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Are Collective Investment Scheme regulations fit to protect the investor? A cross legislative environment study of the effectiveness of their principles and rules.

Giovanni Bandi

A Thesis submitted for degree of Doctor of Philosophy

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Table of Contents

Table of Contents 2
Acknowledgements 8
List of cases 9
UK (England and Wales) cases and FCA enforcement actions 9
United States cases and SEC No-Action letters and enforcement actions 9
Hong Kong cases and SFC relevant actions 11
EU Countries cases (depositary) 11
List of legislation 12
European Union 12
UK 12
USA 13
HK 13
Table of Abbreviations 14
Legislation and Regulations 14
Cases 15
Introduction 16
Socio-legal background of this research 16
Methodology and research questions 17
Thesis substance and hypothesis 17
Validity and perimeter of the analysis 18
Research main academic contribution 19
Research content and structure 20
Chapter one 20
Chapter two 20
Chapter three 21
Chapter four 21
Chapter five 22
Chapter six 22
Thesis conclusions and recommendations 23
Chapter one: Collective Investment Schemes: the art of pooling assets together 24
What is a Collective Investment Scheme? 24
Introduction: why a Collective Investment Scheme? 24
Defining a CIS 26
Identifying a common scheme for CIS regulations 27
In the United Kingdom 28
In Hong Kong SAR 30

In the United States of America ... 31
Not so similar judicial cases ... 33
Evidence from US courts ... 33
Evidence from UK courts ... 35
Mapping a global definition of CIS ... 37
Background study in OECD countries ... 38
The parties involved in a CIS ... 40
A generic scheme ... 40
The operative angle ... 43
The CIS operator and investor relationship ... 44
The CIS and depositary-custodian relationship ... 46
Mapping CIS in this research context ... 47
The investor of a Collective Investment Scheme ... 48
Distinguishing funds through the investor's investment objective ... 48
Investors from the regulator's perspective ... 50
Counter-market definitions ... 52
Conclusions ... 54
Chapter two: Fiduciary duties and economic reasoning in the context of a Collective Investment Scheme ... 56
Fiduciary duties in investment management ... 56
Introduction ... 56
Fiduciary and contractual duties in this research context ... 56
Building a coherent framework for the analysis of fiduciary duties ... 57
The United Kingdom standards ... 58
Background information ... 58
The Kay Review ... 60
Interpretative scheme for CIS under the Law Commission Investigation ... 61
Duties of a fiduciary ... 61
Duty of loyalty ... 62
Duty of care (for UK pension trustees) ... 64
The United States standards ... 65
The special case of the USA ... 65
ERISA standards ... 66
Standards of conduct ... 68
US securities regulation in comparison to ERISA standards ... 69
The Hong Kong approach ... 71
Regulatory background ... 71
Note on judicial findings ... 74
The economic activities of a CIS and its fiduciary duties ... 74

Fundamental economic concepts related to a CIS 74
CIS financial operational duties requiring fiduciary standards 75
Interpreting Economic theory of fiduciary law in a CIS context 78
Notes on evolving economic reasoning and CISs' conflicts of interests 80
Conclusions 81
Chapter three: The independent entity: fiduciary to a fiduciary 83
Introduction 83
The role of the CIS independent oversight entity 83
Background study by IOSCO 83
The IOSCO CIS governance principles 86
Definition of the independent oversight entity 87
Independence criteria, empowerment conditions and functions to be performed by the independent oversight entities 87
Comparative analysis of the depositary as independent oversight entity 89
Methodology applied in this research 89
In the United Kingdom 91
UK CIS rules background 91
Definition of a UK depositary and functions 91
Safety of the asset and correctness of the transactions 92
Is the CIS investor asset safe? 93
Is the CIS manager acting for the CIS investor? 94
Is the depositary a fiduciary in the UK? 96
Judicial cases in the United Kingdom 99
Relevant notes on UCITS cases from other European countries 100
In Hong Kong 104
Hong Kong CIS rules definition on trustee/custodian and functions 104
Is the CIS investor asset safe? 104
Is the CIS operator acting for the CIS investor? 105
Is the depositary in Hong Kong a fiduciary? 106
Note on cases for the Hong Kong custodian 107
Notes on the depositary role in the US 109
Conclusions 110
Chapter four: Directorship of a Collective Investment Scheme: a complicated job or a useless one? 111
Introduction 111
The United States model for the independent oversight entity: CIS directors 111
Directors' duties under the Investment Company Act 1940 112
ICA federal requirements for independent directors 112
ICA federal requirements for all directors 114

Specific duties of the directors 115
The CIS assets valuation 116
The advisory contract 117
Directors' fiduciary duties under state law 118
Duty of loyalty and duty of care 119
A US peculiarity: the business judgement rule 120
Directors' insurance and limitation of liability 122
Directors are the key to governance 123
US case law 124
Independent directors' status 125
CIS directors as fiduciaries and conflicts of interests 126
Director duties in advisory fee setting: Gartenberg 129
Directors in the UK 133
Introduction 133
Open-Ended Investment Companies 134
A new proposition for CIS directors in the UK 135
The Authorised Corporate Director 135
Is the ACD the actual CIS operator in an EEA context? 137
Upcoming policies on UK's CIS directorship 138
The UK and the business judgement rule 140
UK judicial cases 141
Authorised Corporate Director responsibilities 141
CIS directors' good faith and a company's best interests under common law 143
Relationship between ACD and investment manager 145
Directors in Hong Kong 146
Introduction 146
The case of the self-managed CIS 147
The case of Open-ended Fund Companies 147
Note on Hong Kong custodian cases 148
Conclusions 149
Chapter five: The role of the investment manager: keystone to a multi-party relationship 151
Introduction 151
The mutual fund manager in the US 151
The ICA and IAA in context 151
Duties of the US-based CIS operator 154
Conflicts of interest & disclosures 154
CIS valuation duties under the SEC regime 156
Operational duties (conduct and investment management) 157

Key regulatory cases and administrative actions in the US 159
Investment management activities 159
Antifraud 160
Valuation issues 161
Disclosure and misrepresentation 163
Affiliated transactions 166
CIS operators in the UK 167
A complex UK rulebook 167
The CIS operator in the UK 169
Key UK regulatory framework requirements 170
Disclosures documentation 170
Modifications of a CIS 171
Valuation duties for managers under COLL 171
Operational duties (conduct and investment management) 173
UK cases involving CIS operators 176
Fiduciary standards 176
Valuation issues 178
Disclosure and misrepresentation 179
Affiliated transactions 181
The Hong Kong case 182
HK rulebook simplicity 182
CIS operator duties 183
Regulatory cases 185
Fraud 185
Valuation 186
Conclusions 187
Chapter six: International standards for CIS regulations: IOSCO, IMF and the rise of soft law 189
Introduction 189
The setting up of securities standards 189
FSAP context for CIS regulators 191
Assessment of CIS Principles 192
Requirements for CIS governance 196
IOSCO’s examination of governance for Collective Investment Schemes 196
IOSCO’s Principles for the oversight function of the CIS independent entity 198
Some independence requirement incongruences 199
Testing the IMF analysis for CIS principles 200
FSAP on IOSCO Principles: the US and Hong Kong 200
FSAP Technical Note on fund management for the UK 203

Commentary on FSAP findings for the US, Hong Kong and the UK 204
Legal status of IOSCO principles for CIS 206
Funds' passporting: Asian evidence for *lex financiera*?.. 207
Asia Region Funds Passport 209
Hong Kong Mutual Recognition of Funds... 210
ASEAN CIS 211
Passporting schemes standards as soft law.. 212
Conclusions 213
Thesis Conclusions 215
Main findings... 215
Effectiveness of fiduciary duties.. 215
Effectiveness of governance rules for a CIS.. 217
On the international rules making.. 219
Recommendations 220
Enhancing CIS related policy for principles and fiduciaries 220
Prescriptive rules on CIS Governance activities and liabilities 221
Internationalisation of CIS policy making... 222
Bibliography 224

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Re Godfrey (1883) 23 Ch D 483 at 493, by Bacon VC
Re Whiteley (1886) 33 Ch D 347
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Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2009] OJ L174/1

Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions [2014] OJ L257/1

UK

Companies Act 2006
FCA Handbook COLL Collective Investment Schemes
FCA Handbook COLLG The Collective Investment Scheme Information Guide
FCA Handbook COND Conduct of Business sourcebook
FCA Handbook FUND Investment Funds sourcebook
FCA Handbook PERG The Perimeter Guidance Manual
FCA Handbook SYSC Senior Management Arrangements, Systems and Controls
Financial Services and Markets Act 2000
Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulation 2001

USA

Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code)
Employee Retirement Income Security Act of 1974
Investment Advisers Act of 1940, 15 US Code.
Investment Company Act of 1940, 15 US Code
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SEC Advisers Act Rule 206(3)-3T (Temporary Rule Regarding Principal Trades with Certain Advisory Clients)

HK

Code of Real Estate Investment Trusts
Fund Managers Code of Conduct (Third edition pursuant to the Securities and Futures Ordinance (Cap. 571))
Securities and Futures (Amendment) Ordinance 2016
Securities and Futures Ordinance (E.R 2 of 2012)
SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products – Code of Unit Trusts and Mutual Funds (2nd Edition, April 2013)

Table of Abbreviations

Legislation and Regulations

ACD Authorised Corporate Director UK
ACS Authorised Contractual Schemes UK
AIFMD Alternative Investment Fund Managers Directive
AIFs Alternative Investment Funds in Europe
ARFP Asia Region Funds Passport
AUT Authorised Unit Trust UK
CIS Collective Investment Schemes
COLL Collective Investment Schemes sourcebook UK
CSRC China Securities Regulatory Commission
DAR Detailed Assessment Reports
DOL Department of Labor USA
ERISA Employee Retirement Income Security Act of 1974 USA
ETF Exchange Traded Fund
FCA Financial Conduct Authority
FMCC SFC: the Fund Manager Code of Conduct HK
FSAP Financial Sector Assessment Program
FSB Financial Stability Board
FSMA Financial Services and Markets Act 2000 UK
FSS Financial Sector Surveillance
FUND Investment Funds sourcebook UK
IAA Investment Advisory Act of 1940 USA
ICA Investment Company Act of 1940 USA
ICI Investment Company Institute USA
ICVC Investment companies with variable capital
IE CIS Independent Entity
IFA Hong Kong Investment Fund Association
IMA Investment Management Association UK
IOE CIS Independent Oversight Entities
IOSCO International Organization of Securities Commissions
KIID Key Investor Information Document EU
MiFID Markets in Financial Instruments Directive EU
MRF Hong Kong Mutual Recognition of Funds
NAV Net Asset Value
NURS Non-UCITS Retail Schemes UK
OEIC Open-Ended Investment Company
OEIC Regulations Open-Ended Investment Companies Regulations 2001 UK
OFC Open-ended Fund Company HK
PRIPs Package Retail Investment Products EU
QIS Qualified Investor Scheme UK
REIT Hong Kong Real Estate Investment Trusts
REIT Code of Real Estate Investment Trusts HK

ROSC Report on the Observance of Standards and Codes
SC5 IOSCO Standing Committee 5 on Investment Funds
SEC Securities and Exchange Commission
SFC Securities and Futures Commission
SSB Standard Setting Body
UCITS Undertakings for Collective Investment in Transferable Securities EU
USC United States Code
UTMF Code on Unit Trusts and Mutual Funds HK

Cases

AFP Arch Financial Products LLP
BNY BNY Mellon Trust & Depositary (UK) Limited
CCM Commonwealth Capital Mgmt. LLC
CFM Capita Financial Managers Limited
CFM Capita Fund Management
DAF Descartes Athena Fund SPC
FCAM Full Circle Asset Management
KCM Kornitzer Capital Mgmt
LBIE Lehman Brothers International Europe
MCI Martin Currie Inc
MCIML Martin Currie Investment Management Limited
SSGA State Street Global Advisors Asia Limited
TAML Threadneedle Asset Management Limited
VPHK Value Partners Hong Kong Limited
VPL Value Partners Limited

Introduction

Collective Investment Schemes ("CISs") are the most common type of financial vehicle created for the efficient pooling and management of third parties' assets. At the end of 2017, investment management firms provided over 114,000 regulated funds across the globe, invested in underlying assets estimated to be worth $49.3 trillion.[1] In spite of their economic relevance for both individuals and the global financial ecosystem, academic analysis on their governing rules has not been pursued extensively, nor have they been subject to criticism regarding the effectiveness of these rules. The very simple question of whether CIS regulations, constructed to ensure the security of those subscribing to these schemes, are adequate in their aim is yet to be answered.

This research attempts to establish a common analytical framework for the various CIS regulatory environments under scrutiny while establishing whether they are constituted by similar structures and principles of fairness regarding the parties involved. Their specific common intent is to establish rules designed to clarify the rights of investors and the duties of advisors and third parties. The principles envision a risk-limited operating model and establish the role of the CIS Operator, constructing a safe environment for an investor. The aim of this thesis is to document whether there is a gap between that intent and the de facto rules imposed on CIS markets, and who benefits from this gap.

Socio-legal background of this research

In December 2013 "The Economist" published one of its weekly editions with an unusual front page depicting a large black meteorite about to hit an anonymous, rural valley.[2] The magazine was referring to Blackrock's status as the largest investment manager in the world with over $4.1 trillion of assets, making it the largest shareholder in banks and petro-chemical companies, and an investor in most of the listed stocks worldwide. Five years later Blackrock's assets under management reached $6.32 trillion, making it the largest investment management firm worldwide. Its main competitor, Vanguard, has also reached the $5 trillion asset under management landmark. Blackrock's and Vanguard's statuses are due to their activities as managers of various types of collective investment schemes, such as mutual funds, exchange traded funds and other legal forms. To give some perspective, iShares, one of Blackrock's subsidiaries, whilst managing just 27% of the group's total assets, offers over 740 collective schemes in various countries.[3]

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[1] Investment Company Institute, 'Investment Company Fact Book 2018' 58th Edition <https://www.ici.org/pdf/2018_factbook.pdf> accessed 20 April 2018.

[2] The Economist Editor, 'The Rise of BlackRock' (*The Economist*, 7 December 2013).

[3] Steven Nickolas, 'The Top 5 Asset Management Firms for 2019' (*Investopedia*, 26 October 2018). <https://www.investopedia.com/articles/investing/022316/top-5-asset-management-firms-portfolios-2016-

Despite its size, Blackrock is a “mere manager of other people’s money” and, differently from banks, each asset is not its own, but is managed on behalf of investors. This vast player in financial services does not include these assets in its balance sheet but it provides an apparently successful service for managing them. In short, the assets belong to somebody else: the CIS investors. How these clients’ money is pooled in various forms, in different countries, according to the norms of national law or custom regulations is at the roots of this research. This study, however, retains the point of view of the investors, aiming at understanding whether the schemes’ owners or the industry are favoured by these regulations, or whether the latter is perhaps seeking to alter standards for its own purposes.[4]

A CIS exists in a legal form to fulfil various economic needs. To the average citizen, the delegation of money management through the acquisition of CIS units corresponds to the social need to transform potential current spending into future spending without the assets losing their value, or even increasing in value. To expert investors, a CIS is an investment vehicle with predetermined, well-known legal features securing their rights without the need for direct negotiations with the investment managers. For these and many other cases, the rules for CIS have been developed over time and they have culminated in the current legal formulations of a standardised scheme regulating the duties of parties involved.

Referencing three leading markets’ regulatory frameworks, this research introduces the parties involved in the CIS legal relationship to clarify the roles of the agencies embedded in the regulations. These provide guidance on the tripartite CIS/depositary/operator interconnection and highlight duties owed to the CIS investor, striking at the management of the CIS, and evidencing imbalances in the regulations.

Methodology and research questions

Thesis substance and hypothesis

This thesis addresses the significant elements of CIS governance and tests whether they adhere to the highest and common levels of principles found across the various jurisdictions analysed: the United States, Hong Kong SAR and the United Kingdom, the latter as the most relevant implementation of EU-level law. Its originality is based on the analysis of regulations across these global financial centres from the point of view of the investor, aiming at identifying whether the regulations currently implemented provide an effective and unbiased framework of rules for the ultimate

pimco-blk.asp> accessed 20 November 2018.

[4] John Morley, ‘Collective Branding and the Origins of Investment Management Regulation: 1936-1942’ (March 3, 2011) Virginia Law and Economics Research Paper No. 2011-01, 343.

risk taker – the investor in the scheme.

This research is doctrinal in its intent to create a synthesis of the regulatory framework for the countries taken into account by means of different levels of the law. However, it also addresses meta-rules extensively as securities regulations inherently make use of different levels of national norms. Whilst only some jurisdictions, such as the UK and HK, provide powers to their regulators to enhance their system with rulebooks or codes, they all share a CIS-level encoded set of rules as well as active regulator enforcement teams tasked with pursuing cases deemed relevant for the effectiveness of particular rules.

Because of this construction, to obtain a complete view of the effectiveness of these regulations, it is necessary to complement them with analyses of relevant cases and the choices made by the national regulators on relevant enforcement actions. This investigation method advocates the design of regulatory duties to correspond to the cases brought to courts by regulatory agencies, which introduces an element of effectiveness of the framework for the key stakeholder. This holistic approach provides insights not just on the intent on the part of national regulators to enact certain statutory provisions in specific ways but also on the level of cohesion it creates.

This research is also informed by a comparative analysis of the fiduciary duties of CIS Operators, Directors and Depositaries, and generally by a greater focus on the agency risks in the conduct of a CIS's business. Whereas the current academic literature concentrates on the CIS Operator's duties and liabilities toward its company (provided that a CIS is an accidental enterprise), this research proposes to analyse how applicable laws and rules shape a framework with multiple parties that may fail the basic principles and interests pertinent to the investors. The comparative characteristic also allows for an analysis of significant gaps across different legislative environments, effectively identifying a global model for a CIS. Comparability is the key element in understanding the scrutinies carried out by international sovereign entities in verifying the suitability of their national regimes against international standards.

Lastly, this research has made use of semi-structured interviews with enforcement teams at regulators, delegates to standard setting bodies, market participants and regulation experts. Because of the comparative nature of the legal frameworks, no specific question has been addressed directly but, rather, discussions have been informative regarding regulatory trends and existing gaps. No specific mentions have been accounted in the text.

Validity and perimeter of the analysis

This research covers primary sources of law, applicable national regulation as provided by the national competent authorities in the countries analysed, and the enforcement cases carried out by the same, until December 2018. Jurisprudence and

state of law should to be considered valid until then.

The focus of the thesis is also limited to the regulations and standards relevant for the parties involved in the governance and operations of a CIS, excluding other standards that are applicable to parties connected to, or serving the purpose of, the CIS operations indirectly. One relevant case in point may be that of the personal liabilities and activities of the individuals engaged in performing those roles. For example, the study does not take into account the UK's Senior Managers and Certification Regime. Whilst such regulation renders senior people in regulated firms responsible and accountable for their conduct, actions and competence, including Non-Executive Directors, compliance with CIS rules falls to the entity, usually a firm, charged with the governance of a CIS. Another example may be the fiduciaries related to CIS-connected activities: the thesis does not take into account fiduciary standards that are not related to the parties strictly involved in the management of a fund. An example of such related duties are the newly proposed fiduciary standards in the USA applicable to an individual providing advice to invest in a CIS; under the SEC's proposed Regulation Best Interest, the broker-dealer standard of conduct will extend beyond the existing suitability obligations, but these fiduciary duties are not applicable for CIS governance *per se*.

Research main academic contribution

The main contribution of this research to the available, limited academic literature on the topic is the validation of the thesis that over-engineered, partially ineffective archetypal CIS regulations are currently in place. This is accomplished through endorsing the methodology previously described.

This research finding goes beyond the traditional academic discussion of common law jurisdictions being likely to assign fiduciary status to the parties involved in the management of a mutual fund. This research attempts to prove that a multi-fiduciary environment brings with it common law co-fiduciary liability which in turn stimulates cross-fiduciary oversight.[5] Whilst fiduciary duties are identified, court cases indicate the lack of effectiveness of the existing rules and of the expected results of the duties of loyalty and care.

The testing of the CIS governance structures adopted also uncovered the tendency of regulations to favour the industry over the investors because of unclear, overlapping, and at-times unstated fiduciary duties in the schemes' contractual relationships and economic advantages taken by the industry via wrongly addressed conflict of interest rules.

[5] C Rounds and A Delhio, 'Publicly-Traded Open End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal Structures' (2007) 3 New York University Journal of Law and Business 473.

This research also deepens the understanding of the economic aspects of implementing certain CIS regulations using agency models of fiduciaries, questioning their effectiveness in a market relevant to the common investor based on both derived rules and the principles of laws. Doing so, it furthers the understanding of the effectiveness of CIS parties and evidences interpretative flaws in the rules made by lawmakers, regulators and courts.

The study also expands two new areas of research. On the one hand, it introduces the approach of using the pragmatic analysis of rules and regulations while analysing their effectiveness together with the enforcement actions taken by their creators, the regulators, in order to develop a holistic view of the resulting legal status quo. On the other, it touches on the role of the international standard setting bodies and their policy-generation cycles, potentially determining the adoption of similar standards and their elevation into soft law status.

Research content and structure

Chapter one

Chapter one addresses the challenges involved in defining a CIS across different jurisdictions while introducing the agency relationships required for its governance. It first describes how with the development of financial services markets, the various national legislators found themselves in the position of regulating the intellectual service provided by fund managers to investors.

Authorities therefore need to construct a legal shell to preserve rights and elucidate the relationship between parties in the CIS, resulting in the creation of regulatory environments for those schemes labelled collective investment schemes, establishing principles of fairness to the parties involved. The common intent of these regulatory frameworks is to provide rules designed to clarify the rights of the investors and the duties of the advisors and any other third parties. In this multi-party agreement, it is possible to identify all the relevant stakeholders and their interests in the arrangement in place: Investors, Scheme Operators, Depositaries and Regulators.

The chapter also discusses the role of the investors as the asset owners and the distinct approaches taken by different national legislators at defining the investor based on the type of scheme, differentiating between those offerings oriented towards the retail market and those aimed at private investors.

Chapter two

This chapter focuses on the scheme’s concept of several parties independent from each other and the investor’s legal title of shareholder of an entity that is not under

their control. The day-to-day management tasks of the CIS results in a complex system of delegations to agents appointed to carry out duties with significant discretion. This may result in fiduciary standards applicable in the investment management process. This chapter discusses in detail the characteristics of the fiduciary duties for the CIS governance, their effectiveness and the potential shortfalls or gaps.

Chapter two also discusses the economic interpretation of activities carried out by fiduciaries for the CIS. Whereas different roles and activities are distributed among the CIS stakeholders, they all contribute to the relevant economic activity of investing for a third party and reaching their financial goals. The chapter proposes an economic interpretation of the asymmetry of information and moral hazard in the CIS governance as a means to understand the effect of rules for the final economic goal of CIS investors.

Chapter three

Chapter three introduces the international standard requirement for national regulators to implement a system embedding a third party to act as independent entity from the CIS Operator. This 'Independent Entity' must oversee the functions carried out by the latter. Most regulations tend to mitigate this CIS fiduciary risk by implementing the requirement relating to a depositary as the independent entity. The changes implemented in the EU were intended to institutionalise its role as vigilant watchdog (and succeeded).

Because many rules currently in place aim at regulating activities or creating liabilities for misconduct, chapter three discusses in detail how depositaries' roles and responsibilities evolved, ultimately to institutions supporting CIS investors' safety. Using the fiduciary characteristics previously identified, this chapter tests the nature of the rules and regulations around the activities of depositaries across jurisdictions as well as verifying whether they are establishing a *de facto* fiduciary relationship, and to whom this duty is due. This analysis is complemented with a review of judicial cases involving the depositary in the UK and Europe to identify the Courts' interpretation of the role of the depositary and the effectiveness of the rules.

Chapter four

This chapter discusses the role of the board of directors in fund governance and as independent entities. The adoption of a board is particularly relevant for schemes aimed at retail investors and their role is that of controller of the management and operations of the CIS on behalf of its shareholders. In some advanced regulatory environments, they have a significant responsibility of oversight of the fund and of the approval of fees paid to the investment adviser for its services. The concept of

independence of some or most of the board is also discussed as an effective rule in such frameworks.

This chapter also discusses whether there are duties of loyalty and care from a CIS director, given that the particular nature of a CIS allows for conflicts of interests, and the overlap of duties and specific regulatory requirements. In this fiduciary system, directors are within the CIS, and arguably not acting independently, as demonstrated in the review of court cases.

Chapter five

Chapter five is the last of the chapters addressing the parties involved in CIS governance; it considers the key fiduciary, the CIS Operator. The study focusses on the main responsibilities assigned via legislative frameworks to the CIS Operator and the enforceability of those rules. Because of the length of these rules, the chapter focusses on the areas of interest for a CIS investor, such as antifraud provisions, valuation requirements, conflict of interest mitigations, and due disclosure standards.

The study also proposes an interpretation of several court cases to distinguish between the rules in place and their effectiveness. With a greater focus on the lead cases brought forward by regulators, the chapter addresses the main area of focus that has caused economic damage to CIS investors, evidencing a trend of ineffectiveness of rules, when these have not been strictly implemented or interpreted.

Chapter six

This chapter discusses how the evolving CIS market and the fast-paced internationalisation of investment products introduce new risks for those investors who are transacting internationally. The study focuses on the derivation of international standards from the International Organisation of Securities Commissions ("IOSCO") principles and the standardisation of these via the IMF's Financial Sector Assessment Program ("FSAP"). This policy setting process implies a higher level of congruency between CIS regulations across countries and, through the IMF analysis, a system to directly compare country's through the assigned grades.

The analysis also suggests the evolution of IOSCO principles and standards and the possibility of raising these to the ranks of soft law, identifying a case for *lex financiera*. Further evidence of international standardisation is found in the CIS passporting regimes being developed in Asia, providing further validation for an international model that is emerging as prevalent.

Thesis conclusions and recommendations

The last section discusses the thesis conclusions, based on the methodology adopted, addressing three main areas of research shared across six chapters. The first area of analysis is the regulatory status of the CIS in both its instrumental relevance for asset investment and as a specific fiduciary status. The second area addresses all parties involved in the governance of the CIS, identifying their main duties toward the CIS investors, and supported by a detailed exploration of court cases findings and case law. The third area of interest addressed the validation of these rules at the international level and the way they are scoped out.

The recommendations point at ways to correct flaws of rules, designed to promote investor rights based on the duties of operators and third parties. Having identified gaps born from the regulatory trend of requiring more and more specificity, it proposes simple steps to create a safe environment for investors by enforcing stricter principles of fairness around governance onto the CIS parties.

The recommendations also stress the relevance of international organisations and standard setting bodies in setting standards, monitoring implementation and raising best practices. In particular, the IMF FSAP process and the IOSCO Methodology are additional means to support greater international standardisation, providing the grounds for coordination of *lex financiera.*

Chapter one: Collective Investment Schemes: the art of pooling assets together

What is a Collective Investment Scheme?

Introduction: why a Collective Investment Scheme?

In modern economies, the phenomenon of investing in Collective Investment Schemes ("CISs") is strictly related to the needs of millions of people, mostly in developed economies, to safely and successfully preserve and grow personal resources for future consumption.

This investment vehicle's popularity is validated by the amount of investment assets allocated to it. Total net assets in worldwide regulated funds hit $49.3 trillion at year-end 2017, more than double the level in 2008.[6] With inflow of nearly $9 trillion in 2017 alone, it is no wonder that the regulatory frameworks are of relevance. However, it should be remembered that this asset growth is not entirely dependent on the allocation of investments to these CISs. More than 40% of the increase in total net assets of regulated CISs in 2017 reflected robust gains in stock markets around the world and a general appreciation of foreign currencies against the US dollar.

Still, it is fair to state that the growth in demand for CISs has been substantial in the last decade. For example, the total net assets in worldwide regulated long-term schemes (with asset allocation to equity, bond, and mixed/other) were also boosted by strong investor demand for new CIS units, with net sales totalling $11.4 trillion. In 2017 alone, investors across the globe purchased $2.1 trillion in additional shares of regulated long-term funds. Many of these sales were attributable to the United States, where bond funds posted exceptionally strong inflows due to financial market conditions.[7]

The phenomenon is not just explained by the assets allocated to CISs but also by their quantities. At year-end 2017, CIS Operators across the globe managed more than 114,000 regulated CISs, a 36% increase since 2008. CISs in Europe accounted for nearly half of those registered in 2017, while the extended Asia-Pacific region represented 26% of regulated funds, the United States 9%, and the rest of the world 17%.[8] The regional shares change again when considering the ratio of assets to CIS registrations, with the United States maintaining its position as the world's largest CIS market, with $22.1 trillion (45%) of the world's $49.3 trillion regulated total net assets in CISs. Funds domiciled in Europe held $17.7 trillion, or 36% of the worldwide total, the Asia-Pacific region had $6.5 trillion, and $2.9 trillion in the rest of the world.[9] The large amount of assets makes the CIS market an appealing one for skilful finance

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[6] ICI Research Staff, ICI Investment Company Fact Book 2018 (58th edition) figure 1.12 <www.icifactbook.org/ch1/18_fb_ch1 > accessed 20 November 2018.
[7] ibid figure 1.4.
[8] ibid figure 1.7.
[9] ibid 23.

professionals. Indeed, this is a market driven by the relationship between those who promote a scheme and those who subscribe to it; and by the *de facto* capacity of the former to efficiently access and manage certain investments of the latter. The CIS affiliation is therefore based not just on a limited delegation of the power to execute the investment, but one that exists because of the ability of the CIS manager to skilfully fulfil the portfolio allocation duty. Indeed, such skill is the specific requirement on which the agency relationship is established.

In effect, behind the first issue of a CIS we find the attempt to establish a scheme to provide investors with limited assets with the possibility to finance, and gain from, businesses much larger than their monetary excesses.[10] The “Eendragt Maakt Magt” Fund,[11] as envisioned by Dutch banker Abraham van Ketwich in 1774, was a scheme to invest in government bonds and plantation loans. These assets, essentially the portfolio underlying the “negotiatie structure” based in Amsterdam, were in fact a form of large funding used by Dutch investors for colonies in the West Indies. Given the size of the investments, these were not usually available to the smaller investors.

Similarly, the most long-lived closed-end fund in the world, the Foreign and Colonial Investment Trust, now a London-listed investment trust dated 1868, owes its initial success to having entered the virgin market of wholesale investment in diversified portfolios backed by the general public.[12] Indeed, investment trusts, truly the predecessors of modern CISs, were used as a form of investment for British savings in American securities, particularly from 1880 until the beginning of the Second World War.[13]

This trend was analysed at the time by the Federal Reserve in the context of foreign investments in American domestic markets, who confirmed that the inflow of British capital via CIS amounted to a staggering 37% of all American traded securities.[14] The phenomenon of pooled investments grew into a sizeable business in the late 19th century. Specific regulations, however, did not appear until the market crash of 1929. It was the US Senate who took the lead by requesting the Securities Act of 1933 and later the Investment Company Act of 1940 (“ICA”). Traditionally this implementation is associated with the Roosevelt administration’s strategy concerning financial markets security. However, more recent research indicates that the industry might have wanted to be regulated, given the support the implementing committee received.[15] This should not come as a surprise; the popularity of Undertakings for

[10]K Geert Rouwenhorst, ‘The Origins of Mutual Funds’ (2004) Yale ICF Working Paper No. 04-48, <http://ssrn.com/abstract=636146> accessed 29 January 2019.

[11I] ibid, it is clarified that the fund was indeed “called Eendragt Maakt Magt—the maxim of the Dutch Republic – “Unity Creates Strength”.

[12] Rui Esteves and Davide Chambers, ‘The First Global Emerging Markets Investor: Foreign & Colonial Investment Trust 1880-1913’ (2013) Explorations in Economic History (Forthcoming), <http://ssrn.com/abstract=2024921> accessed 29 January 2019.

[13] Mira Wilkins, *The history of foreign investment in the United States, 1914-1945* (Harvard University Press 2004).

[14] ibid.

[15] John Morley, ‘Collective Branding and the Origins of Investment Management Regulation: 1936-1942’ (2011)

Collective Investment in Transferable Securities ("UCITS") among all investors goes beyond the European need for a common standard, and it is very much related to the safety provided by its internal mechanism.

Defining a CIS

At the heart of the regulations and legislations pertinent to the CIS is the need to safeguard the investors in CISs. However, in defining a Collective Investment Scheme the investor would wonder about the struggles that occur when trying to define such a common arrangement in developed economies. Whether or not the term "Fund" is definitively a common one,[16] especially in those Western countries where the pension system relies on private sector fund management, national legislators have been struggling for decades to provide a one-size-fits-all definition of a CIS. This is particularly true for the United States, where the ICA provides a rather restrictive one.[17]

The resolve of national legislators has been pragmatic; the method observable in various legislative environments is that of schematizing a larger-than-necessary definition as a first step. The generally agreed definition provided tends to include all those contractual schemes aimed at pooling the assets of a group for the purpose of investing. Consequently, many agreements not intended to be a CIS fall within the boundaries set by these statements.

Legislators address this involuntary issue by restricting the area of regulatory applicability. In practice, this occurs with the issuing of further exclusions rules, some in an automatic fashion, some left to the market regulators to determine, within the text of the broad definition in the national code.[18] This strategy is perhaps a sensitive one: legislators are striving to characterise an instrument not by its unique form, but by providing a regulatory definition that includes several schemes in a multitude of contractual dimensions[19] and then limiting the grouping effects. Such a perimeter is always drawn via the identification of a number of specific cases referring mainly to legal entities or securities regulated elsewhere. This mechanism allows for a certain degree of flexibility in financial innovation, intended here as new types of schemes promoted to the general public.

Additionally, it serves the regulators' need to quickly correct a dysfunctional market when this is not favouring its overall market goals. To understand this rationale, it is

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Virginia Law and Economics Research Paper No. 2011-01 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1762217> accessed 30 January 2019.

[16] ICI Research Staff, ICI Investment Company Fact Book, (2013, 53 Edition) <https://www.ici.org/pdf/2013_factbook.pdf> accessed 30 January 2019.

[17] See Cox 2008, Spangler 2012 and other main publication. It is quite an interesting observation to the author how leading textbooks all introduce the ICA definition with nouns indicating an issue of sort.

[18] The British HMT, the Hong Kong SFC and United States SEC all have similar rules, as discussed below.

[19] A dimension here is intended as a share class need to allow for "tax wrappers".

important to stress the statutory goals of a regulator. The Securities and Exchange Commission ("SEC") in the United States, the Financial Conduct Authority ("FCA") in the United Kingdom and the Securities and Futures Commission ("SFC") in Hong Kong all have core objectives referencing the protection of investors or consumers while maintaining both efficiency and integrity of the market.[20] When excluding specific cases, regulators are not necessarily limiting access to certain financial services, but narrowing the identification of a CIS that implies, as we will see, the existence of unique fiduciary relationships. The investor can therefore rely on at least one certainty: national level regulations are fashioned with the scope of his protection.

The results, on the other hand, may not be so. Representative bodies of financial institutions take a pragmatic approach. They define regulated funds as collective investment pools that are substantively regulated, open-end investment funds. Open-end funds are generally defined as those that issue new fund shares (or units) or redeem existing shares (or units) on demand.[21] This interpretation, for example, limits the pool to mutual funds and exchange-traded funds in the USA and UCITS and Alternative Investment Funds ("AIFs") in Europe.

The International Organisation of Securities Committee, the supranational body tasked with developing high regulatory standards in capital markets, take a similar approach. It defines a CIS as

"an open end collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments. For the purposes of these Principles, it excludes schemes investing in property/real estate, mortgages or venture capital."

This research will address regulations to do mainly with the CIS definition used by market participants and IOSCO, so as to provide a substantial and plain level analysis of the standards in used across countries.

Identifying a common scheme for CIS regulations

In the world of CIS investments there are few financial centres that can claim a truly international investor base. This research aims to closely analyse the nature of the CIS regulations in those centres and compare their effectiveness from the point of view of international investors. For this reason, we take into consideration the financial regulation of the two largest pools of investors, the United States and the European

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[20] The HK's SFO lists "*to provide protection for the investing public*" <http://www.sfc.hk/web/EN/about-the-sfc/our-role/regulatory-objectives.html>, the UK's FCA writes "*To secure an appropriate degree of protection for consumers*" <http://www.fca.org.uk/about/why-we-do-it/statutory-objectives> and the USA's SEC informs to be the "*Investor's Advocate: How the SEC Protects Investors…"* <http://www.sec.gov/about/whatwedo.shtml#create>.

[21] International Investment Fund Association, 'Open-Ended Fund' (*Glossary*) <https://www.iifa.ca/info/glossary.html#C> accessed 30 January 2019.

Union (taking the United Kingdom perspective as the most relevant implementation of EU-level law), as well as the fast growing investor base of Hong Kong.

In the United Kingdom

The most influential legislative environment in the world of CIS investing is certainly that of the United Kingdom. The Foreign and Colonial Investment Trust is a practical example: its inception was recorded in 1868, half a century before similar funds appeared in the US during the economic expansion of the 1920s. Furthermore, basic common law constructions established in history by English law are an indicator of the vast influence that the country has had on the banking world. The notion of the trust is in fact found in the United States and Hong Kong, both being previously part of the British Empire. This research considers three legislative environments, all of which have in fact derived their concepts of collective investment scheme from the British concept, and have maintained this link as the British concept has evolved due to the implementation of EU directives.

Whether or not the British concept provides a good example of a CIS, this research nonetheless considers the United Kingdom as part of a broader European Union legal framework, and an example of the implementation of the Directives related to this market. Furthermore, certain types of schemes outside the EU single market are much more easily compared to the UK Common law legal system. Such is the case for those CISs that rely on Trust law, a property law not traditionally found in other European countries. So, in the UK framework a reconciliation effort is embedded in the reception of EU financial services regulations.

It follows that the UK Financial Services and Markets Act 2000 ("FSMA") definition is a natural choice for researching a definition of a CIS, as it will naturally include both unit trusts and investment companies with variable capital ("ICVCs"). Curiously, this law is dated 2000, in reflection of the adoption of EU requirements. This is a contrast to the US Advisory Act of 1940, developed in the aftermath of the stock market crisis and following the Securities Act of 1933, and perhaps not updated with the same frequency. While the Hong Kong Securities and Futures Ordinance ("SFO") was only issued in 2002, with few changes having occurred so far.

In a legislative mechanism often observed in national laws, the definition of a CIS is found in the cornerstone of the financial law rather than in the specific rulebooks issued by competent authorities. Apart from the particular European secondary legislative statutes, this characterization is nonetheless observable in several regulations such as the Hong Kong SFO, chapter 571 of the Laws of Hong Kong, and the United States Code, sections 15 U.S.C. § 80b-1 through § 80b-21 and § 80b-1 through § 80b-21, respectively the Investment Advisers Act 1940 and Investment Company Act 1940.

In the UK, FSMA section 235 offers the following definition of CIS:

"In this Part "collective investment scheme" means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

The arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

The arrangements must also have either or both of the following characteristics—

- *the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;*
- *the property is managed as a whole by or on behalf of the operator of the scheme.*

If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

The Treasury may by order provide that arrangements do not amount to a collective investment scheme—

- *in specified circumstances; or*
- *if the arrangements fall within a specified category of arrangement."*

This research aims to identify a common definition of a CIS independently of the location of the scheme or that of the investor. Having naturally selected the largest CIS markets to create a sensible view of its definition, we now extract the basic concepts from the above UK definition as an example of EU-level implementation. This paper will then compare it to the definitions in the United States and Hong Kong.

In Hudson, there is a methodical explanation of the elements fundamental to the UK definition.[22] This scheme identifies key elements introduced under English law that are in fact representative of the notions used in all other European jurisdictions, and those relate closely and are the underlying conditions to the implementation found in the FCA's specialist rulebooks such as COLL Collective Investment Schemes sourcebook or FUND Investment Funds sourcebook.[23] Hudson's schematic view summarizes and evidences the format of a CIS definition, distinguishing between elements and qualifications. These characteristics essentially reference the contractual features of a CIS. The first element identified is the specific legal right borne by the

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[22] Alastair Hudson, *The law of finance* (1st edn, Sweet & Maxwell 2009).
[23] In particular for the Financial Conduct Authority 'Specialist Rulebook' on Collective Investment Schemes (replaced CIS) and Investment Funds sourcebooks.

person taking part in the arrangement of participating in its profits. This is bound to the second element: the necessity of the acquired property, belonging to the CIS, to produce some form of income or profit. Thirdly, there should be persons who can participate in the scheme and, fourthly, the profit has to be generated by the management of the property.

The qualifications on the other hand focus more on the agreements embedded by the CIS with certain external parties. An absolute contractual arrangement is that of the CIS being managed externally on a continuous basis. The CIS is therefore characterized by having a day-to-day external manager, making the parties fundamentally fiduciaries to the entity to whom the administration of the scheme is delegated and/or by a full delegation of the management of the scheme's property, intended as a whole, to an operator. Likewise, all economic activities are to be pooled, stressing that fundamental characteristic discerning a CIS from other contractual forms of investment. In this way, contribution, activities and income must all be pooled.

In Hong Kong SAR

The Hong Kong legislative heritage is evident in defining a collective investment scheme. A modern application of the type of structure envisaged under English law, the very relevant financial services framework, is provided in Chapter 571 of the Laws of Hong Kong, better known as the Securities and Futures Ordinance.[24] The SFO addresses the definition of a CIS in Part I of Schedule 1 to the Ordinance, which was enacted on 1 April 2003.

This definition is in line with that provided in 1974 by the Securities Ordinance and the Protection of Investors Ordinance, and effectively includes "unit trust", "mutual fund corporation" and "investment arrangements". The Hong Kong Financial Secretary has the power to widen or limit the scope of the term from time to time by notice. This mechanism, as described above, it is not unusual.[25] The Securities and Futures Commission, the entity established under the SFO, regulates CISs as well as other financial instruments.

The various elements and qualifications of the Hudson scheme are found in the Hong Kong definition as well. The text used for delineating a collective investment scheme under the Hong Kong legislative framework simply reverses the UK order of characteristics, but substantially addresses the same points. It starts by entailing the economic activities (as with Hudson's qualifications), describing initially how the arrangement in respect of any property acquired, in which persons participate, is not

[24] Olivia S Lee, 'Hong Kong's Securities and Futures Ordinance launches a new era for the securities and futures Market' (May 2003) World Securities Law Report Volume 9 Number 5.
[25] The SFC points so even say that in FAQ.

to be controlled day-to-day by these persons.[26] It continues by specifying that both income and contributions to the CIS have to be pooled. The highlighted UK elements follow, albeit in a different format. The purpose is again the capacity to enable participating persons to acquire right, interest or any benefit in the property, which is the first element in Hudson's scheme.

The second and third elements are found within the statements that any form of return is due to the scheme. Moreover, two different scenarios are specified either: the management of the property that generates the income; or any form of payment – partial or in full of any part of the property – that produces a monetary due to the CIS.[27] The resemblance with the UK makes it possible for this research to consider the HK legislation as fulfilling all the requirements under the scheme, and thus creating a generic transnational definition of a CIS.

In the United States of America

The most evident characteristic of the Investment Company Act of 1940 ("ICA") when compared to other jurisdictions is its complexity. The nature of the ICA and its historical perspective makes it a unique case. Its content is structured so as to address a variety of issues at the core of this research arising from the interrelations between the parties involved with the CIS. In its typical detailed fashion, the United States Code ("USC") Section § 80b-1 through § 80b-21 builds up the definitions it entails for this type of financial instrument progressively.

The USC 15 Section 3(a)(1)(A) speaks of *"an 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"*.[28] Interestingly, the terminology reveals the securities categorization nature of the definition. Timewise, the ICA is a companion to the Investment Advisory Act of 1940 ("IAA"), and a successor of the Securities Act of 1933. Whether or not this regulation was made as an exception to the latter,[29] the noun used in the very first sentence of the definition includes the securities issuance action.

However, the ICA resembles all other legislative frameworks in structuring its definition with a perimeter to the broad statement: all following sections are non-fitting scenarios that are excluded by default. The United States Congress, then, uses a straightforward definition of an investment company describing *de facto* a corporate entity, with several status options, in a matter that resembles more a corporation statutory recognition than a contractual scheme on its own. This is done

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[26] Securities and Futures Ordinance (E.R 2 of 2012) – Collective Investment Scheme (a - i).
[27] ibid (a – iii).
[28] Investment Company Act, 15 USC § 80a–3; the definition of securities is found in Section 2(a)(36) of the Investment Company Act (ICA).
[29] James D Cox, Robert W Hillman and Donald C Langevoort, *Securities regulation: cases and materials* (5th edn, Aspen Publishers 2006).

not without complication, such as the issue raised by Section 3(a)(1)(C) of the ICA, which specifies the investment company to be an entity that *"owns or proposes to acquire "investment securities" having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis"*. This objective, accounting-based test has created a number of issues over time.[30]

It appears that the definition of an investment company does not align with all the points in Hudson. The semantics are not irrelevant; a collective investment scheme does not necessarily appear to be an investment company on its own.[31] The British and Hong Kong legislators have more simply embraced the concept of a contractual scheme with certain required functions. The ICA instead speaks clearly of an "issuer… engaged primarily". Although this latter activity pre-eminently corresponds, it is only with the mutual fund (a specific type of investment company in the form of a management company with an open-ended structure) that there is substantial overlap.

With that statement, the US definition corresponds more to the European one of a UCITS[32] more so than to the UK FSMA text of an investment company. Furthermore, the mutual fund definition on the SEC website reads *"A mutual fund is a type of Investment Company that pools money from many investors and invests the money in stocks, bonds, money-market instruments, other securities, or even cash."*[33] This is one of the few notes on the SEC website[34] that provides the concept of pooling as a fundamental constituent. In other rules this is somehow inferred (for example, in Regulation D there is an exemption section for the private placement regime in use in the US).

The main rule describes the case where a qualified investor can be offered securities under specific restricted marketing conditions, but it is restricted to no more than 100

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[30] ibid.

[31] In 2012 the UK's Treasury created contractual schemes for collective investments in two different legal forms. The Financial Conduct Authority recognised in July 2013 that authorized contractual scheme, even if they allow for specific tax treatment of the underlying as if the investor had bought the asset independently, are CIS.

[32] Council Directive 2009/65/EC O of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/3; the text Art 2 (a) read "with the sole object of collective Investment in transferable securities or in other liquid financial asset referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading".

[33] Securities and Exchange Commission, 'Invest Wisely: An Introduction to Mutual Funds' <https://www.sec.gov/investor/pubs/inwsmf.htm> accessed 1 April 2014, the website specifies that "Investors purchase shares in the mutual fund from the fund itself, or through a broker for the fund, and cannot purchase the shares from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market. The price that investors pay for mutual fund shares is the fund's approximate net asset value (NAV) per share plus any fees that the fund may charge at purchase, such as sales charges, also known as sales loads. Mutual fund shares are "redeemable." This means that when mutual fund investors want to sell their fund shares, they sell them back to the fund, or to a broker acting for the fund, at their current NAV per share, minus any fees the fund may charge, such as deferred sales loads or redemption fees. The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC. In addition, mutual funds themselves are registered with the SEC and subject to SEC regulation."

[34] ibid "we have provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC Policy…".

investors. Albeit a simple quantitative threshold, it can be interpreted as the vast number of potential investors actually involved with the CIS market, and highlights the multiple legal dimensions of the "Investment Company".

The externality of the investors to the company is also implied. The incorporation with the main objective of investing points not to a group of investors, but to shareholders in nature, and indirectly to asset holders via a specific vehicle. Although perhaps not particularly interesting from a demarcation point of view, the ICA statement is of extreme relevance: approximately half of all mutual funds are registered in the United States. This number does not include the fund advisory services provided by US entities to CIS schemes domiciled elsewhere.

Not so similar judicial cases

The difficulties in comparing different jurisdictions are exacerbated by the regulatory structures in those Countries. For this research, the scope of which is centred on the investors and the regulations in their favour, we will be employing a different methodology when reviewing legislative cases. Given that the statutory goals of the three National Agencies discussed all embed the protection of investors and the preservation of market fairness, it is plausible to infer that their actions are driven by the same objective. If so, in determining the functioning of the regulations, we can use cases brought forward by those authorities and compare their results.

This methodology is not without sense: the Enforcement Department is the specialized legal team at a Regulator. Its mandate is usually that of verifying identified breaches and pursuing those cases that will be most representative of the market's faults. These teams, present in the three National Agencies, have taken cases deemed relevant for the determination of CIS schemes to court. Furthermore, such an approach puts the analytical lens on cases that deliberately pursue the protection of investors, and will naturally reference the regulatory system taken into consideration here.

The following analysis evidences the interpretative keystones as confirmed in American and British Courts. To date, no similar findings are found in Hong Kong judgments.

Evidence from US courts

The regulatory mechanism by which several financial vehicles are brought within the scope of the national CIS definition is applicable for the ICA as well as other legislation, but an analysis of the court cases evidences the differences in approach between the US and other jurisdictions.

An analysis of the SEC cases can be broadly divided into two distinct areas. One is a series of judicial cases related to the two main threshold tests for an investment

company, corresponding to what has been titled the "the definitional problem".[35] The ICA-specific sections trigger the inadvertent investment company status of institutions that were not meant to be caught by the ICA, in particular through the 40% investments quantitative threshold posed in section 3(a)(1)(C).[36] The mechanism is mitigated by various exemptions and in particular by the self-determination of being primarily engaged in non-investment businesses.

It was with an application to the SEC for registration as an investment company that this agency came to determine conditions for an ICA. With the criteria set by the SEC in 1947 in Tonopah Mining Co., which received six exemptions on the matter, any company becomes a scheme based on: 1) the company's historical developments; 2) its public representation of policy; 3) the activities of its officers and directors; 4) the nature of its present assets; and 5) the sources of its present income.[37]

However, far more emphasis is given to the assets and income generation points, leaving investors in doubt of whether they are investing in CISs or other corporations.

The second set of cases addresses the grey areas between the two Acts in the USC that define investment companies. The milestone case is, still in line with the methodology employed in this research, a 1946 case involving the NA: *SEC v Howey* ("*Howey*"). Essentially, with the offering of units of a citrus grove orchard and an optional management contract, the company was found to be effectively in line with article 2 of the Securities Act of 1933. In Murphy J's opinion:

"offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. ... Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprises."

While there is clear resemblance to the modern British definition of a CIS, in *Howey* there is no reference to the ICA *per se*. It is with *SEC v Variable Annuity Life Insurance Company of America* that the enforceability of the 1940 definition is given particular relevance. In this 1959 case the SEC took action against an insurer providing annuity contracts without registration under the ISA and without complying with the ICA. The judgment, complicated by a US legal framework with no specific federal regulation and a number of different state-levels ones, is of particular interest as it stresses further the dual investors' dilemma of capital accumulation and external management sought to be protected by regulators.

The controls of the NA as envisioned by ICA become *"of particular relevance to situations where the investor is committing his funds to the hands of others on an*

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[35] James D Cox, Robert W Hillman and Donald C Langevoort (n 29) 1084.
[36] Investment Company Act, 15 USC § 80a– 3 (a)(1)(A) and 3(a)(1)(C).
[37]Christopher P Healey, 'Updating the SEC's Exemptive Order Process under the Investment Company Act of 1940 to Fit the Modern Era.' (2010) 79 George Washington Law Review 1539.

equity basis, with the view of the funds invested in securities and his fortunes will depend on the success of the investment". With this statement the case provided evidence of the restriction of the applicability of the ICA; in evidencing further that *"the Federal Act's control becomes vital"*, the wording remains close to the securities investment type of framework. In this, we find great differences with other, more modern definitions of a CIS: ICA is solely used in the case of capital being pooled for the sake of securities investments.

Evidence from UK courts

In interpreting the definition in FSMA, the UK courts focus their attentions on the identification of contractual schemes that are CIS *de facto*. With a stronger emphasis on investor rights, few cases command the discipline post 2000. In line with this research methodology, we look at the most relevant FSA judicial cases.

The essential considerations are found in *The Financial Services Authority v Fradley* ("*Fradley"*), which applies previous jurisprudence from *The Russell-Cooke Trust Company v Elliot* ("*Russell-Cooke Trust Company*").[38] In the *Fradley* first instance judgment of 2004, the FSA specifically pursued the FSMA section 235 definition to include a betting scheme offering. This scheme had been operating in part by sending unsolicited mail packages to promote the service scheme. The contributions, pooled into one account and for a specific company, were then used to place bets on horses.

In the first instance, it was proposed that a specific agent place bets on subscribers' behalf; this later became compulsory, causing the structure of the operations of the business to resemble one defined as a CIS applying the jurisprudence of *Russell-Cooke Trust Company.* This touched upon all of the main interpretative elements introduced with the Financial Services Act of 1986 section 75, later maintained in its successor, the FSMA section 235. In identifying the activities of gaining assets collectively and lending them, Laddie J. stressed the necessity of an external day-to-day management.

The case confirmed further that specific, unique transactions do not create a CIS and that more than one investor is necessary. Neither is the nature of the assets restricted to any one form. In *Fradley*, the organizational structure becomes an operative CIS when it is coupled with the external day-to-day management created by the agent's betting service. Furthermore, it is found that the nature of the assets can be limited even to just the contributions of the investors, effectively broadening the arrangement's definition, a key to the interpretation of section 235(1). In the appeal, it was further stated that a scheme is a CIS, even if not all participants had transferred day-to-day control of the management of their money to the operators of the scheme,

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[38] Michael C Blair, George Alexander Walker and Robert L Purves, *Financial services law* (2nd edn, Oxford University Press 2009) 15.08.

so long as some participants had, then section 235(2) would be satisfied in respect to them.[39]

More recently, other characteristics have been marked as necessary in view of FSMA section 235. Such is the case in 2013 with *The Financial Services Authority v Asset L.I. Inc*., which highlights the sequential operational process of asset pooling, execution and sharing the profit raised, independently of the understanding of the investors. In this case, the representatives of a land-banking scheme represented their proposition as arrangements to acquire land plots and, following the conversion of such assets into plots suitable for residential building purposes, receive profits. The Court judgment[40] clearly indicated a sequential analysis of the characteristics found in FSMA section 235: no investors had day-to-day control of the property (section 235(2)); and the pooling of the assets occurred with the sole purpose of profiting (section 235(1)). The conduct of the business, including enhancing the property, determining prices and timing of the sale, was delegated in effect to the defendants, who operated the asset company and managed the process independently (section 235(3)). Distribution of proceeds to investors would have followed.

In *The Financial Services Authority v Asset L.I. Inc.*, we observe how all the core elements of the FSMA definition are present, leading the FSA to pursue the case exclusively on the basis of a CIS definition and stressing how the Court's interpretation is a progressive, sequential one. The UK Regulator also used the recognition of the norms in section 235(1) to pursue other petitions. Of interest is the 2012 case of *The Financial Services Authority v European Property Investments (UK) Ltd*, in which another bank-lending scheme effectively enabled investors to receive profits or income arising from the acquisition and subsequent disposal of assets.[41]

Once the constitution of a CIS was identified in accordance with section 235(1), the FSA recognized its jurisdiction to pursue the winding-up of the firm, given that such authorization is required to carry out regulated activities. Furthermore, the FCA appears to be pursuing further clarification on the scope of section 235 to protect investors. With 2014's *Financial Conduct Authority v Capital Alternatives Ltd*, the Court, as a preliminary issue, clarified the definition of CISs to entail the management of assets as a whole. Sublease contracts on a rice farm in Sierra Leone and land plots located in Australia, Sierra Leone and the Amazon forest, which were to be converted into tradable carbon credits, instead became offerings on assets to be managed externally. In the case of the rice farm, even with the Court's interpretation that the investment into the farm was considered holding of its entirety, the actual management could not be considered so. Furthermore, the plots' rights had been divided solely for the purpose of being excluded by section 235, and the proceeds

[39] *The Financial Services Authority v Fradley* [2004] EWHC 3008 (Ch), [2005] 1 B.C.L.C. 479.
[40] *The Financial Services Authority v Asset L.I. Inc* [2013] EWHC 178 (Ch), [2013] 2 B.C.L.C. 480.
[41] *The Financial Services Authority v European Property Investments (UK) Ltd* [2013] EWHC 4340 (Ch).

from the business were not divided amongst investors, thereby precluding the pooling status, as such the scheme was not considered to be a CIS.[42]

In contrast, for the Australian business, the management had always been as a whole, and so it was to be considered a CIS even with no pooling elements in it. This interpretation can now be considered definite as a final decision has emerged following protracted proceedings, an appeal and an eventual trial, which took place over 22 days and concluded in October 2017. In its decision, the Court found that the defendants had

> *"knowingly promoted, established, arranged or operated unlawful collective investment schemes, and knowingly or recklessly made false, misleading or deceptive statements, promises or forecasts for the purposes of inducing persons to invest or remain in the schemes."*

As a consequence, it made restitution orders under the FSMA section .382 for a total of £16.9 million.

