closed-end registered funds are furthermore permitted to invest in derivatives in case they take off-setting positions that would 'eliminate' the derivatives exposure and obviates the

320. A fund fiduciary cannot limit its liability for wilful misfeasance, bad faith, gross negligence or reckless disregard of the fiduciary duties of loyalty and care. *See* notes 238–240.

321. At least for corporate funds. *See* n. 238, *supra*.

need to segregate assets, or invest in derivatives that do not impose any payment obligations above the initial investment (i.e., premium), such as purchased stock options and leveraged inverse float rate notes. Unregistered funds are not subject to any restrictions regarding their leverage use.

Investor meetings are generally not held by US funds and even if they are held, a number of restrictions apply which limits the ability of investors to exercise their voting rights. Such restrictions include, among other things: the use of staggered boards, the inability to remove directors except for cause, difficulty to submit items to the agenda, short notice periods and plurality shareholder vote requirements. In addition, if the investor lives in a state other than the state where the shareholder meeting is held or abroad (as is the case for EU investors), it may be difficult to physically attend the meeting. Electronic/online voting and/or via proxy is allowed under US law, but do not provide for a real solution to this problem due to federal restrictions placed on proxy holders and the fact that it is at the sole discretion of the fund's board or general partner whether or not to allow such voting/online meetings to take place.

The transparency and disclosure obligation of US funds is centred around the duty to publish and provide investors with a prospectus and periodic reports. Registered funds are required to publish either a statutory prospectus (supplemented by additional information in the SAI) or a short summary prospectus and annual, half-yearly and quarterly reports. The prospectus contain detailed information on, among other things, the fund's investment objectives, strategies, performance, risks and costs, the purchase and sale of fund shares and payments to broker-dealers and other financial intermediaries. Unregistered funds relying on certain exemptions are not required to publish a statutory or summary prospectus and periodic reports, but must still provide investors with relevant (and similar) information based on US case law and the safe harbour provision provided in the 1933 Act, to the extent material to the investor. It follows from the assessment of the US law that the (statutory or summary) prospectus must be delivered to investors 'at the carrying or delivery' of the fund's shares. As a result, investors may receive the prospectus after they have purchased the fund's shares, although funds will often provide certain information beforehand to avoid liability on the basis of fiduciary law.

The conduct of business rules applying to US funds are placed in the context of the fiduciary duties of loyalty and care. The assessment of case law shows that state courts accept breach of state law fiduciary duties claims in case they find that a fiduciary relationship exists. In the case of investment funds, such a relationship exists between the manager and the fund and the internal board and the fund investors. In addition, federal fiduciary duties apply to all fund managers (whether registered or not) of registered and unregistered funds and fund directors of registered funds. With respect these duties, investors generally have no private right of action, except for a breach 'with respect to the receipt of compensation for services' in the case of registered funds. The duty of loyalty requires fund managers and boards to act in the best (or sometimes: sole) interest of the fund/investors when executing orders. In case of a conflict, the manager or board should either resolve the conflict, or pass on any profit accrued from the particular conflict to the fund/investors. In this respect, it is particularly interesting that disclosure of the conflict is also a way to 'resolve' the conflict (and prevent liability).

The duty of care focuses on the 'reasonable person standard', which translates as the duty of the manager/board to utilize the 'care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field'. It also includes prohibition to mislead investors and to provide full and fair disclosure of all material facts to existing and prospective investors, thus prior to the investment. The business judgment rule is inseparable from the duty of care and prevents liability when a decision was made in good faith, but it generally does not protect fund boards that have not provided pre-contractual information relevant to investors, such as the information contained in the prospectus of the fund. Next to these duties, federal law rules related to the duty of care also include, among other things, investment due diligence and 'know your customer' (customer due diligence) rules.