The FCA Enforcement stated that the

> *"judgment should send a clear message to all of those who use corporate facades to sell dubious investments. We will do what it takes to hold them to account for their misconduct…Consumers should recognise that there are huge risks involved when investing with unauthorised businesses."*[43]

Mapping a global definition of CIS

This cross-country analysis reveals that CISs in different legislative environments share a few essential characteristics. In a CIS the investor is never one entity; plurality is a prerequisite in its formation. Notably, none of these definitions state the equality of the investors: this is left to the corporate rules of the vehicle holding the asset, and therefore does not limit the CIS to one legal form. However, the legal entity is just a vehicle limited to the investment activity. Another characteristic always present in the formation of a CIS is the co-investment by unrelated parties. Investors are not connected except by the common scope of investing into some sort of asset.

The UK and Hong Kong regulations imply an advisory function in the process. If the day-to-day management has to be external (although investors have the right to be consulted) this has to default to someone. And therefore, if the basic concept of a CIS is that of pooling assets together for the sake of investing, at a minimum some persons, but most often a specialized fiduciary, should be responsible for this. This logic is not

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[42] ibid.

[43] Financial Conduct Authority, 'FCA wins case against Capital Alternatives Limited and others' (Press Release 26 March 2017) <www.fca.org.uk/news/press-releases/fca-wins-case-against-capital-alternatives-limited-and-others> accessed 30 January 2019.

as evident in the US legislative definition. The statute of a company underlines the scope of the creation of the vehicle but does not infer externalities *per se*.

It appears that Hudson's scheme of elements and qualifications is broadly applicable to CISs across different jurisdictions. However, the definitions reveal certain statutory differences in the nature of the CIS that do not allow a significant overlap between the US and other legislative environments. These variations are reduced when comparing the US mutual funds to European UCITS and to Hong Kong trust models, all of which target the retail mass market.

The merit of deciding whether a scheme or a company qualifies as a CIS is of interest for investors only so long as the scheme respects the rules in place for such investments. The guarantee implied with its status is nonetheless used by regulators to pursue specific goals. And the nature of the approach to judicial cases differs from one jurisdiction to another. The UK cases cited here tend to have a more consumer protection approach. Pursuing the identification of a FSMA section 235 scheme, the UK competent authority implies a number of failings in providing certain insurances of a CIS. The US legislator, however, seems more concerned with the operations of a company, perhaps as the 1940 Act is, in effect, the result of studies conducted in 1938[44] aimed at identifying regulatory points to implement within the already existing investment scheme market. Indeed, through a basic cases analysis it appears that there is no precise overlap between the definition of a CIS in the UK or Hong Kong and the definition employed by the US ICA. Its statements are restrictive in the nature of the arrangements and/or the assets in place. However, similarities are observable when comparing the statutory US case of *Howey* with recent CIS judgments in the UK. A US based investment contract resembles the contractual business nature of a CIS as intended elsewhere, *de facto* introducing the Securities Act of 1933 as a necessary element of investor protection with regard to collective investments under the USC.

Background study in OECD countries

The OECD Financial Affairs Division analysis of CIS frameworks is considered the first good attempt to classify OECD Countries' CIS regulatory systems based on legal types. These categories are defined as corporate, trust and contractual forms. Implementing a methodology defined as a "functional approach", the OECD identified systems of governance that have strong and historical connections to geographical areas beyond that of their jurisdiction's legal or regulatory scope. This indicates that the legal nature of the relationships among CIS parties is intertwined with legal governance requirements.

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[44] See United States. Securities and Exchange Commission. [from old catalog], *Report on the study of investment trusts and investment companies* (1938).

These systems are identified as the US mutual fund, the continental European UCITS, the English common law trust and the Japan/Korea contractual system. Whilst the first is characterised by independent directors playing the key role in the protection of CIS investors, the others are somewhat inclined to follow the corporate model adopted in continental Europe which is concurrently influencing the evolution of trust structures in England and Ireland.

The continental European systems are characterized by the compulsory co-existence of certain specified parties in a CIS, which can be organised into a variety of different legal structures that the CIS can assume. However, in the most standardised framework, the EU regulatory frameworks place a common obligation on CISs to include an independent party, often referred to as the CIS depositary. Even if a CIS registration is a matter for the CIS operator – the entity approved for such function by the competent authorities – the CIS depositary is another independent party carrying out further regulated financial activities for the CIS. Its independence is a key attribute for assuming the responsibilities it is charged with, which are not limited to mere custody.[45] This research addresses in detail the nature of the CIS depositary's duties and how these are integral for the goal of CIS investor protection. It will be observed that the inevitable role of the depositary is that of guarantor of the CIS, and that the combination of all the individual duties of the various CIS parties form a structure not dissimilar to that of a fiduciary.

The OECD report is heavily focused on the role of a CIS entity acting as independent third party. This is similar to an analysis of CIS governance carried out later by IOSCO, which preceded the development of its guidance for IOSCO's members on this matter. However, it is worth indicating a discrepancy in terms of the scope of IOSCO's policy. This occurs when comparing IOSCO's core Principles with its CIS Governance standards. The scope of the Principles is broader in addressing securities markets regulation more generally. Their aim is to provide the indissoluble fundamentals to certain regulatory needs and explicit guidance on how to interpret those. The CIS Governance standards address the nature of the relationships of the various parties using the existing standards observable in various jurisdictions.

Whilst the OECD paper and that of IOSCO apply a similar methodology in their analysis, the latter addresses various entities considered stakeholders in CISs, including regulators. It is true that there are several "Independent Entities", which form part of the scheme observed in this research. Also, the IOSCO analysis focuses on the structures aimed at retail investors, similarly to this research. While its regulatory purpose is to provide a higher set of standards for the least knowledgeable investors, it indirectly implies adopting the more complex, and common, constructs of a CIS form, which naturally embeds more requirements and rules for the operators.

[45] John K Thompson and Sang-Mok Choi (n 169) 17.

The parties involved in a CIS

The definitions of a CIS have highlighted that there are at least two distinct parties in the creation of a CIS: the investors and the CIS operator, often referred to as the fund or investment manager. The latter's connection to the CIS is limited in scope. The fund manager's status can be likened to a stakeholder in a scheme or investment company on the one hand, and to a directorship or operational executive of a scheme on the other. This binding relationship is outlined in the investment management agreement, which is at the core of the creation of any CIS.

However, in practice there are different entities involved in the creation, management and decision making of a CIS. As with other types of companies, a fund will have several stakeholders, ranging from independent accountants to distributors. Some are required by applicable rules, depending on the nature of the scheme, and others exist for the operation of the scheme. For example, in the UK a depositary or custodian is required for a UCITS fund while the fund accounting, often delegated to specialized firms, is not a regulated activity requiring UK regulatory permission, but nonetheless is necessarily carried out on behalf of the CIS.

A generic scheme

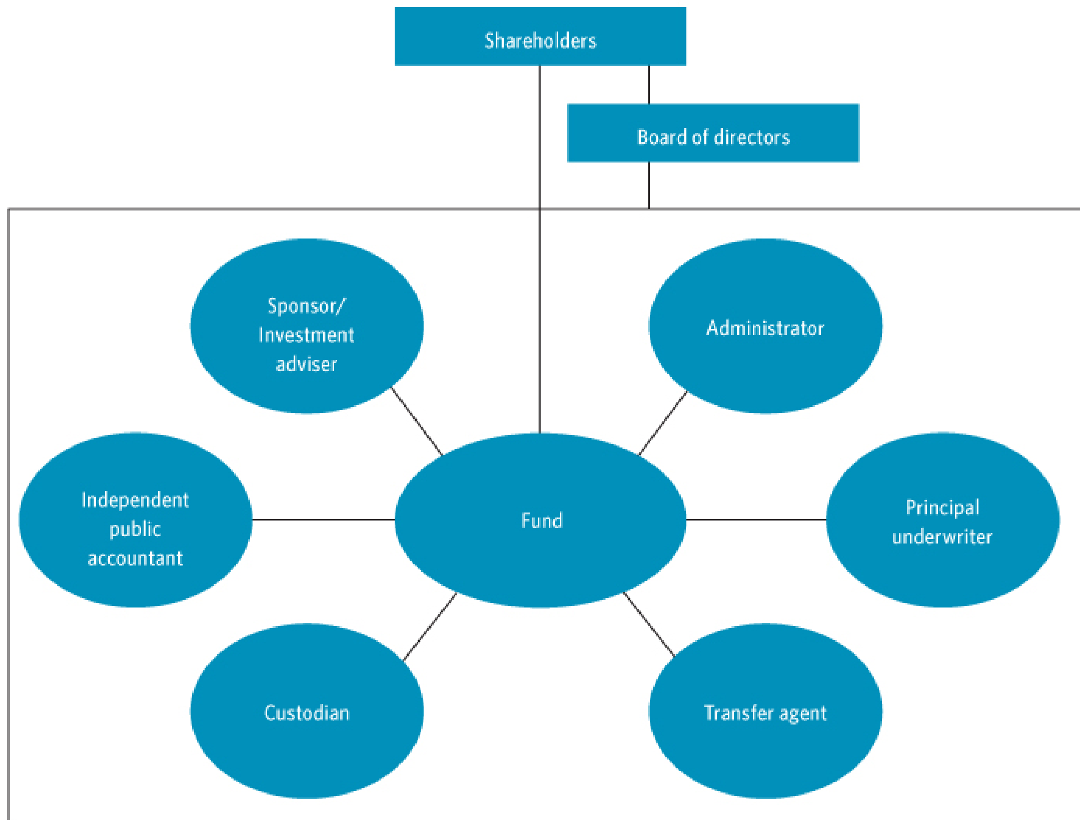
The Investment Company Institute ("ICI") is the US national association of investment companies, created at the time of the issuance of the ICA. With the creation of open and closed investment companies, the market participants created this national institute to represent them.[46] In 1943, the ICI started issuing the Investment Company Fact Book. This research publication updates the US fund market on economic, fiscal and regulatory trends. It is probably considered to be the most comprehensive national level analysis carried out on a yearly basis in the fund industry. The ICI provides an explanation to the reader of the origins of pooled investments in the US, and a basic explanation of its functioning. Given that the target audience is the average investor, it can be considered a good point of reference to identify how the industry explains the management of a collective investment scheme to investors.

The following figure is extracted from the ICI Fact Book. It sets out the various parties involved in the operation of a mutual fund. Importantly, a mutual fund is defined here as an open-ended managed company – the most common type of CIS in the US among retail investors. It is therefore both the most common scheme structure and the vehicle with the highest degree of protection among the types envisioned. Notably, one can conclude that the highest levels of protection for consumers of financial services correspond to a larger number of entities dealing with the product. This usually involves the allocation of several functions or duties to the parties involved. So, by

[46] ICI Research Staff (n 16). ICI Members are managing approximately $15.2.. ICI Members are managing approximately $15.2.

analysing this type of scheme we can in fact look at all possible scenarios of regulatory requirements, and infer to some extent what risks may arise from a CIS through their various obligations.

Figure 1: ICI Scheme for a Mutual Fund



Source: ICI Investment Company Fact Book 2018, Appendix A

Interesting points for further analysis can be drawn from this scheme. The CIS is, in this US case, comprised of the scheme and the board of directors. Also, this representation introduces the concept of the fund as an incorporated company. The investors are in fact indicated as shareholders and owners in the scheme.

The CIS operator here is the sponsor and investment adviser, stressing how the US regime focuses more on the regulatory function and market practice.[47] Interestingly, despite market practice the advisor/manager is not given a role of relative importance

[47] A number of duties associated with the operations of a CIS are found in the US Adviser Act of 1940. This is a different approach from the EU standards where the MiFID is very partially related to the CIS. However, in the context of this research, it has to be stressed that the UK interpretation of MiFID is similar to that of the US legislator, and the categorization of MiFID firms is often extended to non-EU fund operators.

among other parties. On the contrary, the central role in the scheme is depicted as the mutual fund.

Crucial to this investor research is the custodian and its role. The custodian function is here intended to be equivalent to that of the depositary in the EU legislative framework and the custodian/trustee under the Hong Kong rules. The custody of clients' funds is an activity usually reserved for banking activities. Although in principle is not specifically connected with fund management, it is essentially required of the industry dealing with CISs based on the existence of the fiduciary relationship. US legislation demands that an advisor appoint a custodian for funds,[48] and it includes a number of specific requirements that differ from custodians of other type of securities.[49]

Whether or not the USC definition reflects a generic bank duty, the function is the same as that envisioned by EU Law for the role of a depositary, albeit with a few differences. The Hong Kong SFC regulations also address the same function as the trustee/custodian, making a distinction similar to the UK COLL handbook, whose connotations depend on the nature of the legal status of the fund.[50]

The diagram introduces further entities that work closely with the CIS but are not part of its core. This industry is in fact a combination of different service providers, here clearly identified. There are regulatory drivers for the introduction of these entities as well as considerations of economic efficiency. In this scheme we identify the administrator, the public accountant and the transfer agent. These functions share the characteristic of being associated with the day-to-day management of the fund while not being related to the investment decision process, which is left solely to the advisor.

The administrator carries out the activities in respect of the acquisition of assets by the CIS. The term "back-office" is often used to describe these activities. The public accountant has an audit function in respect of the financial statements kept by the CIS to ensure it is valid and adheres to official standards. This is a similar requirement to that for publicly traded securities. The transfer agent effectively manages the book-keeping of the CIS, maintaining the various records necessary to identify the beneficial owners of the CIS and their rights. The entities in this diagram are found across many jurisdictions, and their relationships will be part of the enquiry of this research. The commercial activities are sometimes delegated to a principal underwriter. Although not present in all jurisdictions, the ICA defines its role as the principle subscriber of a fund and the sole intermediary actively dealing with its shares. Its rules tend to relate to the advisor and to the principal underwriter in many cases, particularly those related to the regulated activity of dealing.

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[48] Advisor Act 1940, 17 CFR Part 275.
[49] James D Cox, Robert W Hillman and Ronald C Langevoort (n 29) 1058.
[50] Financial Conduct Authority Handbook, FCA 2013/73 COLL 3.2.1.

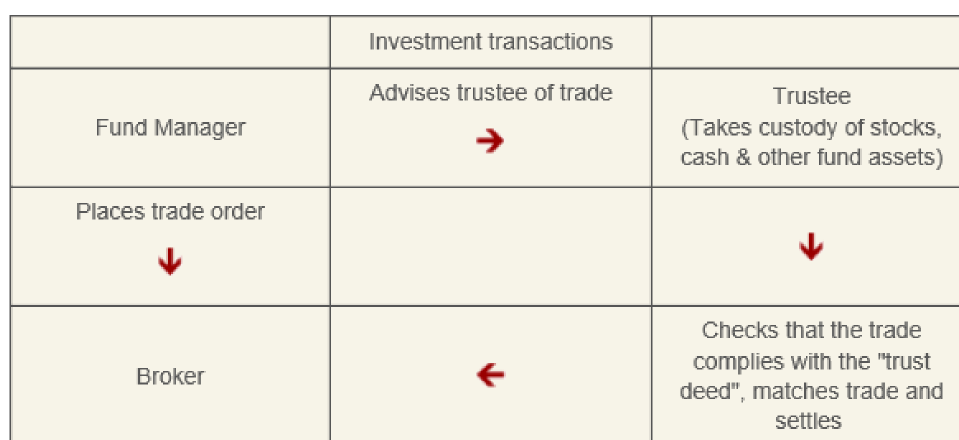
The operative angle

The previous description indicates that there are several entities that are interconnected with the CIS structure of a mutual fund in the United States. A generic analysis will find that among those stakeholders, the board of directors and the depositary/custodian functions are present in the legislative environments across most of the developed and developing fund markets. This is particularly evident for those regulatory environments adopting the IOSCO *Objectives and Principles of Securities Regulation* standards, a policy trend that covers the vast majority of the securities markets worldwide.[51] These standards will be discussed extensively later. At this stage, it is relevant to understand why these parties are in place, how they interact with each other and what their role is in connection with the shareholder/investor.

Effectively, the CIS investor appears to be the least active part in the structuring of a CIS, despite being central to the fiduciary relationship and, more importantly, the provider of investments. It is appropriate, therefore, to look at how these entities operate. A good explanation is provided by another professional trade body: the Hong Kong Investment Fund Association ("IFA").[52] This entity is similar to the Investment Management Association ("IMA") in the UK and the ICI in the US. In a similar way, its main duty is that of providing statistical information to the Industry as well as investor education tools.

Within the scope of providing basic knowledge of what a Hong Kong mutual fund is, the IFA illustrates what the typical transaction to invest a CIS asset looks like from an operational point of view.

Figure 2: Hong Kong IFA diagram for a CIS transaction



Source: Hong Kong IFA – Fund Investment 101

[51] The International Organization of Securities Commissions, 'General Information' <http://www.iosco.org/about/> accessed 1 April 2014; IOSCO's Members cover 95% of the world securities markets.

[52] HKIFA, 'Fund Investment 101' < https://www.hkifa.org.hk/eng/fund-investment-101.aspx > accessed 1 April 2017.

This diagram is somehow incomplete. What the IFA is illustrating is a two-step representation of the cash flows involved in the day-to-day management of a CIS. However, the first step is of course the reallocation of the personal assets of the investors to the CIS. It is also true that in practice the payment is made to the CIS operator, which has duties of care in respect of the segregation of client assets in both subscriptions and redemptions of the fund.

At first, the investors transfer their investment to the CIS operator but for the CIS's benefit. This is typically in monetary form, but other methods are possible. The CIS operator will then advise on the types of assets to acquire for and on behalf of the investors. This is implemented with two simultaneous actions. On the one side, the CIS operator places a trade order with the broker/dealer; on the other, it advises the trustee/custodian of the trade. It follows that the latter will then execute and settle on behalf of the CIS. Thus, the IFA clarifies with a note that the role of the trustee is that of "custody of the assets" in a scheme for the beneficiaries.

The interesting point for the CIS investors is the evidence presented by the flow from the beginning to the end of the process. Validating the generic legislative definitions previously explored, the procedure concludes with the acquisition of some specific asset for various unrelated individuals through an investment process managed by a CIS Operator external to the CIS. It does also imply not just a series of asset management steps, but also a number of existing relationships between different parties. These connections are essential for the functioning of a CIS as they are at the centre of the regulations created for the CIS, particularly those directly connected to the investors. Since the three entities effectively construct the core of the operational functioning of a CIS, national regulations focus extensively on characterizing their roles and duties, often trying to strike a balance between these and the regulators' needs.[53]

The CIS operator and investor relationship

The activities of providing financial advice and discretionary portfolio management are usually captured by securities laws and regulations across jurisdictions, ranging from the Investment Advisory Act of 1940 in the US to the Markets in Financial Instruments Directive ("MiFID") in Europe, with detailed requirements enforced at state level. However, a study conducted by the RAND Corporation in the United States found that many retail investors do not understand the differences between investment advisors and brokers/dealers or the services they offer.[54]

Similarly, a study commissioned by the European Union found that the "riskiness" of a UCITS fund was not properly understood by retail investors and the results of this

[53] Intended here as those requirements put in place with regulations aimed at delineating the duties of fiduciaries involved, and their reporting to the Authorities.
[54] Danny Busch and Deborah A DeMott, *Liability of asset managers* (1st edn, Oxford University Press 2012) 414.

led to the EU adoption of the Key Investor Information document ("KIID"). In both cases, the role that a CIS operator plays is mostly misunderstood. The regulatory distinctions by legal system widen notably on the matter of financial advice or investment advice. The interpretations found in academia tend to look at the judicial system, their distinctions between private and public law and the role of the investment advisor as agent.[55] This research instead takes an approach based on the point of view of the investor, which in this instance, perhaps surprisingly, seems to align more with the regulator's approach to market supervision.

The average investor would deal broadly with two distinct entities when making an investment decision. First, they consult with the person promoting the asset allocation best fitting the investor's self-defined needs. The investor then interacts with the entity managing the financial product that has discretion, within the constitutive documents, on the allocation of the capital and all other investments.[56] The activities run by these persons are fundamentally different: financial promotion is limited to a single piece of advice, a recommendation aimed at identifying the need of the investor at a specific point in time for a specific purpose. The advice is made to a specific investor and it can be followed or not. Once the investors have accepted the recommendation, a transaction involving a financial instrument will follow. If the chosen investment is a CIS, the management of the fund is fully delegated and run periodically, typically daily, and restricted to a specific mandate.

The difference is substantial: the risks associated with wrong advice can occur at the time the recommendation is made and, if wrong, it will have some negative impact later. The management of the CIS is, by contrast, a day-to-day activity. Its risks can arise at any point in time and the manager is continuously providing investment advice without consulting with the investors. Nevertheless, managers' activities are limited by the restrictions established under the investment management agreement. This distinction between "investment advice" and "portfolio management" becomes evident when comparing the US and EU definitions.[57] The EU approach described in MiFID defines the first as the:

"provision of a personal recommendation to a client…in respect of one or more transactions relating to financial instruments"

and the second as the act of:

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[55] ibid para 13.01.

[56] Financial Services Authority, 'Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection' (January 2011) <http://www.fsa.gov.uk/pubs/guidance/gc11_01.pdf> accessed 1 April 2014.

[57] Danny Busch and Deborah A DeMott (48) para 13.06; points to both definitions and their differences, but does not criticize them.

"managing portfolios in accordance with the mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments"[58].

The IAA does not define portfolio management. Retaining the advisory point of view, investors can rely on the identification of who should be considered an investment advisor. This is:

"any person who, for compensation, engages in the business of advising others … as to the value of securities or as to the advisability of investing in, purchasing, or selling securities".

Distinctions are also drafted by the Hong Kong SFO. The Ordinance cites activity-level peculiarities, drawing a distinction between advising on securities or futures or on corporate finance. However, it also adds the regulated activity of asset management, defined as either the management of a real estate scheme or of securities and futures contracts.[59]

The CIS and depositary-custodian relationship

A simplistic analysis of fund management operations would identify two distinct agents with specific responsibilities for the safety of the assets of the CIS. The regulatory reasoning behind this is associated with the necessary distinction between two independent parties to address the issue of asset safekeeping. In fact, a number of potential investor risks can arise should a CIS operator have sole, untested control of the clients' assets.

At a very basic level, this entity could fail to segregate and register properly the assets of the investors and its own. Any co-mingling would expose the client's assets to the CIS operator's creditors in the case of its insolvency. It would also facilitate any type of misrepresentation of the value of the invested assets, the type of investments made or wrong reporting on the level of risks taken with those investments. For these reasons and more, in many jurisdictions the appropriate regulation requires the identification of an authorized custodian/depositary, and the disclosure of this third party to the investors, for example, in the KIID for a UCITS.

However, the requirements differ from one country to another. Bush and De Mott observe that, in Europe, MiFID permits entities managing assets to hold financial instruments and funds belonging to clients if they make "adequate arrangements" to safeguard clients' assets and rights in the event of insolvency and to prevent the use of these assets on the firm's own account without the clients' express consent.[60]

[58] Ibid 13.06 referencing MiFID Title I Art. 4(1)(4) and Title I Art. 4(1)(9).
[59] Securities and Futures Ordinance (E.R 2 of 2012) – Asset Management (a - i).
[60] Busch and DeMott (48) para 13.06; points to both definitions and their differences, but does not criticize them.

Although this is true for generic portfolio mandates, it is not the case for the EU's standard CISs, UCITS and AIFs, currently marketed within the entire EU single market. Both schemes are required to identify to the regulator and investors a depositary for their fund, and its legal structure. Therefore, the requirements exist for all CISs considered freely marketable in the European single market.

In the United States, surprisingly, there is no clear reference in the ICA to a depositary. This is actually found in the IAA and its definition was specifically added as recently as 2003. Keeping in mind the IAA approach of identifying the carrying out of certain functions, an adviser has custody of client assets when it holds "*directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.*"[61] In such a case, an obligation is created for the investment adviser to retain the clients' accounts with a qualified custodian. This entity must have a specific legal nature, such as status as a bank. Qualified custodians will have to maintain the assets in accounts either in the name of the clients or in the name of the advisors in their capacity as an agent or trustee. Hong Kong also follows the above standards. The SFO states the necessity of appointing a trustee or a custodian when a CIS is established for a trust or a mutual fund respectively. It also specifies the type of company that can perform this duty: banks and financial services firms with specific arrangements can be deemed able by the SFC.

The role of safeguarding implied in these rules certainly aims at better protecting clients' assets. However, when looking at the details, the motivation is perhaps also a regulatory one. The custody duty aims essentially at the segregation of the assets from the CIS operator, but national regulators have the power to alter the duties of these entities, adding more risk verification processes, and creating differing statuses between a simple custodian and a depositary.

Mapping CIS in this research context

It is worth creating a summary of the CIS resulting from the analysis carried out earlier. Provided that CIS are open-ended collective schemes, the following table provides a summary of the relevant rules, typology and legal status of these investment vehicles. It is worth noting that in the USA there is no federal level prescription for legal forms, but it is often the case that investment companies are organised as corporations or business trusts (or, occasionally, limited partnerships) under state law.[62]

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[61] Securities and Exchange Commission, 'Custody of Funds or Securities of Clients by Investment Advisers - Definition of Custody' (Release No. IA-2176; File No. S7-28-02) <http://www.sec.gov/rules/final/ia-2176.htm#IIA>.

[62] K&L Gates, "Organizing a Mutual Fund" < http://www.klgates.com/files/Upload/DC_IM_03-Organizing_Mutual_Fund.pdf> accessed 25 October 2019.

	USA	UK	HK
CIS regulatory source	Investment Company Act 1940	EU Directives implementation via FCA Handbook (COLL/FUND)	SFC Handbook for Unit Trusts and Mutual Funds
CIS type	Mutual Fund	UCITS/AIFs	Mutual Fund, Investment Trust
CIS legal form	State level Law: Corporations, Business trusts, Limited Partnerships	Authorised Unit Trust, Authorised Contractual Scheme, Investment Company with Variable Income (OEIC)	Companies with variable capital, Unit Trust, “contractual model”

The investor of a Collective Investment Scheme

This research has so far focused on identifying what a CIS is and who the parties involved in its running are. We have asserted that, historically, the industry of fund management was born out of the social need of individuals to allocate their assets to fruitful investments. The legal aspect that follows is that of creating a structure to accomplish the task. A legally independent scheme pooling the asset of several individuals, the CIS, together with a clear investment mandate, is the vehicle to achieve each investor’s goal. The manager is then an executor of the investment goal who has the knowledge and skills expected of a trusted agent.

It is for this reason that the investor has to be identified and recorded as such in the CIS investment process. This step can be analysed from two different perspectives: the legal framework that identifies the person or company for its legal persona, and the willingness of the investor to be categorised differently, for the sake of investing in something not naturally constructed around his or her financial knowledge and status.

Distinguishing funds through the investor’s investment objective

If the definition of a CIS looks at the status of the two main parties – CIS investors and CIS operators – it is the case that national financial services rules point at those definitions exclusively for the identification of contracts that require regulatory status

as collective investment schemes. When this occurs, the national legal frameworks identify the CIS with standardized investment financial products. Unit trusts, mutual funds and units of collective investment undertakings are predefined types of CIS with specific arrangements and requirements as envisioned by those national laws.

Such distinction is not limited to the identification of special contractual statuses of CIS. It also follows the logic of regulators to identify the investment objective of the investor in the scheme and provide appropriate levels of protection. The scope of protection varied accordingly: applicable rules tend to be stricter with retail investors and less prescriptive to accommodate the speculative intent of asset allocation by professional investors. Moreover, extra rules are set in place should the CIS objective be to contribute to the disposable income of an individual upon retirement. For example, as explained in the following chapter, the parties involved in the management of a scheme identified as holding retirement asset are potentially subject to extra fiduciary standards.

In any case, any of these impositions create an extra layer of investor protection that is additional to that of the CIS rulebooks analysed in this study. For example, in the US the rules applicable to the so-called 401-K account are in addition to that of the mutual fund, which represent 63% of the underlying assets of these retirement-based financial schemes.[63]

Furthermore, these standards are also not generally created by securities regulators but they are policy attributable to Labour and Occupational Pension agencies; the Employee Retirement Income Security Act of 1974 ("ERISA") was issued by the Department of Labour while in Europe the upcoming rules on standardised Pan-European Personal Pension Products are under the standards and scrutiny of the European Insurance and Occupational Pensions Authority.[64]

The authorities' practice of regulating in accordance with the objectives of the investors becomes evident when reviewing the requirements of those regulatory standards. The epitome is that applied by countries within the European Union; hence in the UK by statute. Under EU law, the Undertakings for Collective Investments in Transferable Securities, the Alternative Investment Funds and the Package Retail Investment Products ("PRIPs") are types of CIS that have been standardized so as to unify the investment scheme market across the EU single market. By statute only these types of securities are eligible for marketability within the EU boundaries, effectively creating a standard that is recognised inside and outside of the European Union.

In fact, the UCITS model has been adopted elsewhere and even openly referred to by other national frameworks. The first standard was created in 1985[65] by the members

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[63] Investment Company Institute, 'The US Retirement Market' dataset table 7 <https://www.ici.org/info/ret_19_q2_data.xls. > accessed 01 Nov 2019.

[64] ECMI Commentary, Karel Lannoo, "At last, a Pan-European Pension Product!" No. 45 / 4 August 2017.

[65] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [1985] ojL 375/3.

of the EEA with the fundamental aim to harmonise and enhance investors' protection among the EEA Members.[66] However, it did not achieve the EU's objective of a single market for financial services in Europe and the reality contradicted the expectations.[67] After UCITS II was abandoned, in 2001 the adoption of its third version consisted of two distinctive EU Directives covering rules for a CIS management company and for the standardisation of the CIS, the so-called product directive. It is here that the concept of passporting of a CIS was first developed together with the standardisation of key information of public documentation. In 2009 UCITS IV furthered the standards for notification procedures, master-feeder structure, key investor information, fund mergers and management company passport within the EU. Lastly, in 2014, the fifth revision of the UCITS Directive reformed rules so as to improve and standardise the level of protection enjoyed by UCITS investors through Europe and beyond its borders.

The UK implementation of the EU directives and their requirements are embedded in the FCA Handbook, which points to both rules and standards. The FCA stresses that Unauthorised CISs ("UCIS") are also commonly sold in the UK but are neither authorised nor registered. The FCA's rules relate only to the promotion of these schemes, rather than the schemes themselves.[68] Given that the latter fall outside the scope of this research, they will not be taken into consideration.

The regulatory standards of the UK, the US and Hong Kong cover various requirements regarding the duties of CIS operators. As with other forms of securities, several prescriptive steps are required for a CIS to be lawfully incorporated as such. These procedures occur when the CIS is initially formed, implying that a financial scheme that has the characteristics of a CIS needs to comply with national rules and so with one of the set standards. Most of these mandatory arrangements are embedded in the local regulator's regulations or rulebooks governing the registration of CIS and they are subject to compulsory actions, which are enforced.

Investors from the regulator's perspective

In defining a CIS, we have also stressed that legal statuses granted to, and parties involved in, the subscription of a CIS are in general similar in the various countries. This is true to the extent that investors can think of the CIS model as fundamentally similar across legislative environments. Similarly, the definition of an investor is analogous when comparing different Securities Laws regimes. Regulations tend to

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[66] G. McCormack, 'OEICs and trusts: the changing face of English investment law' (2000) 21 Co Law2-13.
[67] Mohammed K. Alshaleel, 'Undertakings for the Collective Investment in Transferable Securities Directive V: Increased Protection for Investors.' Essex University Articles Repository < http://repository.essex.ac.uk/19658/1/Undertakings%20for%20the%20Collective%20Investment%20in%20Transferable%20Securities%20Directive%20V%20Increased%20Protection%20for%20Investors..pdf> accessed 25 October 2019.
[68] Financial Conduct Authority, 'Unregulated collective investment schemes' (SFDFS058 07/1, FSA Factsheet for Financial Advisors) <www.fca.org.uk/static/fca/documents/fsa-factsheet-ucis.pdf> accessed April 2015.

separate the investor market into two clearly different set of investors: retail and professional. Such a dichotomy is the result of lawmakers' needs to identify those requiring more or less protection.[69] In identifying the EU investor, Moloney evidences how the European legislation fails in producing a unique archetype. Instead, it provides a number of synonymous definitions across different EU directives and regulations, the results of which are descriptive but ultimately meaningless references to the retail investor, the small investor and the average investor.[70] Although no full description is given, there is at least an attempt to state what it is not. Annex II of MiFID clearly references who qualifies as a Private Investor, specifying the nature of the institutions considered to be so and detailing the threshold requirements for individuals opting into the regime. It then simply states that a retail investor is not a professional one. This type of distinction is also present in the Hong Kong SFO. The details have been issued with SFO Chapter 571D as a specification of the persons prescribed as professional investors.[71] This is a relevant detail: the SFC has put further emphasis on the protection of schemes targeting retail clients, which by law have to be approved by the SFC for public offer. This implies that the definition posed is at the level of the product rather than that of the investor. In the annual Fund Management Activities Survey, the SFC also makes a distinction between private and retail-approved schemes, among other types of vehicle. A different distinction is provided in the United States. According to the ICA, the investor is the shareholder of the scheme; however, it also avoids defining who the investor is. Still, in the Securities Act of 1933 we find a requirement to register securities offered to the public. Of this generic "public", some investors are exempt and Regulation D carves out a sub-group defined as "accredited investors". Different categories of investors fall within this group, such as insurance companies, small businesses, investment companies, business development companies and, more interestingly, wealthy individuals.[72] Furthermore, the SEC, in pursuing the power granted within the ICA,[73] introduces the concept of a "qualified investor": an individual who can freely invest in securities that, in general, can have a performance-based fee. The concept behind this is that sophisticated investors have the freedom to subscribe to securities with no particular limitations, such as a hedge funds, another form of CIS. So it appears that the USC tends to identify exceptions rather than investor protection standards. The classification previously described is perhaps not in line with the further regulations recently implemented. With the introduction of the Alternative Investment Fund Managers Directive the European legislator has intended to make the market for the non-UCITS collective investment schemes uniform. In doing so, it has also standardised the hedge fund market and enforced a number of requirements aimed at mitigating the risks to investors.

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[69] Niamh Moloney, *How to protect investors : lessons from the EC and the UK* (Cambridge University Press 2010).
[70] Ibid; in particular MiFID, Art. 4(1)(12), Prospectus Directive, recital 41 and UCITS Directive, Art 28(3).
[71] Securities and Futures Ordinance (E.R 2 of 2012) – Schedule 1 Part 1 s(1).
[72] Investment Company Act 1940, s205 (a)(1).
[73] ibid (e).

Counter-market definitions

A natural question following the definitions of CIS investors is how effectively these regulatory investor buckets correspond to the types of CIS the individuals will be invested in. We have so far verified that regulations enforce constraints on eligibility in terms of the type of CIS, based on the nature of the investors. This is a trend perhaps based on the continuing institutionalization of the financial markets[74] and of particular relevance under the European Commission regime, where the retail investor is becoming synonymous with the consumer of investment products and is being subsumed within the wider consumer policy agenda.[75]

The legal status of the investors might not coincide with the real nature of the CIS. The ideal way to identify this would be to map the definition of the allocations of certain type of fund asset classes to the unit holder. A householder might for example directly own a mutual fund while also being indirectly invested in a hedge fund via a pension scheme. Vice versa, some hedge funds replicate strategies in different scheme types where possible, isolating the investor asset class but providing essentially the same risks to both institutional and non-institutional investors. In the spirit of this research, we look at the trends observable in the CIS industry, given that there is no public data on the nature of the clients in investment schemes.

The fund industry is characterized by continuous evolution. The nature of a CIS, and its scope, allows the market to continuously evolve. For example, with the introduction of the exchange traded fund ("ETF"), a form of CIS that is traded on regulated exchanges, investors have discovered the benefits of national exchanges in the fund industry. Sustained by the online trading facilities used by retail investors, the switch from traditional mutual fund to ETF by both providers and investors is now to be considered dramatic and a major realignment of the CIS industry overall.[76]

Specific asset classes usually reserved for institutional investors are also now relevant for retail investors. Different asset exposures wrapped up in CISs are commonly used for allocation purposes. With the inclusion of the "hedge fund" style of investment, the regulatory framework has had to evolve over time to adjust to such a trend. The Private Placement regime in the US did not succeed in becoming a popular standard. On the other hand, the so-called UCITS III framework introduced some essential changes that allowed the expansion of the market for complex products in the EU framework. The new generation of NEWCITS, a common term for UCITS-compliant funds with exposures reflecting hedge fund strategies, indicates how the CIS has evolved in its underlying investment but retained the same basic scope: accessing a

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[74] James D Cox, Robert W Hillman and Donald C Langevoort (24) 1084.
[75] Niamh Moloney (56) 40.
[76] Valerie Small, 'Investors Moving Away From Mutual Funds and Towards ETFs' (*Business Wire*, 24 January 2011) <www.businesswire.com/news/home/20110124005847/en/Investors-Moving-Mutual-Funds-ETFs#.U0xPg8acMds> accessed 1 April 2014.

market, perhaps above risk expectations, for the sake of investing in something otherwise inaccessible.

The private equity industry is also moving towards gaining a more diversified client base. United States households hold over $19.5 trillion in retirement plans.[77] Two strong trends are observable in their investment patterns: the tendency to use target-date funds and traditional mutual funds. The investment in US mutual funds is usually perceived as an investment into generic economic indicators while the need to invest into a scheduled disinvestment vehicle is characterized by the progressive change in assets over time from equity to fixed income, theoretically insuring the retention of the asset value despite market unpredictability. Furthermore, a clear relationship exists between expectations associated with average returns and the average risk taken by those individuals owning mutual funds.[78]

The combination of the above has inspired the private equity market to start targeting investors across the various categorisations, expanding the offering of CIS by leveraging the long returns and closed-ended nature of the pension. If the above is a realistic trend, then there is not much congruence between the traditional mechanisms to limit the availability of certain CISs to specific investor subgroups, based on the nature of the clients. Within the traditional regulatory framework, this distinction can perhaps be seen in two dimensions: one is the internal structure of the CIS, the other is the actual underlying assets of the fund.

In the first case, the characterization is due to the level of requirements for monitoring of activities that, as previously stated, are constructed around the overlay of different agencies related to the investors. On the other hand, the second dimension regards the availability of the type of asset that the CIS can contractually own. The nature of this, embedded in the investment management agreement and generally speaking external to the financial vehicle, can be seen as the core risk of the investment, while the CIS scheme has in itself some organizational risks.

Regulatory effort to limit these risks for retail investors seems to have shifted over time when reviewing its evolution in these two dimensions. The EU directives for UCITS and AIFs are the most evident cases. The European legislator has allowed investors to take more risks with the expansion of the underlying and securities types allowable under UCITS, the EU standard of a fund freely marketable to all European retail investors.[79] However, it has also introduced more restrictions for the alternative

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[77] Ellen Kelleher, ‘Private equity houses target US pensions’ (*Financial Times*, 7 July 2013) <www.ft.com/intl/cms/s/0/4913a48a-de48-11e2-b990-00144feab7de.html#axzz2ytjHdMqA> accessed 1 April 2014.

[78] Daniel Schrass, Michael Bogdan, and Sarah Holden, ‘Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet’ (2012) ICI Research Perspective 18, no. 6 <www.ici.org/pdf/ per18-06.pdf> accessed 1 April 2014.

[79] Tommaso Derossi and others, *Newcits : investing in UCITS compliant hedge funds* (John Wiley & Sons 2010).

funds, which will require more stringent fiduciary duties around governance of the fund.

Similarly, in Hong Kong the SFC permits the listing and public distribution of real estate investment trusts (“REITs”), specialized real estate funds that own the assets directly, to retail investors. In conclusion, it appears that there are incongruences between the definition of the investor, the assets/strategies in which the investor wants to pursue, and the objectives of investor protection. Rules such as Regulation D, albeit created with the noble intention of investors’ protection, do not effectively create a system where the sophistication of the investor relates to the complexity of the CIS’s underlying assets. In an entertaining 2009 paper on Securities Law,[80] an unsophisticated heir to a large stake in a hotel business is contrasted with an anonymous student, a Harvard MBA, PhD in financial system analysis graduate, with a justifiably large student loan. Under such rules, the knowledge of the latter is not a sufficient condition to allow the student to invest in high risk, unregistered CISs. The unsophisticated heir, however, despite ignorance regarding the complexity of certain CISs, is. This indicates the need for more understanding of the effects of regulatory definitions of CIS investors.

Conclusions

Neither the nature of CIS nor its economic reasoning are complex. Nevertheless, the identification of a globally comprehensive definition by the investor is not a simple task. This research has analysed different jurisdictional definitions to observe that all investors in a CIS are essentially subscribers to an investment contract with a substantial day-to-day delegation to a third party. Another key concept is that of sharing the profit, a consequential characteristic of the pooling of the assets of the investors. In limiting the research scope to these two main characteristics, and those others determined by the Hudson scheme, the contractual pertinence of a CIS is identifiable in the US, UK/EU and Hong Kong seamlessly. This is the case when a specific category is identified, where this research’s definition of CIS overlaps with that of IOSCO’s, which makes it possible to provide the global investor with some degree of protection and judicial congruence when comparing regulatory frameworks.

The identification of at least two parties in a CIS evidences the contractual nature of the parties involved in these schemes. In a mutual fund, the most common and complex form of a CIS, and one available in developed financial systems, the investor has relationships with three distinct persons, creating a series of interconnected fiduciaries. As observed, such a characteristic is often publicized by industry bodies and, unsurprisingly, is something they are keen on explaining. In the upcoming chapters, the effectiveness of these costly relationships will be investigated further.

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[80] Wallis K Finger, ‘Unsophisticated Wealth: Reconsidering the SEC's “Accredited Investor” Definition Under the 1933 Act, 86’ (2009) Washington University Law Review 733 <http://digitalcommons.law.wustl.edu/lawreview/vol86/iss3/4> accessed 1 April 2014.

Finally, investors may identify their own status by regulatory standards. Provided that similarities are once more observed among those main legislative environments, the investor does not necessarily find congruence between the CIS types and his own mandate. Such a situation provides confusion about the nature of the underlying asset, the categories of investors and the structure of a CIS. This status provides some evidence that the existing regulatory requirements might not be in favour of the central party to the CIS: the investor.

Chapter two: Fiduciary duties and economic reasoning in the context of a Collective Investment Scheme

Fiduciary duties in investment management

Introduction

The analysis of the definition of a CIS discussed in the previous chapter provided its basic structure and constituents. Introducing the parties involved in the governance of a CIS shows how the combination of their existence as contracting entities and their specific relationships amounts to the circumstances for a CIS to be formed. The chapter also highlighted how the market operates in practice and the idea that the industry of CISs operates with a different layer of complexity. In particular, it stressed how fundamental aspects of the day-to-day management of the investors' fund, a *sine qua non* for the existence of a CIS, are often delegated or split among parties.

Further prescriptions are in place for the entities carrying out those activities deemed worthy of regulation by national authorities. For example, the CIS party responsible for the day-to-day activities is often identified as the CIS operator, or the investment manager, depending on the legislation. In either case, this party is required to be formally authorised by the local regulator in order to carry out the activity, often complemented by the activity of establishing, operating and winding up a CIS. For example, in the UK this CIS requirement is clearly indicated in the Regulated Activities Order.[81] In the US, the ICA requires a Registered Investment Adviser.

Fiduciary and contractual duties in this research context

It has been identified how the investors in a CIS are parties in a scheme that becomes increasingly complex in its contractual nature. The parties involved in the scheme are hardly limited to the dichotomy of investors, on one side, and the day-to-day asset managers, on the other, as envisioned in the highest statutory definition of a CIS. As demonstrated, there are several parties involved. The question of their duties, either regulatory or contractual, it is an integral part of this research.

In order to understand the relationships between the investors and the other parties, it is appropriate to discuss in some detail what type of relationship it is expected of them. For example, if only these two parties of the CIS scheme are taken into account, the dynamics between them are such that the day-to-day management of the assets is the main duty of the CIS operator. Therefore, there is a question of what type of

[81] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

responsibilities this entity is subject to in carrying out the task and how the CIS operator should behave when acting on behalf of the investors.

The standard of conduct preferred by investors for all CIS parties is that of a fiduciary. To the average investor, the term fiduciary is akin to an ethical relationship, in which one of the parties is entrusted with managing the other's property. In doing so, prudent conduct is expected. The concept is grounded in common law and is therefore very relevant within the context of this research. It is related to the basic legal principle of agency: an investment adviser, as agent, owes fiduciary duties to its client, as principal.[82] Extensive academic research has been carried out on the subject. And yet recent literature indicates that *"the dominant academic view is that the fiduciary relationship is indefinable"* while *"the dominant judicial view is that the existence of such a relationship is a precondition of fiduciary liability"*.[83] What is certain is that among those owing these duties, some are in fact financial fiduciaries. A typical *"example of a financial fiduciary is a trustee but can also be those responsible for people's savings, pensions, and bequeathable fortunes"*.[84]

Financial fiduciaries are therefore those of interest for this research, which focusses on understanding the relationships of those investors entrusting their welfare to others via a CIS. In the following review, when speaking of a fiduciary in relation to a CIS, this should be taken to mean a financial fiduciary.

Building a coherent framework for the analysis of fiduciary duties

In order to construct a scheme to understand when and how fiduciary duties apply in the context of a CIS, this research first analyses the key market of the UK. Once a coherent framework has been identified, it will be compared to those in the US and Hong Kong. This approach is in line with the methodology used in the previous chapter, and it supports the idea of a CIS model that transcends legislative boundaries.

It is important to stress that there is no such concept as fiduciary duty required in regulations that specifically address the CIS. The duty, if applicable, is based on the agency nature of the contractual requirements for a CIS operator or others to act on behalf of the investors. The scope of the analysis below is therefore to articulate, first, what a fiduciary duty might be in the context of CIS investment management and then to produce a standard to apply to a second analysis of the regulatory duties requested of the parties participating in the scheme.

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[82]Lorna A Schnase, 'An Investment Advisers' Fiduciary Duty' (Institute for Fiduciary Standards, 2010) <www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/lornaschnaseFiduciary-Duty-Paper.pdf> accessed 4 February 2019.

[83] Paul B Miller, 'The fiduciary relationship' in Andrew S Gold and Paul B Miller (eds), *Philosophical foundation of Fiduciary Law* (Oxford University Press 2015).

[84] Hanoch Dagan and Sharon Hannes, 'Managing Our Money' in Andrew S Gold and Paul B Miller (eds), *Philosophical foundation of Fiduciary Law* (Oxford University Press 2015).

Provided that a fiduciary standard is applicable, as the investor can intuitively understand, the secondary analysis would be relevant in the comparative law aspect of this research. Not all duties expected will be constant for all regulatory frameworks. The secondary analysis is thus required to evidence all of those duties in relation to the investors, or those in which the objective is that of safeguarding investors even if a direct fiduciary duty is not owed to them. It will be demonstrated that certain rules have this indirect effect, often as a result of a regulator's effort to protect investors.

This research will consider the different actors involved in the CIS. It is, however, worth noting at this stage that only those owing certain duties to the investors will be relevant: CIS managers/operators, CIS directors/trustees and CIS depositaries are the parties that will be examined closely. Those assigned secondary roles in this dynamic will be disregarded when not directly addressing a duty relevant for the investor.

The United Kingdom standards

Background information

With its rich history of trust law, and as leader in common law, courts in England and Wales have been dealing with the agency problem for a long time. It is with the particular case of the director as a trustee[85] that this influential concept has been developed, as in the earliest companies a director was a trustee in the full technical sense.[86]

Based on the UK definition of CIS, this research should focus on the case of the investment manager's duties only. However, the previously identified evidence suggests it is more appropriate to address the potential fiduciary duties owed by all the participants in the day-to-day management under the FSMA classification. In fact, the multiple fiduciary CIS structure is further complicated by those regulatory requirements found at the lower Lamfalussy levels of the implementation of EU directives.

In the UK regulatory system, it is common to find two other relationships which are requirements at a CIS entity level: the directors or trustee of the CIS, intended either as a legal entity or a person, and, in most cases, the depositary of the assets of the CIS. Provided that the agency relationships entered into by directors, in regards to the investor's financial interests, are here intended not just as a corporate duty, the case of CIS directors will be addressed in a manner consistent with the rest of this research.

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[85] Holger Fleischer, 'Legal transplants in European company law – The case of Fiduciary Duties' (2005) 2 European Company and Financial Law 378, 397.

[86] Ibid. On the same topic see L. S. Sealy, 'The Director as Trustee'. (1967) Volume 25 The Cambridge Law Journal, 83,103.

The topic of fiduciary duties in investment management has been subject to a stimulating public debate in the UK, with interested parties arguing the need for further financial services policies. These open considerations are the basis of two documents of significant relevance, the Kay Review of the UK Equity Markets and Long-Term Decision Making ("Kay Review"), published in July 2012, and the Law Commission's *Fiduciary Duties of Investment Intermediaries*, released for publication in June 2014 ("Commission Investigation"). In the context of this research I shall use the term "Commission Investigation" to refer to both the 2014 publication and the Consultation Paper[87] that preceded it, notwithstanding any relevant appropriate citation.

The timing is not coincidental but sequential. The Commission Investigation was created at the request of the UK's Department for Business, Innovation and Skills and the Department for Work and Pensions to the UK's Law Commission[88] to address a question posed by the Kay Review. The subject of interest for both Government agencies was the fiduciary duties for financial intermediaries included by the Kay Review as one of its proposed principles to be adopted in order to create a more efficient equity market.[89]

The aim of the Commission Investigation was therefore to examine how the law of fiduciary duties applied to investment intermediaries and to evaluate whether the law was working in the interests of the ultimate beneficiaries.[90] The appeal of the Kay Review is very much in line with the scope of this research. Professor Kay and his team explored the reasons that equity markets failed for investors. In doing so, they emphasised various aspects of the steps in the investment chain as well as stressed some very important points for this research, which focuses on one type of vehicle used for investment purposes.

While the Kay Report addressed the whole chain of UK equity investment, historically the recipient of UK investments for saving purposes, it also reported that *"asset managers – specialist investment intermediaries – have become the dominant players in the investment chain, as individual shareholding has declined and pension funds and insurers have responded to incentives to reduce their investments in equities."*[91] More importantly, the Kay Review complemented its assertion regarding the status of asset managers – in this research, the day-to-day operator of the CIS – with proposed principles and recommendations on how this type of intermediary should be regulated.

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[87] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com CP No 215, 2013).
[88] ibid 1.2.
[89] ibid paras 1.24.
[90] ibid paras 1.1.
[91] Department for Business, Innovation & Skills, *Kay review of UK equity markets and long-term decision making* (BIS/12/917) 6.

The Kay Review

Reviewing the content of the Kay Review from the investors' angle is a relatively easy task: the study was carried out to address the capacity of savers to benefit from the returns of UK companies through direct or indirect ownership of their shares.[92] On the other hand, the Commission Investigation took a narrower approach and focused on requirements around investment intermediaries' fiduciary duties, using pensions as an example. The selection of pension funds was based on the need to examine multiple questions raised by pension stakeholders[93] and those embedded in the Kay Review.

Many of the findings of the Kay Review are of interest for investors in CIS. Furthermore, pension funds are typically structured in a CIS or will most likely be invested in one or more, as explained in the Commission Investigation. Therefore, the focus here is on what is relevant in the Kay Review for this study, followed by an analysis of the Law Commission Investigation.

In this light, the relevant points of the Kay Review are Principle 5, addressing fiduciary standards at all levels in the equity chain,[94] and Recommendation 7, pertinent for those who exercise discretionary power over others' investments or who give investment advice.[95] Principle 5 makes the clear and far-reaching initial statement that all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers.[96] This grandiose statement is further supported by a strong suggestion that regulatory obligations in the equity investment chain should be raised to fiduciary standards.[97] The logical deduction is therefore that not all agencies' obligations are considered as such today while, in Professor Kay's view, all participants should be bound by fiduciary standards.

Furthermore, Principle 5 identifies the standards to be maintained at all times, such as the avoidance of conflicts of interest, putting clients' interests first and cost disclosure at all times. From an ethical point of view, it is added that the agent should never depart from the generally prevailing standards of professional behaviour. It ends by stating that contractual terms should not claim to override these standards. Whilst the first part of this principle broadly summarises the fiduciary duties, the last point on contractual freedom might sound surprising. This is not the case if referencing the long academic debate about a contractarian approach to fiduciary duties, a school of thought advocating the freedom to override those based on contractual disclosures.

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[92] ibid 9.
[93] Law Commission (n 80) paras 1.24.
[94] Department for Business, Innovation & Skills, (n 84) Principle 5.
[95] ibid Recommendation 7.
[96] Department for Business, Innovation & Skills, (n 84) para 9.1.
[97] ibid Principle 5.

Whether or not this approach, or that advocated by Professor Kay, are correct, it is worth noting the strong point made by the latter.

Recommendation 7 is meant to implement such a principle. It is addressed directly to the regulatory authorities of the EU and it speaks clearly of the need for regulation at domestic levels to apply *"fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions."* This statement is unsurprising and this research will analyse later how the EU regulatory bodies are somehow implementing these standards with complex constructs. Furthermore, Recommendation 7 states that *"[these] obligations should be independent of the classification of the client"*. This further reinforces further the idea, supported here, of examining the regulatory frameworks for CISs independently of the nature of the clients.

Interpretative scheme for CIS under the Law Commission Investigation

It is against the background of the Kay Review that the Law Commission was charged with investigating how the law of fiduciary duties applies to investment intermediaries and to evaluate whether the law works in the interests of the ultimate beneficiaries.[98] As with the Kay Review, the work of the Law Commission is also relevant for the CIS investor. In addressing the multifaceted aspects of fiduciary standards in the investment chain, the Commission is the most relevant research source regarding the types of duties to which a CIS investor can refer. The CIS is a collection of interconnected parties and activities. Each party is allocated several duties to be carried out. The quest to understand what those are and whether they qualify as fiduciary duties is the research method applied here. In order to do so it is best to first understand what duties can be assimilated to fiduciary duties. Furthermore, by way of statutory status, different types of relationships are established between CIS parties and only a few of them qualify as fiduciary ones. Therefore, a comprehensive framework to study the CIS specifically is one that compares the nature of duties in conjunction with the status of the relationship.

Duties of a fiduciary

What are fiduciary duties in the UK? The Law Commission has suggested that these "cannot be understood in isolation. Instead they are better viewed as "legal Polyfilla", moulding themselves flexibility around other legal structures, and sometimes plugging the gaps".[99] Whilst this hints at Professor Kay's accusation that regulators

[98] Law Commission (n 80) para 1.1.
[99] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) paras 3.1.

have been "watering down"[100] their effect, it is fair to state that there is no clear definition of fiduciary duties.

The Kay Review's argument is based on a statement made in the case of *Bristol and West Building Society v Mothew*, without a doubt the main judicial interpretation provided by the English Courts on the matter of defining fiduciary duties. The Kay Review extrapolates part of the case to indicate how *"case law identifies a fiduciary as 'someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'"*.

This statement is quite broad and can easily encompass several relationships resembling a typical agency one. It is therefore not surprising that the Commission Investigation stresses more restrictive interpretations. In particular, it notes that, according to the same *Bristol and West Building Society v Mothew* and a number of other cases, fiduciaries owe both fiduciary duties and non-fiduciary duties, and therefore not every breach of a duty by a fiduciary is necessarily a breach of fiduciary duties.[101] As will be observed later, this is the case for many of the duties of a fiduciary involved in the governance of a CIS.

The clear identification of these duties can be difficult. The Law Commission had been addressing various aspects of these when interpreting which duties qualify in a consultation paper dated 1992.[102] The Commission Investigation and other research activities built on judicial cases over the centuries to develop a comprehensive doctrine. In order to analyse them it is appropriate to first determine what duties are definitely considered fiduciary standards.

Duty of loyalty

Researchers in common law, independent of jurisdiction, all seem to agree on the status of the duty of loyalty as a certain fiduciary duty. A rare contrarian voice has been recently raised at McGill University by Professor Smith. In his view, loyalty should not be a concern for a fiduciary. He envisions that a fiduciary relationship is that of a fiduciary to fulfil his or her mandate only.[103] However, for the reasons spelled out below, this is not generally considered to be the case.

Indeed, UK courts have defined it as the irreducible core of fiduciary duty.[104] This is not surprising. The requirement of being loyal is implied in the fact that *"a fiduciary is someone who has undertaken to act for or on behalf of another in a particular*

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[100] Department for Business, Innovation & Skills (n 84) para 9.13.
[101] Law Commission (n 80) para 3.12.
[102] ibid para 2.4.6.
[103] See Stephen A Smith, 'The Deed Not the Motive: Fiduciary Law without Loyalty' in Andrew Gold and Paul Miller (eds), *Contract, Status and Fiduciary Law* (Oxford University Press 2016.).
[104] *Bristol and West Building Society v Mothew* [1996] EWCA Civ 533 (Bristol vs Mothew). Also see Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com CP No 215, 2013) paras 5.18.

matter in circumstances which give rise to a relationship of trust and confidences".[105] In more economical terms, the manifestation of disloyalty can perhaps be considered as acting in a manner that damages the interests of the principal. It is so determined that the duty of loyalty proscribes misappropriation and regulates conflicts of interest by requiring a fiduciary to act in the "best" or even "sole" interests of the principal.[106]

In 1992, the Law Commission had evidenced several characteristics of the duty of loyalty. In 2014, after the Kay Review and the *Bristol and West Building Society v Mothew* case of 1998, these have been simplified into two broad rules:[107] the "no conflict rule" and the "no profit rule". This is, in part, related to the judgement of Millet LJ, who stressed that the duty of loyalty is a liability with several facets. He specifically states a fiduciary must be acting in good faith, not making profits, not being in a position where duty and personal interest may conflict and not act for his own benefit without consent.[108] However, it is also clarified that these are not intended to be prescriptive, and should indicate the nature of fiduciary obligations.[109] This statement will be used extensively to interpret whether CIS parties owe fiduciary duties. What is proposed in this research hereafter is an interpretation of these duties using basic economic principles often mentioned in investment management literature.

The Commission Investigation provides further interpretation to the mentioned rules. Their interpretation becomes relevant when wanting to analyse the details of actions that may determine a breach of both types of rules. Thus it is the case that fiduciaries should not have conflicts of various kinds with their core duties. The conflicts can be of a dual nature: conflicts between the given duty and the personal interests of the fiduciary and conflicts between the duties owed by a fiduciary to distinct principals. In either case, the duty can be abrogated by a "proper authorisation".[110] A close review of cases by the Law Commission revealed that conflict of interest duties are strict in nature to the extent that, even in the case of beneficial outputs for the principal, a breach of duty can occur. A similarly strong approach is taken to the duty of avoiding potential conflicts: a breach occurs in the instant that the fiduciary has *"put himself in a position where his duty to one principle may conflict with his duty to the other"*.[111]

Similarly, a no profit rule is considered part of the fiduciary standard. Again, this is intended to mean the profits that can be generated by either the use of or by reason of the fiduciary status, even if no disadvantage to the principal is found or if the principal could have gained the profit by it. This rule is of particular relevance for the

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[105] ibid.
[106] Robert H Sitkoff, 'An Economic Theory of Fiduciary Law' (2014) Harvard John M Olin Discussion Paper No 769 <www.law.harvard.edu/programs/olin_center/papers/pdf/Sitkoff_769.pdf> accessed April 2015.
[107] Law Commission, (n 80) para 5.19. The "no conflict rule" and the "no profit rule" were pared with the "undivided loyalty rule" and "duty of confidentiality". These last two are not mentioned in the final report.
[108] *Bristol vs Mothew* (n 97).
[109] ibid.
[110] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) paras 3.29.
[111] Law Commission (n 80) para 3.33. See also *Bristol vs Mothew* (n 97).

investment management industry as the interlinked structure of CIS participants and the profit generation mechanism often provides room for extra profits, for example in the securities lending market.

Duty of care (for UK pension trustees)

The duty of care is the second leg of the fiduciary standards and is undoubtedly one that can easily be identified in financial services, particularly when provisions of safekeeping and management of assets are involved. In this research, the duty of care will be addressed in detail, especially when defining what degree of care is due to the CIS and the nature of due diligence required. It is worth clarifying that the duty of care as intended in the Committee Investigation is often referred to as the "duty of prudence" in the more traditional academic literature.

The Law Commission's consultation paper discusses the nature of the duty of care under different types of laws, with a focus on tort, contract and trust law. In the final draft of the Commission Investigation, only the trustee's duty of care is mentioned, together with a number of references to the Trustee Act 2000 and to investment duties. It is proposed here to also use the Law Commission's analysis of the Trustee as a standard for interpreting those duties which are particular to the CIS. There are two essential arguments favouring this approach. First, a CIS that is lawfully registered with the UK regulators can be a specific form of trustee even in the most articulated structure of a UCITS fund. Second, the duties of a trust resemble those attributable to one or more of the CIS parties, particularly in reference to the investment powers and duties.

The Commission Investigation defines the trustee's duties, referencing the Trustee Act 2000 description. It also clarifies that courts have been interpreting the duty of care not with the traditional prudence characteristics but increasingly with a "reasonableness" standard of conduct.[112] The statutory interpretation of the Trustee Act 2000, which focuses on the trustee as a fiduciary carrying out duties with skill and care, makes clear how these duties can be excluded or restricted with appropriate clauses. Therefore, in the context of the Commission Investigation, which is related to the equity investment process aimed at building pension assets, it is assumed that trustees have the power to exercise discretion in investing. This is in line with the role of the day-to-day manager of a CIS, hence similar duties should be enforceable.

A fundamental activity carried out by trustees which can find an equivalent in the context of a CIS is that of discretionary investing. In particular, the allocation of assets is perhaps the core activity and one that requires the use of the trustee's skills in a

[112] Ibid para 3.72.

prudent way. While a detailed analysis of both the fiduciary and economic aspects will be proposed later, we can state a few core features here.

The UK's body of case law has come to identify fundamental steps in the asset allocation process with a certain degree of precision.[113] Starting with vital cases in 1883, it has progressively corrected expectations placed upon trustees based on modern economic concepts such as hazardous investments, risk mitigation techniques and portfolio diversification, all integral parts of modern portfolio theory. It has even clarified that, when investing assets, certain risks are naturally taken – as with almost all human affairs.[114] The allocation selection is therefore to be taken with a prudent degree of risk[115] but keeping in mind the wholeness of the portfolio constituted and its level of diversification.[116] Hindsight in the investment process must also be taken into consideration,[117] not so much as negligence but in the context of consequential occurrence of events, avoiding any retrospective interpretations.[118]

The duty of care might also imply further activities, such as seeking external advice, when specific skills are temporarily needed, notwithstanding the freedom of the trustee to take heed of the advice or not.[119] This is a potentially common situation for the governance of a CIS that, if clearly stated, invests in complex instruments requiring external advice. The Law Commission also references stewardship as a potential duty of care. It is worth noting here that the Kay Review concluded that this specific duty was so relevant in the investment intermediation process that it should be applied for all parties across its chain.

The United States standards

The special case of the USA

Fiduciary duties of investment advisers, including those of CISs, have been at the centre of political and public discussion in the USA, particularly in 2015 and 2017. Politicians, regulators and academics have been debating in the press and elsewhere the extension of certain fiduciary standards – already lawfully in place – to what is perhaps a unique case.

The USA has, in fact, a very specific example of a stated set of responsibilities for those employers providing retirement plans to their employees. It is so that the

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[113] The Law Commission and other leading textbook all refer to *Re Godfrey (1883) 23 Ch D 483 at 493, by Bacon VC. ; Re Whiteley (1886) 33 Ch D 347; Bartlett v Barclays Trust Co (No 1) [1980] Ch 515 at 531, by Brightman J; Nestle v National Westminster Bank plc [1993] 1 WLR 1260 at 1282. See also the standard investment criteria in section 4 of the Trustee Act 2000.*
[114] *Re Godfrey* (1883) 23 Ch D 483 at 493, by Bacon VC.
[115] *Bartlett v Barclays Trust Co (No 1)* [1980] Ch 515 at 531, by Brightman J.
[116] *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1247.
[117] Law Commission (n 80) paras 3.81.
[118] Nestle v National Westminster Bank plc [1992] EWCA Civ 12.
[119] Law Commission (n 80) paras 3.83.

Employee Retirement Income Security Act of 1974 (“ERISA”), a law promulgated in accordance with the will of the US Department of Labor (“DOL”), includes specific provisions for those who are to be considered fiduciaries and the responsibilities embedded therein. Among other provisions, these rules have provisions for causes of action by a plan’s participant.

The ERISA’s fiduciary standards, as envisioned by the DOL, are not exclusive: these are specifications for various parties to the pension schemes management, including the scheme adviser. However, an IAA registered advisor is already subject to standards assimilated to fiduciary duties as potentially interpreted under section 206. The interpretation in *Transamerica Mortgage Advisors v Lewis* leaves no doubt that the US Congress intended to impose enforceable fiduciary obligations.[120]

This is not to say that a party to the governance of a US-based scheme is not subject to fiduciary duties. This research addresses extensively both the duties for the CIS operator and for the CIS directors of a US mutual fund.[121] The unusual element is that the pension-related statute also covers the standards of an administrative nature for those entities involved in the management of a US private pension plan. Perhaps this is notable because the DOL is not a financial services regulator. In any case, ERISA’s definitions in section 3 introduce the DOL’s wish to enforce the given standards in two case scenarios.

The two ERISA definitions make a fiduciary of both the full investment management scenario with discretionary powers[122] and that of the plain advisory with no executive authorities.[123] Interestingly for this research, it clarifies how the investment company, the most common CIS type in the USA, is never to be considered a fiduciary.[124] Entities classifiable more generically as financial institutions also have an obligation to acknowledge in writing their fiduciary status in respect of the plan[125] to which they are parties.

ERISA’s requirement that fiduciary standards be enforced in investment management makes it an interesting case for this research. Pension beneficiaries are *de facto* investors, collectively postponing their financial needs to the future and entrusting an agent with their welfare. This makes such a relationship in this case very pertinent.

ERISA standards

As discussed above, the ERISA’s statutory requirement of fiduciary duties is a unique case. The fiduciary construct is divided into three main areas of the legislative text.

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[120] *Transamerica Mortgage Advisors v. Lewis,* 444 U.S. 11 (1979).
[121] See chapters 5 and 4 respectively.
[122] Employee Retirement Income Security Act of 1974 (ERISA), Section 3(38) point A and B.
[123] ERISA Section 3(21) point A.
[124] ERISA Section 3(21) point B.
[125] ERISA Section 3(38) point C.

These are found in different parts of this Act and broadly address who is to be considered a fiduciary, based on the activity they carry out on behalf of the plan; what standard is requested of the fiduciary identified; and what constitutes conflicts of interests for the fiduciaries.

ERISA directly addresses the identification of a fiduciary, stating that those entities rendering one or more investment management activities to a plan ought to be considered as such. More specifically, the two definitions cover the full spectrum of possibilities within the US legislative framework. It first clearly identifies those exercising discretion, or a similar form of control of the plan. The definition takes a closed interpretative approach as it lists the cases in which someone has authority or control on either the management or disposal of the assets of the plan as it exists.[126]

This is not intended for the regulated financial activity of portfolio management of a CIS. It is rather to be considered an investment fiduciary. The mere selection of a number of potential investments would be considered as part of this activity, without being considered an adviser under the IAA. A similar economic activity to discretionary investment management is that of investment advice. Even without exerting discretion, advisors rendering their services to a plan for a fee or compensation have to be considered as fiduciaries under ERISA. Again, this is not the case for an advisor, as intended by the IAA, where unique approach is taken on the matter of administrative functions.

Typically, these are delegated or even not considered to be financial activities under the regulatory obligations in the management of a CIS. On the other hand, ERISA makes a fiduciary of anyone who is part of the activities of running a pension plan if the entity has some form of discretionary authority or discretionary responsibility over it.[127] The interpretation also encompasses those who are eligible to access the plan or benefits on behalf of its subscriber. The employer sponsoring a plan certainly falls at least into the administrative category and is therefore considered a fiduciary.

ERISA makes a distinction between who is a generic fiduciary of a plan and the specific investment manager that has to be specifically considered one. There are three attributes defining this special fiduciary. Firstly, the entity needs to have the powers to manage, acquire or dispose of a plan's assets. It also has to be a registered investment adviser, either under the IAA or under State law. For example, a bank or an insurance company[128] can be an investment manager under ERISA. Thirdly, and more interestingly, the financial institution has to acknowledge in writing that it is a fiduciary in respect of the plan.[129] This approach is perhaps the only case in which an investment advisory firm is required to confirm such duties in writing.

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[126] ERISA Section 3(21) point A (i).
[127] ERISA Section 3(21) point A (iii).
[128] ERISA Section 3(38) point A,B (i-iv).
[129] ERISA Section 3(38) point C.

Standards of conduct

ERISA's interpretation of the type of personal conduct expected of a fiduciary is reported in two different sections. The first prescribes what fiduciary duties are, in the context of its duties, while the second lists a fiduciary's prohibited activities. The expectations regarding the fiduciary's standard of conduct are succinctly summarised in its title, which is the "prudent man standard of care". Other points in the section cover various case scenarios regarding the ownership of assets as well as controls exercised by the beneficiaries.

The fiduciary duties under ERISA are a clear construct of the traditional standards in common law complemented by some specifications typical of the legislative trend in the US to encode several scenarios. Firstly, it is stated that the fiduciary shall conduct his duties in respect of the plan in the interest of the participants and beneficiaries.[130] This requirement should be interpreted as one of fidelity to the beneficiaries. Also, its semantics are of relevance, as the "sole interest" mentioned is intended here as exclusivity. Both characteristics indicate that the first paragraph is in fact the duty of loyalty. Interestingly, all other points are a subset of this duty. The structure chosen, which ends with the wording "solely in the interest of the participants and beneficiaries", suggests that ERISA interprets the duty of loyalty as an overarching one.

ERISA's version of the duty of prudence (duty of care) follows from this. The definition touches upon the various concepts raised under UK case law. It refers to the conduct of an enterprise by a prudent man using "care, skill, prudence and diligence" in his actions.[131] Moreover, two other main characteristics are provided as requisites of the fiduciary. His deeds have to be "in a like capacity and familiar with such matters".[132] However, these are somehow confined to his capacity to conduct "an enterprise of a like character and with like aims", hence limiting his duties. An easy parallel can be drawn between such a statement and the obligation to exercise care and skills previously discussed. Interestingly, an answer to the hindsight question is provided by stating that the expectation placed on the fiduciary is of discharging his duties under the circumstances then prevailing.[133]

ERISA lists further duties for its fiduciaries. Again, it appears that concepts previously discussed apply in the US case as well. The first is a requirement in relation to the diversification of the investments. ERISA's provisions draw from modern portfolio theory literature and require the investments to be diversified "so to minimize the risk of large losses".[134] Further, an obligation to act "in accordance with the documents

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[130] ERISA Section 404 (a)(1).
[131] ERISA Section 404(a)(1)(B).
[132] ibid.
[133] ibid.
[134] ERISA Section 404(a)(1)(C).

and instruments governing the plan" exists, as long as this does not clash with further ERISA provisions.[135] More points are raised within the text of section 4. However, for the scope of this analysis, these are not of interest and they will not be addressed further, given their aim of regulating specific administrative case scenarios and similar obligations.

ERISA's guidance on governance is complemented by its listing of a number of plan transactions that are prohibited or subject to some restrictions. Conceptually, these ERISA provisions are trying to avoid any type of conflict of interest between the plan and the parties related to it. Among these, the fiduciary is not to deal with assets of the plan in his own interest or on his own account[136] and may not act in any transaction involving the plan in which the fiduciary may represent a third party's interests adverse to the interests of the plan or its beneficiaries.[137] Furthermore, the fiduciary may not receive any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets.[138]

US securities regulation in comparison to ERISA standards

In the context of the offering of financial services in the US, the ERISA covers an important set of rules and requirements for any investor. Furthermore, the pension planning nature of this Act allows for a more appropriate comparison between the UK standards discussed by the Law Committee, as its investigation also addresses the fiduciary standards of pension trustees. However, within the scope of this research, the topic of the relationship between the CIS and its fiduciary is the relevant one. Hence, the fiduciary of a US-based CIS, as defined by the IAA, would be an advisor.

US securities regulation standards are less prescriptive about the fiduciary duties than those of ERISA. The IAA reflects the congressional recognition "of the delicate fiduciary nature of an investment advisory relationship" and the will to expose conflicts of interest which might incline a CIS operator to render advice which was not disinterested.[139] However, these are not conclusively expressed in the IAA. The fiduciary duties are imposed on an adviser by operation of law because of the nature of the relationship between the two parties.[140] It follows that IAA section 206 listed those aspects of anti-fraud transactions which could be implied by such relationship anyway.

Case law has clarified certain expectations of the IAA registered advisor on the matter of fiduciary standards. In fact, the original intent of the legislative bodies of the US was that *"of the delicate fiduciary nature of an investment adviser – consciously or*

[135] ERISA Section 404(a)(1)(D).
[136] ERISA Section 406(b)(1).
[137] ERISA Section 406(b)(2).
[138] ERISA Section 406(b)(3).
[139] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
[140] *See In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb 18, 1948).

unconsciously – to render advice which was not disinterested".[141] An advisor must therefore serve his client with undivided loyalty and must never put himself into a position where his own interests may come in conflict with those of his or her clients, unless the client gives informed consent to those dealings.[142]

Nevertheless, the IAA reflects the approach of the US rule-makers on the subject of disclosure policies in securities regulation, differing from ERISA on some fundamental aspects. One evident difference between securities regulations and ERISA is the treatment of conflicts of interest between the fiduciary and the plan. This is the case for conflicts of interest for related transactions between the investment manager fiduciary, as stated in ERISA section 3(38), and the investment advisor under section 206 of the IAA. In the first case, it can be observed that the regulatory approach is one of absolute avoidance of transactions that may link the plan to activities connected with the fiduciary. In fact, in such cases ERISA makes the presumption that the manager is not acting in good faith.[143] Whilst the IAA has a similar prohibition in its rules, the regulatory effect is that of avoiding deception of the advisee by the fiduciary[144] rather than indicating a prohibited behaviour upfront.

This is not to say that the IAA does not establish an unlawful status for the advisor employing schemes to defraud the CIS investor or engaging in operations having that effect. What is stressed here, rather, is that the regulator, in the case of transactions, allows for these to occur while requesting specific information be given to the CIS, even in the case of impracticality, extending this approach to accounts specifically created within that scope.[145]

Several SEC releases on IAA matters have confirmed such an interpretation. In the case involving Western Asset Management Company, a registered adviser under the IAA, the manager had allocated certain assets to an ERISA account that were not usually eligible for such investments. After inverting the transaction at a later stage, to avoid economic losses, the CIS adviser failed to advise the clients. Accepting the settlement, the SEC, independently of the client being an ERISA standard, reported that, in accordance with IAA Section 206(2), investment advisers have a fiduciary duty that requires them to act in the best interests of their clients and to make full and fair disclosure of all material facts.

More CIS-centric is the SEC's statement regarding various parties of the JP Morgan Group engaged in the management of certain schemes. The CIS investors were not informed of the parties' preference for investment in the Group's managed funds nor

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141 James D Cox, Robert W Hillman and Donald C Langevoort (n 29) 1084.

142 David C. Kaleda, 'What it Means to be an ERISA Fiduciary: A Comparison to the Securities Laws' (NSCP Currents May/June 2013) <http://www.groom.com/media/publication/1269_ERISA_Fiduciary_Comparison_to_Securities_Laws.pdf> accessed July 2015.

143 Tamar Frankel and Arthur Laby, *Regulation of Money Managers* (third edition, Wolters Kluwer) 12.02

144 Investment Advisers Act of 1940 (IAA) Section 206.

145 SEC Advisers Act Rule 206(3)-3T (Temporary Rule Regarding Principal Trades with Certain Advisory Clients) <https://www.sec.gov/info/smallbus/secg/206-3-3-t-secg.htm> accessed 15 February 2019.

were they advised of the favourable economic terms, proportional to the investments, for services provided to the CIS manager by a Group affiliate. The scheme would have benefited only proportionally and, evidently, this constructed a conflict of interest between the JP Morgan parties. The SEC found that the JP Morgan CIS adviser breached its fiduciary duty to the CIS clients by failing to adequately disclose conflicts of interest.[146] Again, the relevant rules were those under IAA section 206.

Another example is that of the compensation of the fiduciary providing advisory services. This case has direct comparisons with the CIS industry. Under ERISA, the fiduciary investment methodology of payment is mostly limited to its activity as the IAA adviser. The entity is barred from entering into a contractual agreement that provides for compensation on the basis of a share of capital gains or similar economic effect.[147] However, on non-pension plan activities, the SEC has, by virtue of the powers given in the IAA, the ability to exclude such requirement for its registered advisers. Indeed, this is the case, and is common practice, for qualified investors and for CISs that are invested in complex or high-risk assets.

It appears that the ERISA standards described above and subscribed to by advisers are very much in line with those expected of the fiduciary standards, whereas the IAA's standards are somewhat less stringent.

The Hong Kong approach

Regulatory background

Fiduciary standards are intrinsically embedded in common law systems. It is unsurprising then that such standards exist in Hong Kong as well. The SFO, the country's main financial law text, does not directly give a definition or concept but it mentions fiduciary matters in various contexts. For example, it is used as a standard for certain equitable interests in the ranking of applicable collateral rights under the rules for clearing houses.[148] Or in the case for determining when a corporation should be regarded as a subsidiary, establishing that shares or powers held in a fiduciary capacity do not count as such. It is at the level of the codes elaborated by the SFC that we can find some material with direct references to fiduciary duties. Interestingly, the most direct references are those in relation to the fiduciary standards applicable to the markets of CIS and the duties of investment managers.

Whilst the SFC's codes do not have the force of law, their scope is to supplement codes and guidelines with guidance in respect of the minimum standards of conduct:

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[146] Security and Exchange Commission, 'JP Morgan to Pay $267 Million for Disclosure Fails' (Press Release 2015-283, 2015).
[147] ibid.
[148] Securities and Futures Ordinance, Section 52 *Application of market collateral not affected by certain other interests, etc.*

their interpretation should not override the provisions of any law.[149] The SFC codes of interest to this research are three: the Fund Manager Code of Conduct, the Code on Unit Trusts and Mutual Funds ("UTMF") and the Code of Real Estate Investment Trusts ("REIT"). The first specifically addresses the conduct applicable to fund managers and therefore may include fiduciary duties.

As is the case elsewhere, these duties are not stated upfront. Instead, the Fund Manager Code of Conduct prescribes "due skill, care and diligence" in all key activities for a CIS operator, including its staff ethics. Whilst these will be discussed in a different chapter, the discussion of the fiduciary nature of the CIS operator in Hong Kong relates directly to the CIS regulations.

The rules mentioning the fiduciary standards are to be found in the UTMF and the REIT. Both sets of rules contain provisions in relation to the formation, management and conduct of CISs, regardless of the different nature of the underlying pooled assets. In effect, these two regulatory standards cover the vast majority of retail CISs in Hong Kong, who are the natural recipients of such standards. For CISs, the fiduciary standards are an integral part of the conduct required by the SFC. It is clearly stated in the SFC's general principles that the management company shall act in the best interests of the REIT's holders, to whom the management company owes a fiduciary duty.[150] This is an essential part of the generic requirement for principle six of the SFC, which requires good governance and the avoidance of conflicts of interest. This standard is further applied in the same regulation at the level of the trustee, as it is specified that under the general obligations of trustees, these have a fiduciary duty to hold the assets of a schemes for the benefit of the holders.[151] This requirement is expected of all REIT, independently of the applicable Code, given that trustees have to fulfil the duties imposed on them by the general law of trusts.[152]

The UTMF and the REIT have one common regulatory note embedded in the text related to fees. According to both Codes, certain CIS transaction fees may be inconsistent with the fiduciary standards of a management company if they are percentage-based payments for brokerage transactions.[153] This was added as a requirement following a public consultation undertaken by the SFC.[154] The aim of that 1994 consultation was to verify the understanding of the portfolio manager market of so-called "soft dollar" benefits. These were common payments received by investment managers from brokers employed to execute transactions. The result of this policy exercise, after having collected views from various interested parties, was

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[149] Securities and Futures Commission, Fund Manager Code of Conduct (2014), at 1.
[150] Securities and Futures Commission, Code of Real Estate Investment Trusts, GP6.
[151] ibid 4.1A.
[152] ibid 4.1A (Note).
[153] ibid 9.10 (Note) and Securities and Futures Commission, Code on Real Estate Investment Trusts, 4.1A and Code on Mutual Funds 6.16.
[154] The note is that originally mentioned in article 6.33 of Securities and Futures Commission, 'Cash Commission Rebates and 'Soft Dollar' Benefits Received by Managers from Brokers' (Dec 1994).

the bringing to light of a conduct contrary to the fiduciary standards expected of a portfolio manager.

The SFC's Cash Commissions Rebates and "Soft Dollars" Benefits Received by Portfolio Managers from Brokers consultation (SFC Cash Rebates Consultation) noted that *"It is generally recognised in Hong Kong and other common law jurisdictions that a portfolio manager owes fiduciary duties to his clients"*.[155] This matter-of-fact approach taken by the local industry has been also confirmed in another consultative statement by the Hong Kong Investments Funds Association.[156] The observations of the SFC Cash Rebate consultation provide background to the Hong Kong fiduciary standards for the CIS market. Effectively, the SFC expects these standards to be applicable for all persons providing investment management activities, particularly if they are CIS operators.

In the final version of the SFC Cash Rebates Consultation, the Hong Kong regulator justified further the introduction of this guidance note, providing its own interpretation of the meaning of fiduciary duties. It stated clearly that this particular relationship has to be intended as one in which *"a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice"*.[157]

The description left for current interpretation goes further as it provides a definition of the principle of fiduciary duty and a breakdown of the expected rules, four in total, with which a fiduciary must comply. First of all, it describes the fiduciary's obligation to avoid situations in which his personal interests conflict with those of the customer, which it defines as a no-conflict rule.[158] The absolute rule not to profit from fiduciary status at the detriment of a customer is indicated as the no-profit rule.[159] Both specifications are not dissimilar to the cases examined earlier.

However, the latter does not seem to clarify whether a contractual relationship can modify this requirement. The duty of "undivided loyalty" is stated using two logical paradigms. The fiduciary owes undivided loyalty to his customer and therefore must not place himself in a position where his duty to one customer conflicts with his duty to another; a consequence of this duty is that a fiduciary must make all the information that is relevant to the customer's affairs available to a customer.[160] Lastly, differently from other definitions analysed earlier, the SFC sets out a clear requirement of confidentiality and prohibits potential misuse of information obtained in confidence from one customer for the benefit of other persons.[161]

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[155] Ibid pt 18.
[156] Securities and Futures Commission, 'Consultation in increasing short position transparency' (Sept 2009).
[157] ibid pt 18.
[158] ibid pt 18.1.
[159] ibid pt 18.2.
[160] ibid pt 18.3.
[161] ibid pt 18.4.

Note on judicial findings

The judicial review of breaches of fiduciary duties specific to CIS structures is not present here. From the analysis above, it is fair to infer that the fiduciary duties of financial advice overlap with those pertinent to the CIS operator, who has more discretion implied in his mandate.

In *Susan Field v Barber Asia Limited*, the complainant sued Barber Asia Limited, a private financial advisory firm, claiming she had lost a significant amount of money owing to investment advice she received from her financial advisor and the advisor's responsible officer, Andrew Barber.[162] The judge found that Barber Asia Limited did not violate regulatory rules as written.

However, in failing to warn Ms Field of the particular risks involved in gearing her investment, in effect a strategy intuitively contrary to her stated conservative profile, Barber Asia Limited had breached its duty of care in the investment process.[163] On 17 June 2003, the Court of First Instance awarded Ms Field damages for Barber Asia Limited's negligence in the sum of £219,890.25 plus interest and costs. On 15 July 2004, Barber Asia Limited's appeal against the First Instance judgment was dismissed by the Court of Appeal.[164]

The economic activities of a CIS and its fiduciary duties

Fundamental economic concepts related to a CIS

The economic nature of a CIS is a fundamental aspect of this research. The CIS exists because of the need for various individuals to invest their wealth: investing is the business nature of the entity forming the CIS. In modern societies, the extra income is subject to a trade-off choice between consuming at present or in the future.[165] A CIS is a vehicle in support of the latter option. The economic need is that of finding an investment so as to retain or grow the value of current assets for future consumption. In this context, the knowledge gap in terms of how to allocate one's assets becomes the fundamental skill of the CIS operator, while at the same time creating a principal-agent relationship between the operator and the investor. Whilst there are plenty of economic theories regarding investors' behavioural patterns, these are not explored in this research. Instead, it is here proposed to use, while not

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[162] *Susan Field v Barber Asia Limited (HCA7119/2000).*

[163] Securities and Futures Commission, 'Court of Appeal Upholds SFAT Ruling regarding the SFC's Decision to Suspend Andrew Nicholas Barber for Mis-selling' (Press Release 13 Sept 2006) <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=06PR199> last accessed 9 February 2019..refNo=06PR199>.

[164] *Susan Field v Barber Asia Ltd [2004] 3 HKLRD 871 (CACV 194/2003).*

[165] See the basic theory of subjective expected utility elaborated by Herbert Simon in 1959 and more recent literature on behavioral economics such as: Olivia Mitchell and Stephen Utkus, 'Lessons from Behavioural Finance for Retirement Plan Design' (2003) Pension Research Council Working Paper; O'Connor 2002 and others)

expanding on, some of the most common ideas in economics and finance to understand whether or not the set of rules in place is commensurate, adequate and in favour of the CIS's investors.

The relationship created from the need described above is that of the agency, which is often at the centre of various theories of a Firm's management. It touches upon, among other notions, governance and concepts of company ownership. Economists tend to find a negative cognizance for this relationship and it is often indicated as the "agency problem". For academics in social sciences, the agency problem arises whenever one person, the principal, engages another person, the agent, to undertake imperfectly observable discretionary actions that affect the wealth of the principal.[166] By its design, in this interpretation the principal is the beneficiary or investor and the agent is the fiduciary. In the case of a CIS, the agent is the CIS operator.

The unobservable asset management action is the key economic element of this analytical approach and the element that links it to fiduciary law. The economic impact is on the output of the principal but it can also be reflected in that of the agent. Cooter and Friedman pose a very clear question to interpret the principal-agent model: *"How can one party be induced to do what is best for another without specifying exactly what is to be done?"* Posing limits on an agent interferes with his ability to deliver the expected outcome and, at times, affects the use of the skills he was hired for in the first place.

In the context of a CIS, the agency relationship is, broadly speaking, between the investor-beneficiary and the CIS operator-agent. The uncertainty regarding the output is usually mitigated by the contractual scope of the pooling of the asset, a necessary step for the creation of the CIS. If more parties are involved, this can have the effect of a combination of more than one agent. As a consequence, the agency relationships are formed between the CIS and the investors and the CIS and one or more managing parties. This is of the utmost importance when combining the duties of the various agents. CIS regulations tend to address those duties independently and, in most circumstances, attempt to monitor the agent actions via a combination of different fiduciary-like rules. Indeed, the regulatory structures of the CIS under the legislative frameworks taken into account here all imply a mitigation of the risks associated with the delegation of the management duties that is similar, if not equal, to those typical of fiduciary law.

CIS financial operational duties requiring fiduciary standards

Cooter and Freedman provide an interpretation of the agency issue using adaptations of economic models that fit the CIS relationships very well. Fundamentally, their view

[166] Robert H Sitkoff, 'An Economic Theory of Fiduciary Law' (2014) Harvard John M. Olin Discussion Paper No769 <http://www.law.harvard.edu/programs/olin_center/papers/pdf/Sitkoff_769.pdf> accessed April 2015.

is grounded on the identification of two important exposures faced by a principal-beneficiary. On the one hand, with regard to the risk of the fiduciary, the risk may take the form of misappropriating the principal's asset or some of its value.[167] On the other hand is the risk of mismanagement, indicated as the neglect of commensurate management activities of the asset by the fiduciary. The two core fiduciary duties find a direct relation to these risks. Misappropriation is governed by the duty of loyalty while mismanagement is governed by the duty of care.

The misappropriation risk is explained via an analysis of what the authors come to define as the principal's dilemma, which is a statement of the possibility of the principal behaving in a manner that is self-regarding or not other-regarding and the impossibility for a principal to observe all acts. The dilemma is linked to the availability of the outcomes only and to the doubts of the conductive steps taken to reach any economic results. To explain this, Cooter and Freedman use an Appropriation-Incentive model based on a three-branch binary behavioural system. In their renowned paper, a binomial tree structure is used to represent this explanation. This research attempts to use these economic interpretations of the fiduciary duties, applied to the CIS structure. In this section it will refer only to the type of risks identified. The same model will later be used to provide information on how a CIS governance is built so as to mitigate these risks, thanks to the duties of the fiduciaries of a CIS.

In the Appropriation-Incentive model, the first determining factor is the contractual relationship between the agent and the principal. This relationship does not need to be explicit and it follows that, if determined, the principal places some asset under the agent's control.[168] In the second branch, the valuation of the asset occurs after a "natural" choice. Its states of the world are indicated as good or bad depending on the profitability of the relationship and the yield associated with it. In the original example, displayed below, a unit of the asset is either doubled or halved. It follows that the next case scenario has four options. The probabilities at each of the two scenarios are those of either being loyal and delivering the asset at its real value or being dishonest and misappropriating the asset or part of it.

These statuses are indicated as "true" or "false" and the negative impact is represented as a loss of half a unit in each case. If seen in conjunction with the outcome of the valuation of the asset, there are four terminal values and there are three potential economic results. However, these statuses are all dependant on the fiduciary's conduct. So, in the case of the outcome of half a unit, the values are potentially the result of misappropriation.

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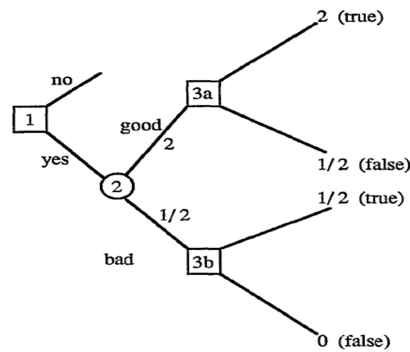
[167] Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: its economic character and legal consequences' (1973) 66 New York Law Review, 1049.
[168] ibid 1050.

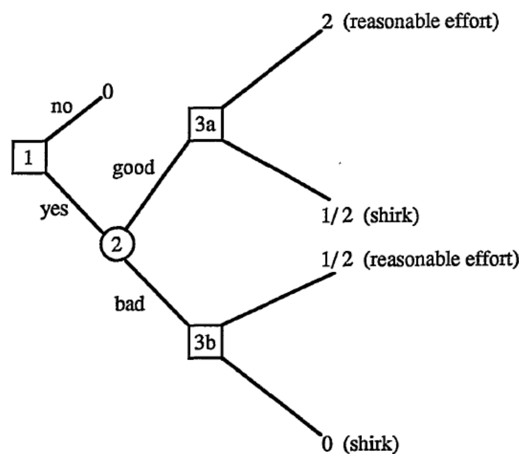
Figure 3: Cooter and Freedman Appropriation-Incentive model[169]



The same output is valid for a second model used by Cooter and Freedman to describe the potential risk of mismanagement. This Effort-Incentive model has an equivalent economic structure to the Appropriation-Incentive model. However, it differs from the previous one in the causal nature of the statuses of the third branches. The reason is to be found in its wish to interpret the duty of care. This Effort-Incentive model attempts to explain the economic results of the mismanagement of the asset rather than its misappropriation.

It is the case that after entering into a relationship arrangement and the occurrence of the determination of the value of the assets, respectively branches one and two in both models, the statuses of the world as determined in branch three are directly connected to the efforts and risks taken by the agent on behalf of the principle. The productivity of the principle is directly connected to the decision-making process that affects the end value of the asset. Reasonable efforts or shirking behaviours are the determinant of the economic outcomes. Once more, the determinant of the final scenarios is attributable to the performance of the principal and his conduct is key in defining the outcomes.

Figure 4: Cooter and Freedman Effort-Incentive model[170]



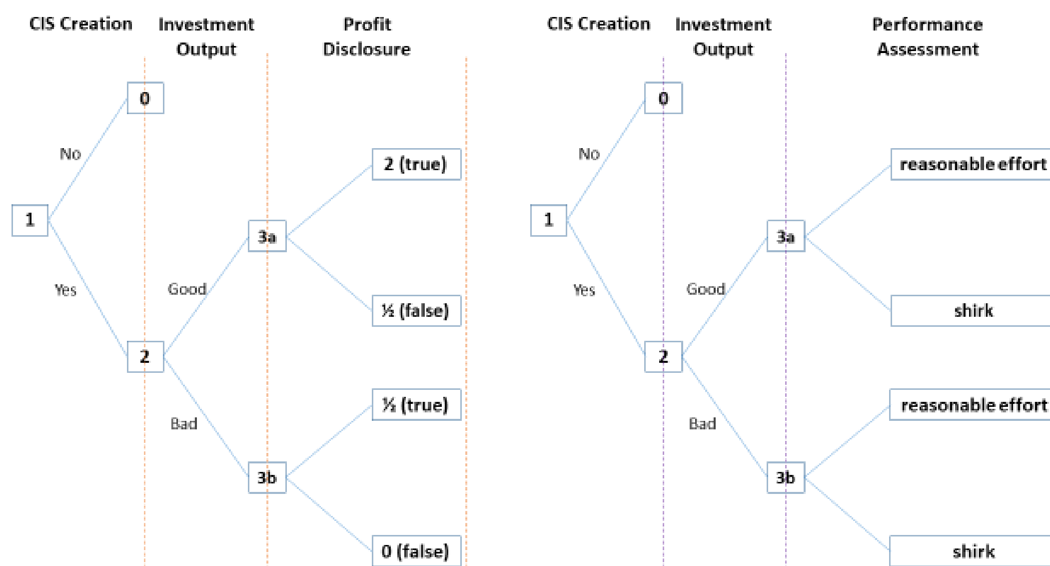
[169] Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: its economic character and legal consequences' (1973) 66 New York Law Review, 1049, Figure 1.
[170] Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: its economic character and legal consequences' (1973) 66 New York Law Review, 1049, Figure 2.

Interpreting Economic theory of fiduciary law in a CIS context

In the case of a CIS, these models can be interpreted with the recurring cycle of activities that are typical of fund management. More interestingly, both models allow us to identify the reasons behind the need for fiduciary standards in the management of a CIS and therefore the attempts of the regulators to elaborate a control structure.

The first branch is the creation of the typical relationship between the principal and the agent, creating a post-contractual information asymmetry known as hidden action or moral hazard.[171] For a CIS, as previously observed in chapter one, with the elements of a *de facto* relationship the CIS comes to existence. Similarly to this scheme, the CIS relationship is established with the loss of control over the asset by the principal in favour of the agent. This step can be indicated as the *CIS creation*.

Figure 5: Elaboration of Cooter & Freedman Appropriation-Incentive and Effort-Incentive models for CIS



What is referred to as a "choice of nature" in branch two and the resulting states of the world are less clear in the case of a CIS. The output results are the direct results of the choices made by the agent regarding how to allocate assets or how to manage any given investments. Therefore, in the case of duties of care, effort and risk for a CIS, the second branch is partly the result of choices made at the discretion of the agent. The use of the agent's skills is a precondition from the first branch and determines what the *investment output* of the CIS is. However, any losses and other inefficiencies resulting from the misalignment of the principal's and the agent's

[171] J.J Laffont and & D. Martimer, *The Theory of Incentives: the principle-Agent model* (2002) Princeton University Press.

interests, the so called agency costs,[172] are mitigated by the activities of the CIS independent party, and it represents a cost on its own. This fiduciary 'costs' are therefore increased in this combination of roles.

The misappropriation risk, as interpreted in the Appropriation-Incentive model, refers to the capacity of the principal to retain part of the asset after "natural choice". In the case of a CIS, this risk is related to the retention of the profit of the investment or proceeds coming from the asset allocation. The principal's duty of loyalty has a stronger bearing here on the correct disclosure than the undue appropriation. Therefore, the CIS-related risk is that of an incorrect *profit disclosure* rather than misappropriation. In addition, the inherent risks identifiable in the third branch are those where the CIS legislative frameworks tend to focus their rules.

Chief among them is the full and fair disclosure by the fiduciary of conflicts of interest,[173] in which the misappropriation is intended as a profit made by the agent that may have clashed with the ability of the principle to profit further. CIS regulations are often rules that focus on various ways of separating out the actual valuation of the CIS or preserving the asset or creating governance around the registration of the asset.

Mismanagement of a CIS can occur in several forms. While the Effort-Incentive model refers to a ranking of efforts, with "reasonable" and "shirking" at the positive and negative binomial ends, the risk scenarios for a CIS are often mitigated by encoded duties of the parties involved. The efforts involved in managing a CIS correctly are mostly referred to as taking action with care and with a commensurate level of risk, accounting for a *performance* that is observable post execution. The prudence to be observed is that of the skilled fiduciary in investment management matters who has been engaged to operate the CIS.

The above approach is somewhat limited in interpreting the areas of operation of the fiduciary. It is in effect a model in which one fiduciary is taken into account for one economic outcome. Sitkoff observed that judging the agent on the basis of the agent's results is likewise an imperfect mechanism for resolving the agency problem because circumstances outside of the agent's control may affect the outcome.[174] In the latter case, the question arises as to whether the results could have been different if more prudence or avoidance of conflicts had been used. In economic science, asymmetric information is when one party knows something that the other does not know; the knowledgeable one may distort or misrepresent the information.[175] In the principal-agent relationship, one is unable to constantly observe the action of the

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[172] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308 (1976).
[173] Robert H. Sitkoff (n 159) 1043.
[174] Robert H Sitkoff (n 159) 1041.
[175] David Besanko, David Dranove, Mark Schaefer, Mark Shanley, *Economics of Strategy* (5th Edition 2009).

fiduciary party.[176] This inability to assess the cause of the agent's failure is the already mentioned post-contractual asymmetry known as moral hazard.[177]

This line of thinking introduces the concepts of costs associated with the principal-agent relationship. Transaction costs are those contingencies that could not be foreseen or detailed at the time that the parties entered into their agreement. These costs support the idea that the misalignment of the interests in the agency brings extra economic inefficiency, indicated as agency costs. Therefore, the goal in regulating the agency relationship is to minimize agency costs.[178]

Notes on evolving economic reasoning and CISs' conflicts of interests

The topic of agency relationships and fiduciary duties, in the purely economic setting for the CIS, is a subject that requires further, detailed analysis that it is not provided extensively here or found elsewhere. It is certainly the case that national authorities are aware of potential conflicts of interest: the vast majority of CIS regulations aim at mitigating potential factors that may induce a CIS operator to misappropriate or mismanage the investors' assets.

For example, the requirement for an independent entity in the governance structure of a CIS, discussed in detail in the following chapter, is fundamentally a statutory mechanism to avoid a bilateral-only relationship between the CIS and its operator. This third party, in the CIS context, is the guarantor to ensure that a CIS reaches the "true" state for the Appropriation-Incentive model, as it is tasked with the oversight duty of the operator's activities and the verification of the segregation of the CIS's assets from those of other parties involved in the management. Likewise, other rules, such as the written requirements for prospectuses for investors, remuneration rules for operators, requirements relating to the disclosure of fees paid and pre-determined, externally analysed contractual relationships between parties all establish milestones to meet the "reasonable effort" outputs described for the Effort-Incentive model.

An accurate mapping of CIS regulations, a topic for further research, may be able to identify more precisely the relationship between Cooter and Freedman models and the various securities regulations. However, the evolution and continuous changes of these rules suggest that the final, best scenarios for the CIS investors are not always reached by the implementation of the existing rules. In effect, this research aims at understanding the effectiveness of these rules to reach the best economic scenario. In the context of these models, the rules imposed on the fiduciaries aim at excluding the negative results from the possible outputs.

[176] Frank H Easterbrook and Daniel R. Fischel. 'Contract and fiduciary duty' (1993) The Journal of Law & Economics 425, 446.
[177] ibid.
[178] Robert H.Sitkoff (n 159) 1042.

CIS regulations may represent a specification embedded in these models. They represent that set of mandatory core requirements to the fiduciary obligation that cannot be overridden by agreement.[179] For example, a CIS may lend assets or conduct self-dealing to the CIS Operator so that both parties can benefit from it. The allowance of such conduct does not preclude the operation of fiduciary law, which provides substantive safeguards, such as requiring the fiduciary to act in good faith and deal fairly with and for the principal,[180] intended here as the CIS. The methodology proposed in this study simply aims to understand the extent to which the analysed CIS regulations fall short of reaching that best scenario, described in those economic terms.

Conclusions

The higher standard of conduct for all jurisdictions analysed in this research is that of a fiduciary. Perceived as embedding an ethical relationship in the agency context, a fiduciary duty ensures prudent conduct from the party in the CIS governance. However, this study has concluded that the identification of the duties of care and loyalty for a party in the governance of the CIS implies a fiduciary duty. The fiduciary duty, in agreement with the findings of academic researches and court cases, is a guarantee that applicable rules are carried out effectively. Hence, in this research context the attribution of a fiduciary duty is the legal step to secure effective rules.

However, fiduciary duties are not always stated nor are they even across jurisdictions and, at times, they are not evenly implemented within the same framework depending on their applicable rules, creating discrepancies. In the case of Hong Kong, the applicable CIS regulation avoids the use of the terminology in the text of the regulation but mentions it in related commentary. In the US, ERISA points to the disparity between fiduciary standards that are explicit and directly addressed to parties from those that are limited in scope and perimeter.

Likewise, the UK's Law Commission interpretation on its distinction of applicable fiduciary standards for CIS registered under company laws against those under trust law is open to criticism. If the applicable regulations explicitly recommend a CIS operator to act with care as well as to be loyal to the CIS, and all FCA rulebook coincide, fiduciary duties should be due independently of whether the CIS is a trust or a corporation.

The reluctance to state higher fiduciary duties may be caused by the implications in terms of litigation. From the analysis of the economic model previously proposed, it transpires that the fiduciary standard requires an agent acting exclusively in a way to reach the most favourable outcomes. Therefore, any hazardous action by the agent is

[179] Robert H Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 BU L Rev 1039.
[180] ibid.

interpreted as breaching the fiduciary trust, and any shortcoming from the expected economic output is intended as the economic damage caused by the fiduciary.

Chapter three: The independent entity: fiduciary to a fiduciary

Introduction

The recent growth in the market for CISs is *pari passu* to the regulatory trend of modification of contractual standards for the parties involved in these schemes, usually with repercussions on the agents' potential liabilities. The phenomenon is also related to those governmental policies, especially in Europe, aimed at accelerating the use of CISs for financing economic activities[181] as well as the CIS market's need to streamline investments for retail investors.

As a result, the regulatory reforms addressing these markets ensure that in modifying those dynamics the parties are obliged to meet a set of duties and responsibilities aimed at the protection of the investors. The practice of rearranging the governance of the CIS parties involved in its management also raises the question as to which of these parties should be considered a fiduciary and to whom. Favourably for this research, policymakers tend to relate the legal and governance liabilities of the parties involved in a CIS to the key mechanisms ensuring investor protection and mitigating conflicts of interest.[182]

In accordance with international standards and modern regulatory practice, a third, independent party is required in CIS governance. As identified in the first chapter, authorities often require a depositary or a custodian to be appointed. However, this is not a complete requirement, but rather a choice that depends on the national legal framework under analysis.

This chapter discusses first on the concept and duties of a CIS independent entity, which can take various forms, as established by sovereign bodies tasked with implementing international standards. It will then address the most commonly adopted form: a depositary or custodian. The analysis includes the UK and Hong Kong formats but excludes the US by virtue of its construction. Judicial cases are examined in light of the appropriate national laws and regulations.

The role of the CIS independent oversight entity

Background study by IOSCO

The IOSCO analysis is fundamental to this research for two reasons. First, it establishes how to interpret the requirements regarding CIS governance of IOSCO's signatories, which include the UK, US and Hong Kong regulators. Second, it makes

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[181] See consultation on EUVECA and EUSEF AIF standards at <http://ec.europa.eu/finance/investment/venture_capital/index_en.htm>.

[182] John K Thompson and Sang-Mok Choi, 'Governance systems for collective investment schemes in OECD Countries' (OECD Financial Affairs Division 2001) 4.

a strong argument for the necessity for Independent Entities and for the correct functioning of the CIS.

IOSCO had already identified the intrinsic agency risks within the CIS framework in a paper published in 2000 as part of the development of the CIS Governance standards. Thus its Technical Committee focussed its efforts on what it came to define as *"one primary general principle concerning CIS governance – independent review and oversight of the CIS operator's fiduciary duties, including conflict of interests"*, regardless of the structural form of the CIS.[183] Furthermore, the analysis addressed how to interpret those principles related to the independent review and oversight functions.

Grounded on the generic OECD principles for correct governance, the IOSCO analysis offered a definition of what CIS Governance stands for. Its short definition contains two broad characteristics. First, CIS Governance is intended as a framework for both the organisation and the operation of the CIS. Its *modus operandi* is relevant as it is where conflict of interest can rise in practice. The second characteristic is a requirement of efficiency and exclusivity for "the interests of the CIS investor", which resembles the definition of a fiduciary duty. The latter interpretation is further supported by the conclusive specification of acting "not in the interests of the CIS insiders".

Like the OECD, IOSCO classifies the governance models of a selection of countries to produce five standards, albeit differing slightly from those discussed above. These models are not uniquely adopted in each country; in IOSCO's summary matrix, two governance structures are usually checked under each national regulation.[184] The main reason for this *de facto* mixed approach within single legislative frameworks is the evolution of the legal status and integration of different regulatory systems over the years. The most evident case is that of Europe. Indeed, it is observable that all European countries included in the OECD research sample have adopted two standards, while non-EU common law countries have shown a widespread predilection for a single model.[185] In any event, the regulatory need to act in the best interest of investors is the reason for such diversity. Processes and functions to mitigate conflicts of interest and checks on fiduciary duties enable the monitoring of those procedures. It is a natural consequence to have a variety of arrangements, even in the same jurisdiction.

The classification identified by IOSCO proposed five different types of models, differentiated by the legal structure adopted and the nature of the independent entity. Both dimensions are related to the CIS investor's rights and duties, strengthening the scope of this research to identify whether these rules are effectively an advantage.

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[183] International Organisation of Securities Commissions, 'Examination of Governance for Collective Investment Schemes' (Part 1 Final Report, June 2006) 2.
[184] ibid chart 1.
[185] ibid.

Applying these dimensions, IOSCO lists two Corporate models, two Contractual models and one hybrid Corporate and Contractual. What is key in distinguishing these models is the recognition of the type of Independent Entity ("IE"). For the Corporate model this can be either the board of directors or the depositary. Likewise, in the Contractual model the IE can be the depositary or the trustee. From the CIS investor's point of view, investing in a Corporate model is to effectively become a shareholder by acquiring shares in a company investing in a portfolio of securities.[186] This is in contrast to the Contractual model, in which the CIS investor buys unit shares that provide interest in a portfolio of securities that has legal existence in itself.[187]

To these models, the Hybrid Corporate and Contractual model is added. It is indicated that,

"notwithstanding the structure of the CIS, in practice it is the CIS Operator who is responsible for the day to day oversight and operations of the scheme"

and that

"a Supervisory Board at either the level of the CIS itself or at the level of the Management Company, or an Independent Review or Compliance Committee, play a central role ... monitoring the CIS Operator's compliance with fiduciary and regulatory obligations".

In the historical context of the regulatory system for CISs there might have been the need for this particular statement to be made. However, no clear reference is made to a potential fiduciary duty of this Supervisory Board. Furthermore, the paper appears to contradict itself as the distinctions between the duties of a depositary and those of a trustee are unclear if not deemed equivalent, although the distinction made at the level of fiduciary duties is often indicated.[188]

IOSCO classifies the legislative environments taken into consideration in this research, providing a generic interpretation of what will be analysed in detail in this chapter and the next. Within its five types of systems, the US is identified as a Corporate model, using the board of directors of the mutual fund as the key independent party. The UK is characterised by the adoption of two distinct models: the corporate/depositary and the contractual/trustee. However, the Hong Kong model is reported as using the contractual/trustee model only. This is due to the IOSCO CIS Governance analysis being dated 2006, before the reform of the new SFC UTMF rulebook of 2010. At the present time, using the same interpretative parameters, the

[186] International Organisation of Securities Commissions (n 171) 6.
[187] ibid page 7.
[188] The IOSCO paper indicates that this model can be compared with the one previously presented as the functions performed by the depositary are exercised by an entity designated as the Trustee, which is responsible for both the oversight of the CIS Operator and for the safekeeping of the CIS assets.

Hong Kong legislative environment would be classified with a double regime that also includes the corporate/depositary model.

The IOSCO CIS governance principles

IOSCO has attempted to exemplify broad principles to be applied in the governance of the CIS. However, it should be noted that the principles are presented as generic statements discussing the observable characteristics of the standards in the pool of countries selected rather than in hardcoded statements. Thus, instead of listing their highlights, I here analyse the logic that connects those broad statements.

In the view of IOSCO, the IEs are the primary source of independent review and oversight of the action of a CIS operator.[189] This view rests on a set of actions entrusted to these entities by regulatory statutes. The main obligation is to review the activities of the CIS operator by the IEs, implying that applicable statutory rules are in place and that the IEs verify their compliance. Furthermore, it requires a constant surveillance of the activities carried out by the CIS operator beyond those enforced by the national regulators – that is, those found in the contractual arrangements between CIS and its operator.

Therefore, IOSCO states that the IE's ultimate scope is to ensure "applicable rules, their contractual obligations and their duties, from *"'an outside, although objective and informed, perspective', and therefore protect CIS investors from divergent behaviours of the CIS Operator"*. Although having more than one party is a prerequisite for CIS governance, IOSCO assumes that there are several IEs, which intertwine in their duties of monitoring CISs. It is stated that *"the role and concept of Independent Entities assumes different forms among the various CIS Governance structures"* even if they all aim to *"provide an 'outside perspective' to meet the goal of CIS Governance – the protection of CIS investors"*. The examples of the CIS board of directors, the CIS regulator, the CIS compliance committee and the CIS auditor are mentioned in defining this scope.

This multiplicity does not seem to be particularly helpful when trying to understand the nature of the IEs as it is difficult to set the legal status and statutory permissions of a government established agency on par with that of a company statutory body such as the CIS board of directors or one of its subsets. Furthermore, IOSCO envisions that *"Independent Entities should be empowered with sufficient conditions to exercise [their] functions in an effective and independent manner"* but without undermining the activities expected of the CIS operator. In specifying its reasoning, IOSCO speaks of IEs as being able "to report to relevant bodies", listing these as *"the board of*

[189] International Organisation of Securities Commissions (n 171) 10.

director of the asset management company, regulatory authorities, external auditor", contradicting the earlier indication that these were IEs.

Moreover, a certain degree of economic autonomy is expected of some IEs. When the IE is a depositary or trustees, which is the case for both the UK and Hong Kong, the need for economic independence is further specified, as is the financial capability to compensate the unitholder in the case of undue losses. This seems to be contradictory, as it groups – certainly in the case of the Corporate model – the liabilities incurred by the directors as individuals and those of a large corporation together.

Definition of the independent oversight entity

With a second report on the same topic, IOSCO clarified some of the contradictory statements made on the methodology chosen and described above, while providing an understanding of the characteristics of these independent entities. In the report, IOSCO treated three topics that generated the final principles of CIS governance and addressed the requirement for an Independent Oversight Entity directly.

In this second part, the wording denoting IEs becomes "Independent Oversight Entities" ("IOE"). The logic for changing terminology is of particular interest for the CIS investor. The IE of relevance is the one carrying out the oversight function on behalf of the CIS and its investors. Whilst not providing a definition or an exhaustive list, it is reported that more than one IOE exists in most regulatory frameworks, hinting at the previously published paper. What is common to all IOEs is the type of activities overseen as well as the legal and contractual obligations established with the entrustment of the CIS. These commonalities appeal to the logic that the IOE exists to protect the interests of the CIS investor and their duties in the first place.

Independence criteria, empowerment conditions and functions to be performed by the independent oversight entities

The IOSCO's vision of the requirements for IOEs is expressed through various principles. Independent explicit powers and specified functions are the characteristics necessary for the third-party oversight function to exist. IOSCO provides description of these principles. The following will contain an interpretation which is consistent with the essence of this research, centred on the CIS investor.

Independency refers to various principles indicating the arrangements around the IOE. It is necessary for a third party to be completely unrelated to the CIS operator. Inevitably, this status is a prerequisite when the IOE is appointed in this function and it cannot be *"under conditions that prevent the decision-making process from being*

tainted by any type of conflicts of interests with the CIS Operator".[190] Furthermore, this independence is necessary at a "practical level"[191] and the equivalence of the CIS IOE being responsible for the oversight is paired with that of the CIS operator being its asset manager. Provided that independence is established, explicit powers ought to be attributed to the CIS IOE. To carry out activities on behalf of the CIS investor, the IOSCO principles envision the IOE having access to all information necessary to perform its role. In support of this, the third powers-related principle states that the IOE *"should be given rights to review the legal and operational conditions of the CIS management"*,[192] implying the enforceability of conflicting contractual limitations. Moreover, the IOE should be provided with the necessary means to fulfil its obligation, intended as the capacity to conduct activities incurring costs which will be supported by the CIS. The function of oversight is grounded in three principles, drawing from the statement made regarding the independence principle of the CIS oversight function. In IOSCO's view, this is carried out by a collective of IOEs. This interpretation of the CIS oversight function supports this research's view that the oversight activities, by their nature and design, are different and may be allocated to different parties. It also indirectly supports the idea that it requires a great deal of effort to provide for effective supervision of the CIS operator.

The first function-related principle indicates that IOEs should be able to have oversight of both the CIS operator and of its activities. This distinction is of relevance for the CIS investor. Whilst most regulatory constructs allow for an automatic oversight capacity of the manager's activities, especially when a depositary is requested, IOEs should be entitled to oversee the CIS operator itself. Such an ability, if effectively implemented – and it rarely is – provides great comfort to the CIS investor. Equally important, the second function-related principle states that the IOE *"should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investor's wealth and interests in the CIS"*. This is a key activity from the CIS investor's point of view and one that requires far-reaching powers, such as those stated earlier. Finally, the IOSCO specifies that the IOEs should be able to report to the regulators or the CIS investor, clarifying finally that the latter is neither an IE nor an IOEs.

An important point is to be stressed in conclusion. IOSCO's principles for the governance of CISs provide a strong background to the need for oversight of CISs. Details are provided on the characteristics of the criteria and conditions for a CIS IOE. However, there is no mention of the safekeeping of the assets on behalf of the CIS investor. The IOE of IOSCO is charged only with ensuring that certain mechanisms exist to avoid the expropriation of assets. The discharge of this requirement is inefficient when it is considered that, logically, the first prerequisite would be to

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[190] International Organisation of Securities Commissions, 'Examination of Governance for Collective Investment Schemes: Independence Criteria, Empowerment Conditions and Functions to be performed by the 'Independent Oversight Entities' (Part 2 Final Report, June 2006) II.1 7.
[191] ibid II.2 9.
[192] ibid III.3 9.

ensure that the CIS assets are entrusted to someone who is not in conflict with the CIS operator. This point will be discussed further below.

Comparative analysis of the depositary as independent oversight entity

Methodology applied in this research

The IOSCO framework requires the statutory establishment of a CIS IOE. The form this may take determines *de facto* how the oversight function is tasked and the model of choice adopted at a national level. However, the types of CIS IOE observable in those legal frameworks can vary greatly. Whilst similar names are common, for the purposes of comparative research it is preferable to observe and consider the duties requested of the CIS IOEs.

This proposed methodology considers the fundamental reasons behind the requirement for a CIS IOE. As discussed, the regulatory frameworks address the questions of uncertainty of CIS manager action with the creation of the CIS IOE. Nevertheless, from the CIS investor's point of view, this regulatory conundrum may be posed in a more simplistic way. The CIS investor, often an individual with limited knowledge and resources, is interested in verifying that certain questions are correctly answered on his behalf. In transferring his own asset, he loses control of it. Hence, fiduciary standards are expected, following the logic discussed in the previous chapter. His questions are therefore about verifying whether the main fiduciary, the CIS manager, is acting according to these standards, especially in the case of retail investors.

The capacity to answer this question is not straightforward, as the identification of the exact fiduciary standards are not definable by design. In a common law court these can be interpreted as guiding principles of specified areas of the agency relationship. In the case of the financial regulatory frameworks, these are duties requested of the CIS manager. However, CIS regulatory constructs are built so as to suggest that a third party, the CIS IOE, is also in place to verify whether the fiduciary duties are correctly implemented. This occurs with the transposition by regulators of various sets of policies aimed at constructing a system to address the concerns of the CIS investor. The question of whether such an appointment makes the CIS IOE a fiduciary as well will be discussed when looking at the duties and statements made at a regulatory level.

Irrespective of such an important question, the duties of the CIS IOE result from the need to fulfil certain obligations of the CIS investor. Recollecting the definition of the CIS, the key *raison d'être* of the CIS in the first place is the transfer of the investors' assets to a CIS and the vesting in an external party, the appointed CIS manager, of the day-to-day management of the CIS's assets. The risks borne in such a process are the basis of the questions posed by the CIS investor.

The first question to answer is related to the safety of the asset. In losing the direct ownership of the asset, in exchange for rights in respect of the CIS, the CIS investor naturally requires its safekeeping. Secondly, as the investment transactions on behalf of the CIS begin to be executed by the CIS manager, the CIS investor will enquire as to how this was carried out. While the first question can be answered with a degree of certainty, the second carries multiple risks. These may be summarised into the two requirements of the CIS investor for each of the activities carried out on his behalf. Firstly, that the transactions occur in line with the agreed CIS statute, and that the investment purpose for the creation of this scheme ought to be respected. Secondly, as clearly stated by IOSCO, that in the process of executing a transaction, it is the best interests of the CIS investor, and not those of the CIS manager, that are to be taken into account. These two broad requirements are addressed at a regulatory level by a number of duties imposed on the CIS IOE. Its role is to mitigate those two categories of risks.

Before looking into the details of the duties of the CIS IOEs within the various legal frameworks, it is worth noting one aspect of the needs of the CIS investor. Commercial and securities law frameworks often promote the use of external entities for the verification of activities carried out by entities considered public. However, such appointments are a matter of confirmation of activities conducted at such institutions.[193] This is not the case for the CIS framework.

In the previous chapter, this research presented a model[194] to verify fiduciary congruence by the CIS operator, which proposed to observe the output as a meter by which to address whether misappropriation occurs. In adapting that agency model to the CIS case, it was clarified that the three binomial steps occurred over time and with specific actions. In order to avoid the risk described therein, the regulators created a third party, the CIS IOE, which acts at the same time as the CIS operator. The duties tasked to the CIS IOE imply a capacity to intervene or to verify actions between the creation and the investment output of a CIS. In this respect, its authority differs from other third parties, which conduct post-activity auditing services.

The review of judicial cases regarding the CIS IOE depends on the nature of the model adopted by the various countries under scrutiny. The function of a depositary, examined in this chapter, is appropriate for the UK and Hong Kong courts. The following chapter, on CIS directors, will focus extensively on court cases in the US. The correct research question in the context of this study of the CIS regulatory framework, from the CIS investor's point of view, rests with the acknowledgement of the depositary's liabilities. Having explored its duties at the national level, the question of the effectiveness of the governance as envisioned by the regulators for the depositary is to be found in case law. Therefore, judicial cases addressing depositaries'

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[193] The most common example in the financial industry is that of the appointment of an external Auditor for Publicly traded companies.

[194] Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: its economic character and legal consequences' (1973) 66 New York Law Review.

liabilities based on losses of the assets under custody or failings of correct oversight on the part of the CIS operator are the concern of the second part of national-level analysis.

In the United Kingdom

UK CIS rules background

More than one CIS typology is currently available under UK law. The Financial Conduct Authority (FCA), having inherited the policy making function from its predecessor,[195] currently enforces two distinct sets of CIS rulebooks under the "Specialist sourcebook".[196] These are the COLL Collective Investment Scheme (COLL) and the FUND Investment Fund sourcebook (FUND). Historically, these sourcebooks were created to implement the EU directives known as UCITS and AIFMD respectively. Whilst their content addresses similar topics, COLL has also absorbed the traditional formation of trusts sold to the public under English law. Furthermore, this rulebook has been subject to several changes due to the issuing of new EU financial services directives that affect both investment managers and CIS. This is not the case for FUND, which transposes the details of the EU directive of reference more linearly.

As this research was carried out, UK law had been subject to modifications addressing the obligations of UCITS schemes depositaries. In the UK context, such changes meant new responsibilities under the COLL rulebook. However, a close analysis of the obligations reveals that the UCITS V Directive, for the most part, simply aligns the obligations of a depositary under COLL with stricter ones found under FUND. It follows that the depositary functions described under FUND are those addressing the question of European Institutions' preferences regarding the type, nature and duties of a CIS IOE. The depositary is therefore the bearer of the crucial duty to separate asset-keeping and management functions[197] independently of the business models and arrangements[198] of the CIS.

Definition of a UK depositary and functions

The rules constituting the FUND and COLL sourcebooks do not define in a single statement what a depositary is. Rather, they report what its role in the CIS framework is. On account of this regulatory method, it is only possible to indicate that the

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[195] The FCA was created as a result of the division of the Financial Services Authority in the FCA and the PRA.

[196] In 2016 this is correct and a reflection of the EU Single Market approach of two types of CIS eligible for an EU passport in all of its Market.

[197] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2009] OJ L 174/1.

[198] Dir 2011/61/EU (AIFMD) para 32.

depositary is a specific CIS IOE, based on the legal structure of the CIS, who is charged with certain tasks. For example, in the common case of an investment company with variable capital, this is the person to whom the safekeeping of all of the scheme property is entrusted.[199]

Under FUND, a depositary is the person fulfilling this function (of a depositary) in accordance with article 21(1) of AIFMD or one or more of the functions of cash monitoring, safekeeping or oversight in the case of non-EEA AIF.[200] For the sake of this comparative research, it is best to clarify that within the UK legislative framework a depositary is a trustee when the CIS is registered as an Authorised Unit Trust.

The duties of the depositary are the keys to understanding what the role and regulatory status of the depositary is. As discussed before, these originated from the EU directives. The following analysis uses the combined duties as stated in the commonly denominated AIFMD and UCITS V Directives and those contained within the FCA's sourcebook to answer the methodological questions posed in this research.

Safety of the asset and correctness of the transactions

The duties of a depositary are proposed as his paramount obligations.[201] This is because of the regulatory status the depository has been granted. In fact, only one depositary may be appointed for a CIS for this to be lawfully registered as such.[202] This nomination should also be documented with the evidence of a contract in written form, which binds parties under UK contract law. This condition has not always been in place. It is with the FUND sourcebook that the UK first introduced the requirement for EU AIFMD standards.[203]

As the example of UK CIS rules implementation, the points raised earlier about the questions of the CIS investor find some answers in different parts of the FCA sourcebook. This has a few broad themes that can be summarised as addressing the eligibility, conflicts of interests, functions and permissible delegations of the depositary. Combining the rules and regulatory guidance points set out under these themes, the CIS investor is given some answers to those two wide-ranging questions.

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[199] Financial Conduct Authority, 'UK depositary' <https://www.handbook.fca.org.uk/handbook/glossary/G3147.html> accessed January 2016.

[200] ibid.

[201] Directive 2014/91/EU (UCITS IV) of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions [2014] OJ L257/1.

[202] FCA Handbook FUND Investment Funds sourcebook (FUND) r 3.11.4. This is derived from Dir 2011/61/EU (AIFMD) art 21.1.

[203] ibid r 3.11.19.

Is the CIS investor asset safe?

The concern regarding the safety of the asset is addressed by various obligations imposed on the depositary in the form of entrusted duties and also as explicit requirements the depository must fulfil as the appointed entity. On one hand, the depositary is charged with a function to verify the security or safekeeping of the CIS asset, in whichever form this might be. On the other, the depositary itself is subject to certain financial preconditions or eligible criteria to be fulfilled before being appointed.

The rationale behind such requests is that not only must the management of the assets be structured so as to avoid misappropriation but also that the viability of the entity responsible for keeping the assets must have sufficient financial resources to operate in a feasible manner. In the case of a UK FUND-compliant CIS, the depositary status eligibility is linked to the entity capital requirements. In accordance with the minimum standards of EU Law valid for other CIS standards, a depositary can only be either a credit institution[204] or an investment firm already providing client services of safe-keeping and administration of financial instruments, with own funds in excess of €730,000.[205] The rationale for this strong economic requirement is also confirmed in the case of delegated depositary duties.[206]

Provided that these capital requirements are met, the depositary is entrusted with a number of obligations. These are the core functions that a third party, within the logistics of a CIS regulatory system, is expected to carry out. Some of these aim to address the safeguarding of the various types of assets, and thus respond directly to the CIS investor's requirement for asset safekeeping.

The depositary, as is semantically intuitive, is the recipient of the CIS asset according to UK regulatory statute. UK statutory requirements provide rules on how to address the various aspects of its possession. The UK FUND sourcebook addresses them by the nature of the assets: cash, financial instruments and other assets.

The safety of the assets starts with the monitoring of the cash – the amounts related to subscriptions or redemptions of the units or shares[207] – in accounts opened under the CIS's name or under the names of those acting on its behalf, and with never co-mingling this cash with that of the depositary or the CIS manager.[208] The safekeeping of the asset of course extends to the financial instruments acquired by the CIS. The UK depositary is charged with registering in its books all the CIS custodial assets, in the form of financial instruments, in accounts registered within eligible institutions and in segregated accounts.

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[204] Credit institutions and investment firms established in the EU are subject to the Capital Requirement Directive (Directive 2013/36/EU).
[205] FUND r 3.11.10.
[206] ibid r 3.11.28 (4).
[207] FCA Handbook FUND Investment Funds sourcebook (FUND) r 3.11.20 (1).
[208] ibid r 3.11.20 (2)(a).

The requirement of recordkeeping and asset ownership information filing is extended to the non-custodial assets.[209] This specification points to one crucial interpretation of the role of the depositary: an independent third party ensuring complete transparency of the asset ownership of the CIS. Not only are these precautionary rules the core of the asset segregation requirements but they are also fundamental in ensuring the identification and safety of the assets in any eventuality. In effect, the model adopted in the UK and Europe embeds one clear logic: the obligation to guarantee asset safety is on the CIS IOE, while it is the CIS operator that receives and manages the CIS assets and money. In doing so, a number of oversight activities can naturally be implemented, including those that prevent misappropriation by the latter.

Is the CIS manager acting for the CIS investor?

In the context of the IOSCO principles, the CIS IOE is the third party charged with the oversight of the activities of the CIS manager. This is perhaps the most integral part of the function of supervision of investment management activities.

The European mechanism envisioned makes the depositary the screening party for most of the activities of the CIS manager that have an economic effect on the CIS assets. Its empowerment is beyond the mere cash monitoring role described above, and includes a set of detailed responsibilities described as oversight duties. Together, these functions cover the whole spectrum of the economic cycle of a CIS, introducing monitoring techniques aimed at externalising the control of the CIS operator.

With the advancements in the investment management industry, certain economic activities have become necessary for the correct financial management of a CIS. These are generally understood to be of two different types: activities to do with the management of the asset forming the CIS and activities related to the utilisation of these assets for CIS investments. As a result, both FUND and COLL, the UK implementation of the EU directives, contain specific requirements covering those types of activities.

The first set of requirements deals with the collective nature of the CIS. The CIS Operator is in fact responsible for operating the transformation of the incoming and outgoing assets from the CIS for the CIS investors. The EU regulator outlines these requirements as the sale, issue, repurchase, redemption and cancellation of units or shares[210] of the CIS. So, in the case of an alternative UK CIS, the depositary must ensure that those activities are carried out in accordance with the applicable national law and the instrument constituting the fund.[211] Typically, this requirement aims to

[209] ibid r 3.11.23.
[210] Dir 2014/91/EU (UCITS IV) art 22.1 and Dir 2011/61/EU (AIFMD) art 21.9.
[211] FUND r 3.11.25 (1).

reduce the risk of the investor failing to receive his assets while investing and disinvesting.

However, provided that most CIS Operators have appropriate systems and controls, the real risk from the CIS investor's point of view is not so much operational but mainly one of correct valuation of the CIS asset. In determining creation and cancellation prices, an overriding principle is that, when the manager/operator deals with the fund as an agent for the incoming or outgoing unit holders, the interests of the existing unit holders should not be affected.[212] This risk of mismanagement by the CIS is mitigated, again, by the obligations of the appointed depositary. In the case the FUND rulebook, the depositary must ensure that the value of the units or shares of the CIS is calculated in accordance with the applicable national law, the instrument constituting the fund and FUND rule 3.9 (Valuation).[213]

The other set of activities requiring the oversight of a CIS IOE are those concerning the utilisation of the subscribed capital for CIS investment purposes. It was previously described how the function of safekeeping and cash monitoring requires the depositary to hold the CIS assets in custody. In the case of the FUND rulebook, the prescriptions are for cash, financial securities and all other assets. It logically follows that, during the life cycle of the asset investment of a CIS, the depositary is the only entity among the CIS parties able to settle financial liabilities incurred through transactions entered into by the CIS operator on behalf of the CIS. This is valid for transacting scenarios in which the assets have been purchased or dismissed. For such reasons, the EU provisions require the appointed depositary to carry out only those instructions of the CIS operator that do not conflict with applicable national law or the instrument constituting the fund.[214]

This is a strategic choice made by the EU legislators when adopting this model for both their CIS standards.[215] The rationale is equally practical and historical. If the depositary is that entity created with the scope, as described by IOSCO, to supervise the duties of the CIS operator, a concrete policy would allocate the financial management capacity to the same entity. This allows for an *ex-ante* verification of various activities and certainly a close monitoring of those key risks for the CIS investor. However, this CIS governance-related advantage, is accompanied by the liability toward the CIS and its investors in case of losses. Such accountability is present even in the case of delegation to a third party by the depositary, which is a common scenario when the CIS is investing in assets located in foreign countries.

This requirement has been considered key to the European CIS governance framework, to the extent that, in the case of the alternative funds under AIFMD, a

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[212] SJB Mehta and others 'The Financial Management of Unit Trust and Investment Companies' (1996) 2 British Actuarial Journal p 120.
[213] FUND r 3.11.25 (2).
[214] Dir 2011/61/EU (AIFMD) art 21.9 later implemented in FUND r 3.11.25 (3).
[215] ibid art 21.9 and in Dir 2014/91/EU (UCITS IV) art 22.3.

contractual transfer of liability to the selected third party is necessary, making such a party directly liable to the CIS, or to the investors of the CIS, for the loss of the financial instruments held in custody.[216] This was later addressed in the context of the UCITS model in its latest directive in 2014. In addition to the key oversight functions above, the depositary ought to control other investment-related activities affecting the CIS investors.

As their asset is utilised for a transaction, the disposal of the assets and any of the resulting considerations ought to be remitted to the CIS within the usual time limits.[217] This specification is relevant for the possible risks of misappropriation and mismanagement of the assets earned. A similar rationale is applied to the depositary's duty regarding the income. Under the FUND rulebook, a CIS's income is applied in accordance with the applicable national law and the instrument constituting the fund.

Is the depositary a fiduciary in the UK?

It is evident that the functions of the depositary aim to create a system to externalise the supervision of activities of the CIS operator in general and to monitor key economic activities in the lifecycle of a CIS. These were identified as the duties of cash monitoring, including safekeeping, and the oversight function with all its obligations. Given such prominence, the question is whether the depositary must be considered a fiduciary to either or both the CIS and the CIS investors. Whilst the CIS operator is a natural recipient of fiduciary duties, the UK depositary status is not so straightforward.

The contractual relationship between the CIS and the appointed depositary is evidenced in their contractual requirement. However, as discussed in the previous chapter, it is not customary for UK parties to articulate fiduciary duties in a written format, in contrast to the case of the ERISA in the USA. It is argued here that the intention of the EU legislator has been to introduce a rank of sort when policing obligations under the AIFMD and UCITS V Directives. This intent can be inferred when analysing the requirements for the delegation of depositary duties to third parties.[218] For example, in the case of the AIFMD, the depositary is expressly allowed to discharge itself of its liabilities, subject to a contractual transfer to that third party and when allowed in the contract with the CIS, if it can be proved that it has exercised due skill, care and diligence and that the specific requirements for delegation are met.[219]

[216] Dir 2011/61/EU (AIFMD) para 45.
[217] FUND r 3.11.25 (3).
[218] Recommended reading is: Reinout Wibier, 'Can a modern legal system do without the trust?' (2013) in Lionel Smith (ed), *The Worlds of the Trust* (Cambridge University Press 2013).
[219] Dir 2011/61/EU (AIFMD) para 45.

The latter condition emphasises that a fiduciary complies with its status when carrying out its agency duties. To a certain extent, this can be further deduced from the regulatory approach taken by the UK regulator when implementing those EU directives. The FUND rulebook clearly indicates, as a general obligation, that both the CIS operator and the depositary must, in the context of their respective roles, act honestly, fairly, professionally, independently and in the interest of the AIF and its investors.[220] Similarly, the COLL rulebook requires the depositary, when acting in this capacity, to act solely in the interests of the unitholders.[221] Moreover, in the same context, the COLL rulebook states that the depositary must take reasonable care to ensure various activities considered crucial for the safety of the CIS investors' assets are carried out.[222]

Taking this regulatory evidence, it is possible to distinguish the fiduciary duty of the depositary, intended as the CIS IOE, from that of the CIS operator. The question is whether the regulatory specifications above address the two duties characterising a fiduciary status. In both FUND and COLL rulebooks this question is answered positively. The resonances appear evident not just in those governance arrangements described above but also in the phrasing used by the regulators. Statements such the "must take reasonable care" or "exercise due skill, care and diligence" indicate their will to impose standards of practice and liabilities on losses which are *de facto* appropriate for a fiduciary relationship.

Provided that the regulatory framework supports this fact-based fiduciary relationship, the question remains regarding to whom these are owed. Is the depositary an agent of the CIS or of its investors? The answer has to be found again in the intent behind the regulatory structure and the resulting CIS governance structure. In this regard, CIS investors are addressed directly and effectively hold a fact-based fiduciary relationship with the depositary. A specification in the UK rulebook's general duties sections sustains this interpretation required under EU Law. The depositary, charged with duties and liabilities beyond those intended under the IOSCO principles, has an obligation to act *specifically* in the interest of the CIS investors. Whilst in the FUND rulebook this duty is extended to the CIS itself, the COLL rulebook does not specify this. However, it supports this view when stating that the depositary must act *solely* in the interest of unitholders, leaving no room to interpret it as anything but a clear duty of loyalty to the CIS investors. The fact-based fiduciary relationship exists between the CIS investors and the depositary.

Another point to consider relates to the legal structure of the CIS. For the UK case, the broad distinction to make is between the trust structure and the corporate structure: an authorised fund can only be either an authorised unit trust ("AUT"), an investment company with variable capital ("ICVC") or an authorised contractual scheme

[220] FUND r 3.11.5.
[221] FCA Handbook COLL Collective Investment Schemes (COLL) r 6.6.4 (3).
[222] COLL r 6.6.4 (1-2).

("ACS"). It follows that either trust or corporate law can be applied. The Law Committee has actually discussed this point in the consultation paper introduced in chapter two when addressing fiduciaries' relationships to CISs. Its interpretation relied on the traditional reading of the governance of the trust in comparison to that of the corporation, without considering the actual regulatory rulebooks.

The Commission Investigation indicates that, for unit trusts, it is possible that both the trustees and managers would be subject to fiduciary obligations.[223] It also specifies that where a duty arises, it would be owed to the class of unit holders as a whole.[224] The Law Commission also discussed a presumed distinction to the corporate model, indicating that *"investments in an open-ended investment company are unlikely to give rise to fiduciary duties to investors"* and that *"they are not set up under trust."* In this view, such a distinction implies that the investor in an open-ended investment company ("OEIC"), an ICVC in the UK regulated context, is buying

> *"units in the profits of the scheme as opposed to instructing another to invest on their behalf. It is therefore difficult to find a fiduciary relationship, as the obligations to investors are essentially arm's length and are governed by contract and company law. The duties of company directors are generally owed to the company as a whole, not to shareholders."*

It appears that the articles of the CIS rulebooks currently enforced in the UK widely contradict such interpretations. The most evident contradiction is that the trustee, in the context of a public CIS constituted as an AUT, is to be considered its depositary. The duties of a depositary appointed for an AUT are exactly those for an ACS and differ from the depositary of an ICVC solely on tax returns filings and auditor appointment matters.[225] Also, in accordance with the general duties mentioned earlier, the trustee-depositary has duties to act in the interests of the unitholders or investors, in direct opposition to the statement that fiduciary duties are owed *"to the class of unit holders as a whole"*.

It is unclear why the Law Commission believes that a CIS that is a trustee differs from the CIS corporate model in terms of delegation. From a governance point of view, the unit holders of an AUT, ICVC and ACS do not differ as the CIS operator is instructed to invest the assets on the CIS investors' behalf. In its function of CIS IOE, the depositary is delegated with only the supervision of the investment decision-making process, even for the AUT.

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[223] Law Commission (n 80) para 12.52.
[224] ibid.
[225] COLL r 6.6.2 table of applications. To be noticed is that no distinctions are made under FUND.

Judicial cases in the United Kingdom

It does not appear that UK courts have addressed cases involving a depositary of a CIS or a trustee of a CIS specifically. This seems to be the case regardless of the methodology embraced here of analysing cases taken forward by enforcement teams at the local regulatory level. However, it is worth mentioning a notorious and relevant Regulator's Notice, which will be discussed in depth later.

The case of interest for the CIS liabilities is that of the CF Arch Cru Funds, the Investment Fund and the Diversified Fund. As reported on the website of the FSA – the predecessor of the current UK regulator, the FCA – these non-UCITS retail CISs were suspended on 13 March 2009 on the grounds that they had insufficient liquidity to meet the anticipated redemption requests of the CIS investors.[226]

At the date of suspension, the Investment Fund was valued at £255.5 million and the Diversified Fund at £107.8 million. After some partial distributions totalling £54 million, in accordance with the last published valuation dated 31 March 2011, the Investment Fund was valued at £113.1 million and the Diversified Fund at £35.8 million.[227] Capita Financial Managers Limited ("CFM") was the Authorised Corporate Director – intended as the CIS operator – of the Arch Cru Funds, while BNY Mellon Trust & Depositary (UK) Limited ("BNY") and HSBC Bank plc ("HSBC") were the depositaries of the Investment Fund and of the Diversified Fund respectively.

While the case directly addresses the CIS operator's[228] responsibilities, it is silent on the responsibilities of the depository. The same is true of the FSA's Decision Notice published on the matter (these notices usually tackle contraventions and regulatory breaches of the FSA's principles of business). This document is the only publicly available information on the work of the regulator, which did not take the parties to court. Instead, the FSA announced on 21 June 2011 that, together with CFM and the CIS's depositaries BNY and HSBC, it could confirm the voluntary establishment of a £54 million package to make payments to eligible investors in the CF Arch Cru Funds and return a substantial part of their investment to the CIS investors.[229]

There are no details of the marginal contribution of the three parties to the fund. It appears, however, that the depositaries had to contribute to the loss of the CIS investors. It is not the scope of this research to establish whether such a consideration can be considered an admittance of fault. It is nonetheless sustained that, within the scope of the CIS rules, which significantly resemble the structure of UCITS ones as

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[226] Financial Services Authority, 'FSA Announces £54 million Package for CF Arch cru investors' (FSA/PN/055/2011 Jun 2011) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/055.shtml> para 2 accessed January 2016.

[227] ibid para 3.

[228] Winston Penhall, 'Fiduciary duties of UK investment managers and conflicts: the arch financial products case' (2015) 16 3 *Journal of Investment Compliance* 43.

[229] Financial Services Authority (n 214).

far as the depositary is concerned, the regulator must consider the depositary partly liable for losses in a CIS.

Relevant notes on UCITS cases from other European countries

As the current UK regulatory framework is a reflection of the EU one, it is worth considering whether any interesting cases in other EU countries can help in understanding to what extent the UCITS/AIFMD depositary framework is functioning as expected. Two cases involving infamous financial services failings serve the purpose of this research, which is constrained by reporting cases carried out in English.

The first interesting case is French, and relates to the delegation of the safekeeping function by UCITS depositaries.[230] The CIS discussed by the Court of Cassation of Paris had appointed Société Générale and RBC Dexia as depositaries. These CISs had been using the prime broker services of Lehman Brothers International Europe ("LBIE"), a European arm of the global investment bank that failed in 2008, in the form of an International Prime Brokerage Agreement ("IPBA") under English law. Furthermore, the CIS had entered into tripartite contracts with the custodian banks and LBIE. Under these agreements, certain functions were delegated to LBIE, including safekeeping of the assets of the CIS.

LBIE had rights to re-use the CIS assets and, according to the Court of Cassation, provided that the CIS had been registered as a UCITS, such arrangements were subject to the provisions of the EU Directive on financial collateral arrangements. With title transfer arrangements in place, the collateral provider could transfer full ownership of financial collateral to the collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations.[231] The title of the assets had been transferred to LBIE, which effectively became a debtor of an obligation equivalent to that of the asset used.

On 15 September 2008, Lehman Brothers filed for "Chapter 11" bankruptcy in the USA. The LBIE subsidiary in the UK went into administration and PricewaterhouseCoopers was appointed administrator. In France, the depositaries requested the restitution of the assets to LBIE, the prime broker, while the funds requested the same of the depositaries.

The Court of Cassation in Paris released the judgments dated 4 May 2010. Its Commercial Chamber confirmed the Court of Appeal decision dated 8 April 2009 and stated an obligation of restitution *"absolue et immédiate en toutes circonstances"* (absolute and immediate under any circumstances) of the UCITS assets *"sous*

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[230] Arrêt n° 500 du 4 mai 2010 (09-14.187) - Cour de cassation - Chambre commerciale, financière et économique.
[231] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (2002) OJ L168/21(b).

conservation" (under the custody) of the depositaries. These were found to be liable for the safekeeping of the assets, and therefore for the repayment to the CIS investors.

Another case of interest, yet to be concluded in European courts, is that of the notorious and fraudulent Madoff Ponzi scheme. Bernard L. Madoff Investment Securities LLC was an American financial firm operating in various markets including that of CIS management. Various CIS structures were set up in 1990 and later with client money with performance marketed as yielding CIS gains above average. In 2008, following some family events, it was uncovered that the CISs were in fact operating as "Ponzi schemes", a type of fraudulent CIS in which the returns are not the result of gains in investments but rather are made up of the cash assets of other investors in the scheme, and are thus fictitious.

The overall assets invested in the Madoff scheme included some European funds via so-called feeder-funds. These CISs were created with the scope to invest assets solely into the Madoff's CIS in the US but retained a locally (EU) compliant legal structure. Two large-scale funds known to the public were Thema International Funds ("Thema"), a CIS in the form of UCITS registered in Ireland, and LuxAlpha SICAV ("LuxAlpha"), a UCITS-compliant CIS based in Luxembourg. Evidently, both judicial cases are well suited for discussing the responsibilities of a depositary in the UCITS framework, which have now also been adopted for CISs under the AIF framework. In the case of Thema, the result is of interest in this chapter and those to follow.

The Thema CIS case presents more than one remarkable point to support the loss bearing status of a depositary in the failing of a CIS. The parties involved were those expected in a UCITS structure, as described above: the CIS (Thema International Fund PLC), the CIS IOE or depositary (HSBC Institutional Trust Services (Ireland) Limited) and the CIS operator/manager (Thema Asset Management Limited).

In a judgement of February 2013, Charleton J provided preparatory background to the statuses of the parties and their responsibilities in preparation for the Bernie Madoff fraud litigation.[232] In *Thema International Fund Plc v HSBC Institutional Trust Services (Ireland) Ltd & anor* the parties were the CIS as plaintiff and the depositary as defendant. The CIS operator was a third party. In seeking amendment of the provided pleadings, Charleton J provided feedback on the then current pleadings and his interpretation of the positions of the parties. In summary, it was stated that, allegedly, the business relationship between the two parties had been established in accordance with the UCITS regulations in 1996, as well as via a private document called the custody agreement, which was updated in 2006. The allegations were put forward on the basis that liability also exists in contract, tort and for breach of

[232] *Thema International Fund Plc -v- HSBC Institutional Trust Services (Ireland) Ltd & anor* [2013] IEHC 76.

fiduciary duties, with a particular reference to the appointment of Bernie Madoff as sub-custodian constituting a breach of duty/contract.[233]

Whilst the defence pointed to the responsibilities of the CIS operator, Charleton J made a number of clear remarks. First, he stated that the plaintiff, Thema, was claiming back not only the money expended but also *"the substantial bulk of their claim…that they put into the defendant as custodian, sums of hundreds of millions in those currencies"*. More interestingly, Charleton J speaks of the rights of the CIS investor directly as he clarifies that *"it is clear that investors, and I am told there may be about 250 of them and they are called unit-holders, put their money into the plaintiff Thema"*. His interpretation goes further into the CIS governance structure as he quotes directly from Regulation 43 of the Irish UCITS regulations, a rule prescribing the trustee's liability for any losses suffered by either unit-holders or the investment company. In his interpretation, the CIS investors are *"those who bought units can sue the trustee, alleged to be the defendant; or the investment company, which is the mantle the plaintiff Thema assumes, can recover"*.

With this background, it is unsurprising that the case was never concluded. The financial press reported in May 2013 that Thema International Fund Plc and HSBC Holdings Plc settled in respect of the London-based bank's liability for the fund's losses.[234] Interestingly, the deal was struck *"for an undisclosed amount"* and it did not include an *"admission of liability on the part of any party"*. Spokespersons clarified that HSBC stated that *"it has good defences but recognises the risks and uncertainties inherent in defending a complex UCITS claim of this nature together with the significant burden and expense involved in doing so."*[235]

This case was preceded by another, related one. In *Kalix Fund Ltd & anor v HSBC Institutional Trust Services (Ireland) Ltd & anon*[236] the plaintiff was an investor in one of the Thema CISs. Kalix Funds, an institutional unitholder, brought forward proceedings directly against HSBC, the depositary; this was, in effect, the first case to reach trial. With communication to the financial press, HSBC settled the dispute with Kalix Fund without disclosing the terms. It is known that Kalix sought $35.6 million from the depositary and that the settlement arrived a day after the trial started.[237] These settlements effectively blocked the trial, preventing a final judgment on the liabilities of the depositary, but suggest an interpretation of liabilities on the part of the depositary.

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[233] Ibid para 4.

[234] Stephanie Bodoni, 'HSBC Settles Thema Fund's Suit Over Madoff-Linked Losses' (Bloomberg, 29 May 2013) <http://www.bloomberg.com/news/articles/2013-05-29/hsbc-settles-thema-fund-s-irish-suit-over-madoff-linked-losses> accessed 11 February 2016.

[235] ibid.

[236] Kalix Fund Ltd & Anor vs HSBC Institutional Trust Servies [Ireland] Ltd & Anor, [2009] IEHC 457 (2009)

[237] Stephanie Bodoni, 'HSBC Settles Thema Fund's Suit Over Madoff-Linked Losses' (Bloomberg, 29 May 2013) <http://www.bloomberg.com/news/articles/2013-05-29/hsbc-settles-thema-fund-s-irish-suit-over-madoff-linked-losses> accessed 11 February 2016.

While the Irish courts have disclosed their interpretation of the regulatory status of the UCITS depositary, the situation has not been as clear for a similar CIS structure linked to the Madoff Ponzi scheme, but this time based in Luxembourg. Given that Luxembourg is the EU country with the largest number of authorised UCITS funds, this uncertainty is surprising.

The second similar case is that of the CIS LuxAlpha SICAV, (Société d'investissement à capital variable, which is an open-ended collective investment fund, much like a unit trust of OEIC), which was another feeder-fund and UCITS compliant scheme almost entirely invested in the Madoff funds.[238] The prospectus of the CIS indicated UBS as both CIS operator and custodian of the fund, while an entity known as Access International Advisors was named as portfolio advisor.[239] The entity was not Madoff's but this SEC-registered independent advisor had, according to the press, entered into an agreement with UBS, signing an indemnity agreement for which UBS would act only as a "figurehead" to third parties for both CIS operations and custody. Furthermore, UBS would not have borne the losses endured by investors in LuxAlpha and the sole responsibility for the fund's failure should have been with Access International Advisors.[240]

When the Madoff case come to prominence, the then Luxembourg Ministry of Finance stated that *"The principle is very clear: the custodian bank has to indemnify investors"* and *"Regarding the law, the situation is not that difficult: the custodian bank has a responsibility to make restitution for these asset"*.[241] However, on 2 July 2015 the Court of Cassation of Luxembourg released its judgment on the capacity of the CIS investors to pursue legal action against UBS, which was the entity registered as CIS operator and depositary, in case of losses as per the EU directive's indication. The request was denied.[242]

This approach in Luxemburg appears to contrast somewhat with the meaning of the regulatory system which was directly upheld by the French Courts and considered pragmatic, if not upheld, by the Irish ones. However, overall, it appears that the interpretation of the majority of cases so far is that liability lies with the depositary in the case of losses, with CIS investors able to pursue legal action directly.

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[238] Ellen Kelleher, 'Investors call for UBS to pay' (Financial Times, 1 Dec 2013) <http://www.ft.com/intl/cms/s/0/608c7986-57b8-11e3-86d1-00144feabdc0.html#axzz46G1EJSK5> accessed 11 February 2016.

[239] Luxalpha Sicav, 'Sales Prospectus' (August 2004) <http://www.luxalphainliquidation.lu/pdf/informations/prospectus/complets/August_2004.pdf> accessed 13 March 2016.

[240] Ellen Kelleher, (n 225).

[241] Edouard Fremault, 'Press Release Madoff – Luxalpha SICAV' (Deminor, 2 Jul 2015) <http://www.deminor.com/drs/en/news/6752/press-release-madoff-luxalpha-sicav > accessed 11 February 2016.

[242] Cour de cassation du Grand-Duché de Luxembourg N° 67 / 15 du 2.7.2015. Num 3509 du registre.

In Hong Kong

Hong Kong CIS rules definition on trustee/custodian and functions

The SFC's approach to the IOSCO's CIS governance standards is similar to that of the UK. Intuitively, historical reasons and the eligibility of trust law make the CIS regulatory framework in Hong Kong similar in nature to that of the UK.

The IOSCO principles requiring a CIS IOE are comprehensively addressed in chapter four of the SFC UTMF rulebook. This section of the SFC's regulations addresses the appointment, scope and duties of the third party indicated as "trustee/custodian". This designation is referenced across the UTMF rulebook and it indicates that the applicable obligations are shared, regardless of whether the CIS is registered as a unit trust or a Mmutual fund.

The appointment of a trustee/custodian is a condition *sine qua non*: no collective scheme seeking authorisation can exist without having appointed a trustee/custodian. Clearly, a trustee is appointed in the case of a CIS being registered as a unit trust and a custodian is employed in the case of a mutual fund corporation. The appointment itself is carried out by the CIS operator as one of its duties. The scope and modalities used by this entity in selecting and verifying a custodian's standards and activities are described in this research later while discussing the Hong Kong CIS Ooperator standards as demanded of the SFC's Fund Manager Code of Conduct.

Still, the UTMF rulebook, as the legislative setting for a specific financial vehicle, identifies a series of requirements and obligations for the trustee/custodian with themes that resemble the UK standard but in a simplified manner. The subjects of eligibility and obligations are discussed directly while the requirement of managing conflicts of interest is addressed, setting out strict independence for the parties involved.

Is the CIS investor asset safe?

The appointment of the trustee/custodian is subject to explicit economic and financial conditions placed on the candidate entities. The eligibility criteria follow the same rationale as that observed for the EU-UK regulatory frameworks, focussing on the viability of the entity responsible for keeping the assets and its operational capacity as a financial institution.

The entity has to respect two parameters: financial regulatory status and capital. The first is fulfilled when the trustee/custodian is an HK financial institution, either a bank or a trust company, or a foreign banking institution that the SFC deems acceptable.[243]

[243] Securities and Futures Commission, SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products – Code of Unit Trusts and Mutual Funds (2nd

The latter criterion is satisfied when the trustee/custodian has a minimum of HK$10 million in issued and paid-up capital and non-distributable capital reserves, irrespective of whether this is the actual bank/trust or its subsidiary.

The above criteria are of importance due to the general obligations to which the trustee/custodian is subject. Whilst the UTMF does not make a distinction between functions like the UK FUND, the stated obligations combine those of cash monitoring, safekeeping and oversight of the CIS operator, usually indicated as the management company.

Given financial soundness, the trustee/custodian is responsible for taking into its custody all the property of the CIS in trust for the holders or the scheme in accordance with the provisions of the constitutive documents.[244] This activity, resembling the UK function of safekeeping, follows the duty of registering cash and registrable assets in the name of, or at the instruction of, the trustee/custodian,[245] which on its own is responsible for monitoring cash flows.

Is the CIS operator acting for the CIS investor?

To verify the correct execution of those activities that may conflict with the CIS investor's expectations, the Hong Kong legislator has adopted the European model whereby a depositary is the screening party for most of the activities of the CIS operator in the economic cycle of a CIS. This creates the double advantage of adopting a standard that is well-known in the international investment management community and fulfilling the IOSCO principles addressing the governance of CIS.

The Hong Kong requirements that fit the previously mentioned functions of oversight are those addressing the lifecycle of the investor assets and those that address the lifecycle of the CIS asset. Replicating the UK approach, the trustee/custodian is tasked with ensuring that the sale, issue, repurchase, redemption and cancellation of units/shares effected by a scheme are carried out in accordance with the provisions of the constitutive documents.[246] In combination with this duty, the trustee/custodian verifies that the methods adopted by the management company in calculating the value of units/shares are adequate to ensure that the sale, issue, repurchase, redemption and cancellation prices are calculated in accordance with the provisions of the constitutive documents.[247] The combination of these two duties confirms the capacity of the trustee/custodian, as with the UK depositary, to verify any agency misconduct when assets are invested or disinvested in the CIS.

Edition, April 2013) (UTMF) r 4.2.

[244] ibid r 4.5 (a-i).

[245] ibid r 4.5 (a-ii).

[246] UTMF r 4.5 (b).

[247] ibid r 4.5 (c)

The UTMF rulebook also exploits the safekeeping rule to address the responsibilities of oversight of the CIS asset lifecycle. The trustee/custodian, as the party holding the cash and assets, must carry out the instructions of the management company in respect of the investments unless they are in conflict with the provisions of the offering or constitutive documents, or with the Unit Trust Code.[248] Furthermore, the trustee/custodian has an obligation to ensure that the investment and borrowing limitations, as illustrated to the CIS investors, and the conditions under which the scheme has been authorized, are all complied with.[249]

Where the SFC improves on the EU's directive-level rules is on the representation of the activities carried out for the CIS investors. The UTMF requires the trustee/depositary to issue a report to the holders, to be included in the annual report, on whether in its opinion the management company has in all material respects managed the scheme in accordance with the provisions of the constitutive documents. This approach has an interesting regulatory aspect as the CIS investors can obtain statements not only on the status of CIS operator activities but also regarding the steps that the trustee/custodian has taken if the management company has not managed the scheme appropriately.[250] This method allows for both a recognition of potential liabilities and a discharge from these.

Is the depositary in Hong Kong a fiduciary?

The similarities in regulatory framework and legal background extend to the final question, regarding the form in which the duties are carried out. Is the trustee/custodian to be considered a fiduciary?

Some of the arguments raised in the case of the UK depositary can apply in this legal context as well. Firstly, there is the predilection of the SFC to issue the UTMF rulebook in a format suggesting that there is an equivalence between the trustee and the custodian in a unit trust or mutual fund, respectively. In its text, as a guidance note to the article obliging the appointment of a trustee/custodian, it specifies that, while trustees are expected to fulfil the duties imposed on them by the general law of trusts, in the case of a mutual fund corporation the responsibilities of a custodian should be reflected in a constitutive document.[251] The Note specifically mentions a Custodian Agreement format drafted as an appendix to the UTMF rulebook.[252]

This sample document makes few distinctions between the wordings to be contractually used for a unit trust and those for a mutual fund corporation. In the first case, the rulebook states that the property of the scheme is held in trust by the trustee

[248] ibid r 4.5 (d).
[249] ibid r 4.5 (e).
[250] ibid r 4.5 (f).
[251] UTMF r 4.1 Note (1).
[252] ibid.

for the holders of the units.[253] In the case of the mutual fund, the property is also held in trust by the custodian for the scheme.[254] The use of the wording "held by trustee/custodian on trust" suggests that the same interpretation of a fiduciary relationship under trust law might be applicable, even though the mutual fund corporation is not governed by such law.

Further analysis can be drawn from the definition of a fiduciary in the Hong Kong investment management of financial services context. In the previous chapter, this research proposed an examination of the SFC interpretation of these duties based on the definition provided by this regulator in its Cash Rebates Consultation. Its core elements can be transposed to the role of a trustee/custodian. In that paper, a fiduciary is an entity or a person that undertakes to act on behalf of the CIS investors, with a certain discretion or power that affects the interests of the CIS investors who depend on the fiduciary for information and advice.[255]

Based on this definition, the trustee/custodian could be considered a fiduciary to the CIS. One missing link to the UK approach in the Hong Kong regulatory framework is the lack of any statement referencing duties to the unitholders or investors. The fiduciary status, if the above logic applies as a matter of applicable law, would be to the entity constituting the CIS, which is the unit trust or the mutual fund, not to its investors, as is explicitly stated in the UK rulebooks.

Note on cases for the Hong Kong custodian

It is a matter of fact that Hong Kong does not offer a variety of judicial cases on parties involved in a CIS. Few cases have been identified that can contribute, directly or indirectly, to interpreting the CIS investor safeguards embedded in the SFC regulations. As with the UK, there is no direct court case for which a trustee/custodian has been a party in litigation regarding its statutory and contractual duties when the claimant was the national authority. However, an interpretation of the safeguarding mechanics and duties of the trustee/custodian is possible with *Secretary of Justice v Schmitt, Charles Lee*.

This case relates to Charles Schmitt, a Hong Kong-based hedge fund manager and the founder of the CSA Absolute Return Fund.[256] The matter first came to light when the SFC received information from senior managers of Charles Schmitt & Associates Limited who reported some unusual fund movements and investment transactions relating to the CSA Absolute Return Fund to the SFC. SFC investigations found sufficient grounds for suspecting misappropriation and referred the matter to the Hong

[253] ibid appendix D4 (c).
[254] ibid appendix D5 (a).
[255] Securities and Exchange Commission (n 147) 18.
[256] *Secretary of Justice v Schmitt, Charles Lee* (CAAR 12/2006) *(On appeal from HCCC NO. 71 of 2006).*

Kong Police.[257] The court records for *Secretary of Justice v Schmitt, Charles Lee* describe his misappropriation of client assets and the forging of accounting documents to cover losses. The hedge fund collapsed in 2004, costing CIS investors a total loss of $189 million.

In its function as CIS independent entity, the custodian collected the net asset values, on a monthly basis, of units in the sub-fund investments in which CSA Absolute Return Fund had invested. The custodian used this information to compile a monthly valuation of the CSA Absolute Return Fund and to inform the CIS investors, setting out on a quarterly basis the value of the individual investments in these funds. The auditors of this CIS were Ernst & Young.[258]

After the collapse of the CSA Absolute Return Fund, Schmitt pleaded guilty in the Hong Kong High Court. No records are provided of the Order that has likely been issued as a result. However, the Court appointed a liquidator, PricewaterhouseCoopers, who filed a suit against the CIS's auditor, Ernst & Young, and the custodian appointed for the CIS, Bermuda Trust (Far East) Limited.[259] The latter institution became part of HSBC Institutional Trust Services (Asia) following the acquisition of the whole Bank of Bermuda group by HSBC.

Subsequent enquiries by investigators revealed that no investment had been made by the CSA Absolute Return Fund into the master funds via the sub-funds, as the CIS advisor had represented to the CIS investors, the CIS custodian and its auditors.[260] However, the lawsuit allegations put forward against the custodian and auditor were for failures related to the CIS, including the failure to get audited accounts of investments, the failure to identify financial statement shortcomings and the failure to recognize discrepancies in financial statements.[261] Press and members of the public reported that the suit was based on breaches of duty of care, and both parties settled with the liquidator without disclosing the detail of this settlement in 2009.[262] It appears that after the settlement, the liquidator received a total sum of $16 million, most likely from the auditor and the administrator.[263]

Whilst no further records are available of subsequent actions, it seems plausible that the CIS custodian failed to verify the correct valuation of the CIS. It is also possible that it failed to verify the nature of the administrators providing the valuations of the sub-funds. In fact, it is alleged that Schmitt also created the four offshore companies

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[257] Notes on the case and SFC action can be found at Securities and Futures Commission, 'SFC Bans Charles Lee Schmitt for Life for Misappropriating Client Assets and False Accounting' (Press Release 18 October 2006)<https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=06PR220> last accessed 11 February 2019.
[258] *Secretary of Justice v Schmitt, Charles Lee* (n 243) 12.
[259] Enoch Yiu, 'Schmitt gets 41/2 years jail for hedge fund fraud' (South China Morning Post, 26 October 2006) <https://www.scmp.com/node/569028>.
[260] *Secretary of Justice v Schmitt, Charles Lee* (n 243) 19.
[261] Enoch Yiu (n 246).
[262] Shinya Deguchi, 'Case N 12 CSA' (The Importance of Being Diligent, 1 May 2014) <http://www.being-diligent.com/case-n-12-csa/> last accessed 11 February 2019.
[263] ibid.

acting as “fund administrators” that sent fake statements to the Bank of Bermuda.[264]

Notes on the depositary role in the US

The US standard for the CIS IOE differs, particularly regarding the role of the depositary in CIS governance. Here it is worth stressing once more that, in the case of the US, this research focuses its analysis on the ICA.

The main difference between the ICA and the UK and Hong Kong rulebooks is that the former does not make the depositary a CIS IOE, as intended under IOSCO. It appears that such an oversight role is part of the CIS director’s duties, albeit with the regulatory requirement to appoint a custodian. In fact, in accordance with the ICA rules, every registered management company must place and maintain its securities and similar investments in custody.[265] However, the duty to execute this requirement is on the CIS itself.

The rule of safekeeping of the CIS assets is practiced in the USA as well. Furthermore, the same regulatory cornerstone regarding the capital adequacy of the entity carrying out the safekeeping is in place: the custodian must be a bank, a savings association or a registered broker-dealer.[266] This requirement, establishing the qualified custodian[267] regime, aims at the safekeeping of the asset but does not give oversight responsibilities on the matter, confirming the main difference *vis-à-vis* the other regulatory framework and its non-CIS IOE status.

To clarify, the USC has some provision for the use of a depositary. In the view of the SEC, amendments to include provisions allowing a securities depository to have custody of investment company assets were due to several market needs. On this matter, the SEC indicated the need to expand the types of investment companies that can maintain assets, expand the types of depositories they can use, and update the conditions they must follow to use a depository, as well as the need to respond to developments in securities depository practices.[268] However, this type of depositary only owes *“at a minimum to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain such financial assets”*.[269] Its other provisions do not conform to any other oversight duties of the independent entity.

[264] ibid.
[265] 15 USC § 80a–17 - Transactions of certain affiliated persons and underwriters - f.
[266] Ibid.
[267] Securities and Exchange Commission, ‘Custody of Funds or Securities of Clients by Investment Advisers’ (Release No. IA-2176) <https://www.sec.gov/rules/final/ia-2176.htm> accessed October 2015.
[268] ibid.
[269] U.S. 17 CFR 270.17f-4 *Custody of investment company assets with a securities depository* art a) 1).

Conclusions

The depositary in the UK and the custodian in Hong Kong are the CIS independent entity third-party regulatory models adopted to provide risk mitigation regarding the inherent potential conflicts of interest between a CIS and its operator. In the UK and Hong Kong cases, however, the depositary model is also an advancement from the appropriate principles elaborated by IOSCO. Whilst these provide a requirement, with appropriate standards, for the CIS IOE to be tasked with the oversight function, there is no requirement for absolute avoidance of the assets being held by the CIS operator. Furthermore, the international standards mentioned do not explicitly address safekeeping as a function of its own, but rather discuss the mechanisms aimed at circumventing the expropriation of CIS assets.

The duties in an agency relationship characterised by a fiduciary status resonate with the governance arrangements described for the depositary/custodian and in the regulators' descriptions of their affairs. Case law in Europe, related to the interpretation of UCITS standards on depositaries, confirmed indirectly the potential, fiduciary status of the latter in the UK context.

Depositaries and custodians are required to verify the activities of the CIS operator with reasonable care and diligence, indicating a clear fiduciary standard. Perhaps their role is better defined as that of a fiduciary tasked with verifying that the activities of the CIS operator, potentially a fiduciary in its own right, are carried out correctly. In this sense, the depositary/custodian is a fiduciary to a fiduciary.

Chapter four: Directorship of a Collective Investment Scheme: a complicated job or a useless one?

Introduction

In recent years, both regulators and the industry have had extensive and public discussions regarding the role of CIS directors, and particularly their independence. For example, research by the rating agency Fitch, in the context of the European market, found that almost a quarter of boards that oversee European mutual funds have no independent directors.[270] Across the 145 UCITSs examined, just 33% of board members were independent, meaning they had no direct link to the asset manager, custodian or administrator for the CIS. In contrast, about 75% of directors on US Mutual Fund boards are independent.[271]

Some EU regulators had previously taken action to clarify their expectations of CIS boards. For example, the Central Bank of Ireland, also tasked with financial markets supervision, has implemented guidance on the tasks of the board of UCITS and AIFs. Since it is common in Ireland for certain tasks to be delegated externally, the regulator decided to streamline which of the boards' significant tasks in which can be delegated – of which there are six in total, including investment and risk management – may or may not be passed on and under which circumstances. The UK has also taken the initiative on this. New rules, yet to be enforceable, have been proposed and discussed as part of its normal policy-setting framework, following a public consultation broadly addressing the regulatory status of asset management.

This chapter, however, discusses the roles and duties of CIS directors when they are employed for the functions envisioned of the CIS independent entity. In this context, when comparing the UK, Hong Kong and the US legal frameworks, only the latter has implemented rules to address the board of directors in this way. Nevertheless, at times, a director's duties may be relevant and so an analytical context is proposed for these, together with the relevant key judicial reviews.

The United States model for the independent oversight entity: CIS directors

It was previously explained that the US did not implement the CIS governance requirement for an Independent Oversight Entity in the form of a depositary. IOSCO's IOE duties are instead to be found within the responsibilities of the CIS directors for

[270] Attracta Mooney, 'Many fewer independent fund directors in Europe than the US' (Financial Times, 23 April 2017) < https://www.ft.com/content/21133602-266b-11e7-8691-d5f7e0cd0a16> accessed 8 November 2017.
[271] Ibid.

the governance of a registered mutual fund that complies with the Investment Company Act 1940. The American version of the oversight function is therefore constructed with various duties and tasks assigned to the CIS directors.

Directors' duties under the Investment Company Act 1940

CIS directors and other trustees are subject to various duties, deriving from both state and federal law. As previously indicated, this research focuses mainly on the federal level requirements, analysing the CIS model and duties as implemented by the ICA.[272] At state level, the regulations concerning companies and CISs share a number of similarities, allowing for a horizontal analysis and comprehensive view of the risks incurred by CIS investors in a US mutual fund. In the course of this analysis of the US normative construction, this research touches upon the Maryland and Delaware regulatory frameworks, given that these states are where the highest number of CISs are incorporated.[273]

ICA federal requirements for independent directors

Although the CIS mutual fund model, just like any other company, is organised pursuant to the state in which it is incorporated, rather than under federal law, the US legislator provides a general set of requirements in the ICA that must be complied with.

The most interesting ICA requirement from the perspective of a CIS investor is probably the mandatory independence of part of the board. Section 10 of the ICA provides that at least 40% of the investment company's directors must be "independent". The wording used by the US legislator refers to individuals who are "uninterested persons" and who are subject to rules of ICA section 2.[274] Generally speaking, the term "interested person" refers to *"fund insiders, members of their immediate families, insiders of the fund's investment adviser, and insiders of the fund's principal underwriter"*.[275]

Judicial cases have defined further the role of independent directors under the ICA. In *Burks v Lasker*, the US Supreme Court provided an interpretation of the role of the independent directors as intended by the US Congress when drafting the ICA. The case related to CIS investors in an ICA-compliant fund who brought forward a derivative suit in the Federal Court against most of the fund company's directors. Its

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[272] 15 U.S.C. 80a-1 et seq.
[273] H Kent Baker, Greg Filbeck and Halil Kiymaz, Mutual Funds and Exchange-Traded Funds: Building Blocks to Wealth (2015, Oxford University Press) 72.
[274] 15 U.S.C. 80a-2 (a) (19).
[275] William Sjostrom Jr, 'Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940' (2006) Kansas Law Review 54 251, 260.

judgement is considered to define both the status and duty of these parties. Brennan J. pointed out that the ICA

> *"was designed to place the unaffiliated directors in the role of 'independent watchdogs' who would 'furnish an independent check upon the management' of investment companies... In short, the structure and purpose of the [Investment Company] Act indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders."*[276]

The independent directors requirement aims at establishing a form of protection for CIS investors from the inherent conflicts of interests that can arise from the CIS operator's employees forming the majority of the governance of the CIS.

The US regulator pursued an improvement of the governance dynamics of those companies, largely CISs, that take advantage of the so-called "Exemptive Rules"[277] when, in 2001, the SEC implemented stricter requirements regarding directors' independence. Whilst facilitating the ordinary governance of the CIS, according to the SEC these exemptions *"involve inherent conflict of interest between funds and their managers, and therefore rely on independent directors to monitor those conflicts"*.[278]

The proposed SEC provisions indicated a requirement for companies wishing to rely on such rules to have a majority of independent directors, ensuring that they are nominated and elected by other existing independent directors, and that they all have access to independent counsel.[279] In 2004, the SEC further amended these provisions, adopting a rule requiring that at least 75% of CIS's directors should be independent and that the board have an independent chair.[280] However, this rule was overturned by a Federal Appeals Court decision in 2006.[281] The Court sent the rule back to the SEC for consideration, but it was never readopted.

As a replacement for these requirements, in 2010 the SEC issued new rules for the governance of CISs, requiring a higher level of disclosure of the board's leadership structure. Under SEC Rule 10e-1, the board composition requirements set by the ICA, together with the above-mentioned Exemptive Rules, are temporarily suspended in the case that a CIS fails to meet the requirements concerning independent directors because of the death, disqualification, or resignation of a member of the board. Should

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[276] Burks v. Lasker, 441 U.S. 471, 484-85 (1979).

[277] The Exemptive Rules (Rule 10f-3; Rule 12b-1; Rule 15a-4(b)(2); Rule 17a-7; Rule 17a-8; Rule 17d-1(d)(7); Rule 17e-1; Rule 17g-1; Rule 18f-3; Rule 23c-3) exempt funds and their business affiliates from certain provisions of the Act.

[278] Securities and Exchange Commission, 'Final Rule: Role of Independent Directors of Investment Companies' (Release Nos. 33-7932; 34-43786; IC-24816; File No. S7-23-99, 3 January 2001) <https://www.sec.gov/rules/final/34-43786.htm> accessed 12 February 2019.

[279] i.e. counsel whose activities in the previous two fiscal years has been of such nature as not to negatively affect his judgment)

[280] Securities and Exchange Commission, 'Final Rule: Investment Company Governance', (Release No. IC-26520; File No. S7-03-04, 27 July 2004) <https://www.sec.gov/rules/final/ic-26520.htm> accessed 12 February 2019.

[281] U.S. Chamber of Commerce v. SEC (U.S. Ct. App. D.C. April 7, 2006).

the vacancy be filled by the remaining directors, the suspension period will be of 90 days; on the other hand, should a shareholder vote be required to fill the vacancy, the suspension will last for a longer period of 150 days.

One important ICA rule requires the independent directors to meet at least once a year, separately from the other directors, to review and discuss a series of matters concerning CIS governance. Such matters include the approval of investment advisory and distribution agreements, and the selection of independent auditors. These governance activities are particularly important as they guarantee the independence of the acceptance of the terms of business with the CIS operator, on the one hand, and of those for the independent accountancy review, on the other.

It becomes evident that the ICA's governance mechanisms rely on the independent directors to guarantee the CIS's IOE activities envisioned under IOSCO standards. Further to this requirement, the ICA has implemented a requirement for director disclosure – the obligation for independent directors to disclose any change in their status promptly. The SEC rules require full disclosure about a CIS's independent directors, including, but not limited to, any element that might give rise to a potential conflict of interest. Best practice as recommended by the ICI, the relevant trade body for US-based CIS, requires directors to complete an annual questionnaire on their business, financial and family relations with the investment adviser, principal underwriter, other service providers and their affiliates.

ICA federal requirements for all directors

The ICI, the trade body of CIS managers in the USA, established an advisory group on mutual fund directors. Its report, Best Practices for Fund Directors, indicated that the board's fundamental responsibility is to *"ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled [...] it is the responsibility of the fund's board to evaluate the performance of the fund's investment adviser and that of its other service providers"*.[282] The American Bar Association's view on the topic describes, simplistically but effectively, that the directors' role is one of *"kicking the tyres, looking for warning flags."*[283]

The directors of a US-based CIS do not manage funds on a day-to-day basis. The governance of the CIS is constructed so that their role is one of general oversight of the activities of the investment adviser, the administrator, the custodian and all the other subjects to whom a CIS has delegated its authority. Their role is often carried out in collaboration with the support of an independent legal counsel who advises the directors on compliance matters. In practice, CIS directors manage a number of service providers to the scheme, who are often required to issue written reports on

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[282] Investment Company Institute, 'Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness' (Washington DC, 1999).
[283] American Bar Association, 'Fund Directors' Guidebook' (2003) 59(1) The Business Lawyer 201, 240.

various aspects of the status of the CIS. This documentation is generated throughout the accounting year and it is often released and analysed in connection with scheduled board meetings.

The generic oversight of risks potentially incurred by CISs in the US is not dissimilar from those in other countries. As observed for the duties of a UK or Hong Kong based depositary, the directors of a CIS have a mandate to monitor different types of risks. However, priority is given to some tasks over others. Whilst their general responsibility to ensure that the fund is managed properly and in the CIS investors' best interests, particular attention is given to poor economic performance of the CIS or in cases where the adviser is providing affiliate services that might involve a conflict of interest.[284] The American Bar Association states a number of issues of regulatory compliance and monitoring that should be kept under close scrutiny by CIS directors. In particular, it is stressed that the monitoring of compliance programs, investment oversight activities, agreement of brokerage or trade allocation policies, management of insider trading risks and business continuity planning require the attention of CIS directors.[285]

Specific duties of the directors

The ICA assigns a series of specific duties to CIS directors, which cover various aspects of the governance of the CIS. These duties are broadly related to the key contractually governed delegations of the CIS investors regarding correct investment management and asset records. Of the first type is the requirement for directors to be tasked with the annual approval of the advisory and principal underwriting contracts.[286] These contracts should imply fiduciary standards in determining the fairness of the terms of the investment management agreement with the advisor. Equally important is the directors' responsibility for the selection and nomination of persons to fill the vacant role of independent directors,[287] which is relevant for the board's role as the CIS IOE.

The correct management of the assets acquired by the CIS is of equal importance, as it indirectly guarantees the safeguarding of the CIS investors. With this in mind, the ICA requires that CIS directors select an independent accountant on an annual basis,[288] in order to guarantee an independent economic assessment of the wealth of the CIS.

In addition to the duties described above, the SEC improved the duties of the ICA with the adoption of a number of amendments to foster the governance of the CIS.

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[284] H Norman Knickle, 'The Mutual Funds' Section 15(c) process: Jones v. Harris, the SEC and Fiduciary Duties of Directors' (2011-2012) 31 Review of Banking & Financial Law 265.
[285] ibid 241-246.
[286] 15 USC Section 15(c).
[287] ibid Section 16(b).
[288] ibid Section 32(a)(1).

Some of these have enforced direct oversight responsibilities for CIS directors in corporate life actions, such as those for the structuring of multi-class agreements[289] or for mergers with affiliated funds.[290] Other SEC-sponsored rules have extended the oversight capacity of the CIS board, implementing signing off requirements for key policies such as those mitigating conflicts of interest.[291]

Rules of particular prominence that evidence the oversight duty for CISs in the US model are those requiring the directors' approval of the compliance policies and procedures of the CIS and of the its adviser, underwriter, administrator and transfer agent, as well as the approval of the designation and the compensation of the chief compliance officer of the CIS.[292]

The CIS assets valuation

A certain importance is placed on the valuation of the CIS assets, a fundamental activity to guarantee the correct redemption and subscriptions in the CIS on the part of its investors. IOSCO found that *"If CIS portfolio securities and assets are incorrectly valued, CIS investors may unfairly pay more for their shares (or unfairly receive less upon redemption), and investors remaining in the CIS also may be adversely affected"*.[293] It follows that the ICA requires directors to determine the "fair value" of portfolio securities if the market values are not readily available[294]

As with other jurisdictions, the Net Asset Value ("NAV") has a fundamental relevance for a CIS as it is the basis upon which the shares are sold or redeemed. It also informs most asset-based payments, such as Rule 12b-1 regarding advisory fees. It is therefore of the utmost importance that the CIS assets are valued in a fair and accurate way on a daily basis. It is the CIS directors' duty to determine and approve the valuation methodologies as well as to periodically monitor the accuracy of such valuations.

Securities can either be valued at market price, when market quotations are available, or at fair value using financial formulations. The difficulties of an accurate NAV increase with the complexity of the underlying portfolio, requiring CIS directors to be constantly involved in the process. For this reason, in 1970 the SEC issued guidance for CISs and their counsel, with the aim of assisting them in the process of valuing portfolio securities for which market quotations are not readily available.[295]

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[289] Rule 18f-3(c)(1)(v)).
[290] Rule 17a-8(a)).
[291] 15 USC, Adoption of policies and procedures relating to purchases from affiliated underwriter (Rule 10f-3(b)(1), purchases and sales to affiliated funds (Rule 17a-7(e)) and brokerage transactions with affiliates (Rule 17e-1(b)).
[292] ibid (Rule 38a-1).
[293] International Organisation of Securities Commissions, 'Principles for the Valuation of Collective Investment Schemes', (13 May 2013) 1.
[294] ibid (Section 2(a)(41)(B).
[295] Investment Company Institute, Accounting Series Release No. 118, Investment Company Act Release No. 6295, (December 23, 1970).

In 2015, the SEC issued further guidance on the topic, listing all relevant sources and litigation on the topic.[296] In order to stress the importance of a correct NAV, following a considerable amount of litigation and enforcement actions, the SEC reiterated that, while CIS directors may seek the help of others in calculating the fair value of the fund's securities, the ultimate responsibility rests upon them.[297]

The regulator's interpretation of the position of CIS directors became clear with an ICA Release in 2013 regarding a settlement reached with the board of directors of a CIS who had had delegated their fair responsibility to a valuation committee without providing adequate guidance regarding how the valuation should have been carried out.[298] According to the SEC, the valuation procedures provided no meaningful methodology or other specific direction in respect of how fair value determinations for specific portfolio assets or classes of assets should be made.[299] As a result of their inactivity, the SEC charged the directors with a violation of ICA rules, which require CISs to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities law by the fund.[300]

The advisory contract

Of utmost importance is the duty under ICA section 15(c). This imposes an annual obligation on CIS directors to review the advisory contract with the CIS operator, a keystone of the fiduciary relationship between the CIS investors and their directors. The advisory contract is usually entered into for a two-year term and, after the term has expired, it can be continued on an annual basis, should the continuation be approved by either the CIS board of directors or the CIS investors. Given the costs associated with asking all shareholders their opinion in the contract renewal process, this task is usually carried out by the CIS directors. In undergoing this revision process, they have the power to request from the CIS operator such information as may be reasonably necessary to evaluate the terms of the contract.[301] It is the adviser's duty to comply with the CIS director's request. The renewal of the advisory contract must be approved by the CIS independent directors at a board meeting called specifically for this reason.[302]

The advisory contracts embed various aspect of the contractual relationship, including the compensation of the CIS operator. To prevent excessive compensation, the ICA places a fiduciary duty upon the CIS operator *"with respect to the receipt of*

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[296] Securities and Exchange Commission, 'Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies — Select Bibliography of the Division of Investment Management' (31 July 2015). <https://www.sec.gov/divisions/investment/icvaluation.htm> last accessed 06 April 2017.

[297] *In the Matter of Seaboard Associates Inc.*, Investment Company Act Release No. 13890 (April 16, 1984).

[298] *In the Matter of J. Kenneth Alderman et al.*, Investment Company Act Release No. 30557 (June 13, 2013).

[299] ibid, § 18.

[300] 15 US Code 38a-1.

[301] ibid § 80a–15.

[302] ibid § 80a–15.

compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."[303] Despite this clear indication, the advisory contract has been the subject of several judicial decisions, which will be analysed in more depth later in this chapter.

Furthermore, the economic effects of an imbalanced advisory contract are such that the SEC adopted specific amendments to the review procedure, requiring each CIS to disclose the way in which its directors evaluate and approve the investment advisory contracts. Following these amendments, CIS directors are required to include in their decisions to review the adviser's contract

"(1) the nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors."[304]

These points closely resemble the so-called "Gartenberg factors" elaborated by the Court of Appeals in the milestone case *Gartenberg v Merrill Lynch Asset Management, Inc.*,[305] a fundamental case in CIS-related matters.

Directors' fiduciary duties under state law

The fiduciary duties under the ICA are stated only in *"respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser"*.[306] In fact, analysis suggests that this key requirement led to mass litigation, to the extent that a quarter of all mutual funds became targets for this kind of dispute between 2000 and 2009,[307] which shaped the activities of CIS directors. CIS boards now spend much of their time in the boardroom completing paperwork designed to serve as evidence of due diligence and good faith in case of future excessive fee suits.[308]

Nevertheless, there is still a strong case for full fiduciary duties. It must be remembered that the governance of a CIS within the US legal framework is subject to

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[303] 15 US Code 80a-36(b).

[304] Securities and Exchange Commission, 'Final Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies' (Release Nos. 33-8433; 34-49909; IC-26486; File No. S7-08-04).

[305] *Gartenberg v. Merrill Lynch Asset Management Inc.*, 694 E2d 923, 928-29 (2d Cir. 1982), cert, denied, 461 U.S. 906 (1983).

[306] 15 US Code § 80a-35(b) (2012).

[307] Investment Company Institute, '2013 Investment Company Factbook' (2013) 10 fig.1.2.

[308] John D Morley, 'The Flawed Mechanics of Mutual Fund Fee Litigation' (2015) Volume 32, Issue 1 Yale Journal on Regulation.

several statutory and common-law rules. Bines and Thel[309] find that the three duties that govern investment management law – in their opinion the fiduciary requirements of duty of care, loyalty and the public duty – *"remain the common conduct postulates underlying investment management law. In the fullness of time, however, the means for promoting and measuring fiduciary conduct have changed remarkably."* Their argument leads to the conclusion that, whereas the particulars of the enforcement of fiduciary conduct and of remedying breaches were once mainly the product of common law developments and scholarly commentary, statutory controls and regulatory oversight in separately defined spheres of activity now dominate.[310]

Having identified the ICA duties, intended here as the statutory requirements which "dominate", the common law principles are to be found under the law of the state within which the CIS is incorporated. Given that the three most popular forms of organization are Massachusetts business trusts, Maryland corporations, and Delaware statutory trusts,[311] these states' law are most relevant to this research. Under state law, directors have two main functions within the company: decision-making and oversight. In pursuit of such functions, CIS directors are also subject to the two duties forming the fiduciary relationship: those of loyalty and care. Furthermore, some courts and authors have added a third duty, that of good faith, forming a so-called "triad of duties".[312] The existence of such fiduciary duties at state level is widely accepted, and their formulation varies only slightly from state to state. In Delaware, courts have referred in recent years to the existence of the duty of disclosure, a derivation that flows from the duties of both care and loyalty.

Duty of loyalty and duty of care

According to the American Law Institute, a director's fiduciary duty can be described thus:

> *"A director … has a duty to the corporation to perform the director's … functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."*[313]

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[309] Harvey Bines, 'The Varieties of Investment Management Law, Fordham Journal of corporate & Financial Law' (2016) 21, 71.
[310] ibid.
[311] Investment Company Institute, '2017 Investment Company Factbook' (2017)>.
[312] H Norman Knickle, (266) 304.
[313] ibid, 305.

Such a definition draws from the descriptions given to the director's duty of care by the Maryland Corporations and Associations Code[314] as well as by Delaware's General Corporation Law.

The duty of loyalty is the key state-level requirement for registered CIS directors. They are to act in the best interests of the company, regardless of where their own interests (or those of another person or organization) may lie. By virtue of the statutes, CIS directors are forbidden from using their position for any kind of personal advantage. Like other CIS fiduciaries, if a director has a personal interest in a transaction, the individual should take particular care to avoid improper self-dealing or other forbidden practices. Conditions and procedures in the case of self-dealing and transactions involving interested directors are often established at state level in order to ensure their validity.

The duty of care requires directors to have or to acquire adequate knowledge of the matters upon which they are called to operate, in order to reach reasonable decisions. If a director has specialised knowledge or, in any case, greater skills than an ordinary person, the law requires this greater skill to be applied. This interpretation becomes important when directors of a CIS have different skill sets and must take a governance decision.

A US peculiarity: the business judgement rule

While it is widely accepted that CIS directors are subject to the fiduciary duties of loyalty and care, their actual application is in fact in contrast to the so-called "business judgment rule". According to this rule, in making business decisions, directors of incorporated companies must be

> *"informed with respect to the subject of the business judgement to the extent the director ... reasonably believes to be appropriate under the circumstances, must not be interested in the subject matter and must rationally believe the decision advances the best interests of the corporation."*[315]

The business judgement rule therefore presumes that CIS directors act in good faith and in the belief that their actions always are in the best interests of the CIS. Once this is proven, CIS directors' fiduciary duty of care is relaxed, and the burden of the proof of directors' negligence rests on the plaintiffs.

While the presumption offered by the business judgement rule is a powerful weapon in the arsenal of CIS directors, it can only be used if certain threshold requirements are met. In particular, the CIS director must not have violated his duty of loyalty,

[314] Maryland Code, Corporations and Associations § 2-405.1

[315] H Norman Knickle, citing the American Bar Association, 'Principles of Corporate Governance: Duty of Care of Directors; The Business Judgement Rule' (1992) § 4.01.

abdicated his function, or simply failed to act, without a conscious decision in this direction. In addition, the decision taken by the CIS director must be the result of their informed business judgement.

According to Sjostrom,[316] the application of the business judgement rule for CIS is based on five main reasons. First, CIS directors are not immune from mistakes, no matter how well-intentioned and informed they might be. By preventing courts from second-guessing their decisions, even if they proved to be mistaken, the rule *"encourages competent individuals to become directors who otherwise might decline for fear of personal liability"*.[317] Second, the rule prevents CIS directors from taking overly cautious business decisions, which might run counter to the CIS's interests. Third, most of the time, courts do not have enough business expertise to second-guess CIS directors' decisions or evaluate their merits. This is especially so because *"[t]he circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information."*[318] Fourth, the business judgement rule shields CIS directors by placing a limit on shareholders' involvement in the management of the company. This is strictly related to the fifth and final reason, according to which CIS investors already have a tool to express their disappointment with actions taken by the board actions, since they have the power to replace them.

Some authors argue that the peculiar nature of mutual funds, whose boards are only representatives of CIS investors, with no management role (which is instead given to the appointed adviser, the CIS operator), invalidates the application of the business judgement rule to directors.[319] In other words, since the CIS directors make no business decisions, they should not be subject to a limitation of liability based on the business-like nature of the decisions that are contested. Roiter[320] supports this view by stating that *"the primary role of fund directors is not to exercise an all-encompassing business judgment over a fund's operations, but instead to monitor the fund adviser for compliance with legal and fiduciary duties."*

It is possible that favourable legislation at the state level might unfairly limit the responsibilities of a CIS director if their actions are in breach of their fiduciary duties. In order to avoid regulatory arbitration, the courts have identified a federal cause of action with the deliberate intent to override state-level standards. Indeed, in *Brown v Bullock* the Second Circuit held that

> *"It is unreasonable to suppose that Congress would have wished to permit its purpose to protect investments in all investment companies ... to be frustrated if [the*

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[316] William Sjostrom Jr (n 263) 279-280.
[317] *Air Line Pilots Ass'n v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989).
[318] *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) at 886.
[319] Lyman Johnson, 'Protecting Mutual Fund Investors: An Inevitable Eclecticism' (Washington & Lee Public Legal Studies Research Paper Series Accepted Paper No. 2016-20).
[320] Eric Roiter, 'Disentangling Mutual Fund Governance from Corporate Governance' (2016) 6 *Harvard Business Law Review* 1, 4.

laws of] a particular state of incorporation should be satisfied with lower standards of fiduciary responsibility for directors than those prevailing generally".[321]

In the Court's opinion, the ICA intrinsically intended to *"create a federal body of law giving rise to a distinct federal claim."*[322] In addition, the ICA allows the SEC to bring an action against directors who have allegedly *"engaged in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company"*. As a result of this action, CIS directors may be prohibited from acting in such capacities and may be subject to other sanctions *"as may be reasonable and appropriate under the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in Section 1(b) of the Act."*[323]

Directors' insurance and limitation of liability

CIS directors may incur liability and expenses for claims related to alleged breaches of their duties, or of federal securities law, or of other state laws. Both the SEC and the ICI suggest that, in order to ensure the full independence of their directors, this professional risk can be mitigated with adequate directors' and officers' liability insurance coverage and/or indemnification from the CIS.[324]

Most US state corporation laws, along with the American Bar Association's Model Business Corporation Act ("Model Act") and business trust law, allow CISs to include in their charter provisions aimed at limiting director's personal liability to the fund and the shareholders for monetary damages arising from breaches of the duty of care. However, the liability insurance coverage subscription comes with some restrictions. The limitation perimeter does not extend to liability to third parties, to claims for non-monetary or equitable relief, or to violations of federal securities law. Furthermore, ICA section 17 limits the ability of the CIS to relegate its directors' liability to cases other than those caused by sheer negligence.[325] As a result, liability cannot be limited when it has been caused by conduct such as wilful misfeasance, bad faith, gross negligence or reckless disregard of duties.

According to state legislation, indemnification of CIS directors against liability and any related expenses is allowed, with limitations. Commonly known as a "raincoat provision",[326] under the Model Act, indemnification is possible only when the CIS director has acted in good faith and with a reasonable belief that any action was taken in the company's best interest. In the case of criminal proceedings, a CIS director must also prove that he had no reasonable cause to believe that the conduct was unlawful.

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[321] *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961).
[322] ibid.
[323] 15 US Code § 80a-36(a).
[324] American Bar Association, (n 270) 265.
[325] 15 US Code Section 17(h).
[326] William Sjostrom Jr (n 262) 281.

Subject to certain limitations, the Model Act allows a corporation to provide for a broader indemnification in its charter.

The SEC interprets the ICA's provisions to limit liability for conduct amounting to wilful misfeasance, bad faith, gross negligence or reckless disregard of duties specifically. In its view, the CIS is required to use "reasonable and fair means" in determining whether this has been the case. Three practical scenarios are taken into consideration: a final decision by a court or other body on the merits; a reasonable determination based upon a review of the facts by a vote of the majority of the disinterested directors not involved in the proceedings; or such a reasonable determination by an independent legal counsel in a written opinion.[327]

Given such regulatory interpretation, the question remains as to how CIS investors, who are substantially represented by the CIS directors, should manage the requirement to cover their directors' legal expenses. State corporation statutes usually cover cases in which a CIS can advance monies to its directors with a view to cover expenses incurred in a judgment. Broadly, these statutes require CIS directors to provide the CIS with a written undertaking that any funds advanced will be repaid should the outcome of the judgment be against them.

Further to this topic, the SEC requires that the director give security for the advance and insure this against losses arising from lawful pursuits. Other CIS directors, or an independent legal counsel, can determine the director's entitlement to the indemnification. In this case, state law requires the CIS director to sign a good faith affirmation that he or she meets the applicable standards for indemnification.

Directors are the key to governance

From the above analysis, it is evident that the US regulatory framework for CISs relies on directors to ensure proper governance. This is not easily accomplished, adding to the regulatory risks carried by CIS investors in the USA. The overlap of federal and state level duties complicates the important balance between the duties of CIS directors, mainly stemming from the ICA under federal law, and directors' liabilities, provided by state legislation. Robertson argues that, while most of the directors' obligations come from state law, they are also subject to the provisions of the ICA. In his view *"Fund directors must, as a practical matter, consider their responsibilities under state law as inextricably linked to those under federal law"*.[328]

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[327] Ibid, 266.
[328] Hope Lewis and James Hackney Jr, 'Chapter 2: Duties of Fund Directors Under State Law' in Robert Robertson (ed) *Fund Governance: Legal Duties of Investment Company Directors* (Law Journal Press 2017) 2-53.

Similarly, the business judgement rule may be considered a cap on the fiduciary expectations of CIS investors. For this reason, any gross negligence by a CIS director is considered a limit by US courts. In the case of *Smith v Van Gorkom*, a Delaware court stated that the duty of care requires the director to follow four main principles when reaching a decision. First, the director must decide in good faith, keeping the best interest of the corporation at heart; second, it is a director's duty to reach an informed decision, in reasonable reliance on reports and opinions of committees, employees and experts; third, the decision must be rational; finally, the decision must be in compliance with applicable laws, even if this means going against the company's best interest.[329]

The independent directors of a CIS are the key element for its correct governance. They are to act as watchdogs on the external adviser and on its affiliates. Their fiduciary duty under state law is integrated with a special obligation under federal law to protect the interests of shareholders against any potential mismanagement or abuse by the management.

The role of the independent CIS director is especially relevant in the case of shareholder derivative litigation. This is because the procedural complexity of such actions usually entails a determination as to whether a board decision is required before the litigation is allowed to proceed, or whether it should be excused as futile given the disabling conflict of interest of the majority of the board. It is now standard practice for CISs to appoint a special litigation committee, composed entirely of non-interested directors, tasked with reviewing derivative litigation. The result is that, in the vast majority of cases, such committees vote to avoid or dismiss the litigation, on the basis that it is not in the best interests of the CIS. According to shareholders and commentators, structural bias, originating from the desire to maintain well-established social and professional ties, may cause the non-interested directors to vote to protect interested directors from litigation, undermining the interests of the CIS investor. While the theoretical existence of this issue has been recognized, courts do not usually consider it, but rather defer to the recommendations of non-interested directors, thus allowing this specific vicious cycle to continue uninterrupted.[330] This fact calls into question the effective governance of the US-based CIS, and of its investor base, arguably the largest pool worldwide.

US case law

It is clear that the role of CIS directors in the US legal framework constitutes the key to the proper functioning of the ICA model. Judicial review supports our understanding of the perimeter of action that these CIS directors have. For the sake of interpreting the US courts' judgments, the term "fund" within the following

[329] ibid, 38.
[330] ibid, 53.

assessment indicates a CIS registered as a mutual fund, and "adviser" as a CIS operator, both with the SEC.

Independent directors' status

As previously identified, directors of a CIS mutual fund hold the function of the CIS independent entity, which is *de facto* the only body that can truly represent the interests of CIS investors in the governance of an ICA CIS.

The question is therefore why the ICA model does not require by statute that CIS independent directors form the majority of a board. A jurisdictional review of SEC cases reveals a rejection of the regulator's attempt to establish a minimum 75% of independent directors on CIS boards. In 2001, the SEC issued a final rule with the intent to amend certain Exemptive Rules under the ICA. The proposal for ICA-compliant funds was to require independent directors to constitute the majority of the CIS's board of directors. Furthermore, only independent directors could select and nominate other independent directors, and any legal counsel to the independent directors must also be independent.[331] The first standard mentioned above was petitioned against by the US Chamber of Commerce, a lobbying group, in 2005. The DC Circuit Court found the SEC in violation of the Administrative Procedures Act, having failed to determine the costs of its proposed conditions and having not addressed a proposed alternative to the independent chair proposal.[332]

The following year, the same Court ruled on the SEC re-adoption of that same rule requiring CIS independent directors to constitute at least 75% of the board. In the second judgment, the Chamber argued that the SEC failed

> *"(1) to develop new, and to consider extant, empirical data comparing the performance of funds respectively led by inside and by independent chairmen; and (2) to consider the costs of the conditions it was imposing, which costs in turn impede efficiency, competition, and capital formation".*[333]

The case was upheld on appeal. Interestingly, the argument was based on the standards set under the ICA, which gives regulatory powers to the SEC. The ICA mandates that when the Commission *"engage[s] in rulemaking and is required to consider or determine whether an action is consistent with the public interest [it] shall ... consider ... whether the action will promote efficiency, competition, and capital formation."*.[334] Having failed to disclose a full comparison of the costs and legal performance with the imposition of the new rule, there was no opportunity for public comments on the

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[331] Securities and Exchange Commission, 'Release Nos. 33-7932; 34-43786; IC-24816; File No. S7-23-99' <https://www.sec.gov/rules/final/34-43786.htm> accessed 16 February 2019.

[332] *Chamber of Commerce v. SEC*, 412 F.3d 133, 143-45 (D.C. Cir. 2005).

[333] *Chamber of Commerce v SEC*, 443 F.3d 890, 908 (D.C. Cir. 2006).

[334] 15 U.S.C. § 80a–2(c).

data used for the estimations of the costs involved in complying with the proposed rule.

The same argument was later used in *Business Roundtable v SEC* on the matter of limited shareholder board nominations. Cox and Baucom argued that the level of review invoked by the DC Circuit Court in *Business Roundtable v SEC* and its earlier decisions is dramatically inconsistent with the standard enacted by Congress. Their conclusion was that the DC Circuit Court had assumed for itself a role opposed to the one Congress prescribed for courts reviewing SEC rules.[335]

The SEC did not try to submit the rule again, creating the regulatory gap described above. However, a study published by ICI revealed that CIS independent directors make up three-quarters of boards in 83% of funds registered in the US. In their analysis, between 1994 and 2016, independent directors held 75% or more of board seats in CISs, of which increased from 46% to 83%.[336]

CIS directors as fiduciaries and conflicts of interests

Closely associated with the topic of independence is that of conflict of interest. This is particularly relevant in the context of a CIS, considering that a fund is often the business product of an advisor rather than a voluntary association of investors. There are not many key cases put forward by the SEC regarding potential conflicts of interest for directors. However, for the sake of analytical completeness and consistency, this research will look into ICA Releases as instruments of the SEC's interpretation of the rules at hand.

In 1971, it became clear that CIS directors working within the US mutual funds market had to disclose relevant information that could compromise their independence. In *Moses v Burgin*, a shareholder of the CIS registered as Fidelity Fund, Inc., brought forward a derivative action against the directors, investment adviser and underwriter of the fund. While the District Court had at first dismissed the claim, the First Circuit Court ruled to make those parties liable. It was then noted that one of the primary reasons that the US Congress enacted the ICA was the inherent conflict of interest in the structure of investment companies. According to the Court, the ICA solved this problem by requiring that CIS boards include *"unaffiliated, that is, independent, watchdog directors"*. Hence, the Court concluded that the fund's adviser and fund directors affiliated with the adviser *"were under a duty of full disclosure of*

[335] James D Cox and Benjamin JC Baucom. "The Emperor Has No Clothes: Confronting the DC Circuit's Usurpation of SEC Rulemaking Authority" (2011) Texas Law Review 90, 1811.
[336] Investment Company Institute, 'Overview of Fund Governance Practices 1994-2016' (October 2017) <https://www.ici.org/pdf/pub_17_fund_governance.pdf> accessed 10 March 2018.

information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund."[337]

How the CIS independent directors are to be supported in their role was specified later. In *Fogel v Chestnutt*, a derivative action was upheld against the scheme adviser and four fund directors affiliated with the adviser. Their fault was mainly to have failed to inform the CIS's independent directors of the possibility of recapturing commissions. The Court stated that

> *"The minimum requirement to enable the Fund's independent directors to discharge these [disclosure] duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons"*.[338]

Justice Friendly further clarified that it would have been better to have the investigation of recapture methods, and their legal consequences, performed by disinterested counsel furnished to the independent directors.[339]

This approach implies that an informed CIS independent director is an assurance to the other fiduciaries. Such an interpretation was sustained by the judgment in *Tannenbaum v Zeller*. This case involved an alleged breach of fiduciary duty regarding the possibility of recapture portfolio brokerage commissions for the CIS. Justice van Pelt Brian noted the fiduciary standards under ICA section 36(a), which *"established a federal standard of fiduciary duty in dealings between a mutual fund and its adviser ... includes a duty of disclosure"*.[340]

However, the Court's opinion turned on three aspects of the relationship between CIS independent directors and the other fiduciaries. It was found they

> *"were not dominated or unduly influenced by the investment adviser; were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors."*[341]

Given such relationships with, and actions toward, the CIS independent directors, the Court found that the CIS directors had not been in breach of their fiduciary duty under the ICA.

For the sake of clarity, the Court in *Gafland v Chestnutt* reaffirmed that CIS directors' fiduciary duties are due as *"[t]he directors of the Fund held a position of trust and*

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[337] William K Sjostrom Jr (n 262) 376.
[338] *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975) at 749-750
[339] ibid.
[340] *Tannenbaum v. Zeller*, 552 F.2d 402, 404, 411 (2d Cir. 1977) at 416.
[341] ibid at 418-419.

confidence with respect to the Fund's shareholders, and owed them the obligations commonly associated with fiduciaries."[342] This principle was often cited in cases in subsequent years, including *Seidel v Lee*,[343] and *Goldstein v Lincoln National Convertible Securities Fund, Inc*.[344] In the US model, the CIS independent director is therefore supported in his function by those who may have different interests, eliminating potential conflicts of interest of a different kind.

This became clear in two specific cases after a string of cases in the 1970s. In *Cambridge Fund, Inc. v Abella*, the Court extended the duty of disclosure beyond the recapture issue, finding that the defendants *"had a similar duty of disclosure with respect to the Fund's payment of their legal expenses"*[345] because the situation involved potential conflicts of interest. This decision was also based on

"the recognition that the independent directors were intended to be 'independent watchdogs' and that therefore full effective and neutral disclosure must be made to them as to all issues relating to the management of the fund or its assets and as to which there are potential conflicts of interest."[346]

More recently, the SEC has further defined its policy of no conflicts and stated disclosure for CIS. In 2015, the SEC brought administrative proceeding against Deloitte & Touche LLP, one of its affiliates (Deloitte Consulting LLP) and Andrew C. Boynton. The reason was the existence of an independence-impairing business relationship between the parties. Boynton served on the board of trustees and the audit committee of three funds to which Deloitte & Touche and its affiliates provided advisory services. The relationship between Boynton and Deloitte Consulting was never disclosed in the audit reports that Deloitte & Touche produced for the three funds of which Boynton was a trustee.

Furthermore, whilst the CIS policies expressly stated that the audit committee was expected to evaluate the independence of the auditors, none of them adopted *"sufficient additional written policies and procedures reasonably designed to prevent auditor independence violations, whether aimed at preventing or detecting independence-impairing business relationships or otherwise."*[347] This was in clear violation of SEC Rule 38a-1 under the ICA, which requires funds to put in place *"written policies and procedures reasonably designed to prevent violation of the Federal Securities Law by the Fund"*.[348]

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[342] *Garland v. Chestnutt,* 402 F. Supp. 1318 (S.D.N.Y. 1975) at 1328.
[343] *Seidel v. Lee*, No. 94-422-JJF, 1996 WL 903947 (D. Del. Aug. 16, 1996).
[344] *Goldstein v. Lincoln National Convertible Securities Fund, Inc.*, 140 F. Supp. 2d 424, 428 (E.D. Pa. 2001).
[345] ibid at 622.
[346] ibid at 624.
[347] Deloitte & Touche LLP, 'ICA Release No. 31,703 '(July 1, 2015) 3.
[348] 15 U.S.C. 38a-1.

Director duties in advisory fee setting: Gartenberg

From the point of view of a CIS investor, the payment made to the adviser for its services are one of the main expenses incurred in the management of the CIS assets. Ambivalent in nature, these fees are both a necessity for the operation of the adviser and a meter for its skills. From a CIS governance point of view, however, they are not the simplest cost to determine in an effective way.

For this reason, the ICA enforces the highest standards expected. It does so with the text used in section 36(b), which *"deems an investment adviser of an investment company to owe a fiduciary duty with respect to the receipt of compensation for advisory services (i.e., management compensation)."*[349] To enhance these standards, the ICA creates an express, private right of action for CIS investors to sue the investment adviser or its affiliates, on behalf of the company, for a breach of fiduciary duty.

One of the most well-known cases in Securities Law, *Gartenberg v Merrill Lynch Asset Management Inc*. ("*Gartenberg*"), is considered the milestone case on the topic of the CIS operator's fee. In this 1982 case, Mansfield J developed the so-called "Gartenberg factors", used then and later as determinants of the existence of a fiduciary duty for the CIS directors and their advisers.

The case concerned a plaintiff CIS investor who alleged that his adviser had violated fiduciary rules by charging excessive fees. Retaining the District Court's dismissal of the plaintiff's claim, the Court first stated that *"[t]o be guilty of a violation of § 36(b) ... the adviser-manager must charge a fee that is 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."*[350] The latter indicator was considered in the judgment, as it was asserted that *"the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all the surrounding circumstances."*[351]

In order to determine whether fiduciary duties to the CIS investors had been violated, the Court then went on to determine factors to review the fairness of the adviser's fee and, thus, created the so-called "Gartenberg factors". These were detailed as follows: a) the nature and quality of the services provided by the adviser; b) the profitability of the fund to the adviser; c) the adviser's receipt of collateral benefits because of its relationship with the fund (the so-called "fall-out benefits"); d) the extent to which the adviser realises economies of scale as the fund grows; e) the comparative fee structure

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[349] Lyman Johnson, 'A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and *Gartenberg* at Twenty-Five' (2008) 61(2) Vanderbilt Law Review 497, 499.

[350] *Gartenberg v. Merrill Lynch Asset Mgmt.*, Inc., 694 F.2d 923, 1041-42 (2d Cir. 1982) at 16.

[351] ibid at 15.

(a comparison with the fees paid by similar funds); and f) the independence, expertise, care, and conscientiousness of the board in evaluating the adviser's compensation.[352]

The last factor directly addresses the role, constitution and skills of the CIS directors. It was argued that, in interpreting the ICA provisions regarding the contracts of advisers and underwriters,[353] the rule creates a dynamic interplay with the CIS director's fiduciary duty to approve the contract and fee.[354] Therefore, CIS directors must fulfil fiduciary duties beyond their specific duties to request, furnish and evaluate the terms of the proposed advisory contract.[355]

Regardless of the legislative provisions, the amount of litigation concerning advisor's fees is very limited, amounting to little more than a dozen SEC enforcement actions (under either ICA section 15(c) or 36(b)),[356] while private litigants have had very little success.[357]

The interpretation of the CIS directors' role was brought into discussion more recently with the judgement of *Jones v Harris Assoc. L.P.* ("*Jones*") in 2010. Again, the case was brought by a shareholder of a CIS, who alleged that the CIS adviser had charged excessive fees and was therefore in violation of its fiduciary duty under section 15(c) of the ICA. While dismissing the suit on the grounds that it did not meet the Gartenberg factors, the Court of the Seventh Circuit used this opportunity to reject the Gartenberg factors and introduced another standard. According to the Seventh Circuit, the adviser's only responsibility was to provide full disclosure to the CIS board. In the Court's words, the advisor had an obligation to *"make full disclosure and play no tricks"*.[358]

The decision was appealed and the Supreme Court reversed the judgment of first instance, stating that the Gartenberg factors were indeed the standard to be used to

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[352] H Norman Knickle (n 271) 265.
[353] 15 USC § 80a–15 - Contracts of advisers and underwriters.
[354] H Norman Knickle (n 271) 393.
[355] ibid, p 276.
[356] Paul Buchbaum, 'Exchange Act Release No. 16622, 1980 WL 20779' (Mar. 4, 1980), approving settlement of a 15(c) claim and finding that a fund's director

> *"did not adequately fulfill his obligation in overseeing the funds. He failed to make an adequate review of the investment policies pursued by [the adviser] and the disclosure documents disseminated to shareholders and filed with the [SEC]. Further, [he] approved an increased management fee paid to [the adviser by the fund] without requesting and evaluating such information as was necessary to evaluate the terms of the management contract."*.

[357] See for example: *Galfand v Chestnutt,* 545 F.2d at 807 (holding that failure to comply with the *15(c)* process does not, standing alone, establish a *per se* violation of the 1940 Act); *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, *573* F. Supp 1293 (S.D.N.Y. 1983) (dismissing action on the merits unrelated to the *15(c)* process); *Andre v. Merrill Lynch Ready Asset Trust*, 97 F.R.D. 699 (S.D.N.Y. 1983) (dismissing plaintiffs *15(c)* claim as "meritless" on the facts); *Krasner v. Dreyfus Corp.*, 90 F.R.D. 665 (S.D.N.Y. 1981) (discussing the 15(c) process, which the court found the directors have satisfied); *Cohen v. Fund Asset Mgmt.*, Inc., 1980 WL 1488 (S.D.N.Y. 1980) (finding cause of action "only against those persons who are recipients of the compensation or payments of material nature from the [f]und"); *Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass. 1978) (dismissing plaintiff's 15(c) claim for failure to first make demand on the board as per 15(c) procedural requirements); *Halligan v. Standard & Poor's/Intercapital, Inc*., 434 F. Supp. 1082 (E.D.N.Y. 1977) (dismissing plaintiff s 15(c) complaint for failing to state a *15(c)* claim).
[358] ibid at 632.

determine whether the adviser had violated its duties.[359] With this judgment, three principles are now key for the CIS directors. Firstly, the Court in *Gartenberg* did not establish whether an adviser could violate its fiduciary duties in a way other than by charging an excessive fee. Mr Gartenberg's argument had been that the adviser could violate its fiduciary duties by not cooperating with the fund board or by not disclosing all the information necessary to set the fee. The Supreme Court in *Jones* ruled that these duties were limited to avoiding charging an excessive fee: any violation on the part of the adviser in terms of its disclosure obligations can be considered a factor in evaluating the CIS board's decision to grant an excessive fee.

Justice Alito stated that *"an [CIS] adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees"*.[360] The sixth Gartenberg factor became a requirement for *"the independence, expertise, care and conscientiousness of the board in evaluating the adviser's compensation,* plus *whether the adviser fulfils its obligations in the 15(c) process."*[361]

Secondly, in *Jones* it was clarified that the fees charged by the adviser to non-fund clients (such as pensions and individual clients) could be taken into account by the CIS board in determining the excessiveness of the fee in the process of approving the advisory contract. Interpreted broadly, this requires CIS directors not only to take into account non-fund fees, but also to determine whether such fees are relevant.[362]

Finally, the Court focused on the role of CIS directors as independent watchdogs in stating that

> *"In recognition of the role of the disinterested directors, the [Investment Company] Act instructs courts to give board approval of an adviser's compensation such consideration ... as is deemed appropriate under all the circumstances. From this formulation, two inferences may be drawn. First, a measure of deference to a board's judgment may be appropriate in some instances. Second, the appropriate measure of deference varies depending on the circumstances. ... It is also important to note that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions."*[363]

In sum, the *Jones* decision did not really bring any change to the criteria set out in *Gartenberg*. Therefore, the main factor in assessing whether the CIS operator and the CIS directors have breached their fiduciary duty in the US framework is whether the fee is *"so disproportionate that it does not bear a reasonable relationship to the service the defendant rendered and could not have been negotiated at arm's*

[359] *Jones v. Harris* L.P., 130 S. Ct. 1418, 1426 (2010).
[360] ibid.
[361] H Norman Knickle (n 271) 282.
[362] *Jones v. Harris* at 1428.
[363] H Norman Knickle, (n 271) 284 citing *Jones v. Harris* at 1428-30.

length."[364] This was demonstrated recently in *Kasilag v Hartford Investment Financial Services, LLC*,[365] in which the Court had to verify if there was responsibility on the part of the adviser for breaching his fiduciary duties under ICA section 15(c). In a case substantially similar to those above, the Court, in its final decision rendered in February 2017, applied the Gartenberg factors as described and found that the plaintiffs had not met their burden of proof in demonstrating that the fee was so unreasonably excessive that it could not have been the result of arm's length bargaining.

The SEC has further clarified its view on how the information flow to the CIS directors determines their responsibilities in various recent public releases on the ICA. In 2015, the SEC initiated administrative proceeding against *Kornitzer Capital Mgmt.* ("*KCM*"), a registered adviser, for failing to *"furnish information that was reasonably necessary for the Board to evaluate the terms of KCM's advisory contracts in violation of Section 15(c) of the Investment Company Act"*.[366] The Release specified how the SEC examined the concept of "reasonably necessary information", referring to a number of fund filing disclosure requirements it has published over the years, in particular those promulgated in 2004.[367] According to the guidelines, a CIS must include in its CIS investors report a discussion concerning *"the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund."*[368] The reason for this stems from the ICA Release no. 26,486 in which the Commission noted that *"it would be difficult for a board to reach a final conclusion as to whether to approve an advisory contract without reaching conclusions as to each material factor"*.[369]

Further details were provided in another ICA Release the same year. In an effort to encourage CIS directors to evaluate advisory contracts with particular care, the SEC issued a number of rules. In particular, in accordance with reporting requirements, following a CIS board's approval or renewal of an advisory contract, *"the fund's next report to shareholders must discuss, in reasonable detail, the material factors and conclusions that formed the basis for the board's approval or renewal of that contract."*[370] The details should be comprehensive regarding the duties and tasks assigned, including the nature of the extent and quality of the services provided, together with the cost and profits that the CIS Adviser expects to realize.

In *Commonwealth Capital Mgmt. LLC ("CCM")*, the CIS advisor, connected to various trust funds, failed to submit all the information that the CIS directors had requested. Specifically, it omitted information about the fees paid by comparable

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[364] *Jones v. Harris* at 344.
[365] *Kasilag v. Hartford Investment Financial Services, LLC*, Civil No. 11-1083 (D.N.J. Dec. 17, 2012).
[366] Kornitzer Capital Mgmt., Inc., ICA Release No. 31,560 (Apr. 21, 2015) at 2.
[367] Securities and Exchange Commission, 'Disclosure Regarding the Approval of Investment Advisory Contracts by Directors of Investment Companies' (Investment Company Act Release No. 26486, June 30, 2004).
[368] Kornitzer Capital Mgmt, Inc. (n 353) at 9.
[369] ibid.
[370] Commonwealth Capital Mgmt., LLC, ICA Release No. 31,678 (June 17, 2015).

funds as well as sufficient disclosure about the services the CIS adviser intended to provide compared with those provided by others. However, the CIS directors did not ask for additional information before approving the contract, considering the fees to be within an appropriate range. They also failed to report to the CIS investors their discussion and information used to justify entering into a contract with the adviser, thus violating section 30(e) of the ICA. The CIS directors were therefore found to have violated their duties and fined by the SEC.

Directors in the UK

Introduction

Under chapter 2 of the UK Companies Act 2006,[371] company directors have seven major duties: the duty to act within powers, in accordance with the company's constitution and for the purposes for which they are conferred;[372] the duty to promote the success of the company, requiring the director to act in good faith and in the interest of the company's members as a whole;[373] the duty to exercise independent judgment;[374] the duty to exercise reasonable care, skill and diligence, at the level that may be reasonably expected by a person carrying out his functions and with regard to the specific skills that the single director has;[375] the duty to avoid conflicts of interest;[376] the duty not to accept benefits from third parties, when such benefits are conferred by reason of his being a director, or his doing (or not doing) anything as director;[377] and the duty to declare his or her interest in proposed transactions or arrangements.[378]

These standards would apply to the directors of those CISs registered as LLCs. However, there is a regulatory requirement to consider the directors of this type of LLC, which is authorised by the FCA as a CIS, like those of other collective schemes that are not incorporated. Therefore, like in the US, the role and duties of the CIS directors are to be found at the level of CIS regulation. In contrast to the US model, the current role differs noticeably and is intended to address tasks that have more to do with management than independent governance. As discussed in chapter three, the CIS IOE function is assigned to a depositary. The CIS IOE function is therefore not addressed in this context.

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[371] UK Companies Act 2006.
[372] ibid § 171.
[373] ibid § 172.
[374] ibid § 173.
[375] ibid § 174.
[376] ibid § 175.
[377] ibid § 176.
[378] ibid § 177.

For practical reasons, and to be consistent with other parts of this research, the following analysis will focus on the nature and duties of CIS directors in the framework of Open-Ended Investment Companies.

Open-Ended Investment Companies

With the creation of a CIS, there is a need for the scheme to assume a legal form. As previously mentioned, the majority of CIS incorporations in the UK in the last few years have taken the corporate form. In 2001, the UK government sponsored the promulgation of a specific regulation to create companies with variable capital. This was also a move to align its legislative framework to that of Continental Europe, which often uses the SICAV format, and that of the US. As a consequence, an Open-Ended Investment Company ("OEIC") is *"a body corporate, most or all of the shares in, or securities of, which can be realised within a reasonable period."*[379] These OEIC structures follow dedicated legislation in the form of the Open-Ended Investment Companies Regulations 2001 ("OEIC Regulations")[380] in addition to the regulatory provisions contained in the Company Act 2006 and those of the COLL.

In order to exist publicly, an OEIC must be registered by the FCA and, as with other types of investment vehicles, it must have at least one director. Directors must be authorised persons according to the relevant regulation and, in the case of companies with single directors, it must be a body corporate (therefore falling within the category of the Authorised Corporate Director ("ACD")).[381] In practice, it is uncommon for OEICs to have more than one director.[382]

The OEIC Regulations detail the corporate code that an OEIC abides by. The directors are first and foremost integral organs of such a corporation. The level of performance expected of them in the exercise of their duties is clearly stated in section 35.[383] This section clarifies a question posed many times regarding the fiduciary duties of the parties involved in the governance of the CIS. With it, the UK government states upfront that the directors are to take into account the interests of the company's employees as well as those of the shareholders. The second paragraph explicitly frames this duty of the OEIC director as a fiduciary duty, by stating that duty imposed by this regulation on a director is owed by him to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.[384] A director of a CIS owes, by statute, fiduciary duties equal to those that any other UK company would expect from its directors.

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[379] FCA PERG Handbook The Perimeter Guidance Manual (PERG) 9.3.3.
[380] Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulation 2001.
[381] ibid, section 15(6).
[382] Paul Dickson (ed), 'United Kingdom', *The Asset Management Review* (5th Edition, London: Law Business Research Ltd 2016).
[383] ibid, section 35.
[384] ibid, section 35(2).

It is worth noting that the interests of the employees and, especially, of the company's shareholders, are not considered prominent by the OEIC Regulation, but these factors are only included in those that the director must have regard to in his decision-making process. Other powers are given to the CIS directors of an OEIC. They have the ability to bind the company within the limits set out by the law and the company's constitution.[385] Obligations undertaken in the name of the company by the directors, beyond the power afforded to them by the instrument of incorporation, can still have effect if *"ratified by a resolution of the company in general meeting"*.[386]

The OEIC Regulations are in effect limited in scope. The UK Government was aware of the extensive requirement posed by the FSA/FCA in its rulebooks. It is realistic to state that the regulations exist to allow for specific tax treatment and capital formation and disintegration in the embedded system of unit creation. The duties of the OEIC Directors are therefore also limited. For the most part, these are to be found in chapter 6 of COLL or other specialist rulebooks for CISs.

A new proposition for CIS directors in the UK

The Authorised Corporate Director

Under OEIC Regulation and COLL, CIS management may be carried out by the so-called Authorised Corporate Director (ACD), whose role is comparable to that of the manager of an Authorised Unit Trust (AUT). As with any other Authorised Fund Manager (AFM), in order to exercise this role an ACD must be authorised by the FCA.[387]

Under FCA rules, an OEIC's affairs must be governed by a board, which can consist of one or more directors. The composition of the CIS board of directors in the UK differs greatly from that in the US, particularly regarding the legal nature of the CIS directors. In the US, the ICA defines directors as *"any director of a corporation or any person performing similar functions ... including any natural person who is a member of a board of trustees of a management company created as a common-law trust"*,[388] in accordance with the general principle of law (contained in a number of states' legislation),[389] that only natural persons may serve as directors of corporations.[390]

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[385] ibid, section 39.
[386] ibid, section 42.
[387] ibid 1A.1.6.
[388] 15 U.S.C. 80a-2(a)(12).
[389] According to the Delaware General Corporation Law (DGCL), each member of the board of directors 'shall be a natural person.' Del. Code Ann. tit. 8, § 141(b). Section 8.03 of the Model Business Corporation Act requires boards to 'consist of one or more individuals', while under section 1.40 of the same Act, an individual is 'a natural person'. In addition § 1722(a) of the Pennsylvania Business Corporation Law requires directors of corporations to be natural persons'.
[390] Stephen Bainbridge, 'Corporate Directors in the United Kingdom' (UCLA Law & Economics Research Paper Series, Research Paper No 17-04).

In contrast, in the UK, under the COLL framework, CIS directors of a so-called investment company with variable capital can be either natural or legal persons. If there is only one director, COLL rules require it to be a body corporate authorised under the FSMA.[391]

Further developments are expected in this field as part of the Small Business, Enterprise and Employment Act 2015. The UK government had pledged to amend the rule, contained in the Companies Act 2006, allowing for the presence of corporate directors for smaller companies. The UK Government's intention is to create a ban on the possibility of having companies or artificial legal persons acting as directors of other companies. With the introduction of such regulations, only natural persons would be allowed to be employed by companies as directors. However, the changes were delayed until October 2016, and subsequently indefinitely, with no further guidance on when the restriction should enter into force.[392] It is plausible to expect exceptions for ICVCs, particularly in the light of the new contractual format CISs in the UK.[393]

A CIS cannot exist without an ACD. If, for any reason, it ceases to have one, the CIS depositary, in his function as CIS independent entity, must promptly appoint a new one.[394] In order to avoid creating a situation where the CIS remains without an authorised director, COLL forbids an acting ACD to terminate his appointment unless a suitable successor has been found who is ready to step in at the same date as the termination.[395] Any change in the status or the person of the ACD must be duly notified to the FCA.[396]

It was previously indicated that the board of the CIS can consist of one or more directors. If there are two or more directors, the directors that are not the ACD have the duty of exercising *"reasonable care to ensure that the ACD undertakes [his] responsibilities ... in a competent matter"*.[397] At the same time, it is the duty of the ACD to provide all other CIS directors with all the relevant information and explanations.[398] Should the CIS have more than one director, the directors who are not ACD have the same powers and duties of the ACD under COLL 6.6.15 and 6.6.15A (allowing for the creation of committees and delegations).

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[391] Financial Services and Markets Act 2000.

[392] Stephen Bainbridge, 5; Dentons, 'Corporate Directors: No Ban Yet' (20 Oct. 2016) <http://www.dentons.com/en/insights/newsletters/2016/october/20/uk-corporate-briefing/uk-corporate-briefing-autumn-2016/corporate-directors-no-ban-yet> accessed 18 April 2017.

[393] The UK government introduced the Authorised Contractual Scheme in order to reduce tax complexity for investors. It is now an available legal structure for creating a CIS under COLL premises.

[394] COLL 6.5.3(1 & 2).

[395] ibid 6.5.3(4).

[396] ibid 6.5.3(5).

[397] ibid 6.5.5(1).

[398] Ibid.

Is the ACD the actual CIS operator in an EEA context?

It is notable that the duties and responsibilities of an ACD in the UK resemble those expected of an investment management company elsewhere. From the point of view of a CIS investor, the ACD is certainly responsible for managing some of the important risks incurred as unitholder. For example, the ACD's duty to ensure that the investment objectives and policy of the CIS are respected or to verify that the investments are made in transferable securities, in the UCITS case, certainly makes the ACD the fiduciary responsible for the investment management process. A number of other responsibilities, if not the COLL rules and guidance, clarify that indeed the ACD or AFM, depending on the legal status of the CIS, is the CIS operator.

The FCA clarifies in the COLL syllabus that an ACD is intended as *"the director of an ICVC who is the authorised corporate director of the ICVC in accordance with COLL 6.5.3 R (Appointment of an ACD) including, if relevant, an EEA UCITS management company or incoming EEA AIFM"*. In the context of the EU UCITS Directive, the series of duties for the management companies make them ultimately responsible for the operations carried out by the UCITS. It is accepted, however, that the management company delegates most of these tasks, with the sole limitation that it cannot become a mere "letter box" entity.[399]

Furthermore, relevant prerequisites of the UCITS manager can be associated with those of the ACD in a non-UCITS scheme, including being of *"sufficient good repute and ... sufficiently experienced"*,[400] and the requirement of independence.[401] In addition, EU directives provide that the national authorities of a UCITS management company's home state must require the company to put in place *"sound administrative and accounting procedures"* including *"rules for personal transactions by its employees"*,[402] while designing its internal organisation with the aim of minimising *"the risk of UCITS' or clients' interests being prejudiced by conflicts of interests"*.[403] As seen above, the latter is a strong requisite for ACD compliance.

Again, the ACD of UCITS schemes, indicated as UK UCITS management companies providing collective portfolio management services for an EEA UCITS scheme, have specific duties. In particular, they need to act in the best interest of the scheme and its unitholders. The ACD must also ensure that the unitholders are treated fairly, that the interests of a specific group of unitholders are not placed before that of any other group of unitholders; *"appropriate policies and procedures for preventing*

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[399] Ernst & Young, 'European Mutual Funds: An introduction to UCITS for US asset managers' (2005) <http://www.ey.com/Publication/vwLUAssets/EY-european-mutual-funds/$FILE/EY-european-mutual-funds.pdf> accessed 21 Apr 2017.

[400] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) OJ L 302, 17.11.2009, p. 32–96

[401] ibid, art 7.2.

[402] ibid, art 12.1(a).

[403] ibid, art 12.1(b).

malpractices that might reasonably be expected to affect the stability and integrity of the market" are to be applied.[404]

Finally, under EU regulations, no single company can act as both UCITS management company and a depositary as the same time. Furthermore, the management company and the depositary are under an obligation to act independently of one another. This independent status is valid for the ACD as well.[405]

Upcoming policies on UK's CIS directorship

Between 2015 and 2017, the FCA published the findings of an extensive market study on asset managers and the industry in which they operate. The regulator's aim was to understand how these entities compete to deliver value to both retail and institutional investors. Given that the findings indicated flaws in competition and the value for the UK investors, the FCA reviewed its findings and, after publication in 2017, proposed a number of modifications to its rules, including some addressing the status of independent directors. In 2018, the FCA finally provided market participants with a policy statement regarding the remedies and changes to its handbook to be made in 2019 and 2020.

When a UK CIS is established as an OEIC, the AFM typically acts as its sole corporate director. Where the fund is constituted as a unit trust or contractual scheme, the AFM performs an equivalent function, meaning that the AFM carries out the responsibility of considering and acting in the best interests of investors, as set out in COLL.[406] However, AFMs do not themselves manage the assets of the CIS, but rather delegate the management of these assets to another firm that carries out portfolio management. There are two common business models for this arrangement: delegation to another portfolio manager within the same group of companies and delegation to third-party portfolio managers.

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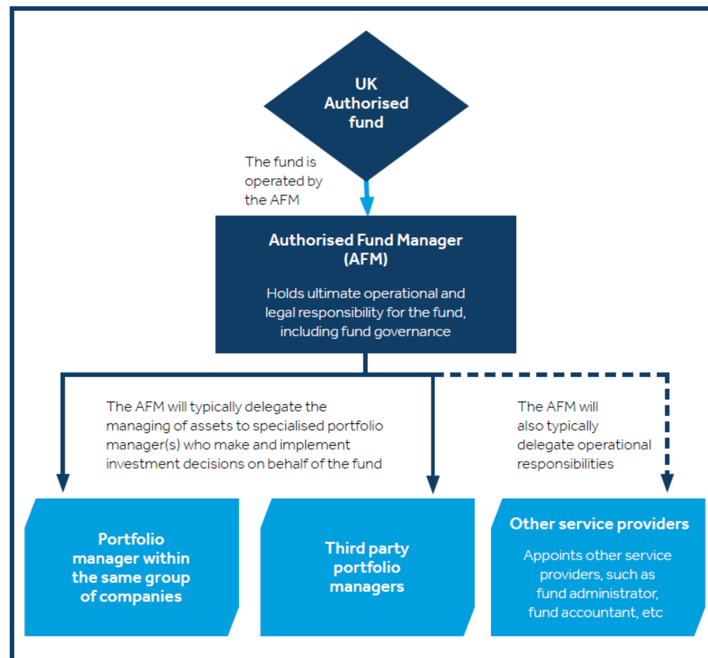
[404] COLL 6.6A.2(3).

[405] FCA Handbook COLLG The Collective Investment Scheme Information Guide (COLLG) 2A.1.3(4).

[406] FCA Consultation Paper CP17/18, 'Consultation on implementing asset management market study remedies and changes to Handbook' (June 2017) point 3.12-13 <https://www.fca.org.uk/publication/consultation/cp17-18.pdf> accessed 15 January 2018.

Figure 6: FCA diagram for AFMs activities



Source: FCA CP17/18

When there is a link between the AFM and the portfolio manager, the directors of the AFM may be employees of the portfolio manager, or directors of the parent company. This creates an inherent tension between the interests of shareholders of the AFM and the wider group and the investors in the fund.[407] However, AFM boards must balance the interests of their investors and shareholders. The FCA market study suggests that this balance is not always being struck appropriately; the regulator itself suggests that this is in part due to the fact that AFM boards are generally staffed exclusively by executives of the firm. In order to rebalance and to ensure that the question of what is in the best interests of CIS investors is subject to greater scrutiny and challenge, the FCA proposed that AFMs appoint a minimum of two independent directors and that they comprise at least 25% of the total board membership.[408]

The FCA considered market participants' concerns regarding various aspects of the proposed rules, including the potential harm it may have on smaller and younger AFMs. However, the FCA reported generally positive feedback from industry and asserted that

"all investors should benefit from independent scrutiny no matter how large the AFM is and how long it has been operating. We recognise that this will cost money,

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[407] ibid, 3.14

[408] Financial Conduct Authority, 'Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18' (Policy Statement CP18/18 , April 2018) point 2.16-17 <https://www.fca.org.uk/publication/policy/ps18-08.pdf> accessed 06 June 2018.

but believe that this is proportionate to the benefits we expect independent directors to bring. We believe that the cost is justified even in the early years of start-up AFMs, as independent directors' perspectives are particularly important in a firm's formative years during which, for example, its strategy and culture are set."[409]

The FCA statement is yet to be fully interpreted as the rules have yet to enter into force.[410] However, the statement is somewhat misleading. The cost of the directors in a CIS is borne by the scheme itself, not the CIS operator. However, it is customary for the directors to receive below average payments if the director is also already an employee of the portfolio manager. Hence, the cost is still borne by the CIS investor rather than by another party involved in the governance of the CIS.

The UK and the business judgement rule

The UK legal framework does not recognise the existence of a business judgement rule, or a formal equivalent, in the same way that US state law does. It is well-established that English courts tend to shy away from reviewing business judgements. This point was clearly made in the judgment of Lord Wilberforce when he stated in *Howard Smith v Ampol Petroleum Ltd*, that

"it would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, on such a question, if bona fide arrived at. There is no appeal on merits from management decisions to courts of law, nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at".[411]

It has since been affirmed that, so long as a director acts with the aim of promoting the success of the fund for the benefit of the CIS investors, the courts will not question that choice, even if it has proved unsuccessful.

It is arguable that other methods employed by UK judges in analysing cases might provide the same effect. In Kershaw's opinion, the approach taken by UK courts in reviewing the management's decision-making process is similar to that of the courts in the US.[412] According to Kershaw, the review of business decisions must be made in light of the director's duty of care towards the company.

His logic follows the review process of the courts. Where there has been a breach of such a duty, courts must necessarily review the director's decision in order to

[409] Financial Conduct Authority, 'Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18' (Policy Statement CP18/18 , April 2018) point 2.31 <https://www.fca.org.uk/publication/policy/ps18-08.pdf> accessed 06 June 2018.
[410] This dissertation covers research available until end of 2018. The new COLL rules will be entering into force in September 2019
[411] *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821.
[412] David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press 2009), 475.

determine its nature. Only by assessing its outcome can it be held that a specific decision was one that a reasonable director would have taken. Therefore, English courts act very similarly to those in the US, in particular those in the state of Delaware. The main difference lies in the standard of care, particularly in the way this standard acts as a gatekeeper to prevent court review. While in Delaware the gross negligence standard applies, barring courts from reviewing decisions that do not derive from gross negligence by the director, in the UK this standard is much higher, amounting to the *"objective/subjective reasonably diligent person standard"*.[413]

UK judicial cases

Authorised Corporate Director responsibilities

The leading FCA regulatory case concerning the responsibilities of parties to a CIS in the UK is that concerning the losses to investors in the CF Arch Cru Investment Funds and the CF Arch Cru Diversified Funds. It has been noted that the depositaries of these funds, together with the ACD, agreed to pay Arch Cru investors the sum of £54 million.[414] However, the Regulatory Notice, well known to the UK public, focused largely on the role of the latter and somewhat dismissed the implications for the former.

Capita Financial Managers Limited ("CFM"), in its role as ACD of these funds, was subject to public censure by the FSA (the predecessor of the FCA) for breaches of the FSA Principles and the COLL rulebook. Given that both CISs were OEICs and ICVCs, this regulatory action is of particular interest for this research.

CFM delegated the investment management of the CIS to Arch Financial Products LLP ("AFP"), a CIS manager regularly authorised to conduct investment management activities, while it remained primarily responsible for other aspects as ACD.[415] The CIS had invested mainly in the shares of the Guernsey-based company Arch Guernsey ICC Limited, listed on the Channel Islands Stock Exchange and suspended from it in 2009. The CIS appointed AFP as investment manager, who invested in a variety of assets. AFP undertook this investment activity in its own right, in its capacity as investment adviser to the Arch investment company, and not in its capacity as CFM's delegate.[416] The UK-domiciled CIS raised about £422 million after being heavily marketed through 900 independent financial advisers. The listed entities invested in

[413] ibid
[414] Broke Masters, 'Extra Compensation for Arch Cru Investors' (Financial Times 30 April 2012) <https://www.ft.com/content/8a88b050-92d0-11e1-9e0a-00144feab49a> accessed 16 February 2019.
[415] Financial Services Authority, 'Final Notice Capita Financial Managers Limited' (12 November 2012) <https://www.fca.org.uk/publication/final-notices/capita-financial-managers.pdf> accessed 10 March 2018.
[416] ibid, 2.3.

assets ranging from ships and wine to student accommodation and an adhesive tape manufacturer.[417]

The FSA enforcement division took action against the parties involved in the management of the Arch Cru CISs, based on both its COLL rulebook and Handbook Principles. This was in line with FSA practice at the time, as case law reveals, which continued to rely on the high-level principles of the FCA Handbook to sanction compliance failings.[418] In particular, Principles 2 and 3 of the PRIN rulebook were applied. Their effects determine a status similar, but not explicitly stated, to that of a fiduciary for the CIS parties involved. Principle 2 requires that *"a firm must conduct its business with due skill, care and diligence"*, while Principle 3 reaffirms that *"a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"*.

The corporate director of a UK CIS must adequately identify and mitigate potential conflicts of interest between the delegated CIS manager and the CIS. The ACD did not carry out this function; neither did it sufficiently monitor the performance and compliance of the investment manager, hence it failed to apply Principle 2.[419]

Similarly, Principle 3 was violated by the ACD as it failed to *"ensure it had sufficient processes and procedures in relation to the appointment of its investment manager delegate to the Funds*" or to *"adequately monitor the liquidity of the Funds ... what processes were in place at AFP to ensure compliance with the prudent spread of risk obligation"*.[420] Because of its role as fiduciary, similar concerns could have been formulated about the actual value of the underlying assets, technically listed on an exchange, in order to *"consider the application of an alternative fair value pricing methodology at a sufficiently early stage to ... setting out when fair value pricing should be invoked"*.[421]

The violations of these high-level principles are intertwined with those of the COLL rulebook. Its provisions, as seen before, range from the obligation to keep records, to assess a market's eligibility before investing in it, to oversee the investment manager's strategies and, importantly, to accurately value the CIS and calculate the price of its units. Whilst COLL has provisions for the delegation of powers and responsibilities, these do not provide for a total discharge of the responsibility of the ACD. According to the FSA in the case of Arch Cru, *"the ACD role carries important regulatory obligations in relation to the protection and fair treatment of investors"*;[422] further,

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[417]Steve Johnson, 'Guernsey funds sue UK's Arch Financial' (*Financial Times,* 15 January 2012) <https://www.ft.com/content/7af75860-3d32-11e1-ae07-00144feabdc0> accessed 10 March 2018.
[418] Rüdiger Veil, *European Capital Markets Law* (Hart Publishing, 2013) § 33.21.
[419] Financial Services Authority (n 402) par 2.4.
[420] ibid, par 2.5.
[421] ibid Regarding the breach of the Principles, see also *Arch Financial Products LLP v Financial Conduct Authority* [2015] UKUT 13 (TCC).
[422] ibid, par 6.5.(1).

"an ACD is a corporate body and authorised person given powers and duties ... responsibilities include dealing with the day to day operation of the OEIC, managing the OEIC's investments, buying and selling the OEIC's shares on demand, and pricing the OEIC's shares based on the value of the OEIC's assets. These responsibilities (particularly responsibility for managing the OEIC's investments) may be delegated, but overall responsibility for performance of the obligations remains with the ACD."[423]

CIS directors' good faith and a company's best interests under common law

This research has previously analysed how the CIS registered by Mr Madoff in Ireland and Luxembourg created a discrepancy in the interpretation of the fiduciary duties of the independent entity of a CIS. The depositaries of the CIS, which had fewer dues than those embedded in the current UCITS framework, may or may not have had fiduciary duties, depending on the interpretation of the court in question.

The US-based Madoff business also operated from the UK. Madoff Securities International Limited was an FSA-licensed firm (FCA Register Reference number 140825) with a number of regulatory authorisations, including those relating to providing advisory services and dealing in investments as both agent and as principle. In effect, this operation was a proprietary trading business, legitimate in nature and it was not part of the Ponzi scheme.[424] However, in a 2013 High Court case, the liquidators of the UK-based entity brought forward allegations against the previous directors of the company, against Mrs Sonja Kohn, an Austrian businesswoman, and against entities with which she was connected. They claimed against them in respect of payments totalling around $27 million made by the firm to entities connected with Mrs Kohn.[425]

The judgment in *Madoff Securities International Limited (In Liquidation) v Raven and Ors* is reputed to be a source of guidance for executive and non-executive directors of Cayman-based CISs, a model often implemented in the hedge fund industry. In this case, Popplewell J exemplified the scope of a CIS director's common law duty to act in good faith and in the best interests of the company.[426] While the facts of the case took place before the implementation of the Company Act 2006, meaning that the case had to be decided under common law, the judgement specifically stated that *"nothing in this case turns upon any distinction, to the extent that there be any, between the duty at common law and the statutory codification"*.[427]

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[423] ibid, par 4.2.
[424] Lara Kuehl, 'When May a Director Agree to Disagree? The Implications of Madoff v Raven' (Maples Group, 29 October 2013) <https://maples.com/en/Knowledge-Centre/Industry-Updates/2013/10/When-May-a-Director-Agree-to-Disagree,-d-,-The-Implications-of-Madoff-v-Raven> accessed 17 February 2018.
[425] ibid.
[426] *Madoff Securities International Limited (In Liquidation) v Raven and Ors* [2013] EWHC 3147.
[427] ibid, par 189.

The allegations against the directors of Madoff Securities relied on their breach of duty, either knowingly or through their reckless indifference, regarding the existence of violations in the company's operations. It is understood that these were in the form of payments for research, the charges for which are usually accounted to the CIS. The plaintiff affirmed that the payments were instead made as reimbursement to Mrs Kohl for the introduction of prospective CIS investors.

The court dismissed the claims as unfounded but provided several points of guidance for CIS directors in the Cayman Islands. Popplewell J initially reiterated the principles underlying the duty to act in the best interests of the company,[428] pointing out that a director may delegate some of his responsibilities to others while retaining the duty to inform himself about the company's affairs and to supervise such affairs together with his fellow directors. For this matter *"it is therefore a breach of duty for a director to allow himself to be dominated, bamboozled or manipulated by a dominant fellow director where such involves a total abrogation of this responsibility"*;[429] *"It is the duty of each director to form an independent judgment as to whether acceding to a request is in the best interests of the company"*;[430] and *"If a director has knowledge of a fellow director's misapplication of the company's property and does not act to prevent it, is considered as a party to the breach of fiduciary duty"*.

However, in Popplewell J's view, a director is entitled to rely upon the judgement, information and advice of another director whose integrity, skill and competence he has no reason to suspect.[431] This statement seems to reflect a certain empathy of the part of the court in respect of the position of the defendants. Arguing further regarding the dynamics of modern corporate management, he discussed the case in which a board of directors may reach a decision as to the commercial wisdom of a particular transaction by a majority. In such a case,

> *"the minority director is not thereby in breach of his duty, or obliged to resign and to refuse to be party to the implementation of the decision ... a director is not in breach of his core duty to act in what he believes to be the best interest of a company merely because, if left to himself, he would do things differently"*.[432]

It is on these grounds that the directors of Madoff Securities in London were found not guilty, albeit despite evident concerns that the directors had not questioned the value of the research provided to the advisor.

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[428] ibid, par 188-209.
[429] ibid, par 191.
[430] ibid.
[431] ibid, par 193.
[432] ibid.

Relationship between ACD and investment manager

In 2013, the FCA imposed a combined financial penalty of approximately £18.6 million, settled at an early stage, on companies belonging to the Invesco Perpetual group: Invesco Asset Management Limited and Invesco Fund Managers Limited, which was the largest retail investment business in the country at the time.

The CIS compliance breach occurred between May 2008 and November 2012, during which time both firms failed to comply with regulatory obligations. The fault was in respect of the composition of the assets of the CIS and the appropriate disclosure of risk to the CIS investors. In particular, the CIS had been managed so that investment limits for certain asset classes had been breached, CIS leverage had been introduced without prior information or a description of the associated risks having been provided to the CIS investors; in addition there were other failings regarding valuation and the fairness of asset allocation.[433] It was calculated that, because of these operational failings, the CIS funds suffered actual losses of £5.3 million and that CIS investors were practically exposed to greater levels of risk than they had been led to expect.

These failings constitute breaches of Principle 3, concerning the effective risks control of the business organisation, and Principle 7, concerning the information that is to be disclosed to clients in a way that is clear, fair and not misleading.[434] Furthermore, there were specific breaches of the COLL rules described in detail earlier. Because Invesco Fund Managers Limited was the ACD of these CISs, it was responsible for dealing with the day-to-day operation of the funds, managing the funds' portfolio of investments, buying and selling the funds' shares at the demand of investors, performing valuations of the funds' assets and calculating the price of shares. Throughout the period of the breach, the ACD delegated its portfolio management responsibilities in respect of the CIS to Invesco Asset Management Limited. As explained earlier, the COLL provisions are such that Invesco Fund Managers Limited retained its regulatory responsibilities in respect of the CIS.[435]

Therefore, when the CIS over-invested in assets, it was the ACD who failed to comply with the investment restrictions set out in COLL regarding the investment powers of the CIS. The FCA applied the same responsibilities when it found that the CIS Manager introduced leverage of up to £1 billion into some of its CISs through the use of derivatives without disclosing this adequately to CIS investors.[436] It is the ACD's responsibility to produce and maintain the documents used by the CIS investors to assess the fund's risks.[437]

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[433] Financial Conduct Authority, 'Final Notice to Invesco Asset Management Limited and Invesco Fund Managers Limited' (24 April 2014) <https://www.fca.org.uk/publication/final-notices/invesco-asset-management-limited%20.pdf> accessed 17 February 2019.

[434] FCA Handbook PRIN Principles for Business (PRIN).

[435] Financial Conduct Authority (n 419) 4.2 and 4.3.

[436] ibid.

[437] Under EU rules for UCITS these are the KIID and the Simplified Prospectus. The Final Notice reported failing to update both documents.

As a consequence of the duties assigned to it in COLL, Invesco Group had to compensate the CISs in full in respect of the £5.3 million of losses caused by the ACD's breach of investment limits; it also implemented new systems and controls in relation to the allocation of orders and the timely recording of trades.

Directors in Hong Kong

Introduction

As discussed earlier in relation to the depositaries, the legal framework for CISs in Hong Kong bears many similarities to that of the UK. However, the applicable rules are more straightforward than those of the ACD model applied in the UK. In the Hong Kong framework, there is no overlap between the role of a director and that of a CIS operator. Consequently, there are not many provisions for CIS directors under the rules issued by the SFC. Only in one case is there a clear correspondence between the management and directorship roles – that of the self-managed fund.

As with the US and UK legal frameworks, only a regulatory agency can authorize a CIS. This means that under the UTMF, the creation of CISs must be authorised by the SFC, under the conditions considered appropriate by the Commission itself.[438] The UTMF sets the main responsibilities for the CIS Operator by stating that, in the management of the scheme, the company and its directors must not only work within the limits set by the constitutive document, but also bear the best interest of the holders in mind. In addition, they must fulfil the duties imposed by general law.[439]

One important provision regulates the relationship between the CIS and its operator. The ability to remove the latter in the case of mismanagement is entrusted to the CIS directors (or the trustee of the CIS). The CIS directors are required to have *"good and sufficient reason ... in the interest of the holders"*[440] in order to execute the change. Following the dismissal of the management company, the CIS directors or the trustee must appoint a new one as soon as possible.

The CIS directors share the duty to appoint an auditor, who must be independent from all parties, to audit the scheme's annual report, which is published in accordance with the details issued by UTMF rulebook.[441] One main difference with other regulatory frameworks observed in this research is the CIS units pricing requirement. This is essential for the subscription to and redemption of the CIS. The directors have no responsibility to ensure a valid process, as this is left to the CIS operator.

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[438] Securities and Futures Commission, UTMF (n 225).
[439] ibid, par 5.10.
[440] ibid, par 5.11(b).
[441] Securities and Futures Commission, UTMF par 5.15;5.17.

In fact, for the CIS assets not listed or quoted on a recognized market, the UTMF requires the procedure to be carried out on a regular basis by a professional person approved by the trustee or the custodian, which can be the management company itself.[442] Whilst this reinforces the idea that CIS directors in the Hong Kong regulatory framework are accountable neither to the CIS independent entity nor the CIS operator, it is surprising to note that the Hong Kong regulator does not provide a verification process for the CIS investor in the CIS units' dealings.

The case of the self-managed CIS

Under chapter 5 of the UTMF rulebook – except for the special case of a "self-managed scheme" – every CIS must appoint a management company, which must fulfil certain requirements in terms of standards stated therein. These include, among others, those associated with requirements for prudence and expertise, in line with CIS investors' expectations. The CIS operator must be primarily engaged in the business of fund management and have sufficient financial resources at its disposal to be able to conduct its business efficiently and meet its liabilities.[443] The directors of the CIS operator are subject to the Commission's scrutiny with regards to their good repute and their experience in conducting the activities required of them in the governance of a CIS.

The UTMF rulebook provides the option of creating a "self-managed" CIS. Such schemes are managed by the board of directors of the CIS, which would perform the same functions as the CIS operator.[444] In such cases, the law places some limitations on the directors' range of action, in addition to requiring the CIS's managing procedures to contain certain specific provisions. In particular, the CIS directors of a self-managed scheme are not allowed to deal with the scheme itself as principals, while the articles of incorporation must provide for the ability, afforded to holders, to call a meeting and remove any director whom they do not consider "fit and proper" to manage the CIS assets.[445] In addition, the CIS directors' fees and remuneration should be decided by the holders themselves.[446]

The case of Open-ended Fund Companies

With the introduction of the Securities and Futures (Amendment) Ordinance 2016,[447] a new form of corporation for investment fund was introduced to the Hong Kong system: the open-ended fund company ("OFC"). In contrast to the already-existing

[442] ibid, par 6.12.
[443] ibid, par 5.2.
[444] ibid, par 5.7.
[445] ibid, par 5.8.
[446] ibid, par 5.9.
[447] Securities and Futures (Amendment) Ordinance 2016, Ord. No. 16 of 2016.

mutual fund model, which assumed incorporation of a simple LLC in place of the fund, this new type of CIS is structured in corporate form with limited liability. The typology aligns the Hong Kong framework with those of other countries as it develops a specific form of company exclusively to be used by CISs, which can issue and cancel shares on a statutory basis. This is very much the corporate vehicle introduced in the UK by the OEIC Regulations.

The CIS directors of this type of company are legally responsible for all its affairs. An OFC must have at least two directors, who are individuals over the age of 18. In contrast to the UK system, a CIS cannot have corporate directors, therefore excluding the ACD model and aligning Hong Kong more closely with the US.

Like the directors of a non-financial regulated company, CIS directors of the OFC owe certain statutory and fiduciary duties to the company. Their nature is not dissimilar to that analysed elsewhere. It is important to mention the duty to act in good faith for the benefit of the CIS as a whole and to use powers for the sole purpose of the benefit of CIS investors as a whole. Importantly for the governance of a CIS, directors of an OFC cannot delegate powers except with proper authorisation, while retaining the requirement that they exercise independent judgment. Fiduciary standards are also stated in the form analysed elsewhere: the duty to exercise skill, care and diligence and to avoid conflicts of interest are required. Other duties, in the form of prohibitions – such as not to enter into transactions in which the CIS directors themselves have an interest and not to gain advantage from their position[448] – are further examples of company directorship duties standards generally adopted by US and UK company regulations.

It is worth noting that OFC directors do not need to be authorised under SFO rules. This is because it is mandatory for CIS directors of an OFC to delegate their investment functions to the CIS operator of the OFC in any case. Interestingly, they are not required to reside in Hong Kong, but each non-resident CIS director is expected to appoint a process agent in Hong Kong.

Note on Hong Kong custodian cases

This research has not found any recorded case in the Hong Kong jurisdiction where CIS investors have brought a case against a CIS director to court. However, it should not be inferred that the SFC is unconcerned by their status. A simple analysis of the SFC enforcement cases related to company directors of listed entities reveals a strict interpretation of fiduciary duties and conflicts of interest. However, it is worth mentioning one precedent set by the Securities and Futures Appeals Tribunal, which

[448] Companies Registry, ‘A Guide on Directors’ Duties’ (July 2009) <https://www.cr.gov.hk/en/publications/docs/director_guide-e.pdf> accessed 17 February 2019.

led the SFC to revoke the license of a CIS operator and ban its CIS director and officer for 10 years.

The SFC took action against Richmond Asset Management Limited and its owner, Graham Bibby, following an investigation that revealed a conflict of interest between the firm he both owned and managed, and the CIS investors. The investment made by the CIS adviser amounted to $5 million from 36 clients. Its aim was to invest in a company and a plot of land in Phuket, Thailand.[449] The investment was executed through four unauthorized CISs in which Bibby held management powers as CIS director. According to the SFC, the conflict of interest was generated by the fact that Bibby and his wife had substantial undisclosed interests in the land that constituted the CIS's investment.

The SFC found Bibby and the CIS operator not to be fit and proper persons. In his role as CIS director, Bibby failed to properly avoid and disclose potential conflicts of interest to his clients, abusing clients' trust. In so doing, they demonstrated they were unfit to be licensed to conduct regulated activities.[450]

Conclusions

Within the scope of this study, considering the role of CIS directors in the governance of a US CIS is fundamental to understand the effectiveness of rules from the investors' perspective. Elected to the IOSCO's independent entity status, these mutual fund directors act as fiduciaries for the operationalisation of ICA requirements while they are liable for the running of the incorporated vehicle under state legislation. The independent directors' role within the CIS board is the key element for its correct governance. These are to act as watchdogs on the external adviser and on its affiliates. Their fiduciary duties under state law are integrated with special obligations under federal law to protect the interests of shareholders against any potential mismanagement or abuse by the CIS operator. However, their personal liabilities are limited, based on the so-called business judgement rule, which can be considered a restriction of their fiduciary duties toward the CIS investors.

The UK system for CIS directors is evolving from that currently enforced by the ACD – a corporate level directorship resembling an outdated form of trust that clashes with that derived from implementing EU standards. Having clarified that the ACD acts mainly as the CIS operator at the EU level, the new regulatory proposition aims to

[449] Securities and Futures Commission, 'SFC revokes licences of Richmond Asset Management Limited and its responsible officer Graham Frank Bibby and bans him for 10 years' (Press Release 31 Oct 2016) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=16PR111> accessed 17 February 2019.
[450] Ibid.

standardise the role of the board of a UK CIS in a way that is not dissimilar from that of the US.

The CIS director’s role in Hong Kong is limited in terms of both liabilities and duties, if, as in the UK, the role of independent entity is mainly attributed to the custodian. The few court cases that have occurred make it clear that the Asian regime leverages the conflict of interest findings to integrate a lean regulatory requirement that is currently evolving toward the OEIC’s standards.

Whilst the roles vested in CIS directors in the different jurisdictions are clearly identified, it is not simple to reach a conclusion as to whether the employment of their expertise is sufficient. In the case of the US, these individuals carry out complex functions that may be overwhelming, given the limited operational set up on one hand and the limitation of liabilities towards CIS investors on the other. In the case of the UK, the important duties of an independent entity are mainly covered by the depositary: as a result, their role may even be redundant. The same could be argued for the Hong Kong regime, although the Hong Kong regime is not proposing to evolve the CIS directorship further. In both cases, there is a potential overlap of roles.

One way to consider their employment as an advantage is, again, in terms of the costs associated with the expenses charged to the CIS investors and the extra benefit in effective governance rules. Their cost is more justified if they are carrying out the independent oversight function than if they are simply executing a few public corporate duties, especially if these are incidental to the corporate format that a CIS may take.

Chapter five: The role of the investment manager: keystone to a multi-party relationship

Introduction

The most relevant party to the collective investment scheme (CIS) governance structure, both by way of regulatory construct and in the eyes of the scheme's investors, is the CIS operator, often called the fund or investment manager. Here, the term "CIS operator" will be used, as the role extends beyond that of portfolio management.

Modern CIS regulations often split the various activities expected for the correct working of a pooled scheme into a number of regulated functions, and then they assign these to various parties in the scheme. The CIS Operator is considered the key party to the CIS because not only does it carry out the main economically relevant investment activity but it is also tasked with the most sensitive functions such as subscription and redemptions of fund units and valuation of a scheme's net asset value.

This chapter addresses the CIS Operator's fundamental duties in the USA, UK and HK as set out in the relevant national-level regulations. Because of the incredibly vast number of rules in place, this research addresses the key rules from the point of view of the CIS investors. Each section then identifies the effectiveness of the rules via the judicial review of relevant cases, identifying flaws and evidencing the existence of a sub-set of rules implied by case law rather than by legislation, mainly in the case of the litigious US.

In this context, the chapter completes the analysis of the three key governance parties to the CIS and exhausts the CIS investor duties owed by them, pinpointing the areas in which the regulations under analysis may fail or have already done so.

The mutual fund manager in the US

The ICA and IAA in context

In the architecture of a collective investment scheme, the investment advisor is often in full control of the fund and is expected to act on behalf of the CIS's investors. This relationship implies high levels of integrity and trust. The United States Congress approved the Investment Company Act of 1940 on 22 August of that year as federal legislation. Alongside the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, the ICA serves as the backbone of the financial regulation in the US. Later amendments such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 have attempted to enhance the legal framework of all these

Acts.

It is not a coincidence that the IAA and the ICA were promulgated in the same year. The ICA was a response to the financial crises of the 20's and 30's, and specifically to the failure of investment companies to act in the best interests of their shareholders. As a means to ensure the secrecy of their practices, such companies had willingly limited transparency levels and had created highly complex financial structures.[451] For this reason, it is useful to analyse how the IAA complements the ICA. While the latter is directed at the regulation of investment companies,[452] the former is broader in scope and applies to

> *"any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities".*[453]

The term securities includes those typical underlying investments of publicly offered CISs: notes, bonds, stocks, mutual funds, debentures, and certificates of interest.[454]

The ICA addresses the status of the investment company in those cases when the investment adviser is an outsider to the company, acting in accordance with the contractual relationship to the CIS.[455] An important feature to be kept in mind regarding the adviser-fund relationship is that the fund shareholders are often passive, and will in most cases redeem their shares rather than engage in voting.[456] Passivity on the part of investors increases the demand for a more rule-based regime in order to prevent complex financial structures, insider trading and fraud. By prohibiting certain investment options, the ICA tries to limit the investment options and associated risks that an IAA advisor would usually consider.

The difference in legislative requirement between the two Acts depends on the special nature of an adviser-fund relationship.[457] The ICA is considered rule-based regulation, while the IAA is more principle-based, though the latter has moved towards a more rule-based framework following later rules adopted by the SEC.

The ICA is focused on the overall supervision of investment companies, including the requirements for independent directors and the appointment of a chief compliance

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[451] Editorial Board, 'The Investment Company Act of 1940' (1941) 50 3 The Yale Law Journal 440, 440.
[452] 15 USC § 80a–3. When used in this title, ''investment company'' means any issuer which—(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.
[453] 15 USC § 80b–2(a)(11).
[454] 15 USC § 80b–2(18).
[455] 15 USC § 80a–2.
[456] Hristiyania Atanasova, 'The Scope of Investment Advisers' Fiduciary Duties When They Merge' (2008) 27 Annual Review of Banking & Finance Law 509, p 528.
[457] Arthur S Gabinet and George M Gowen III, 'The Past and Future of Implied Causes of Action under the Investment Company Act of 1940' (2002) 3 Villanova Journal of Law and Investment Management 45, p 49.

officer. Under the ICA, the investment company has a number of restrictions and expectations regarding the protection and supervision of the schemes, and while certain rules created under the IAA directly address investment advisers, the rules under the ICA are more general. Reflecting their fiduciary duty, advisers are expected to modify their strategy according to the restrictions set out in the act or to the rules subsequently adopted. The IAA, on the other hand, focuses on the advisers primarily through the prohibition of fraud and the requirement of mandatory disclosure.

Importantly, the ICA is mainly concerned with the regulation of external advisers to investment companies, who act as independent contractors subject to fiduciary duties.[458] It is stated that an investment adviser is any person who, pursuant to a contract with a CIS, regularly furnishes advice to the same with respect to the desirability of investing in, purchasing or selling securities or other property. It is also lawful for those empowered in this way to determine what securities or other property shall be purchased or sold by a CIS.[459] This empowerment action, and the corresponding role of the adviser, implies that this entity has a fiduciary duty towards the investors it aims to serve, as a reflection of the foundational duty of loyalty owed by all parties working for the benefit of the CIS investors. In trying to appraise doubts raised by many parts, the US regulator implemented a specific rule for breach of fiduciary duties[460] (as discussed in the previous chapter for the directors).

The advisor, then, is the CIS operator in the context of this research. Its fiduciary duties are clear, as explicitly mentioned in the ICA. There are three aspects of this fiduciary duty. The first part requires the advisor not to breach such a duty through personal misconduct, although it does not clarify the nature of the "personal misconduct test" that is to be applied. This section further states that the SEC is authorised to bring an action against those responsible for the alleged misconduct. This characteristic potentially allows for CIS-related judicial cases as it encompasses all breaches of fiduciary duty involving personal misconduct. However, it is more likely to be invoked with respect to concealed breaches of duty.[461] The second section on the other hand gives a right of action to a security holder in addition to the Commission and it does not require the plaintiff to prove personal misconduct. Since it lowers the standard of proof, a CIS can only bring an action following a breach as a right of action in return for compensation. Many cases that relate to excessive fees paid by a CIS are pursued under this section because of the "adviser domination and control".[462] In any case, there are no doubts that a CIS operator in the US has a fiduciary duty towards both the SEC and the CIS investor. The third section of the norm extends its provisions to any corporation or other trustee performing the

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[458] Julian Franks, Colin Mayer, and Luis Correia Da Silva, *Asset management and investor protection: an international analysis* (OUP Oxford, 2003).
[459] 15 US Code §80a-20 (Definitions)
[460] 15 USC § 80a–35 - Breach of fiduciary duty.
[461] Donald C Langevoort, "Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty" (2005) 83 4 Washington University Law Review 1017.
[462] ibid.

functions of an investment adviser.

Duties of the US-based CIS operator

As discussed, the IAA governs the duties of a registered financial adviser under the US federal legal framework. In the context of this research, the US adviser is the CIS operator of a mutual fund registered under the ICA. For this reason, this research first reports the main IAA standards that are relevant for CISs. It then addresses the specific rules for advisers embedded at the ICA level. Although this document does not exhaustively cover all the standards required of a registered IAA adviser for a compliant ICA scheme, it touches upon those that, by way of legal construct or intrinsic nature, have been sources for litigation by CIS investors or specifically addressed by the SEC.

A registered investment adviser under the IAA becomes the CIS operator of a US mutual fund following the assignment by the CIS directors. The regulatory link between the ICA and the IAA is built around the contractual relationship between the CIS and its adviser. In fact, the ICA prohibits a person from serving as an investment adviser to a registered investment company except when a written contract is in place that has been approved by the vote of a majority of the outstanding voting securities of the registered CIS.[463] ICA rules also provide a strict set of temporary exemptions from this shareholder requirement when certain circumstances lead to a sudden termination of the contract. This was to prevent a CIS from being harmed by losing investment advisory services before shareholders could approve a new investment advisory contract.[464] However, it is also an attempt to mitigate the risk for the CIS investor as it prevents a CIS from being bound without its consent to an advisory company under changed control.[465]

Conflicts of interest & disclosures

The IAA prescribes a surprisingly limited number of duties for advisers as CIS operators. In fact, most of the activities charged to this fiduciary are implied through various regulatory provisions and CIS information disclosure requirements.[466] The common denominator of this set of rules is to prohibit any conflicts of interest that might compromise a CIS operator’s ability to act in the best interests of the CIS.

One of the key rules governing the operator-CIS relationship is found in section 206 of the IAA, a notorious rule under which most litigation is brought. It sets out the

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[463] 15 U.S.C. § 80a-15(a).
[464] See 17 CFR 270. 15a-4.
[465] Alfred Jaretzki, ‘The Investment Company Act: Problems Relating to Investment Advisory Contracts’ (1959) 45 6 Virginia Law Review 1023.
[466] Securities and Exchange Commission, 'Regulation of Investment Advisers by the U.S. Securities and Exchange Commission' (March 2013) <https://www.sec.gov/rules/final/ia-2204.htm> accessed 15 June 2017.

standards of conduct for an investment advisory business. It is often referred as the "anti-fraud provision" and requires the adviser not to defraud, deceive or manipulate its clients, including potential clients. In practice, the rule is intended as the determinant of the relationship between the advisor and the CIS, which is of a "delicate fiduciary nature" such that it is necessary for the law to create conditions to eliminate conflicts of interests on behalf of the adviser.[467] The case of *SEC v Capital Gains Research Bureau*,[468] mentioned on several occasions already, is the key judgment on the matter.

US securities regulations give particular relevance to the disclosures by CIS operators. The rules are comprehensive in their requirements to avoid the possibility of misleading the investors, for the CIS disclosures to be presented in such a way to represent the truth and to be comprehensive of any potential or present conflicts of interest.[469] The latter requires CIS operators to *"act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice"*.[470] Under Rule 204-3, the adviser is obliged to make a written disclosure to its clients before entering into an advisory contract. The duty is to disclose all material facts to the advisory relationship in a brochure. The disclosure must present sufficient facts for the client to evaluate the level of risk related to the conflict of interest,[471] and to continue to do so if any material facts changes,[472] in theory providing a client or a CIS director with the information necessary to decide whether or not to proceed with the contract.

More extensive disclosure is expected from the CIS itself. As part of its registration process, every registered CIS must file various documents with the SEC that the regulator describes as *"necessary or appropriate in the public interest or for the protection of investors"*.[473] In effect, their variegated nature supports the above statement and they aim to provide better information to CIS investors about fund costs, investments and performance.[474] In broad terms, the requirement for any CIS registered under the ICA is to disclose fund expenses paid by the shareholders during the reporting period as well as its summary portfolio schedule. Furthermore, it must provide the CIS's portfolio holdings in categories and include the view of the CIS operator on the vehicle's performance in its annual report to shareholders.[475] This is

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[467] *SEC v Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (quoting 2 Loss, Securities Regulation (2d ed. 1961), 1412).
[468] 375 US 180 (1963), cited in Francis J. Facciolo, 'Do I Have a Bridge for You: Fiduciary Duties and Investment Advice' (2014) 17 University of Pennsylvania Journal of Business Law 101, p 114.
[469] 15 USC § 80b–11(g)(1).
[470] 15 USC § 80b–11(g)(1).
[471] Securities and Exchange Commission, "Form ADV Part 2, Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements" <https://www.sec.gov/about/forms/formadv-part2.pdf> accessed 2 March 2019.
[472] ibid.
[473] 15 USC § 80a–8(a).
[474] Securities and Exchange Commission, 'Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies' (ICA Release No. 25,870, 18 December 2002).
[475] 17 CFR 270. 30a and 30b1-1.

executed via the filing of annual and semi-annual reports to the SEC.[476]

CIS valuation duties under the SEC regime

The topic of CIS valuation is particularly relevant for the case of US mutual funds. Transcripts of the US Senate's banking and corruption hearings in 1940 confirm that, before the ICA was established, market practices often resulted in substantial dilution of CIS investors' interests. In particular, these mistreatments included those using backwards pricing to increase investments in the fund, thus enhancing management fees while causing dilution for existing investors.[477] This was contrary to the very nature of how the Senate interpreted the scope of an open-end company. This security was meant to be

> *"unlike any other type of investment company, principally because of the highly important distinguishing feature that their shareholders can, by contract right, withdraw their proportionate interest at will simply by surrendering their shares to the company for redemption at liquidating value"*.[478]

The ICA was drafted with this principle in mind. The units of this type of CIS must be redeemable securities under the terms of which the holder, upon presentation to the CIS, is entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.[479] The question is, therefore, how to evaluate the assets of an ICA-registered CIS in the first place and what the fair share of assets should be for the CIS investor redeeming its shares, particularly where the value of the assets is distinguished by the nature of the securities in which the CIS invests.

When it comes to the valuation of a CIS in the ICA context, a question arises: does this fall under the role of the CIS director or of the CIS operator? Generally, the ICA requires a registered CIS to use market values to value portfolio securities for which market quotations are readily available; and when these are not, they are to value assets by using their fair value.[480] This fair value of non-market traded CIS securities must be determined in good faith by the CIS directors in the case of the ICA-registered mutual fund.[481] Regulatory texts and related judicial cases point to the legal responsibility of the CIS and highlight the responsibility of the CIS directors for certain assets. In practice, these directors are not experts in valuation matters. For this reason, an ICA-registered CIS that is invested in non-market traded assets often

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[476] See details of SEC's Form N-SAR.

[477] United States Congress Senate Committee on Banking and Currency, Subcommittee on Securities and Exchange, 'Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency' (76th Congress, 3d Session, 1940), at 137-145 (Statement of Mahlon E. Traylor).

[478] ibid 20, at 453.

[479] 15 USC § 80a–2(a)(32).

[480] Securities and Exchange Commission, 'Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bigliography of the Division of Investment Management' <https://www.sec.gov/divisions/investment/icvaluation.htm> accessed 2 March 2019.

[481] 15 USC § 80a–2(a)(41).

employs valuation committees. Their membership, scope of delegated authority and reporting obligations to the CIS board are formalised either in a written charter or in the CIS's valuation policies and procedures.[482] Furthermore, the CIS operator's chief compliance officer and other compliance personnel have an important role in ensuring that a CIS's valuation procedures are designed to prevent violations of federal securities laws.[483]

CIS directors of open-end structures are responsible for establishing the timings for current net asset value calculation and for approving any changes.[484] The frequency of valuations depends on the CIS redemption policy: a distinction evident, for example, between closed-end and open-end structure. The latter must generally compute its net asset value at least once daily, holidays excluded.[485] This is of great importance for the CIS investor as these values are used to calculate the prices at which CISs sell and redeem their shares.[486]

The SEC has increased the number of applicable rules and interpretations over the years, testimony to the importance of this activity for investor protection. Of particular relevance is the definition of the current net asset value dictated by the SEC via its ICA rules. This definition details the steps and considerations to use in computing periodically the current price of redeemable security.[487] It covers various aspects of CIS valuation. Details are provided on the use of current market values and fair values as determined, on the time threshold for the prices to reflect changes in values, on the treatment of expenses and fees and the dividends and on income borne in the CIS. Other specifications cover money market funds, the treatment of illiquid assets and other scenarios that may pose risks to the fairness of the CIS investor's redemption price.

Operational duties (conduct and investment management)

A number of generic requirements have the overarching intention of protecting the interest of clients, and the public interest, and of allowing the SEC to assess systemic risks. For this reason, it is unlawful to act as CIS operator unless one is registered with the regulator in accordance with the IAA.[488] Being a registered investment adviser triggers regulatory requirements for the entities as CIS operators. They must adopt and implement written policies and procedures reasonably designed to prevent violations of the IAA. Policies and procedures are to be reviewed annually,[489] and they should address, at a minimum, the portfolio management processes, the accuracy

[482] Securities and Exchange Commission (31) p 13.
[483] ibid p 14.
[484] 17 CFR 270.22c-1(d).
[485] 17 CFR 270.22c-1(b).
[486] 15 USC § 80a–2(a)(41)(B).
[487] 17 CFR 270.2a-4.
[488] 15 USC § 80b–3.
[489] 17 CFR 275.206(4)-7(b).

of disclosures, the safeguarding of client assets and any other plans[490] normally expected of a financial advisor who acts as a fiduciary. In fact, whilst policies and procedures are not required to contain specific elements, the CIS operator is encouraged to consider conflicts and compliance factors that may compromise the adviser's ability to protect the fiduciary relationship. A failure to comply with this rule is a violation of section 206(4) of the IAA.[491] An extra layer of protection is provided with the ICA Rule 206(4)-8, which prohibits advisers of pooled investment vehicles from making false or misleading statements to CIS investors, or prospective ones, or from defrauding them.[492]

As a guarantee of its standards, the CIS operator must implement a Code of Ethics as intended under Rule 204A-1. These typically resemble those enacted for supervised persons by other national authorities. For example, any employee of a CIS operator with access to client transactions must submit a report to the chief compliance officer and obtain approval prior to making certain investments. It is common for CIS directors to review the details of these arrangements on a regular basis.

Furthermore, the CIS operator must agree to a number of specific investment-related provisions aimed at mitigating the risk to CIS investors created by the delegation of the portfolio management activity. In particular, the ICA requires the CIS operator to maintain a CIS sub-classification, limit the transactions aimed at increasing the CIS liabilities to those provided within the registration statement and, more generally, not to deviate from the CIS policy in respect of concentrations of investments or any pre-determined investment policy. These can only be modified by a majority vote of the CIS's outstanding voting securities.[493] Such requirements have been further refined by the SEC with its adoption of the so-called investment company names rules. This prohibits the naming of a CIS with a name suggesting that the company focuses on a particular type of asset investment without this type constituting at least 80% of the CIS's assets.[494] A violation of this threshold is considered to be misleading the public and the CIS investors.

Other relevant ICA provisions actuated by a CIS operator are those addressing the inherent risks determined by the portfolio composition. As for retail investment funds elsewhere, an ICA-compliant scheme cannot invest in certain securities deemed not suitable to the public nature of a CIS available to all types of investors. These limits extend, for example, to the purchase of any securities on margin, if not necessary for the clearance of transactions, and to the execution of short sales of any securities.[495] Other suitable examples are the indirect ownership of companies through a CIS: no

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[490] Securities and Exchange Commission, 'Final Rule: Compliance Programs of Investment Companies and Investment Advisers' (17 December 2003) <https://www.sec.gov/rules/final/ia-2204.htm> accessed 15 June 2017.
[491] 17 CFR 275.206(4)-7.
[492] 17 CFR 275.206(4)-8
[493] 15 USC § 80a–13(a).
[494] Securities and Exchange Commission, 'Investment Company Names' (ICA Release No. 24,828, 66 Fed. Reg. 8,509 Feb. 1, 2001).
[495] 15 USC § 80a–12(a).

more than 3% of the total outstanding voting stock of a company, nor its issued securities having an aggregate value in excess of 5% of the value of the company assets, are allowed.[496] These limits, imposed on the CIS Operator in the management process, reinforce the nature of the CIS and the protection of its investors.

Key regulatory cases and administrative actions in the US

Whilst it is not possible to summarise all the somewhat extensive ICA-related litigation that has occurred in the US since 1940, a synthetic judicial review, combined with the SEC's publicised No-Action Letters, provides clarity on the legal safeguards currently in place in the US context.

Investment management activities

The CIS operator of a registered and compliant fund is appointed by a written contract detailing its services. This agreement is ratified by a majority vote of all outstanding voting securities of the CIS.[497] This norm supports the idea that the CIS investors should be informed and aware of any new entities carrying out investment management activities on their behalf.

A CIS may enter into contractual arrangements with different advisers. Best practice dictates that a principal adviser, usually the CIS operator, may allow for contracted sub-advisers to manage parts of the CIS assets, due to their expertise in a specific asset class or experience in foreign markets. In publicly-offered schemes, CIS investors, as shareholders, are not sufficiently skilled to evaluate whether a sub-advisor has those abilities, nor it is reasonable to expect all shareholders to contribute to the selection process. The question is therefore whether the CIS operator may appoint a sub-advisor without the approval of the CIS investors.

The SEC's No-Action Letter for the First Trust/Gallatin Specialty Finance and Financial Opportunities Fund has clarified these doubts. The SEC investigated the case of Gallatin Asset Management, a sub-advisor of the homonymous CIS, who had notified interested parties of its resignation as sub-adviser. Gallatin indicated that, following personnel changes within its equity team, it had conducted an internal review of its capabilities and determined that it was in the best interests of the CIS investors, and its own, to resign.[498] While continuing to serve for the time period prescribed in the ICA, Gallatin was issued at the end of the period an interim sub-advisory agreement by the CIS operator, who had been unable to find a suitable alternative. However, such a temporary arrangement was not ratified by the CIS

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[496] 15 USC § 80a–12(d)(1)(A))
[497] 15 USC § 80a–15(a).
[498] First Trust/Gallatin Specialty Finance and Financial Opportunities Fund, SEC No-Action Letter (July 11, 2008), p 1.

investors. The CIS operator stated that the occurrence was simply to ensure continuity of portfolio management services to the CIS.[499]

Despite the breach of a prescribed rule, the SEC's Chief Counsel of the Division of Investment Management did not recommend that the firm be subject to enforcement actions. The main reason was that it would not have been possible for CIS investors to vote. This ICA-related No-Action Letter also confirms that, in the regulator's view, ensuring the correct management of the assets is in favour of the CIS investors and has priority over a formality that, in most cases, is difficult to apply.

Antifraud

Most CIS investors do not have direct access to the individuals performing the portfolio management activity of their scheme. Staff at the CIS operator carry out the function upon receiving the mandate from the CIS directors. In effect, this relationship between CIS investors and CIS investors is impersonal in nature, and probably differs from other investment mandates that an IAA adviser usually services.

In order to avoid fraud, several ICA rules have been adopted over time to protect pooled assets from unlawful activities. In 2007, the so-called Goldstein case puzzled the American fund industry. The case turned on the question of whether hedge fund managers who had fewer than 15 CIS clients should register with the SEC as IAA advisers, or be exempt from this, as is normally the case for individuals. Evidently, one can either count a CIS as one client or, instead, count the many CIS investors in the single CIS as many clients. It should be stressed that this rule did not affect ICA-compliant CISs, which required registered CIS operators anyway.

The interpretation of the court was in favour of the fund equalling a single client. Some prominent authors believed at the time that this interpretation had left the entire industry without even any modest progress toward the oversight of fraudulent activities by advisers to pooled assets.[500] Following this case, the SEC issued new rules addressing fraud by advisers to certain pooled investment vehicles. The IAA prohibits any investment adviser from engaging in fraud and applies equally to advisers who are required to register and those who are not.[501] The rule was designed to clarify the SEC's ability to bring enforcement actions under the ICA against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle.[502]

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[499] ibid p 2.

[500] Harvard Law Review, "Judicial Review of Agency Rulemaking — District of Columbia Circuit Vacates Securities And Exchange Commission's "Hedge Fund Rule"; *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[501] Todd Zaun, 'Goldstein v. Securities and Exchange Commission' (2007) 1 Journal of Business Entrepreneurship and Law < https://law.pepperdine.edu/jbel/content/vol1/zaun-final.pdf> accessed 05 October 2017.

[502] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, IAA Release No. 2,628, 72 Fed. Reg. 44,756 (Aug. 9, 2007).

These defensive mechanisms for investors in pooled schemes are routinely used by the SEC. A good example is found in the proceedings against Michael G. Thomas, adviser of the CIS registered vehicle named Michael G. Investments. The SEC found evidence that this CIS operator made material misrepresentations to prospective investors concerning his own past investment performance, the personnel managing the CIS and the CIS's projected performance. Even though the CIS operator did not allocate a single unit of the fund, he was found to specifically be in violation of ICA antifraud provisions.[503]

Furthermore, conduct leading to conflict of interest is also interpreted as fraudulent action. This was the case in *US v Tagliaferri*. The court explicitly stressed how a CIS operator can violate antifraud provisions by engaging in various types of conduct including scheming to defraud; executing a course of business which operates as a deceit; sale or purchase of a security to or from a client while acting on the behalf of someone other than the client (without disclosing the transaction and obtaining the client's consent); or any course of business which is manipulative.[504]

Valuation issues

The topic of CIS valuation is key to the analysis of the governance risks taken by a CIS investor. A CIS operator's valuation presents potential conflicts of interest: a CIS operator might be incentivised to make a more attractive valuation in order to reap higher fees, or otherwise benefit itself, to the detriment of the fund and the fund's investors.[505] In the USA, cases have demonstrated a strict interpretation of the relevant ICA rules and the SEC's unwillingness to accept lax standards in the industry.

The case concerning the so-called Morgan Keegan funds, a set of CISs later rebranded Helios funds, is relevant for understanding the impact of valuation, as it addresses the dynamics of the various parties involved in the governance of a set of CISs. It also points out certain deficiencies in the US regulatory framework as described in this research. Furthermore, the case is related to CISs invested in securities backed by subprime mortgages – the type of security that was responsible for the financial crisis of 2008. These instruments lacked readily available market quotations and, as a result, the securities had to be priced by the CIS directors using "fair value", a methodology prescribed by ICA.[506]

The CIS operator of the Morgan Keegan funds was Morgan Asset while Morgan Keegan was the principal underwriter and distributor of the open-ended CIS's shares. ICA standards dictate that each CIS director is responsible for pricing the funds'

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[503] Michael G. Thomas, IAA Release No. 4,102 (June 3, 2015).
[504] *US v. Tagliaferri*, No. 15-536 (2nd Cir. 2016).
[505] Salvatore Massa, 'Outside a Black Box: Court and Regulatory Review of Investment Valuations of Hard-to-Value Securities' (2016) 8 William and Mary Business Law Review 1, 70.
[506] In the Matter of Morgan Stanley Asset Management, Inc; Morgan Keegan & Company, Inc; James C Kelsoe Jr; and Joseph Thompson Weller, CPA, ICA Release No. 29704 / June 22, 2011 para 14.

securities in accordance with the CIS's declared policies. Even though the CIS's prospectuses indicated that the CIS operator was the entity pricing the securities, the CIS directors had delegated the responsibility for pricing to Morgan Keegan (and not Morgan Asset).[507] This entity was tasked with generating each CIS's NAV on a daily basis and it set up a valuation committee to estimate the prices assigned to each security.

The SEC found that Morgan Keegan failed to fulfil its responsibilities, as determined in the arrangements from the CIS directors, to price those securities in accordance with their valuation policies. The gaps extended to unsubstantiated price adjustments that inaccurately inflated the prices of certain securities. No evidence was found to justify any of those pricing adjustments. Furthermore, despite the CIS's valuation policies and procedures requiring fair values provided by external sources, although they obtained external broker-dealer price confirmations, individuals at the CIS operator actively screened and influenced those prices confirmations used by the Morgan Keegan valuation committee and for audit matters. This disinformation extended to deliberately failing to inform the CIS directors that certain securities should have had reduced values.[508]

Given the clear misconduct of the CIS operator, the collusion between it and Morgan Keegan, and the failings of the individuals involved, the question of the negligence of the CIS directors remains. With this background, the SEC ordered an enforcement action against the former CIS directors for failing to properly oversee the valuation of mutual fund portfolio securities, a noteworthy step by the SEC, which rarely brings enforcement actions against independent directors.[509] The SEC found that the CIS directors failed to specify a fair valuation methodology; nor did they review how each of the CIS's securities were evaluated. The SEC also stated that, given the delegation to determine fair value to the valuation committee of the CIS adviser, the directors should have complemented this with meaningful, substantive guidance on how those determinations should be made.[510]

The question of how CIS directors who are not valuation specialists can provide directions on the pricing of complex securities to an expert committee sponsored by the CIS operator remains unresolved. The SEC is aware that CIS directors are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. Most CIS directors fulfil their obligations by reviewing and approving pricing methodologies but these are more typically recommended and applied by the CIS operator. In reviewing and approving pricing procedures, CIS directors are primarily concerned with determining whether those methodologies and procedures are reasonably likely

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[507] Securities and Exchange Commission, 'SEC News Digest' (Issue 2011-120, 22 June 2010).
[508] ibid.
[509] Bibb Stretch, Jeffrey Schellenger, "SEC institutes administrative proceedings against eight registered fund directors for failure to properly oversee asset valuations"(2013) 14 1 Journal of Investment Compliance 29.
[510] In the matter of J Kenneth Alderman, CPA; Jack R Blair; Albert C Johnson, CPA; James Stillman R McFadden; Allen B Morgan Jr; W Randall Pittman, CPA; Mary S Stone, CPA; and Archie W Willis III, ICA Release No. 30300 / December 10, 2012, para 1.

to result in the valuation of securities at prices that the CIS could expect to receive upon their current sale.[511]

Another potentially unfavourable regulatory construct for the CIS investors, related to the valuation of the CIS, is that of the timing of the valuation. The order of execution of trades and NAV determination can determine abusive practices of unit management. The US CIS market was hit by a scandal in the summer of 2003 when revelations of widespread late trading and market timing activities by CIS operators led to increased public scrutiny.[512] Late trading relies on submitting subscription orders after the value of the CIS has already been determined, hence abusing the information already known and potentially inflating the valuation of the fund. Market timing is based on some CIS investors rapidly buying and selling CIS units so as to take advantage of any discrepancies between the latest NAV and that forecasted using the market prices of the underlying assets for the day. In this way, certain CIS investors can time their purchase and redemption of CIS units to expropriate wealth from other fund holders.[513] This was particularly immoral as certain large CIS operators permitted some large CIS investors to prey on smaller ones.[514] The issue culminated with the SEC reaching an agreement in principle with a specific institution, Bank of America, and it enforced a payment of $375 million in disgorgement and penalties while effectively forcing the exit of this intermediary from the securities clearing business.[515]

On top of enforcement actions, the SEC released new ICA rules that required open-end CISs to disclose the risks to CIS investors associated with the frequent purchase and redemption of CIS units in their prospectuses. It also introduced rules requiring CIS operators to disclose their policies and procedures with respect to such frequent purchases and redemptions.[516]

Disclosure and misrepresentation

An important topic for CIS investors is the losses that occur following the CIS operator's misrepresentation of underlying investments or assets. In US securities law the concept of loss causation for securities is linked to the cause and effects of such misinformation on the price of the security.[517] US courts have established that loss

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[511] Securities and Exchange Commission, 'Division of Investment Management: December 1999 Letter to the ICI Regarding Valuation Issues (8 December 1999).

[512] Cox, Hilman, Lavengoort (24) p 1109.

[513] Gregory Bryant Kadlec, 'On the Solutions to the Mutual Fund Timing Problem' (30 August 2004) <https://ici.org/pdf/wht_04_mkt_time_solutions.pdf> accessed 2 March 2019.

[514] Tom Lauricella, 'Industry Lobbyists May Have Known as Early as 2000 About Market Timing' (*The Wall Street Journal* 22 March 2004) <https://www.wsj.com/articles/SB107990670748261213> accessed 2 March 2019.

[515] Securities and Exchange Commission, 'SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading' (SEC Press Release No. 2004-33, Mar. 15, 2004).

[516] Securities and Exchange Commission, 'Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings' (Release Nos. 33-8408; IC-26418; File No. S7-26-03).

[517] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).

causation is similar to a standard of proximate cause in traditional tort actions, as there must be an actual economic loss, and the misrepresentation is the proximate cause. Courts have also clarified that *"simply purchasing shares of stock at an inflated price does not meet this standard"*.[518] In short, the loss must be caused by the materialisation, in the price, of the concealed risk.[519]

The mechanism of how securities are priced is key to this remedial concept for CIS investors. By design, this legal mechanism, used for listed companies, requires a system of securities pricing in a regulated secondary market for which traded prices are disclosed to market participants. In this system the price incorporates all the public information available to the participants. A new disclosure, fraudulent or not, produces a reaction in the market whereby the price of the share will be corrected by incorporating the new information. However, in the context of CIS, there is no secondary market for CIS investors to prove loss causation with the same dynamics.[520]

US judicial cases do not draw a definite answer to this regulatory dilemma. An example is provided by the analysis of three different court cases, brought forward by CIS investors, addressing loss causation for investments made by the CIS operator for the same asset class of mortgage-backed securities.

The first case was brought against Charles Schwab, as the scheme operator, and was found in favour of the CIS investors: the misrepresentation of the fund's risk profile and mix of assets was caused by the changes *"in the investment policies and, specifically, the allocations invested heavily in risky mortgage-backed securities which declined in value – thus, they overstated the value of the fund's holdings"*.[521]

In the second case, concerning State Street, the court did not agree with the above case. Some scholars have attributed this to the difference between transaction causation and loss causation.[522] It was noted that a misrepresentation in the nature, extent and mix of the fund cannot correct the value of the actual shares.[523] In its judgment the court stated *"that it is bound by the text of sections 11 and 12"*, referring to the text in the Securities Act of 1933 that provides investors with the ability to hold parties liable for damages caused by untrue statements of fact or material omissions.[524]

This differing interpretation was modified later by the judgment in the case of Oppenheimer Rochester Funds. In this judgment, the court linked the fund value and the misrepresentation to the CIS investor, finding that it is the price-volatility and risk

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[518] Mercer Bullard, 'Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?' (2008) 76 Cincinnati Law Review 559.
[519] *Lentell v. Merrill Lynch & Co*, 396 F.3d at 173.
[520] Mercer Bullard (n 74) 443.
[521] Samuel L Moultrie, 'Loss Causation, Mutual Funds, and Securities Claims: An Uncertain Future for Shareholders' (2013) 25 Regent University Law Review 443, 457.
[522] In Re State Street Bank and Trust Co. Fixed Income, 774 F. Supp. 2d 584 (S.D.N.Y. 2011) at 593-94.
[523] Samuel L Moultrie (n 77) 461.
[524] Adam M Apton, 'pleading Section 11 Liability for Secondary Offerings' (American Bar Association, 4 January 2017) <https://www.americanbar.org/groups/litigation/committees/securities/practice/2017/pleading-section-11-liability-for-secondary-offerings/> accessed 2 March 2019.

associated with aggressive and highly leveraged investment strategies *"that resulted in"* the devaluation of the fund's NAV.[525]

Some research has pointed out that, in a CIS context, the problem of windfalls to CIS investors is outweighed by the dangers of a potential windfall. CIS operators in violation of prospectus disclosure rules would receive an unfair windfall because they could have posted misstatements in a prospectus, causing investors to purchase shares, and then receive management fees even though investors may not have purchased shares *"but for"* such misstatements.[526]

Professor Langevoort has expanded the academic analysis on this topic, elaborating on a number of failings of the courts when interpreting certain duties of the CIS operator.[527] In 2011, class action cases disappointed CIS investors' groups with some unusual interpretations of ICA rules. Of particular importance is the case of *Janus Capital Group, Inc. v First Derivative Traders* ("*Janus*")[528] for which an advisory firm acting as CIS operator was held not responsible of misrepresentation of its conflictual late trading policies, disclosed in the prospectus, because such statements were filed by, and in the name of, the CIS and not the CIS operator.[529] In the judge's view, statutory language must be interpreted literally and verify whether the CIS operator obtained money or property *"by means of"* a materially false or misleading statement or omission.

Professor Langevoort constructed the argument that violations of the statutes occur when an economic gain for the CIS operator, obtained inflating management fees by misstating its late-trading policy in prospectuses, occurs.[530] Such interpretation supports the idea that statuary rules for CIS are built in favour of the investors.

This is not to say that the US regulator supports the interpretation in *Janus* either. In *SEC v Daifotis*,[531] the SEC's Enforcement Team alleged that the CIS operator issued a number of misstatements regarding the status of the CIS and that the portfolio manager, a certain Mr Daifotis, did not operate within the disclosed assets' concentration policies for the CIS. Notwithstanding the settlement reached in 2012, the Supreme Court pointed out that, given that parties agreed the individual made several misleading statement in person, the same section does not apply as it does for *Janus* and, rather, it should be interpreted in terms of *"to employ any device ... [or] to obtain money"*.[532] Whilst not changing the mechanism in *Janus*, the US Supreme

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[525] In re Oppenheimer Rochester Funds Grp. Sec. Litig. 838 F. Supp. 2d 1148 (D. Colo. 2012)at 1175.
[526] Samuel L Moultrie (n 77) 467.
[527] Langevoort DC, "Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty" (2005) 83 4 Washington University Law Review 1017.
[528] *Janus Capital Group, Inc. v. First Derivative Traders* 131 S. Ct. 2296 (2011).
[529] The rules are referring to ICA Section 17(a) as well as CFR 10b-5,
[530] Donald C Langevoort, 'Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence' (Georgetown Public Law and Legal Theory Research Paper No. 12-019), 955.
[531] *SEC v. Daifotis*, No 3:11-cv-00137 (N.D. CA. Filed Jan. 11, 2011).
[532] Thomas O Gorman, 'Janus and Primary Liability in an SEC Enforcement Action' (*LexisNexis* 15 August 2011) <https://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2011/08/15/janus-and-primary-

Court tries to tilt the balance somewhat toward the CIS investor, albeit without correcting its inherent ambiguity.

Affiliated transactions

The set of rules addressing affiliated transactions are good examples of codified, legal requirements in securities regulations that CIS investors would naturally expect in a professional environment. Most of them simply contain the good sense or normal standards expected of any fiduciaries involved in the management of third-party funds. However, most regulators worldwide provide detailed instructions to avoid dubious behaviours that, under common law systems, one would expect not to be a necessity.

In the case of the ICA, the provisions relate to affiliated persons of another person – which is defined, in the most simplistic case, to include any person directly or indirectly owning, controlling, or holding with power to vote 5% or more of the outstanding voting securities of the other person. The same is applied to any person controlling the other person, directly or indirectly, and entities associated with the CIS such as the CIS operator, officers, directors and so on. Transactions between the CIS and affiliated persons are to be avoided when either of the entities knowingly sells, purchases, borrows or lends money to the other party. This basic conflict of interest provision is also extended to potential transactions to which the CIS is a joint party.

The most representative court case on this topic, for the purposes of the present research, is the case of Martin Currie, which has been addressed by both the SEC and the the UK's FCA, as the CIS operator was located in the latter jurisdiction while the actual CISs were registered in the US under the ICA. The case regards the evident abuse of position by the UK-based Martin Currie institutional investment managers, who fraudulently used its US-registered investment companies to rescue another client during the market crisis of 2009.[533] Martin Currie managed, under instructions from a single team of Shanghai-based advisors, its registered subsidiaries Martin Currie Investment Management Limited ("MCIML") and Martin Currie Inc ("MCI") as well as the two funds, The China Fund Inc. and the Martin Currie China Hedge Fund L.P. These schemes made similar investments in public and private Chinese companies.

The Martin Currie China Hedge Fund had acquired illiquid assets and required moneys to satisfy the CIS investors' redemption requests. Martin Currie executed a transaction of convertible bonds, on behalf of The China Fund, in a subsidiary of The Martin Currie China Hedge Fund. The proceeds of the investments were partially used to redeem assets owed to the Martin Currie China Hedge Fund, therefore allowing the

liability-in-an-sec-enforcement-action.aspx?Redirected=true> accessed 2 March 2019.

[533] In the Matter of Martin Currie Inc. and Martin Currie Investment Management Ltd., SEC Release No. 30062 / May 10, 2012.

latter to have more liquidity at disposal.

The SEC found that MCI and MCIML acted deceptively in structuring this improper bond transaction by The China Fund to benefit he Martin Currie China Hedge Fund and in failing to make fair disclosure of material facts to the CIS board of directors of The China Fund.[534] Further notes confirmed irregularities in the valuation procedures, in particular regarding the disclosure of the required information necessary for the CIS board of The China Fund to correctly address the convertible bonds valuation. The violations enumerated by the SEC for the Martin Currie case relate to both the ICA and the IAA; of particular relevance for the CIS investors are the IAA's antifraud provisions and the ICA's affiliated transaction provisions.

On the one hand, the authorities considered Martin Currie's advice to The China Fund to invest in its client bonds a material misrepresentation and an actual omission of the CIS operator involvement. The unscrupulous guidance concerned the investment rationale and the pricing of the bonds. The misrepresentation extended to the board of directors, which is the CIS independent entity, for their approval, and therefore the action amounted to fraud or deceit of a client, in this case the CIS itself.

On the other hand, the CIS operator wilfully aided, abetted, and caused violations of the ICA by allowing an affiliate of the CIS to participate in a joint arrangement with the CIS without a Commission order.[535] This was in contravention of the SEC rules intended to limit or prevent participation by a registered CIS on a basis different from or less advantageous than that of another participant, which was evidently the case here for the CIS operator.

The SEC, taking into consideration the collaboration of the CIS operator and the compensation previously accrued toward the CISs for the losses occurred, imposed a civil penalty of $8,300,000.

CIS operators in the UK

A complex UK rulebook[536]

The Undertakings for Collective Investment in Transferable Securities and the Alternative Investment Fund Managers Directives are in place to facilitate cross-border activities of fund managers and CISs within the European Union. EU member states are required to implement the provisions of these Directives in order to make the European common market fully available for CIS operators. When the Directives

[534] ibid.
[535] In the Matter of Martin Currie Inc. and Martin Currie Investment Management Ltd., SEC Release No. 30062 / May 10, 2012, Violations section, B.
[536] This research has been carried out and documented before the end of 2018. Any effect of the referendum result of 2016, or any changes on the applicability of EU law within the United Kingdom, could not be taken into account. The statutory instruments for EU law are used to understand the CIS rules applicable within the UK framework.

are implemented, the authorisation to operate a CIS from one national EU competent authority is sufficient to carry out business in another EU member state as long as the rules of the CIS are followed.[537] As already indicated, the competent authority responsible for the implementation of the rules in the UK is the FCA,[538] author and keeper of the applicable regulations, including the specialist sourcebooks previously mentioned, COLL and FUND, aimed at specific CIS models. Other applicable CIS operator rules may be found in other sourcebooks, such as the Conduct of Business, Senior Management Arrangements, Systems and Control, and the Perimeter Guidance Manual. Whether a CIS operator of a fund must follow the duties in COLL, FUND or both depends on the nature of its authorisation and the CIS's status, including whether it is a close-ended or open-ended fund.

UK-based funds are registered as either Authorised Unit Trusts, Authorised Contractual Schemes ("ACSs") or Investment Companies with Variable Capital.[539] For AUTs and ICVCs, shareholders are the legal owners of the units, and a CIS operator of these legal structures has similar duties. ACSs, on the other hand, are not legal units in their own right and are created for tax transparency purposes. An investor wishing to invest in an ACS must be a professional client or a sophisticated investor.[540] ICVCs are better known as open-ended investment companies and they are regulated under the 2001 Regulation of the same name.[541]

Furthermore, a CIS operator has specific duties depending on how the CIS is promoted. Its status can be that of a UCITS (the EU standard for retail funds), a non-UCITS retail schemes ("NURS") or a Qualified Investor Scheme ("QIS").[542] UCITS are facilitated for European cross-border marketing under the condition that the UCITS comply with the prescriptive rules.[543] NURS and QIS do not comply with the UCITS Directive and are sold within the UK under the precepts of the AIFMD.[544] Finally, QIS are solely marketed to experienced CIS investors.[545]

The level of complexity described here is the result of the UK's old but successful investment management legal framework having met the EU regulatory requirements. However, since the EU developed the UCITS framework, this has become the most successful and well-known CIS structure in the UK, across Europe and outside the

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[537] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] OJ L302/32.

[538] Financial Services and Markets Act 2000, Part I.

[539] Investment Management Association 'Authorised Funds: A Regulatory Guide' (2014), 6 <https://www.theinvestmentassociation.org/assets/files/industry-guidance/20140801-authorisedfundsaregulatoryguide.pdf> accessed 18 November 2017.

[540] COLL 1.2.2(3).

[541] The Open-Ended Investment Companies Regulations 2001.

[542] Financial Conduct Authority, 'Authorised and Recognised Funds' (9 February 2018) <www.fca.org.uk/firms/authorised-recognised-funds> accessed 2 March 2019.

[543] Niamh Moloney, *EU Securities and Financial Markets Regulation* (Oxford University Press, 2014), p.221, Directive 2009/65/EC Art 2.

[544] COLL 1.2.2 Guidelines; Charles Muller, Alain Ruttiens, *A Practical Guide to UCITS funds and their risk management* (Responsible Publisher, 2013), p 41.

[545] Directive 2009/65/EC Art 2.

EU Single Market. Given this, this research will focus on the duties of a CIS operator as described in UCITS, the most common CIS structure worldwide.

The CIS operator in the UK

One of the most important duties of a UK CIS operator, or the ACD in the case of ICVCs, is the requirement to appoint the CIS independent entity, a depositary (as previously discussed), to safeguard the property of the schemes and to ensure that the CIS assets are protected from personal interests.[546] This rule is in line with the UCITS requirement that a depository be appointed to give full protection to the CIS investors.[547] Furthermore, the CIS operator must also confirm the eligibility of the trustee and ensure that the appointment is evidenced in a written contract.[548] This requirement adds to the emphasis found in UCITS on implementing internal control mechanisms, but no written contract, so as to have a clear separation between the two functions.[549] In this regard, it is evident that the UK regime imposes stricter duties on managers than the EU regulatory regime.[550] This requirement comes from the need for UCITS to be available to all CIS investors, including those with minimal levels of financial knowledge who are unable to assess the risk appropriately, in contrast to investors in alternative funds.[551]

In line with the details discussed in previous chapters, the duty of the CIS operator is to manage the schemes on a day-to-day basis; delegation of such duties is allowed to the extent that the operator is still able to supervise the management of the investment.[552] Moreover, the overarching duty is to act in the best interests of the investors. [553] This is not just a UK prerogative, but a need evident in EU CIS-related directives and required by the European legislator.[554] In particular, UCITS highlights the need to create a uniform approach to *"authorisation, supervision, structure and activities of UCITS"* established in the member states and the information that they are required to publish *"in order to protect investors as well as ensure the stability of the financial market"* with an emphasis on transparency.[555] This explicit prioritization on the part of European securities regulators is unsurprising. Following the financial crisis, it has been necessary to regain trust in the financial markets and demonstrate to

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[546] Investment Management Association (n 526).
[547] Directive 2014/91/EU Article 23.
[548] COLL 6.6.A.11, Directive 2009/65/EC Article 22.
[549] Marco Bodellini, 'Does it still make sense, from the EU perspective, to distinguish between UCITS and non-UCITS schemes?' (2016) 11 4 Capital Markets Law Journal 528, 533.
[550] Investment Management Association (n 526) 6.
[551] Oksana Martanus, Elena Merekina, 'Alternative investment funds under new financial and legislative reality and Russian Specific', in Agata Gemzik-Salwach A and Krzysztof Opolsi (eds) *Financialization and the Economy* (Routledge, 2017) 112.
[552] Directive 2009/65/EC.
[553] *Unitholder meaning the person holding the interest, and whom is registered of the scheme as the holder of that unit.* On the topic, see: Christopher Buttigieg, 'The 2009 UCITS IV Directive: A critical examination of the framework for the creation of a broader and more efficient internal market for UCITS' (2012) 6 Journal of Business Law 2, 10.
[554] Oksana Martanus, Elena Merekina (n 538) 113.
[555] Directive 2009/65/EC.

investors that companies are regulated and financial services monitored.[556] COLL resonates with the overall need to ensure financial stability and prudent supervision through system implementations particularly focused on risk management.[557]

Key UK regulatory framework requirements

Disclosures documentation

For investors in CISs to be able to make informed decisions, a level of transparency regarding the legal and economic status of the vehicle forming the CIS must be present.[558] COLL requires that *"an authorised fund manager, a depositary and any other director of an ICVC"* must publish a prospectus and prepare half-yearly and annual reports for its investors within two to four months of the end of the accounting period.[559] This duty is usually the responsibility of the CIS operator but it is often delegated to administrative subcontractors. The information provided must contain key CIS information including its balance sheet, income statement, expenditure accounts, specific remuneration expenditure and a report on activities for the financial year.[560] These documents must be available on request to the CIS investors, free of charge, giving them the opportunity to monitor their investments as they wish.[561]

Furthermore, in order to provide an easier way of assessing and comparing CISs, UCITS managers must publish a document containing Key Investor Information. This is a standardised short document enabling CIS investors to evaluate the riskiness, cost and nature of his or her investment without reference to other documents.[562] These European requirements, together with those regarding the remuneration policy, have been adopted in COLL for investor protection purposes. The UCITS Directive states that the document must be easily understandable and in conformity with other similar documents to allow for comparison.[563] In the exercise of voting rights, the CIS operator must develop adequate and effective strategies for determining when and how voting rights attached to ownership of scheme property are to be exercised, and it is expected to make this strategy available to the unitholders.[564]

A European peculiarity is the remuneration disclosure that all CIS operators must report together with the specific policy in place for the CIS.[565] The annual report must

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[556] Christopher Buttieg (n 533) 2.
[557] COLL 6.12.5; FUND 3.4.4; Directive 2011/61/EU Art 15(3), 24(3).
[558] Charles Muller, Alain Ruttiens (n 531) 133.
[559] COLL 4.2.2., 4.5.2, 4.5.3, Directive 2009/65/EC Chapter IX `Publication of a prospectus and periodical reports`, article 69.
[560] Directive 2009/65/EC Art 69 and Schedule B of Annex I; Directive 2011/61/EU Art 22 and 23.
[561] Directive 2009/65/EC art 75; Directive 2011/61/EU Art 22.
[562] Directive 2009/65/EC Article 79.
[563] Directive 2009/65/EC Article 78; COLL 4.7.2.
[564] COLL 6.6A6.
[565] FCA Handbook SYSC Senior Management Arrangements, Systems and Controls (SYSC), 19E.2 Remuneration policies and practices; Directive 2009/65/EC Article 69, Directive 2009/65/EC Article ANNEX I, Directive 2011/61/EU Art 13.

contain information regarding the total remuneration paid by the CIS operator to its staff, together with a description of how the remuneration and the benefits have been calculated and the details of any material changes from the previous year's remuneration policy.

Modifications of a CIS

COLL and FUND set out various rules as to how a CIS operator is to deal with changes in the fund or in the operations of the fund. The UK regulator details both the way such changes are to be carried out and at which point in time the CIS investors should be notified.[566] In particular, it provides three degrees of changes that require different acknowledgements, or agreements, depending on the materiality and effects on the scheme and its unitholders.[567] Fundamental changes require prior approval via an extraordinary resolution. Changes are considered to be fundamental when they entail changes in the purpose or the substantial risk profile of the CIS, are materially prejudiced toward CIS investors or where a *"new type of payment out of the scheme property"* is proposed. A step below "fundamental" are those changes deemed significant, requiring a pre-event notification only; such changes would affect CIS investors' ability to exercise their investment rights or be reasonably expected to cause them to reconsider their participation in the scheme. A change in fund manager is one such significant change.[568]

In certain cases, the FCA, the UK regulator, must be notified. This is the case for amendments to the instrument of incorporation, changes in the address of the head office, changes in directors, a change of depositary or for any change in the information submitted under the OEIC Regulation 2001. Key information, such as the appointment of a new auditor or any order regarding mergers and divisions related to the scheme, must also be communicated to the FCA.[569]

Valuation duties for managers under COLL

The CIS operator has control over, and responsibility for, the issuing, cancellation, sale, valuation and redemption of units of the CIS. However, this role is balanced with that of the CIS independent entity, which is the depositary/trustee within the UK framework. The balance of powers is extended to the implementation of accounting policies and procedures as required for any type of CIS operator.[570]

The CIS operator of a UCITS fund must establish appropriate procedures to ensure

[566] Investment Management Association (n 526), 16.
[567] COLL 4.3.
[568] COLL 4.3.6A.
[569] COLL 6.9.11.
[570] COLL 6.3.3, 6.3.3A, 6.3.3D; Directive 2009/65/EC Article 85; Directive 2011/61/EU Art 19.

the valuation of assets and liabilities of each scheme it manages, and ensure that all assets and liabilities of the scheme can be directly identified at all times.[571] This idea of this great responsibility is to avoid any mispricing affecting the CIS investors directly or indirectly. The rules are clearly set out in the interest of the unitholders, with the expressed goals of ensuring that the units are priced in a fair and regular manner, that any dilution effects in the value of the CIS caused by the issue or cancellation of funds is mitigated, and that the prices are made public in an appropriate manner.

All units must follow the same procedure in the authorised fund, or in a sub-fund of an umbrella. For each scheme managed, the CIS operator of a UCITS scheme must establish appropriate accounting procedures.[572] The CIS operator has a duty to provide at least two valuation points per month. If he chooses to limit the number of valuations to two, these must be at least two weeks apart.[573] Some schemes, such as UCITS or non-UCITS money market funds, require daily valuations. In addition, in these cases the CIS operator must carry out valuation on a mark-to-market basis at least once a week.[574] The unit price must be calculated according to the net value of the scheme property and in accordance with the instrument and the prospectus.[575] Once the valuation has been carried out, the CIS operator must not sell for more than the maximum price, or redeem for less than the cancellation price of the unit.[576] The CIS operator is also required to demonstrate control of the calculation of its valuation. In order to protect the true value of the fund, the CIS operator is under a duty to limit dilution when selling, redeeming, issuing or cancelling units.[577]

The depositary oversees the procedures and ensures that they are satisfactory, in line with its role as independent entity. In practice, such reviews are carried out on the systems and controls in place. COLL does not set the required frequency of these checks and it simply requires that they are carried out more frequently where the depositary suspects that the systems and controls are weak or otherwise unsatisfactory.[578]

The depositary must be notified of any instance of incorrect pricing. It will then report to the FCA those instances it considers material or any instances of incorrect pricing where the error is above the given threshold of 0.5%, or where the depositary believes that reimbursement or payment is inappropriate.[579] Since COLL assigns the CIS operator with the economically relevant duty of addressing instances of incorrect pricing by reimbursing the affected CIS investors at the time the breach occurred, the

[571] COLL 6.3.3A(1) 6.3.3D; Directive 2009/65/EC Article 85.
[572] COLL 6.3.3D; Directive 2009/65/EC Article 12(1)(a).
[573] COLL 6.3.4.
[574] COLL 6.3.13.
[575] COLL 6.3.5(1).
[576] COLL 6.3.5B.
[577] COLL 6.3.8.
[578] COLL 6.3.6G3(4).
[579] COLL 6.3.6G4(3).

depositary's findings must be material. In fact, it can relieve the CIS operator of this duty if the breach is found to be of minimal significance. In contrast, if the depository does not consider the breach to be material, the depositary is expected to ensure that the payments are accurately and promptly calculated and paid. If the payment is inappropriate, the depositary should report the matter to the FCA. In this case too, the main underlying concern is to avoid prejudicing the rights of the unitholders.

Operational duties (conduct and investment management)

CIS units management

The complex duty of CIS units' subscription and redemption, which implies their creation and cancellation, is placed on the CIS operator, and it may refer directly to the depositary, depending on the legal nature of the CIS. At a minimum, the CIS operator, in order to protect unit holders' and/or investors' assets, as explicitly envisioned in the relevant directive,[580] must pay the depositary in respect of any unit it has agreed to sell during the period of the initial offer.[581]

The CIS operator must ensure that the number of units corresponds with the number of unitholders upon valuation, to ensure that issuing or cancellation does not confer on itself or an associate a benefit or advantage at the expense of a current or potential CIS investor.[582] Similarly to the COLL validation rules, the descriptive regulatory framework is designed to ensure that unitholders are protected at all times from conflicts of interest on the part the CIS operator.[583] Any failure to follow this requires the CIS operator to reimburse the fund for any costs incurred.[584]

The UK regulations place a duty on the CIS operator to ensure that there are enough funds of the right currency in the scheme. Should this not be the case, the CIS operator must rectify any shortage as quickly as possible, using reasonable measures.[585] The CIS operator has also a duty to describe the arrangements for the sale and redemption of units in the prospectus.[586] In addition, the CIS operator must be willing to effect the sale or redemption of units in the CIS, in accordance with the conditions set forth in the instrument constituting it and in its prospectus, at all times during the dealing day.[587]

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[580] Directive 2009/65/EC (3),(8).
[581] COLL 6.2.3(3).
[582] COLL 6.2.8.
[583] Directive 2009/65/EC (13).
[584] COLL 6.2.16(1).
[585] COLL 6.2.14(2), (3).
[586] COLL 6.2.16(1).
[587] COLL 6.2.16(2), (3).

Supervisory duties for UCITS

Some of COLL's requirements are explicitly directed at CIS operators managing UCITS schemes and EEA UCITS schemes. Such duties are mainly aimed at the protection of the CIS investors' interests and they address malpractices through the implementation of appropriate policies and procedures, the adoption of fair and transparent pricing models together with suitable valuation systems, and by not placing the interests of any one group of CIS investors above the interests of any other group.[588] In addition, COLL and the EU UCITS Directive place a duty of due diligence on the CIS operator, requiring him or her to exercise a high level of diligence, knowledge and understanding; to establish written policies and procedures on due diligence; to implement risk management policy; and to verify any third parties' ability perform the risk management tasks.[589]

Specific supervisory requirements exist for senior personnel at the CIS operator: the goal of this is to ensure that the fund is better managed, and that adverse consequences following mismanagement are better avoided or addressed.[590] It is these senior personnel who are responsible for the CIS operator's duties to supervise investment procedures, to ensure effective and permanent compliance functions, to ensure and verify the general investment policy, to review the fund's procedures on a periodic basis in order to ensure that they are adequate, and to approve and review the risk management policy and strategies on a periodic basis.[591]

Moreover, the CIS operator must, on a regular basis, report on the procedures and the implementation of strategies used when making investment decisions.[592] It must also report annually to the FCA regarding the types of derivatives and forward transactions to be used within the scheme, including a risk report highlighting the procedure used to evaluate the risk.[593] In this report, the CIS operator must explain the risk management policy adopted for identifying the risks to which that scheme is or might be exposed. The policy must address how the fund manages market risk, liquidity risk, counterparty risk, operational risk, and other risks.[594] The policy must be reviewed periodically in respect of compliance, the effectiveness of procedures and the measures instituted to address deficiencies.[595]

Still regarding risk, the CIS operator must conduct periodic stress tests, implement and maintain a risk limit system for each UCITS, ensure compliance and establish remedial procedures.[596] A stress test would enable the senior management to address

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[588] COLL 6.6.A2; Directive 2009/65/EC Article 25(2).
[589] COLL 6.6.A4; Directive 2009/65/EC Article 14.
[590] Charles Muller, Alain Ruttiens (n 531) 133.
[591] COLL 6.10.2.
[592] COLL 6.10.3.
[593] COLL 6.12.3.
[594] COLL 6.12.5.
[595] COLL 6.12.8.
[596] COLL 6.12.9.

the vulnerabilities and take appropriate steps to mitigate any losses.[597]

Lastly, CIS operators of a UCITS and NURS scheme must ensure that borrowing does not exceed the set threshold of 10% of the value of the CIS. In particular, UCITS schemes are restricted to borrowing on a temporary basis and not persistently.[598] The same supervisory duty applies to the eligibility of securities types of publicly offered CIS, limited to transferable securities and other securities, which are traded by the CIS operator in the first place. This limitation, which is also a supervisory duty, extends to restricting investments to those set in the objective and policy of the UCITS scheme while ensuring the "prudent spread of risk".

Record keeping

The UCITS Directive states that the competent authority of a member state – the FCA in the UK legal framework – may require CIS operators to retain records of their activities.[599] These accounts must include evidence of compliance, units held, acquired or disposed of, and daily records of dilution for up to six years.[600]

These records are necessary to document the investments made and avoid allocations contrary to those described in the CIS documents. Should such an investment be made, the CIS operator must remedy the situation as soon as possible. For example, if an ICVC or umbrella scheme enters into a foreign contract inconsistent with the instrument constituting the fund, the CIS operator has the duty to investigate the inconsistency and take appropriate steps to remedy the situation.[601] The norms provide for an exception to the rule in the case that the remediation is beyond the control of both the CIS operator and the depositary.[602]

CIS operators of UCITS schemes record information for each portfolio, as well as the details of the securities transaction orders,[603] including subscription and redemption orders the fund receives.[604] The records are to be kept for at least five years or longer upon request from the FCA.[605] The CIS operator must make records available to the depositary if requested.[606]

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[597] Charles Muller, Alain Ruttiens (n 531) 133.
[598]COLL 5.5.4, 5.5.5 and5.6.22, Directive 2009/65/EC Art 83.
[599] Directive 2009/65/EC (21).
[600] COLL 6.6.6.
[601] COLL 6.6.5A.
[602] COLL 6.6.14.
[603] COLL 6.13.2.
[604] COLL 6.13.3.
[605] COLL 6.13.4-6.
[606] COLL 6.6.6.

UK cases involving CIS operators

The UK's FCA has brought forward more enforcement actions against its supervised entities in recent years, painting a clearer picture of the conduct expected of a CIS operator. Nevertheless, there has been a limited number of cases. To construct a holistic view of the UK interpretative and enforcement environment, some cases addressing discretionary portfolio management, and therefore not strictly related to CIS management duties, need to be examined. These may refer to interpretations of principles of conduct and standards of business conduct that are not necessarily from the CIS specialist rulebooks.

Fiduciary standards

The landmark case regarding the duties of investment managers in the UK is in all likelihood *SPL Private Finance (PF1) IC Ltd v Arch Financial Products LLP* ("*Arch Cru*").[607] The facts of the case have been discussed earlier, while analysing the duties of the Authorised Corporate Directors, specifically for Capita Financial, the CIS operator. Here, the lens will be on the delegated entity providing portfolio management, Arch Financial Products, the delegated manager of the fund. The decision in *Arch Cru* provides a rare restatement of the liability of investment managers in English law.[608]

Regarding the delegated manager's liability, the 2013 judgment ruled in favour of the claimant in respect of both the breach of the fiduciary duty owed by the delegated manager as an agent to its principals, and for the breach of the contractual duty to exercise reasonable skill and care. The decision was one of the first to delve into the topic, setting a number of principles to be applied to all relationships between a manager and its investors. These included the interpretation that, unless the parties expressly exclude it, a discretionary investment manager agreement will give rise to fiduciary duties, and that the delegated manager has a duty to act with reasonable skill and care due to his position as an agent.

The judgement provided a clear interpretation of the duty of loyalty of the delegated manager towards his principals, whereby it must give preference to their interests over its own. This, in turn, comprises two "sub-duties", namely the duty to avoid any actual or potential conflict, and the duty not to profit from its position as an agent. It has been observed that these duties, due to their nature of special obligations linked to the general fiduciary duty held by the delegated manager, operate strictly, without the

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[607] *SPL Private Finance (PF1) IC Ltd v Arch Financial Products LLP & SPL Private Finance (PF2) IC Ltd v Farrell* [2014] EWHC 4268 (Comm).

[608] Eversheds Sutherland, 'SPL Private Finance (PFI) IC Ltd v Arch and the liability of investment managers: top 10 points to consider' (06 Jan 2015) <https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Financial_institutions/Arch_and_the_liability_of_investment_managers> accessed 27 Dec 2017.

need for the claimant to prove any intentional wrongdoing or even fault.[609]

Should the delegated manager give proof that it has made full disclosure of all material facts and the nature and extent of the firm's interest, then consent can be a valid defence against a claim of breach of loyalty.

The court's judgment made the argument that the delegated manager holds a fiduciary duty towards its investors, and that this stems from a number of duties clearly set out in the FCA's Principles for Businesses. There, it is specified that the delegated manager is to *"conduct [its] business with integrity"*,[610] to *"take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"*,[611] and to *"manage conflicts of interest fairly"*.[612]

Given the fiduciary duty entailed in the portfolio management activities, the question is to what extent a CIS operator or its appointed delegated manager are to be held responsible, and thus whether and to what extent CIS investors are eligible for disgorgement. A case providing insights into the effectiveness of FCA rulebooks on this topic is that of a certain Mr Rocker and his discretionally appointed investment manager, Full Circle Asset Management ("FCAM").[613] This investor sought damages from the defendant asset management company for breach of contract, breach of statutory duty and negligence.

The investor's economic loss amounted to about £820,000 in March 2014 in damages representing a decline in value of more than half of the assets managed by the defendant pursuant to an agreement entered into in May 2009. The claimant alleged that the appointed manager had invested the assets in such a way as to be in breach of its risk mandate, given that his risk profile was one of medium appetite. The portfolio had in fact invested in assets performing with that type of risk for the first three years. The alleged wrongdoing was attributed to a later stage, during which the appointed manager took risks in excess of that of a benchmark portfolio and thus in breach of contract and in breach of the obligations imposed by the Conduct of Business sourcebook.

It was also found that the appointed manager did not activate a "stop-loss" for the client's portfolio, despite the fact that the appointed manager had represented its risk activities as being executed with *"tight"* and *"aggressive"* stop loss features.[614] The judgment restated that the interpretation of this policy for the case would have been a sale of investments performing at 5% or more in any specific investment in the portfolio. Evidently the appointed manager was in breach of contract by failing to

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[609] ibid.
[610] PRIN 2.1, 1.
[611] PRIN 2.1, 3.
[612] PRIN 2.1, 8.
[613] *Rocker v Full Circle Asset Management* [2017] EWHC 2999 (QB).
[614] Ashurst, 'Claimant succeeds in bringing a breach of mandate claim in relation to a discretionary investment portfolio' (Case Summary – Dispute Resolution, 15 January 2018) <https://www.ashurst.com/en/news-and-insights/legal-updates/david-rocker-v-full-circle-asset-management> accessed 3 March 2019.

operate this stop-loss.

The court found that, while the asset manager had acted in breach of its mandate and its obligations under the FCA's Conduct of Business sourcebook, both having allowed the risk profile of the investor's portfolio to exceed the agreed limit and having failed to operate a contractually agreed stop-loss policy, the investor was only entitled to recover the diminution in the value of his investment. The judgment did not quantify the loss but provided the parties with guidance for both cases. The claimant had sought to recover a sum representing the diminution in value of the portfolio plus a sum equivalent to the opportunity cost – that is, the amount of profits that could have been realized should the appointed manager not have infringed the suitable risk barrier.

The court found that the appropriate economic damage incurred by the investor for the misconduct of the appointed manager could be quantified, for both its obligations to stay within the risk mandate and the failure to operate the stop-loss policy, taking into account the excesses of the risk thresholds. In the first case, these were the accounted losses of those months when the risk profile exceeded throughout the month. In the stop-loss case, the amount due was the difference between the determined 5% acceptable loss and the greater loss actually accepted by the appointed manager for the underlying investment. However, it was also determined that the appointed manager was not under an obligation to invest the assets to achieve a particular return. Nor were there any formal contractual obligations to ensure that the portfolio's returns performed at a representative-only benchmark. Morris J felt this claim was misconceived, because the purpose of an award of damages for breach of contract and/or breach of duty is to put the claimant back into the position he would be in, had these breaches not occurred.[615]

Valuation issues

In the period from May 2008 to November 2012, two entities of the Invesco Perpetual Group failed to comply with a number of regulatory obligations. Invesco Asset Management Limited and Invesco Fund Managers Limited, respectively the delegated manager and the ACDs of certain CISs, were found to have jeopardized the assets of the funds they were managing on behalf of investors. The FCA Final Note[616] counted a variety of examples of inappropriate conduct in various aspects of fund management, including CIS asset allocations that were in breach of their investment limits, introducing or abusing use of leverage for certain funds without providing CIS investors with proper disclosures regarding the case and the potential modification of the risk profiles of the funds. The CIS operator also failed to put in place adequate controls to ensure that all funds were valued accurately and that all trades were

[615] ibid.
[616] Financial Conduct Authority, 'Final Notice to Invesco Asset Management; Limited Invesco Fund Managers Limited' (Firms Reference Numbers 122674; 119298, 24 April 2014).

allocated fairly between CISs. This research will focus on the latter aspect.

The group as a whole failed to put in place adequate systems and controls to ensure that it recorded trades in all fixed income funds on a timely basis. It followed that, for over two years, between 2010 and 2011, at least 9% of trades in fixed income CIS were not recorded on the day of execution, creating a risk that the daily valuation of these funds would be inaccurate.[617] Sample testing carried out by Invesco Perpetual's Internal Audit indicated that (on a sample basis) around 35% of the trades not recorded on the day of execution had actually missed the relevant NAV valuation point.[618]

Because Invesco Fund Management Limited was the ACD of these CISs, it was responsible for dealing with the day-to-day operation of the funds, managing the funds' portfolios of investments, buying and selling the funds' shares at the demand of investors, performing valuations of the funds' assets and calculating the prices of shares. COLL requires a CIS operator to carry out a fair and accurate valuation of all the scheme property in accordance with the instrument constituting the scheme and the prospectus when determining the price of units. This inaccuracy on the part of both the CIS operator and the delegated manager, a greater responsibility because they belonged to the same financial group, led to an actual loss of nearly £5.3 million, some of which was attributable to the failure to record trades on a timely basis or to monitor fund managers' allocation of trades in respect of aggregated trades.

For these reasons, the FCA imposed a financial penalty of £18,643,900 on Invesco Asset Management Limited and Invesco Fund Managers Limited.

Disclosure and misrepresentation

Flaws in the operational structure of a CIS operator may cause losses to CIS investors. This was the case for the funds managed by the fixed income emerging markets desk at a large UK based investment manager, Threadneedle Asset Management Limited ("TAML"),[619] where the FSA[620] had already noted an excessive number of errors following a supervisory visit. Such deficiencies were also known to the front office of the CIS operator as they had been brought to the firm's attention by an internal compliance report a year before.

The FSA's concerns were communicated to TAML via a risk mitigation plan, the details of included a description of the risk of individual fund managers initiating, booking and executing trades independently. TAML's response was to appoint "Specified Individuals" to be responsible for all aspects of the dealing in securities on behalf of its funds. Nevertheless, an individual of the company executed an

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[617] ibid par 2.6.3.
[618] ibid par 4.27.
[619] Financial Conduct Authority, 'Notice to Threadneedle Asset Management Limited' (Firm Reference Number 122194, 10 December 2015).
[620] The FSA Conduct of Business Division became part of the current FCA in 2013.

unauthorised transaction worth $150 million, a trade to purchase Argentine warrants on behalf of three Threadneedle funds. If settled, the price paid would have been at four times their market value. It was later discovered that some of these trades were attempted frauds.

Because the fraudulent transactions were not booked to the CISs, the FCA opted not to enforce the provisions of COLL but rather proceeded by interpreting the generic Principles of Business expected of any authorised firm. TAML was found to be in breach of Principles 3 and 11, which point at a lack of adequate preventive and detective controls and a lack of transparency in the description of the trading processes in place in the CIS operator's response to the Authority respectively. For these reasons, the Authority imposed a financial penalty of £6,038,504 on the firm.

Still on disclosure issues, the case brought forward by the FCA against Capita Fund Management ("CFM") is considered one of the landmark regulatory actions concerning the role of a CIS operator and other CIS related-parties' duties. [621] The FCA Notice concerns the Guaranteed Low Risk Income Fund, Series 1 (later renamed Connaught Income Series 1 Fund), an unregulated CIS that CFM had run since March 2008 with the aim of providing short term bridging finance to commercial borrowers in the UK property market.

Only qualified investors were eligible for units in this CIS. Its structure made use of an external company, the Specialist Partner ("SP"), which received cash from the CIS to invest in short term secured loans secured against UK assets. The SP would service the CIS's interest payment obligation to the investors in the fund. Furthermore, a guarantor entity was put in place for assurance of payments should the SP have defaulted on any payment obligation to the CIS. However, both entities were placed into administration in 2012.

An unauthorised fund asset manager, carrying out the function of portfolio management, was responsible for reviewing the loan applications submitted by the SP and for verifying that the application complied with the terms of the CIS's information memoranda. If the application satisfied those terms, the fund asset manager was to supply CFM, as the CIS's operator, with the details of the proposed underlying loan and request that assets be paid from the CIS's accounts to those of the SP.[622] The CIS operator, CFM, was simply to review and approve the draft information memoranda; it delegated to the fund asset manager the task of managing the investments of the fund. Despite retaining the primary responsibility for the CIS, CFM did not consider itself competent to manage the investments of the fund.

As the accounts of the cell company previously set up to intermediate the CIS assets, also used as guarantee to the CIS, recorded a net assets reduction of 94%, and after

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[621] Financial Conduct Authority, 'Final Notice to Capita Financial Managers Limited' (Firm Reference Number 119197, 10 November 2017).

[622] ibid par 4.2.6.

the entity lost other banks' guarantees, the CIS Operator moved to find a replacement for the Operator. In 2009 the new CIS operator took over the responsibilities, triggering the obligation for detailed analysis by CFM.

CFM failed to engage correctly in a number of activities expected of it, most of which directly and negatively affected CIS investors. For example, the FCA found that the CIS was portraying itself as a guaranteed and low risk investment. This was misleading, as the contractual arrangements were such that both income and capital returns were guaranteed by a third party and, therefore, directly exposed to the financial strength of that guarantor. Furthermore, the CIS's risk exposure was in effect solely to the SP, a vehicle company with no public records and a number of small creditors. The CIS documentation also indicated the appointment of an auditor despite the fact that this did not occur.

CFM also failed in the operational aspect of its duties. As a CIS operator, CFM should have reviewed, in the initial phase, the structure and particulars of the CIS in order to carry out suitable due diligence. FCA records demonstrate how this operator did not have the correct skills and knowledge to be operating this unauthorised fund. Despite CFM's inadequate assessment, this CIS operator did not gain further information nor did it implement any systems to control the contractually relevant duties. For example, CFM did not monitor whether the loans fitted the policy's parameters, whether their repayments were recorded or whether lending records were maintained. It is not surprising that CFM itself recorded that it did not understand fully what the responsibilities and duties of an operator were and that *"work was underway now to clarify this before any more Operator business is taken on"*.[623]

Affiliated transactions

In 2012 Martin Currie was handed a £3.5 million fine by the FSA for conflict of interest over a series of bond investments.[624] The facts of the case are described earlier in this research involving MCIML and MCI in the affiliated transactions cases section for the US.

It is interesting to see the breach of rules applied by the FSA in this matter here. For this section it will be sufficient to recall that the facts giving rise to the FSA's Notice related to the allocation of three unlisted bond investments to two China-focus funds – The China Fund Inc. and the Martin Currie China Hedge Fund L.P.

According to the FCA, the defendant acted in breach of Principles 2, 3 and 8 of the FSA's Principles for Businesses, of Conduct rules[625] and of Systems and Senior

[623] ibid par 4.137.
[624] Financial Services Authority, 'Final Notice to Martin Currie Investment Management Limited ("MCIML") and Martin Currie Inc ("MCI") (FSA Reference Numbers 119289 (MCIML) and 122023 (MCI), 2 May 2012).
[625] FCA Handbook COND Conduct of Business Sourcebook (COND).

Management Arrangements.[626] The main charges involved the failure to put in place effective systems and controls to manage the risks involved in the CISs' investments, which partially relates to failing to conduct sufficient due diligence or credit risk analysis of the proposed and executed investments. However, of most relevance is the CIS operator's failure to manage fairly the conflict of interest arising between two of the manager's funds and a further failure to disclose this conflict to one of the funds.[627]

Despite the fact that some of the identified failings were attributable to the individuals acting as portfolio managers, with full discretionary authority over the CISs, the FCA considered that *"the primary responsibility for ensuring compliance with a firm's regulatory obligations rests with the firm itself."*[628] This FCA Notice implies that the UK regulator may address duties of a fiduciary nature when assessing the systems and controls, seniority, skills and conduct of the individuals delegated with discretionary activities. For Martin Currie, CIS operator of the schemes, the failure to put in place effective controls and supervision over the activities of the individuals employed created the breach of fiduciary duties.

One notable difference between the Authorities' rulemaking approaches, reflected in the guidance of the respective enforcement activities, is the inclusion or not of a fraud provision. For the SEC, the fraud occurred under specified IAA rules. For the FCA, the principles of skill, care and diligence in the management and control of its activities, including the CIS operations, together with principles around the avoidance of conflicts of interest, constitutes sufficient deterrent to fraud. The same would have occurred if Martin Currie had been authorised under the FUND rulebook, as there are no specific fraud provisions envisioned there either. Another notable difference is the more-than-double penalty imposed by the SEC against that of the FCA, despite the CIS operator's self-imposed remediation of losses in favour of the CISs.

The Hong Kong case

HK rulebook simplicity

The list of generic duties for the CIS operator, indicated as the management company within the UTMF, is surprisingly short, and yet effective. Chapter 5 of the UTMF provides only three obligations for the CIS operator: correct management of the CIS, record keeping and availability of documents. More duties are found in other sections of the UTMF in its discussion of specified activities.

However, this is not to say that no other rules apply. In contrast to the other parties involved in CIS governance, the SFC has established a special code for those entities

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[626] Financial Services Authority (n 611) par 2.2.
[627] ibid par 2.3.
[628] ibid.

managing investments on a discretionary basis and in pooled schemes. Therefore, in order to understand the standards for the CIS operator in Hong Kong, the CIS investor should look into the latter code specifically designed for fund managers by the SFC: the Fund Manager Code of Conduct ("FMCC").[629]

CIS operator duties

This FMCC is applicable to all entities whose business involves the discretionary management of CISs, defined as fund managers.[630] These guidelines apply to all licensed or registered persons acting as CIS operators, whether or not the CIS is authorised by the SFC.[631] FMCC aims to supplement the codes and guidelines applicable to all categories of licensed or registered person with guidance in respect of the minimum standards of conduct specifically applicable to fund managers.[632] Whilst it does not replace any legislative provisions, codes or guidelines, it highlights existing requirements applicable to fund managers.[633] A cross analysis of the two codes provides a good understanding of the role, activities and expectation in the conduct of the CIS operator in Hong Kong.

The UTMF indicates that a CIS operator must manage the scheme in accordance with the scheme's constitutive documents in the best interest of the CIS investors.[634] This simple yet effective rule has been used in the few SFC enforcement cases in various situations.

The economic activities carried out by the CIS operator are to be detailed in the books and records of the CIS; the CIS operator also has a generic duty to prepare the CIS's accounts and reports.[635] The latter requirement has the dual scope of record keeping and of communications to the CIS investors as there is a duty of at least biannual reports communication for each financial year. Furthermore, the CIS operator must ensure that the constitutive documents are made available for inspection by the public in Hong Kong, free of charge.[636]

The SFC aimed to list all the key requirements for a CIS operator in the FMCC. The following notes indicate the key standards adopted in Hong Kong and the requirements that are comparable in nature to those observed in other jurisdictions analysed in this research.

The FMCC is simple but substantial in its content. Four sections instruct the CIS

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[629] Securities and Futures Commission, Fund Managers Code of Conduct (Third edition pursuant to the Securities and Futures Ordinance (Cap. 571)) (FMCC).
[630] FMCC par 1.
[631] Arner, DW, Hsu, FCB, Goo, SH, et al. Financial Markets in Hong Kong: law and practice (2nd edition, Oxford University Press 2016) chapter 7, par 7.46
[632] FMCC p 1.
[633] FMCC p 1.
[634] UTMF 5.10 (a).
[635] UTMF 5.10 (b).
[636] UTMF 5.10 (c).

operator on the requirements regarding its staff standards and organisation; regarding the core investment management activities and CIS governance parties' coordination, such as custodian appointment; and regarding CIS dealings in terms of its investors, marketing providers and fee disclosures.

The model predicated elsewhere of disclosure of a CIS's constitutive documents, together with the agreements between the parties, as key information for the CIS investor is adopted in Hong Kong as well. While carrying out the core activity of portfolio management, the CIS operator should also ensure that transactions carried out on behalf of a client are in accordance with the portfolio's stated objectives, investment restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile.[637] In the case of a CIS, a written management agreement drafted under the CIS rules is the acceptable equivalent of a client agreement.[638] Transacting for clients, CIS or not, requires a complete prohibition of insider dealing and the correct allocation and record keeping of orders, particularly for IPOs, in order to ensure best execution.

The FMCC allows for both transactions with connected persons and cross trades if these are carried out *"on arm's length terms"*, or in general if conditions are those replicating the best available at market, suggesting that the SFC standards are flexible to the extent of fair economic treatment of a CIS's affairs.[639] As will be observed later, this approach is worthy of the international recognition of good standards for the Hong Kong CIS regulatory framework. The establishment of a risk management framework and, more importantly, liquidity management activities of a CIS are also duties of the CIS operator.

The CIS operator must arrange the custody function appointment with the standards expected of a fiduciary, taking all reasonable steps to ensure that the custodian is properly qualified for the performance of its functions.[640] This responsibility extends to the formulation of the custody arrangements, including the scope and arrangements of related parties, and specific written provisions linking the custodian responsibility to the liabilities in relation to the CIS assets.[641] Furthermore, a CISoperator should in any case ensure the segregation of its own assets from those of clients.

Further to the standard duties of record keeping and appointing auditors, the CIS operator is responsible for the portfolio's asset valuation through the implementation of procedures allowing for independent calculation as well as for provisions determining fair values when the given standards may not be appropriate.

Again, as is the case in other legislative frameworks, the CIS operator is responsible

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[637] Fund Managers Code of Conduct, 3.1.
[638] Arner, DW, Hsu, FCB, Goo, SH, et al. Financial Markets in Hong Kong: law and practice (2nd edition, Oxford University Press 2016) chapter 7, par 7.57
[639] FMCC 3.8.1 and FMCC 3.9.1.b.
[640] FMCC 4.2.1.
[641] FMCC 4.3.2.

for ensuring that the NAV calculation of the units (or shares) in a CIS is carried out in accordance with the terms set out in the CIS's constitutive documents, valuation policies and established operating procedures.[642] This duty extends to the obligation to detect, prevent and correct pricing errors. It is expected that the CIS operator shall compensate the CIS investors in respect of any material error it may make while executing this duty.[643]

Regulatory cases

The Hong Kong characteristic of relatively few cases involving CISs going to court is also true of disputes involving CIS operators. The following analysis, although it does not contain many examples, provides a sample of what courts and the SFC's interpretation of the Codes may accomplish in the context of CIS regulations when proceedings do occur.

Fraud

In April 2009, the SFC commenced urgent proceedings against a number of CIS investors to appoint administrators for the Descartes Athena Fund SPC ("DAF".[644] The scheme was a hedge fund organised around four entities: Descartes Investment Management Ltd, Descartes Global Asset Management Ltd, Descartes Finance Ltd and DAF. The latter was a company created for a discretionary portfolio and incorporated in the Cayman Islands, while Descartes Investment Management was appointed to act as its investment manager. This company had delegated any CIS operator duties to the other manager, Descartes Global Asset Management Ltd, which was already DAF's investment adviser.

The SFC claimed it was dealing with a case fraud, committed by the DAF and its operators. When CIS investors sought to redeem their holdings, DAF purported to liquidate the scheme assets. It also issued false documents, using standards from a major accounting firm, while at the same time sending false statements of the scheme's accounts and its subscription contracts to CIS investors. DAF perpetrated these actions to insinuate that the CIS assets had been dissipated.

[642] FMCC 5.1.1.

[643] FMCC 5.1.2.

[644] The case has been reconstructed with information gathered at an interview with SFC Enforcement and in Securities and Futures Commission, 'SFC recovers $190 million for investors of collapsed hedge fund' (*SFC Enforcement News*, 6 May 2015) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=15PR44> accessed 3 March 2019. On asset freezing orders, see Securities and Futures Commission, ' SFC freezes hedge fund assets' (*SFC Enforcement News*, 28 April 2009) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=09PR58> accessed 3 March 2019; Securities and Futures Commission, 'Court continues orders to freeze hedge fund assets' (*SFC Enforcement News*, 19 May 2009) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=09PR64> accessed 3 March 2019.

When the SFC commenced proceedings to freeze DAF assets, the High Court granted the order and appointed interim administrators. Following the initial action, the SFC traced the CIS assets, which were mainly securities. These had been transferred from DAF's accounts into those of a third party named NBS Limited. The SFC then made a further application to the court to freeze assets held by NBS up to the value of those appropriated from the CIS. NBS claimed to be a nominee of one of the CIS investors, and hence contended its entitlement. The SFC disregarded the claim and reached an agreement with NBS and its beneficiary owner, recovering $191 million for distribution to the creditors of DAF. This paved the way for more than 340 overseas CIS investors to recoup parts of their investments. As of December 2018, the SFC has released no information on any penalties or charges against the CIS operator or its senior management.

Valuation

The SFC has recently taken action to remedy some CIS operators' valuation errors and other economic matters relevant to the CIS investor rights. It has pursued action against firms acting as CIS Ooperators for breaches of statutory duties under the UTMF. This was the case in respect of two authorised firms of the same group, Value Partners Limited ("VPL") and Value Partners Hong Kong Limited ("VPHKL").[645] The firms were respectively the CIS operators for the Cayman-based Value Partners China Greenchip Fund Limited and the Value Partners Greater China High Yield Income Fund. The two entities formed one group, Value Partners.

The two operators had issued shares in excess of the amount of share capital indicated in their respective Memorandum and Articles of Association, a pre-requisite for any open-ended mutual fund corporations established under the laws of the Cayman Islands. Value Partners did not report the incident to the SFC until six months after they were uncovered. This was contrary to the UTMF provisions, under which a management company or CIS operator must manage the scheme in accordance with the scheme's constitutive documents and in the best interest of the holders.[646]

Despite Value Partners having increased the authorised share capital of the two CISs in their Memorandum and Articles of Association, through ordinary resolutions of their shareholders, the SFC fined each of them $2 million for failures to comply with requirements under the UTMF.

In another enforcement action, the SFC reprimanded and fined State Street Global Advisors Asia Limited ("SSGA") $4 million in 2016 for its failure to comply with regulatory requirements in the management of a "Tracker Fund" based in Hong Kong,

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[645] Securities and Futures Commission, ' SFC reprimands and fines Value Partners $4 million' (*SFC Enforcement News,* 25 Jan 2017) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=17PR13> accessed 3 March 2019.
[646] UTMF 5.1.

a CIS structure registered as an exchange-traded fund listed on the Stock Exchange of Hong Kong Limited since 1999.[647] The CIS's stated objective was to provide investment returns corresponding to the performance of the Hang Seng Index.

SSGA acted as the CIS operator and it did not correctly implement internal systems or controls for managing the CIS's cash balances, an economically relevant management requirement for index funds. The lapse occurred in the period between 2009 and 2013 when the CIS cash balances were deposited with State Street Bank and Trust Companies, an entity affiliated to SSGA. In this period, the CIS's Hong Kong dollar account did not receive any interest payments from the related party, and SSGA did not verify the interest offered by other deposit-taking entities.

The SFC demonstrated that an average of 0.01% was due to the CIS in that period. In accordance with the UTMF and the Trust Deed, the CIS Operator should have properly managed those conflicts of interest between its affiliates and the CIS. It also misrepresented the CIS's economic statuses in various interim and annual reports to CIS investors, another breach of the UTMF. Despite SSGA having made a restitution worth the amount of interest, the SFC reprimanded the CIS operator and levied a $4 million fine.

Conclusions

The set of regulations for CISs and the duties required of their operators, provisionally summarised in this chapter, are in most cases lengthy in format and broad in coverage. Yet the question of how effective they are is not straightforward to answer. Indeed, the evidence from the cases, especially those brought forward by national authorities, and the timing of newly released regulations, points to some level of inadequacy.

An example of this provisional finding is evident in the US standards, when addressing either broad principles or detailed rules. For example, at a high level, the introduction of the antifraud provisions in the IAA by the SEC, required to prohibit any investment adviser from engaging in fraud, and designed for enforcement actions to be taken under the ICA, ensures greater penalties and opens courses of action for the regulator. However, this should be somewhat redundant if pooled asset rules are effective in the first place.

Similar ineffectiveness is observable at the level of rules designed to constrict operational risks. This is the case for the US valuation of the CIS, for which the CIS directors are responsible. The rules are inconsistent regarding the latter's responsibility for the valuation as, in order to establish valuation methodologies, they

[647]Securities and Futures Commission, 'SFC reprimands and fines State Street Global Advisors Asia Limited $4 million over management of Tracker Fund' (SFC Enforcement News, 15 June 2016) <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=16PR61> accessed 3 March 2019.

may need external expertise, especially in the case of more complex asset classes. If the responsibility for establishing procedures is then delegated to the CIS operator, it creates a conflict of interest.

US court judgments do not always provide clarity on the lack of precise rules or rebalance the effects toward investors. For example, it is likely that, even if they are disclosed, activities of late trading and their economic effects on the CIS are simply not understood by the non-professional CIS investors.

In the UK, the implementation of CIS rules derived from EU directives seems to have created, in certain respects, an efficient system at the level of the principles to be applied, despite the few fraud cases that have occurred. Cases involving fiduciary duties confirm that the CIS operator is accountable, to a reasonable extent, for the decision making of contractually defined investments and their output results.

However, it is not always the case that such standards reach the desired effectiveness for the CIS. This is the case for the UK rules on CIS valuation. Despite the duty of the independent entity, the CIS depositary, to verify the suitability of valuation procedures of a CIS, cases have been brought to court by the FCA due to a failure to execute these established policies by CIS operators. This fact includes the lack of a "double counting" by the external party, despite the potential capacity of this entity, often a subsidiary financial institution of a much larger firm, to do so.

Like the other jurisdictions, the Hong Kong regulatory framework suffers from the inherent conflicts of interest of the CIS operator despite its simple but clear statutory provisions on the matter. Court cases regarding valuation errors have confirmed that duties carried out by related parties may lead to economically damaging actions for CIS investors, despite the best efforts of CIS rules to provide limits on such losses.

This study's findings suggest that, on a standalone basis, the regulations regarding CIS operators are comprehensive in their coverage but ineffective in some aspects of the management, particularly those in which economic benefits arise from conflicts of interests between parties.

Chapter six: International standards for CIS regulations: IOSCO, IMF and the rise of soft law

Introduction

The nature of CISs has changed over time and it will likely be subject to further modification in the near future. Economic phenomena, such as the access to assets located in different jurisdictions, the creation of CIS structures with governance bodies registered and supervised under different regulatory systems and the capacity of an inexperienced investor to acquire CIS units from other countries, all confirm the greater need for authorities to apply equal and fair standards. These are necessary to guarantee precise economic and legal effects for each CIS investor, now a global citizen, irrespective of his location or that of the CIS's operator or the independent entity. The ability to enforce rights should therefore be considered a minimum standard for all parties in CIS governance.

The context explained in the previous chapters, elaborating on national rules and judicial cases regarding the various aspects of CIS governance, results in some flaws in each regulatory system as currently envisioned by the competent national authorities and their legislators. To draw a clear picture of the regulatory risks undertaken by a global CIS investor it is necessary to take a holistic approach and analyse which elements influence the construction of a CIS framework, how this is evaluated and to what extent it is possible to apply rules and laws across borders.

This chapter first discusses the international standards under the IOSCO framework and the IMF Financial Sector Assessment Program ("FSAP") that is in place to verify implementation. It then discusses the question of whether the legal status of the IOSCO Principles can be associated with that of soft law, introducing the concept of *lex financiera*, and assessing whether the IOSCO standards already allow for cross-border trade.

The setting up of securities standards

The core activity of the IOSCO is to coordinate the world's securities regulators in developing, endorsing and implementing global standards for securities markets. Its programme is driven by the G20 agenda on financial matters, which is coordinated by the Financial Stability Board ("FSB"). More broadly, IOSCO is encompassed in the group of entities and bodies involved in setting standards for financial markets,[648] hence it is identified as a Standard Setting Body ("SSB"). Whilst it continues to work

[648] Rosa María Lastra, *International financial and monetary law* (2nd ed, Oxford University Press, 2015) 10.18

on a standalone basis, IOSCO's involvement with other international entities and SSBs, particularly with the FSB, points to its leading role in standards setting at an international level.[649] Its contributory role is more generally identified with that of a Transnational Regulatory Network. Within the global financial governance system, which incorporates a diverse "legal" and organisational universe of rules and actors, IOSCO's role is based on setting "informal," consensus-based (soft-law) standards and structures.[650]

Nevertheless, the role of IOSCO's Secretariat is not controversial: IOSCO's Objectives and Principles of Securities Regulation are fully supported in the FSB's framework. They are in fact considered part of the Key Standards for Sound Financial Systems, often considered the road map for financial standards, set by the FSB following the G20 Declaration of the London Summit in 2009. On that occasion, G20 leaders called for greater *"consistency and systemic cooperation between countries … that a global financial system requires"*.[651] As a result, the Key Standards for Sound Financial Systems are considered the priority in the implementation of standards, constituting *de facto* broadly accepted minimum requirements for good practice that countries are encouraged to meet or even exceed.[652] IOSCO's Principles 24 to 28 are those specifically designed for CISs. These high-level Principles are quite broad by its very nature and so, as previously explained in chapter 3, IOSCO and its committees have, over time, developed further analysis, guidance, recommendations, and standards to be implemented by national authorities to supplement the Principles.

Furthermore, the governing standards for a CIS are also subject to IMF and World Bank review through the FSAP. The IOSCO Objectives and Principles are then integrated into the FSAP's requirements through the IOSCO's Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation ("Methodology"). In simple terms, the Methodology forms a bridge between the IOSCO Principles, as core assessment standards, and the IMF context of focused reviews for supervisory gaps in financial systems that could exacerbate or fail to contain systemic risk. Whilst a CIS is not considered systemic *per se*, the IOSCO standards and governance are used as part of a FSAP in the form of a Technical Note or in the Financial System Stability Assessment, both of which are usually published.[653]

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[649] Financial Stability Board, 'Chairman letter to G20 Leaders' (3 July 2017) <http://www.fsb.org/wp-content/uploads/P030717-1.pdf> accessed 6 March 2019.
[650] Emilios Avgouleas, 'Rationales and Designs to Implement an Institutional Big Bang in the Governance of Global Finance' (2013) 36 Seattle University Law Review 321.
[651] Rosa María Lastra (n 635) 10.23.
[652] Financial Stability Board, 'Key Standards for Sound Financial System' <http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards/> accessed 05 May 2018.
[653] International Monetary Fund, 'Use of Supervisory Standards in the Financial Sector Assessment Program—Understandings with Standard Setting Bodies' (20 July 2017) point 7 <https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/07/20/pp060817use-of-supervisory-standards-in-fsap> accessed 6 March 2019.

FSAP context for CIS regulators

Following the Mexican and Asian crises in the 90's, in which financial factors played a major role, and in response to calls from the international financial community, the IMF undertook a major effort to deepen its involvement in Financial Sector Surveillance ("FSS").[654] This process led it to take various conceptual and operational steps so that the IMF started placing more attention on the analysis of financial systems of countries, including their regulatory and supervisory frameworks. This process culminated with the introduction, in 1999, of the FSAP and the Report on the Observation of Standards and Codes ("ROSC").

Today the IMF plays a key role in the standards and codes initiative, as it is directly responsible for setting and assessing standards in the core areas where it has relevant expertise and mandate. More relevant to this research, it also assesses the national jurisdictions' compliance with the international standards set by other SSBs, including the IOSCO Principles. These assessments are taken, in effect, on a voluntary basis and the aim is to be assessed on the depth of implementation.[655]

The implementation assessments of financial sector supervisory standards, including the IOSCO Principles, result in graded Detailed Assessment Reports ("DAR") or shorter/ungraded ROSCs. DARs and ROSCs are the primary vehicle for assessing implementation of the IOSCO Principles. These detailed graded assessments are voluntary, even in countries for which an FSAP is a mandatory part of surveillance. However, the evaluation of the quality of supervision or other aspects of the financial system for most FSAPs is carried out through informal targeted assessments, summarised as FSAP Technical Notes.[656]

Between 2014-2015 both the IMF and the World Bank reviewed their FSAP processes. Due to the increasing complexity of financial systems and regulations, the resource-intensive nature of each assessment and the challenge of integrating these into the FSAPs' financial stability and financial development analysis, both organisations proposed an approach that placed a greater focus on internationally relevant issues. The now-adopted IMF macrofinancial approach to supervisory standards assessments limits a FSAP to 17 "'macro-financially relevant" IOSCO Principles out of the 38 total developed by this SSB.

Of relevance to this research, there are five IOSCO Principles for the regulation of CIS, being Principles 24 to 28, of all which the IMF considers to be macro-financially relevant. In the IMF's view, collective investment schemes are important investment

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[654] Carlo Gola and Francesco Spadafora, 'Financial Sector Surveillance and the IMF' (IMF Working Paper No 09/247, 1 November 2009), 62.
[655] ibid 32.
[656] International Monetary Fund, 'A Macrofinancial approach to Supervisory Standards Assessments' (18 August 2014), point 2 <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/A-Macrofinancial-Approach-to-Supervisory-Standards-Assessments-PP4895> accessed 25 July 2017

vehicles for both retail and institutional investors, including key financial system players such as banks, insurers, and pension funds.[657] The IMF considers that robust regulation and supervision (Principle 24) and stringent requirements on client asset protection (Principle 25), paired with appropriate disclosure (Principle 26) and asset valuation (Principle 27), are essential to ensure that this interconnectedness does not lead to the transmission of financial shocks.[658] The IMF also considers that, in some jurisdictions, hedge funds (Principle 28) are highly leveraged and interconnected with other financial institutions, making the assessment of this sector relevant in mitigating a potential source of systemic risk.

Assessment of CIS Principles

In May 2017, IOSCO released a new version of its Methodology. This document aims at providing guidance on how a jurisdiction may evaluate, by oneself or by a third party, the degree of its implementation of the IOSCO Principles. The current Methodology is an evolution of the earlier 2011 and 2003 versions and it attempts to adjust the analysis framework to effectively assess a more complex and evolved global securities market. In the case of the CIS sector, the text now includes guidelines on liquidity management and the regular assessment of asset components of the CISs. Moreover, the IOSCO Principles now classify specific CIS types, such as money-market funds and exchange-traded funds, as categories of funds that require or could require particular guidelines.[659]

IOSCO recognises that increasingly globalised and integrated financial markets pose significant challenges to the regulation of securities markets. Therefore, in a global and integrated environment regulators must be in a position to assess the nature of cross-border conduct if they are to ensure the existence of fair, efficient and transparent markets.[660] This statement of intent is in reply to research observations made after the 2008 financial crisis on systemic analysis.

It was noted then that the essentially domestic focus of the FSAP process did not capture cross-border linkages, influences, risk transmission channels, or institutional interconnectedness, eliminating the FSAP's usefulness in the case of large cross-countries financial institutions. Moreover, the standards themselves were in some cases problematic and backward-looking.[661] In the case of the IOSCO Principles, these standards were dominated by efficient market ideology and by US notions of

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[657] ibid, point 42.
[658] ibid.
[659] BaFin, 'International securities regulation - IOSCO overhauls international standards' (05 July 2017) <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2017/fa_bj_1706_IOSCO_en.html> accessed 23 February 2018.
[660] International Organisation of Securities Commissions, 'Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation' (May 2017) <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf> accessed 03 March 2018.
[661] Emilios Avgouleas, 'Rationales and Designs to Implement an Institutional Big Bang in the Governance of Global Finance' (Edinburgh School of Law Research Paper No. 2012/21).

tight regulation of retail equity markets, ignoring the role of other markets, especially those in which hedge funds were very active. This meant that FSAP surveys missed areas and issues of critical interest, especially the role of unregulated markets in propagating systemic risk. Since then, IOSCO has taken stock of these inadequacies and revised its standards.[662]

The current Methodology addresses the tricky issue of valuing a regulatory framework based on a set of Principles. Because of the variety of both the forms that a regulatory framework can take and of the uses made of it, the Methodology, which advocates proportionality resembles both a capacity-building tool as well as a generic benchmark rather than an explicit set of strict standards. In its latest version, IOSCO makes clear that its Principles are not intended to be a pure checklist and that the regulator and the assessors will need to exercise judgment when using the Methodology.[663]

In this context, IOSCO's description of how to carry out an assessment is pragmatic: four sections with appropriate descriptions: sketch the scope of the Principle at hand, identifies Key Issues, develops corresponding Key Questions for analysis, and benchmarks these responses against a ratings scale. This Methodology specifically contemplates involving the regulator in a dialogue to explain the details of its market structure, laws, and supervisory program and how, in view thereof, the regulator believes its regulatory programme addresses the Key Questions and Key Issues.[664] This information flow through questioning and explanations is considered indispensable in addressing the fulfilment of the Principles by an (external) examiner, including the IMF. In IOSCO's view, a regulatory framework may meet the objectives without referring to the goal itself, and yet the assessment can still be considered a tool for identifying potential gaps, inconsistencies, weaknesses and areas where further powers or authorities may be necessary for enhancements or reforms to existing laws, rules and procedures.[665]

Notes on Key Questions for CIS Principles

The complete set of IOSCO Principles, covering all aspects of the financial services and securities spectrum, can be described as an interconnected system. A number of Principles are complementary to those specifically designated for CISs: rules on conflicts of interest and disclosures are key aspects for the management of fiduciaries and agency gaps in investment management. In order to focus on the topic of this research, the following analysis discards Principle 28, which is related to hedge fund managers only. The antecedent set of CIS Key Questions, covering Principles 24 to

[662] ibid.
[663] International Organisation of Securities Commissions (n 647).
[664] ibid.
[665] ibid.

27, is sufficient to offer an overview of the metrics required to successfully complete an evaluation.

This analysis is presented to address the areas of interest for CIS investor risks, rather than a principle-by-principle type of overview. The reasoning is simple: the spectrum of rules for CISs is vast and it is interconnected with other regulations applicable to financial entities. The sub-scheme of Key Questions – proposed by IOSCO in consultation with its members and its CIS specialist policy setting committee, staffed with experts from various authorities – may be interpreted as guidance regarding relevant CIS regulatory essentials, and therefore as relevant for this analysis.

There are eight explicit areas of focus across three of the CIS Principles, while another area is inferred from the Key Issues of Principle 26. Together, these nine areas of focus are presented in the following order: eligibility criteria, supervision and ongoing monitoring, conflicts of interest and operational conduct, delegation, disclosure (from Principle 26), legal form/investors' rights, separation of assets/safekeeping, asset valuation, pricing and redemption issues. Some of the Key Questions addressed by IOSCO are not discussed here as they apply to the regulator rather than the CIS governance parties.

The first area of interest in an FSAP is the eligibility of a CIS in both marketability and operational terms, and the analysis should verify the presence of criteria. The second category of focus aims at ensuring that CIS operator's compliance requirements are detailed with standards for staff skills, technical resources, compliance arrangements and specifically a risk management framework in line with the scale and complexity of the CIS. These are intended as pre-authorisation conditions for CIS operators within a given legal framework. However, whilst financial resources are necessary for launching its operation, no Key Question requirement exists regarding a minimum amount of prudential assets to be maintained by these operators.

Great emphasis is given to conflicts of interest and operational misconduct. FSAP reviewers' third area of interest must confirm that the regulatory framework has provisions for conflicts of interest between a CIS and its operator or any related parties. If these exist by design, rules should aim to mitigate any potential conflicts of interest with different means including disclosure *"so that the interests of investors are not adversely affected"*.[666] In effect, the Methodology's expectation is to verify that a rule exists so as to require the CIS operator *"to act in the best interest of investors and in accordance with the principle of fair treatment"*.[667] Specification topics are, for example, best execution, appropriate execution/allocation of trades and

[666] ibid Principle 24 Key Question 12.

[667] International Organisation of Securities Commissions, 'Principles for the Supervision of Operators of Collective Investment Schemes' (September 1997) < https://www.iosco.org/library/pubdocs/pdf/IOSCOPD69.pdf> accessed 12 Feb 2016.

due diligence in the selection of investments.

Given the several judicial cases discussed, it is unsurprising that the IOSCO Methodology touches upon the delicate topic of fees and expenses charged to a CIS by its operator, questioning whether rules are in place so that commission rebates, soft commission arrangements and inducements do not conflict with the CIS operator's duty to act in the best interest of investors.[668]

The topic of delegation of core functions, the fourth area of focus, is becoming more and more relevant with the internationalisation of CIS governance, especially when parties are eligible to be located in different jurisdictions. The Methodology's Key Questions sets a *de minimis* requirement for a prescriptive system in which, essentially, the CIS operator cannot become an "empty box"[669] and where the regulatory framework excludes a systematic and complete delegation.[670] Where delegation is allowed, the perimeter should be delimited so that the CIS operator retains the legal responsibilities for those functions to the extent that they are considered as being carried out by the CIS operator itself. Whilst it is not clarified whether investors' rights would come under the (potentially different) legal systems of the delegate or that of the principle, it is requested that regulatory frameworks establish rules so that a CIS operator has the capacity to control and monitor delegates.

Further protection of CIS investors is covered by the long list of requirements for disclosures, under the Key Questions for Principle 26. This fifth area of focus questioning unfolds the characteristics in the Methodology that certain standards are compulsory rather than optional. This is the case for regulatory requirements regarding information, both for CIS investors and prospective investors, on valuation matters, standardised formats of documents applicable across operators, simplicity of language and formats for the content and CIS suitability reports, which are all mandated. In addition, for publicly offered CISs, the Methodology requires a number of inclusions covering all the basics to inform on a CIS scheme's governance, to be circulated periodically.

The Methodology appraises CIS investors' rights, as a sixth category, questioning whether the legal form provides for their interests and rights, properly disclosed, and whether material changes require prior approval or any notification of changes. In this context, the national regulator must be in a position to guarantee that the legal forms are observed, most likely thorough compulsory registration.

Regulatory specifications for the seventh to ninth areas, interconnected in terms of activities of the parties managing the CIS, focus on rules mitigating issues on pricing and redemption of CIS units. In particular, constituent documents, or the prospectus,

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[668] International Organisation of Securities Commissions (n 647). In detail see Principle 24 Key Question 14-g.

[669] International Organisation of Securities Commissions, 'Report on Investment Management, Report of the Technical Committee of IOSCO' (July 1995) <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD45.pdf> accessed 6 March 2018.

[670] International Organisation of Securities Commissions (n 647) Principle 24 Key Question 15.

must provide how prices are generated and units distributed. Any deviance from these rules must be in circumstances recognised by regulation.

Requirements for CIS governance

The Methodology includes the requirement for an assessor to verify that a regulatory system sets standards for the CIS governance in order to ensure that CISs are organised and operated in the interests of their investors and not in the interests of CIS-connected persons.[671] It does so by posing a Key Question that embeds the definition of CIS governance standards given by IOSCO in 2006 and 2007 in its two seminal papers on the examination of CIS governance.

No Key Question mentions verifying whether the CIS independent entity standards or its governance status are in place, despite the extensive guidance on the various roles assigned to this connected entity. Some of these IOSCO papers touch upon activities usually delegated or assigned by regulatory statutes to a CIS independent entity. For example, it is suggested that the segregation of a scheme asset, always separated from those of the CIS operator, must be entrusted to a depositary or a custodian that is independent, or enable a mechanism to determine some independency if the assets are directly held by the CIS operator. Other regulatory requirements suggested are those for the correct valuation of CIS assets and for estimation of the NAV: occurring at a minimum upon subscription and redemption of CIS units, and with relevant and appropriate fair valuation and accounting standards, periodically and externally audited.

The Methodology is therefore electing an extensive analysis of the CIS governance within a regulatory framework referencing the two reports addressing the topic, which also embed further principles to be applied. The first paper published in 2006 defines the scope of the governance and what it is intended to be in the CIS legal context, and establishes the need for a CIS independent entity to be in place. The second 2007 paper elaborates on the required characteristics for this independent party, providing the fundamental principles on how these characteristics should be interpreted in the context of the Methodology.

IOSCO's examination of governance for Collective Investment Schemes

CIS governance is defined in the Examination of Governance for Collective Investment Schemes as *"a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated in the interests of CIS investors, and not in the interests of CIS insiders"*.[672] The generic concept of governance

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[671] ibid Principle 24 – Key Question 4

[672] International Organisation of Securities Commissions, 'Examination of Governance for Collective Investment Schemes' (Part I, June 2006) 10.

applicable in the case of a CIS, with reference to the OECD and IOSCO work, has been already addressed in this research.[673]

The examination analysis for the Methodology provided by Standing Committee 5 on Investment Funds ("SC5") in 2006 used the legal relationship between the CIS parties to classify two generic models of scheme governance – corporate and the contractual – while stating that some jurisdictions may also use a hybrid of the two schemes. The distinction made by SC5 is essentially based on the legal status of the CIS and the entity that carries out the two key fiduciary functions: the oversight function and the safekeeping one. These have already been discussed within the scope of the independent entity in this research, at above chapter three, while scoping the depositary role, and chapter four, when considering the board of directors.

In order to provide background to the applicability of the Methodology and the independent assessments of those principles, further analysis of the first IOSCO examination document is required. The first distinction is given by the entity that constitutes the CIS. In the corporate model, the CIS investors become shareholders by acquiring shares of a company whose principal objective is to invest in a portfolio of securities.[674] In the contractual model, the CIS investors buy unit shares that provide them interest in a portfolio of diversified securities that does not have legal existence for itself.[675] The latter CIS type is characterized by the inability to enter into contractual relationships on its own; the management of its portfolio, therefore, has to be entrusted to a management company.

The second distinction regards the legal nature of the Independent entity. The board of directors, the depositary or the trustee are the main entities responsible for the two key functions. However, in both the contractual model and the so-called hybrid model, other bodies may share some oversight responsibilities. For example, despite its desire for independence, a supervisory board or compliance committee at board level of either a CIS operator or a CIS can perform the functions mentioned to a certain extent. In rare cases, the CIS regulator can also have an active function.[676]

An analysis of the flowcharts constructed by SC5 reveals further distinctions, not clearly stated in its text, when analysing the activities of the parties involved. The main distinction involves the appointment of a custodian: in the given framework, the custodian is necessary for both the corporate model with a board of directors and the contractual model with a trustee.[677] This is due to the phenomenon discussed in chapters three and four above, which can be synthesised as defining the role of the custodian in the CIS governance. This entity is usually a corporation, with specific banking authorizations and infrastructures, that holds the CIS assets. With a

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[673] See Chapter 3
[674] International Organization of Securities Commissions (n 659) 6.
[675] ibid.
[676] ibid 6.
[677] ibid Appendix.

depositary in place – a financial entity with oversight and custody operations duty – the custodian is not directly responsible for the safekeeping of the CIS assets. However, without a depositary, being entrusted with does not amount to being responsible for: a distinction that changes the risks undertaken by the CIS investor substantially.

Another fundamental difference is the relationship envisioned between the CIS operator and the independent entity. In every scenario there is a duty for the independent entity to report to either the depositary or the board of directors and/or the trustee. But it is not the case that their responsibilities are always the same. In the case of the model employing a depositary, the link between the parties is specified as *"shared responsibility towards shareholders"*. In the case of the model with a board of directors or trustee, this is limited to the approval or ratification of contracts and/or a trustee, for restricted transactions. Still, for the trustee as an independent entity, fiduciary duties are explicitly stated.

This classification by SC5 highlights the fundamental issue with the governance of a CIS. It is not so much the legal form taken that determines whether the independent entity is useful, but its duties and responsibility as well as legal accountability. The question of effectiveness of CIS rules is therefore related to the parties' collective ability to act with stewardship toward the investors.

IOSCO's Principles for the oversight function of the CIS independent entity

SC5 conducted further analysis of the CIS independent entity's duties and responsibilities, and in 2007 generated a second part of the Examination of Governance for CIS that specifically addressed the criteria for independence, empowerment conditions and the functions of the CIS independent entity. Whist the basic elements have been discussed in chapter three, a thorough analysis is necessary here to identify the gaps and contradictions.

A statement made by the SC5 documents that, in some cases, one single entity can be empowered so as to meet all the necessary independence requirements with sufficient capability to fulfil the whole arrays of tasks to be entrusted by CIS independent entities.[678] Therefore, one core distinction to make in the CIS governance analysis is the degree of *plurality of CIS independent entities* required and their assigned tasks. The involvement of several parties could be beneficial if the mechanisms are such that multiple fiduciaries duties are entrusted to several parties. And, in some rare cases, a multi-party model even extends an active role to the CIS regulator. Subsequent fiduciary responsibilities are not, as previously found in the cases for the UK, the US and Hong Kong, always explicitly aligned.

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[678] International Organisation of Securities Commissions, Examination of Governance for Collective Investment Schemes (Part II, February 2007) 2.

Because of the variety of arrangements possible, and taking into account the multi-layered differences discussed, the examination of the Methodology's approach can be summarised with the set of Principles provided by the SC5. These standards focus on three aspects of governance: when a party is considered independent, what type of powers should it hold and the exact duties it should be charged with.

On the first matter, the independence is proven when, despite the links to the naturally constructed multi-party governance of a CIS, the CIS independent entity is appointed, dismissed or left to operate under no conditionality from the CIS operator, or from entities that are able to influence the latter. The CIS independent entity must therefore not have a conflict of interest with the CIS operator specifically but must also be able to function independently of the latter. The SC5 examination indicates, in practice, that the line dividing these two entities is drawn from the net distinction of the activities carried out: asset management for the CIS operator and oversight for the CIS independent entity.

An examination of CIS governance framework would also identify three aspects of empowerment of a CIS independent entity. These are given by the latter's ability to receive relevant flow of information intact, to have the economic means and conditions to execute its role and to be vested with effective contractual rights. Functionally, the CIS independent entity is charged with the oversight function and the requirement to verify mechanisms to avoid erosion or unlawful expropriation of CIS investors' interests; it should also have the legal responsibility of reporting to investors and/or national authorities.

Some independence requirement incongruences

Because SC5 provides examples, but not prescriptions, of obvious governance situations that require prescriptions in terms of rules, some lack the level of detail that an examiner may wish to use as a standard. For example, the case of avoidance of conflict of interests is at the base of *required independence* at its formation. SC5 envisions specific rules on the election of the CIS independent entity; clarifies the case for no dismissal of the CIS independent entity by the CIS operator without consensus or giving information to the CIS investors; and clarifies that no direct or indirect link between these entities, even in the forms of affiliation, familial relations or group-level links should exist unless they are economically or legally dependent through a "joint liability mechanism".

Some of these propositions are certainly not reflective of market practice, nor they are in favour of the CIS investors. Firstly, the formation mechanics of the market for CISs mean that the CIS operator treats the creation of a new scheme as launching a new investment product, having estimated the interest within a specific market, with economic dynamics very similar to those applied in the market for goods and services. The launch of a CIS as the result of the initiative of several parties to pool assets, to

be managed by a third party, is rarely recorded, particularly in the retail space. This trend is confirmed in the US and elsewhere by the growth in ETFs, advisor-sponsored exchange traded funds authorised as such by the SEC, which already have assets of $3.4 trillion at the end of 2017,[679] and which are projected to grow above $6 trillion by 2020.[680] This phenomenon is increased by the tendency of investors, professional and retail, to invest in passive funds.[681]

Furthermore, it is unclear in which contest related-CIS parties would not be jointly liable for the CIS investors' losses should legal action be taken. In such cases, jurisprudence on piercing of the corporate veil for either party is ample.[682] The SC5 recommendation also seems partially illogical. Provided that specific functions are assigned to one or more CIS independent entities, a contractually engaged party would still have legal responsibilities.

One important clarification, given only as an example on the matter of requirements for ongoing organisational responsibilities, involves the boundaries for ensuring independence. It is specified that this is accomplished avoiding overlaps of roles of people involved in both the CIS independent entity and the CIS operator. The first may act in a biased way, due to economic interests in the latter's decisions, which are not in line with the interests of the CIS investors.[683] However, this is not the case in the US. As noted in chapter three, the board of directors of a mutual fund registered under the Investment Company Act of 1940 is the CIS independent entity in that regulatory framework, but it is not required to have a majority of independent directors. However, the US framework fulfils the requirement mainly because the independent review of the compliance function compensates for lack of independent directors.[684]

Testing the IMF analysis for CIS principles

FSAP on IOSCO Principles: the US and Hong Kong

An FSAP program report provides insights into a country's regulatory status to the extent that the country's authorities have opted to be analysed against those standards.

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[679] Securities and Exchange Commission, 'Exchanged Traded Funds' (Release Nos. 33-10515; IC-33140; File No. S7-15-18) <https://www.sec.gov/rules/proposed/2018/33-10515.pdf> accessed 16 April 2018.
[680] Greg Tusar, 'The evolution of the ETF industry, Pension & Investments' (*Pensions and Investments*, 31 January 2017) <http://www.pionline.com/article/20170131/ONLINE/170139973/the-evolution-of- the-etf-industry> accessed 6 March 2019.
[681] Robin Wigglesworth, 'Passive Attack: the story of a Wall Street revolution' (*Financial Times*, 19 December 2018) <https://www.ft.com/content/807909e2-0322-11e9-9d01-cd4d49afbbe3> accessed 20 December 2018.
[682] Yannick Hausmann and Elisabeth Bechtold, 'Corporate Governance of Groups in an Era of Regulatory Nationalism: A Focused Analysis of Financial Services Regulation' (2015) 12 3 European Company and Financial Law Review 341.
[683] International Organisation of Securities Commissions, 'Examination of Governance for Collective Investment Schemes: Independence Criteria, Empowerment Conditions and Functions to be performed by the 'Independent Oversight Entities' (Part 2 Final Report, June 2006)
[684] ibid 19

This was the case for the US and Hong Kong in 2014 and 2015 respectively, as both jurisdictions opted for a DAR on their implementation of the IOSCO Objectives and Principles of Securities Regulation. The previous 2011 version of the Methodology, discussed above, was used for both assessments, but none of the findings were related to the 2017 changes to the Methodology, validating the analysis proposed here. This is based on the direct comparison of the US and Hong Kong findings at the Principle level, in the light of the discoveries identified in the previous chapters, and including the ratings contained in the DAR. Furthermore, only recommendations and notes for SEC-related rules on CIS rules are taken into account, discarding those for schemes classified as common pool operators, which come under the US Commodity Futures Trading Commission regulations, in line with the scope of analysis of the previous chapters.

The archetypal Principle 24, which requires a regulatory system to *"set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a CIS"*, is the most extensive in terms of requisite Key Questions. The Principle is fully met by Hong Kong but it is scored as partly implemented by the US. The main difference between the two systems consists of the regulatory programs carried out by their respective authorities. If the SFC operates an effective risk-based system, making use of off-site analysis, thematic reviews and on-site supervisory activities,[685] the SEC's examinations are considered intensive and thorough but, due to resource constraints, only a little over 10% of CIS operators are examined each year.[686] The inspection rate was found to be inappropriate by the assessors, as warranted by the relevance of the sector, despite the SEC's examination of all disclosures and reports filed by CISs and their operators and engaging with the largest asset management firms.[687]

Assessors for the 2015 US report found that the regulatory framework lacked in requirements for internal controls and risk management for the CIS operators, including those under the SEC's framework. This IMF DAR indicates that many of the elements that a risk management framework would entail are covered by the existing obligations,[688] mentioning the compliance rule, custody and recordkeeping rules. Moreover, it points out how the role played by CIS boards provides *"some further assurance on the adequacy of internal controls and compliance arrangements"*. But it does not find a requirement for defined risk management policies, and therefore grades the objective as broadly achieved.

Mandated, specific legal forms of vehicles and segregation of assets requirements are at the heart of CIS investors' rights and assets protection for the schemes. Principle

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[685] International Monetary Fund, 'People's Republic of China – Hong Kong SAR. FSAP: IOSCO Objectives and Principles of Securities Regulation – Detailed Assessment of Observance' (Country Report 14/205 ,July 2014) 26.
[686] International Monetary Fund, 'United States. FSAP: Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation' (Country Report 15/91, April 2015) 26.
[687] ibid.
[688] ibid 157.

25 overlaps somewhat with the requirements of the preceding principle, as its Key Question 4 addresses the status of CIS governance directly despite the fact that the segregation is an activity often associated with the CIS independent entity. Although the FSAP assessors recognise that CIS best practice suggests executing segregation via the vesting of a fully independent custodian, they also note that the IOSCO Principles are not particularly burdensome, as they allow a related party to take on such responsibility provided extra safeguards are in place. In fact, this is the case for Hong Kong, which scored a fully implemented rating, despite allowing only for an affiliated entity to be custodian, with no common directors, when it is not a subsidiary of the CIS Operator. The FSAP also qualifies the requirement for a custodian to be a regulated entity with relevant prudential capital as an additional safeguard.

It appears that the lesser grade assigned to the US framework is conducive to the commodity pools regulations rather than those of the ICA. The FSAP assessors considered that, for mutual funds additional safeguards are provided by the requirement that, where assets are held by the CIS operator itself or its affiliate, an independent public accountant must examine the CIS's assets at least three times during the year.[689] This assessment also confirms the interconnectedness approach taken by the IMF on the analysis of collective investment schemes: Principle 16, requiring accurate and timely disclosures of material relevant to investors' decisions, is predicated on Principle 25. Provided that the US legal and regulatory framework subjects issuers of securities offered to the public to robust disclosure requirements at the moment of the offering and on an ongoing basis,[690] it follows that CIS disclosures are in line with those of other securities types.

As discussed in this research, the regulatory standards for asset valuations and units' pricing of schemes are key safeguards for CIS investors. Principle 27 requires *"a proper and disclosed basis"* for these activities. Hong Kong rules, discussed for the FMCC framework in the preceding chapters, are clear on these requirements: the 2014 FSAP assessors ranked the principles as fully implemented. Some doubts are cast on the US standards. Whilst the broadly implemented grade is assigned based on flaws in the commodity pools regulation, the 2015 FSAP assessors noted that there is no specific requirement for the mutual fund type of CIS, while their interpretation of the Methodology is for a requirement not limited to the accounting adjustments but also including the treatment of investors. They also recognised that the US industry relies on a code of practice dealing with pricing errors for mutual funds, which deals with compensation to investors for losses arising from pricing errors. However, the code is voluntary and the SEC does not have the explicit authority to enforce it, although in some cases it may be able to take action on pricing errors if they result in a violation of US federal laws.[691]

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[689] International Monetary Fund (n 673) 166.
[690] International Monetary Fund, 'A Macrofinancial approach to Supervisory Standards Assessments' (18 August 2014) 113 <https://www.imf.org/external/np/pp/eng/2014/081814a.pdf> accessed 25 July 2017
[691] International Monetary Fund (n 673) 172.

FSAP Technical Note on fund management for the UK

An IMF Technical Note aims at reviewing the effectiveness of the regulation and supervision of a specific sector. A Technical Note does not address the Methodology questions directly, principle-by-principle, but it touches upon its themes in a much deeper way, to the extent that it describes a number of recommendations for the country to implement, with low, medium and high priority. The UK undertook an analysis to form a detailed view of its applicable standards for CISs and their operators as well as for equity trading platforms in 2016. The UK has the largest fund management market in Europe in terms of CIS operators' assets under management and a significant proportion of the regulatory framework in this area, in particular that related to conduct of business and disclosure requirements, has been harmonized at the EU and international levels.[692]

The UK framework for CISs was found to be substantially well developed and comprehensive in its regulatory requirements. Like the US FSAP findings, a substantial number of concerns raised by the assessors are related to the narrow operations of the local competent authority. The FCA was recommended to assure, with medium priority, a process for the authorisation of CIS operators that takes into account their specific risks; to increase the staff and expertise in its centralised event supervision function, who are also tasked also with capital requirements analysis; and to improve its own supervision of investment funds' compliance with valuation requirements.[693]

When addressing regulatory matters, the FSAP team proposed to align the authorisation and reporting requirements of non-EU CISs and their operator to those within the scope of the AIFMD, which introduced complex reports for systemic risk monitoring. The assessors specifically mentioned that the current approach risks falling short of the stringent requirements that IOSCO Principles impose on assessing the applicants' compliance with certain key obligations.[694] This was supported further by the interpretation of Principle 24 of the IOSCO Principles, which recommends that an authority review the risk management and internal controls before approving a CIS operator. Furthermore, this FSAP Technical Note outlined a low priority need to implement liquidity risk management requirements for UCITS operators and a medium priority need to develop a practical approach to measuring the leverage level of a CIS,[695] despite the fact that IOSCO experts had not elaborated further on those standards.

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[692] International Monetary Fund, 'United Kingdom: Financial Sector Assessment Program-Fund Management and Equity Trading Platforms: Regulation, Supervision, and Systemic Risk Monitoring-Technical Note' (IMF Country Report No. 16/161, 17 June 2016).
[693] ibid, Table 1, 7.
[694] ibid, point 56, 26.
[695] ibid, Table 1, 7.

Commentary on FSAP findings for the US, Hong Kong and the UK

Some of the assessments carried out by the IMF, and its temporary enrolled staff, seem not to take into account subtle aspects for the CIS operative framework at the national level. For example, in recording a lack of risk management requirements for the SEC's framework – despite mentioning the compliance, custody and recordkeeping rules – the role of the CIS board is classified as providing some guarantee. However, as previously indicated, the role of the CIS board is in fact that of the CIS independent entity, in the context of IOSCO CIS governance, which provides more than just reassurance *"on the adequacy of internal controls and compliance arrangements"*. Within the IOSCO framework, the CIS independent entity has full oversight function regarding the CIS operator. So, independently of employing written procedures to identify and mitigate risks, the powers and reach of the CIS board should be the focus of attention when it comes to the CIS risk framework. Furthermore, under the compliance rule, it is the CIS board that needs to adopt and implement written procedures and policies designed to avoid violation of federal securities laws. It can be inferred, therefore, that operational and reputational risks, at least, are embedded in the compliance system, while market risks are executed, within the investment management activities, by the CIS operator.

Another element potentially dismissed in an FSAP analysis, by design rather than through assessors' incompetence, is that of the effectiveness of the judicial guidance provided by the local authority as equivalent to a rule. One example is that of the pricing errors rules that must be in place within a framework in the case of US mutual funds. It is legitimate to consider industry-sponsored codes as no more than market practice guidance. However, a quick review of relevant legal cases would demonstrate how precedents addressing NAV computations are related to the units' pricing and may have similar effects to rules.

For example, in the previously-discussed SEC enforcement case involving Oppenheimer Asset Management Inc, the CIS operator's written policies and procedures did not contain provisions reasonably designed to review the Operator's valuations and were not reasonably designed to ensure that valuations were determined in a manner consistent with written representations to CIS investors.[696] More recently, another SEC Enforcement case, involving Calvert Investment Management, discussed improper fair valuation of securities held by a CIS managed by the aforementioned CIS operator. This entity had improperly valued the CIS assets, which, in turn, led to the wrong price for the CIS NAV. Despite having compensated the CIS with an estimated loss amount, the CIS Operator did not precisely calculate the CIS investors' losses in accordance with the CIS' NAV error correction

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[696] Securities and Exchange Commission, 'In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC' (ICA Release No. 3566 / March 11, 2013).

procedures.[697] The correct value should be the adjusted NAV for each affected day during the period, based not only on the correct fair value of the underlying assets but also on the inflated, asset-based management and administrative fees charged.[698] The SEC's settlements with these CIS operators, and the guidance provided by the No-Actions Letter, indicates similar *de facto* effects of settling pricing errors for CISs that would normally be encoded in a regulatory requirement.

Some FSAP grading on regulatory matters may simply be representative of a lower standard than the market or the out of date design of the IOSCO Methodology. This is the case for the FSAP findings on the segregation of the clients' accounts. The Methodology's standards require safekeeping by either a custodian or depositary, which may or may not be independent, or *"special legal or regulatory safeguards in cases where the functions of custodian and/or depositary are performed by the same legal entity as is responsible for investment functions (or related entities)."*[699] In this research context, the lower standard is that of the SEC, which requires only accounts segregation plus an independent public accountant examination. This is in contrast to the Hong Kong standard, which requires a custody appointment that may be related at group level to the CIS operator, and the UK depositary regime, which has its origin in EU law and which requires complete independence and even additional economic liabilities, given the overlap with the CIS independent entity's role.

The IMF FSAP Technical Note on the UK is not particularly burdensome, if observed on a standalone basis, and is even less so when analysed in conjunction with those of other relevant, at times connected, countries. Some of the action requirements are common to those of countries considered EU financial centres for CISs, such as Ireland and Luxembourg. For example, the latter recorded, among a surprisingly long list of high-grade action points, indications to establish specific systemic analysis for its UCITS industry and the strong advice to contribute to the creation of stress liquidity assessments, leverage work and other EU-level regulatory requirements yet to be defined. It should be noted that at the time of the FSAPs' release, IOSCO had not finished consulting on good practice for CIS liquidity or elaborating on guidance related to leverage measures. Also, three of the IMF Technical Notes on the UK findings are related to the FCA staff, the activities carried out and the skills they require. This is not dissimilar from the notes on the SEC's FSAP issued the previous year.

The commonalities evidenced in these large centres for CISs introduce an interesting concept regarding the validity of the countries' FSAP reviews as a tool to rank them. Whilst the IMF is clear that certain countries pose more systemic risks than others do, the question is whether their grade should actually be weighted. The analysis above

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[697] ibid, point 2.
[698] Chris Kentouris, "No shortcuts reimbursing NAV errors, says SEC' (*FinOps Report*, 22 November 2016) <https://finops.co/investors/sec-no-shortcuts-when-reimbursing-investors-for-nav-errors/> accessed 10 January 2018.
[699] International Organisation of Securities Commissions (n 659) Principle 25, Key Question 8.

suggests that some elements are provided: there is no reference given to the SFC on the scale of its resources, despite the fact that it is a key Asian financial centre. The misalignment of lower grades or higher priorities, at least in this research context, can only be reasonably explained by the relevance of a country's sector. This is both at a national and an international level. As briefly observed for Luxemburg, a small European country with the majority of CIS registrations in the Europe, the impact of potential risks goes beyond the national borders and feeds into systemic risks for the entire global financial ecosystem.

Legal status of IOSCO principles for CIS

International standards, guidelines on applications and SSB principles may not be classified as "hard law". This consideration has been predominant in the academic world as it has been observed that most arrangements governing cross-border financial relations, including the so-called Basel Accords, have the effect of "soft law". This assertion is validated by the effective implementation of SSB standards worldwide, including the IOSCO standards discussed above, which occurs on a voluntary, self-imposed way[700] by the national authorities, and only within their legal framework.

These standards have neither a customary character nor a legal character in the traditional sense of the term,[701] but are simply *"policy recommendations of international bodies"*.[702] The question is therefore: why would national authorities adopt different standards? Independent states may implement soft law spontaneously or because of other mechanisms known as "market discipline" and "peer pressure". National implementation is a precondition for compliance, which in turn may be defined as *"state behaviour that conforms to and arises out of an obligation of international law"*.[703]

This also applies to the set of IOSCO Principles for CISs previously introduced. Rules which are created following an SSB indicated standard, or encouraging similar implementation across jurisdictions, have the effect of creating comparable, equally legal effects and hence forming regulatory frameworks deemed equivalent. This trend creates a status quo of relevance when a CIS investor can, in effect, rely on different legal systems to retain the same rights on its own investment independently of the jurisdiction of the registration of the vehicle. In this context, a model to measure the depth of the implementation of soft law addressing CIS, backed by actual national-level enforcement, may even be considered a method for measuring the

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[700] Rosa María Lastra (n 635) 10.12.
[701] Valerio Novembre, 'The bargaining process as a variable to explain implementation choices of international soft-law agreements: The Basel case study' (2010) 10 2 Journal of Banking Regulation 128.
[702] Marco Giovanoli, 'Reflections on international financial standards as 'soft law'' (2002) Essays in International Financial and Economic Law 37 (London,The London Institute of International Banking, Finance and Development,2002), 6.
[703] Valerio Novembre (n 688).

relevance of an SSB as soft law legislator.

The extent of the implementation of similar regulatory standards, favouring cross-border activities, may also be a practical case for the establishment of a *lex financiera*.[704] Given that international financial regulation has proceeded through the harmonisation route, the formalisation of common standards in the CIS regulatory sphere has evolved further through the establishment of memoranda of understanding that, when correctly implemented, have enabled an unprecedented link between what is referred to as soft law and actual, enforceable national regulations.

Furthermore, the IMF's FSAP has contributed to a certain extent to the creation of soft law. In its interactions with the SSBs, the IMF contributes to developing international standards in two main ways. First, it gives voice to those jurisdictions that are not represented, helping to ensure the standards are written in a manner appropriate for everyone. Secondly, as an impartial observer, during the internal negotiations the Fund can advocate for stronger standards.[705] That is not to state that this influence is ultimately effective. At times, the IMF FSAP has provided a weak and defective monitoring mechanism. Even when they are adopted in a timely manner, SSB standards still frequently face enforcement problems, as states are tempted to defect from the cooperative framework – especially when they are under pressure from powerful domestic constituencies. Even IOSCO's record is less solid than it sounds, and most of the convergence has been achieved in areas in which major markets have had a strong interest.[706]

In the case of a CIS, when cross-country standards are not aligned, the risks are amplified: the marketing of a CIS from a different country makes the CIS investor subject to several of the risks associated with the governance standards of the home jurisdiction. In these cases, a CIS investor's ability to enforce his rights may be diminished. For this reason, most jurisdictions have enforced mechanisms to allow for the marketing of CISs that are managed or registered in countries considered substantially equivalent in terms of CIS investor rights and CIS regulatory framework standards. This process has developed further to the extent that so-called fund passporting charters have been established.

Funds' passporting: Asian evidence for *lex financiera*?

The modern nature and structure of the fund management industry is such that economies of scale are increasingly prevailing, concentrating the market growth to fewer and fewer players and shaping the supply of CISs offered at national and

[704] Rosa María Lastra (n 635) 10.12-10.20.
[705] Stephen G. Cecchetti, 'Collaboration in Financial Regulatory Reform: The IMF, the Financial Stability Board, and the Standard Setting Bodies' (IEO Background Paper No IMF BP/18-02/04, 14 December 2018).
[706] Emilios Avgouleas (n 648) 359.

international level, for both retail and professional investors.

This trend is the result of international investment houses consolidating operations and schemes' public offerings across countries, while concentrating the management activities in certain financial centres. The phenomenon makes the asset management industry an essential shaper of a *"new phase of global capitalism, its strategic spaces and its exclusions"* with advanced business services being identified as "organizational commodities" and facilitators of pivotal importance.[707]

Likewise, investors have become more sensitive to fees associated with collective investment schemes and similar, if not equal, underlying assets. The combined overall effect has been to transform the CIS market into one of standardised products on the one hand and fee-lowering economies of scale on the other. Therefore, for the management of a CIS to be economically viable, a greater amount of assets is required, on average, compared with a few years ago.[708]

The economic rationale to seek further assets implies a search for new markets, especially when fees exhaust competition at national level. However, in order to access a foreign market, the applicable CIS regulations have to be taken into consideration. For example, within the European Union, fund promoters can create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction-specific basis.[709] This UCITS provision, a directive in its own right, allows in effect for regulatory arbitrage across EU members. Certain European countries have benefited from taking a more liberal approach than others. For example, the fund industry in Luxembourg has historically developed more by exploiting distinct regulatory advantages than by tax arbitrage opportunities.[710] It is estimated that, as the Luxembourg state actively pursued a flexible and liberal fiscal policy, providing ample freedom to its financial industry, such regulatory arbitrage has indeed benefitted Luxembourg for almost two decades and attracted a large number of fund initiators from abroad.[711]

Some research indicates that each financial transaction possesses a "sovereign stamp", which signifies one specific territory with its particular rules, making territorial embeddedness an inherent strategic character in the production of "finance", and linking the activities that exploit different regulatory spaces with specialized

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[707] Saskia Sassen, 'Global inter-city networks and commodity chains: any intersections?' (2010) 10 1 Global Networks 163.

[708] Oliver Walker, 'Fidelity's zero-fee campaign spurs $6.6bn of inflows' (*Financial Times*, 26 November 2018) <https://www.ft.com/content/d8569037-98fa-35bd-b3e5-861e8168161d> accessed 7 March 2019.

[709] Derbhil O'Riordan, 'A brief guide to marketing investment funds in the EU' (Thomson Reuters Practical Law) <https://uk.practicallaw.thomsonreuters.com/6-577-8426?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1> accessed 20 November 2017.

[710] Sabine Dörry, 'Global production networks in finance. The example of the investment fund industry in Luxembourg' (2014) 43 L'Espace Géographique 227.

[711] Sabine Dörry, 'Strategic nodes in investment fund global production networks: The example of the financial centre Luxembourg' (2015) 15 4 Journal of Economic Geography 797.

functional sites, not least in order to realize arbitrage.[712]

In this context, the ability to offer a CIS across multiple jurisdictions becomes significant. Whilst the EU single market allows so by design, other types of qualified marketing schemes have emerged in the Asia Pacific region. Three main models can be observed: the ASEAN CIS, the Asia Region Funds Passport ("ARFP") and the Hong Kong Mutual Recognition of Funds ("MRF"). All three schemes are focused on increasing cross-border offerings of Asian-domiciled funds to diversify foreign investment management options for retail investors.

These frameworks are designed to be an alternative to UCITS rather than to compete with it. Whilst the European schemes operate in the EU single market on a Home Authorisation-Host Notification passporting arrangement, each of these Asian schemes are based on a mutual recognition model where funds still need to be registered by each Home and Host jurisdiction, although the schemes offer a more streamlined and coordinated process for Host authorization.

Asia Region Funds Passport

Of the various multilateral schemes, the ARFP is the most interesting in terms of economic opportunity, jurisdictional diversity and range of membership. Aiming to start in February 2019, it covers Australia, Japan, Thailand, New Zealand and the Republic of Korea. A number of observers and potential joiners from the 21 APEC economies have been assisting in the negotiation process.[713]

With the objective of fostering financial businesses within the Asia and Pacific regions and strengthening the regional investment management industry, the ARFP has been designed with the long-term goal of also facilitating funds from the Asia region being marketed in Europe through a potential Asian-European mutual recognition agreement. In fact, the consultation submissions indicate a preference for ARFP members to open to regional mutual recognition frameworks and avoiding restrictions or impediment for members to operate with other initiatives, particularly those already in place. A precondition to the eligibility of a country to participate in the framework is the full implementation of the IOSCO Principles.

The envisioned framework is such that an ARFP fund must, by statute, be a regulated CIS, or a sub-scheme part of a regulated CIS, in compliance with the Home Economy regulations, which is the country of incorporation of the fund. The CIS and related governance parties must be compliant with the given Draft Passport Rules[714] in order

[712] Ibid.

[713] As of December 2017 these are: Observers Singapore; Chinese Taipei, Hong Kong, Philippines. Other potential joiners: India, Indonesia, Vietnam.

[714] See Asia-Pacific Economic Cooperation (APEC), 'Asia Region Funds Passport consultation on the detailed rules and operational arrangements', Annexes 1-3 <http://fundspassport.apec.org/files/2015/02/ARFP-Annexes-1-2-and-3-for-release.pdf> accessed 7 March 2019.

to be eligible for a streamlined authorisation by the Host Economy, which is the extra-territorial eligible member country where the CIS can be marketed post-authorisation. The ARFP is built around three levels of standards in order to operate correctly: applicable laws and regulations, common regulatory arrangements and actual passport rules. A few notes relevant for the scope of this research follow.

The ARFP requires a particular condition, as it limits the authority that a Host Economy may exert in its own jurisdiction. The nationally competent authority for the Host Economy Laws will not be able to apply laws and regulations to a Passport Fund or its operator, for which it is the Host Economy, other than in accordance with the details provided in the ARFP.[715] Similarly, the Host regulator supervises the compliance of a Passport Fund with the Host Economy Laws and Regulations that apply to the Passport Fund in its economy as well as the Passport Rules.[716]

The Passport Rules cover the key conduct and prudential requirements, creating a set of minimum standards related to the operator, the independent entity, related parties and the assets eligibility of the Fund. For example, provided that the passported fund is already a regulated CIS, normally distributed in its Home country, only a CIS with a NAV above US$500 million invested in specific securities types (transferable securities; money market instruments; deposits; currency; depository receipts over gold; derivatives; units of other funds), would be eligible for passporting. Further limits apply to the eligible CIS underlying assets, specifically relating to the concentration of securities issuers, the use of derivatives and fund exposures limits. It is fair to state that the ARFP Passport Rules resemble the equivalent standards of the UCITS directives in the EU.

Hong Kong Mutual Recognition of Funds

Since 2015, the Hong Kong SFC has been pursuing a number of bilateral deals with various national authorities. By the end of 2018, the SFC had established agreements with the nationally or federally competent authorities of Mainland China, Switzerland, France and the United Kingdom. However, these MRFs differ in their effects on the cooperative mechanisms as well as in terms of the operational aspects for the CIS operators managing passported funds. For the scope of this document, the case involving the CIS market for Mainland China and Hong Kong SAR is taken as example.

The overall principle underpinning this MRF is the non-exhaustive rules it provides. The CIS, authorised by, or registered with, the relevant authority in one jurisdiction (Home Jurisdiction), should seek authorisation or approval to offer its units to the public in the other jurisdiction (Host Jurisdiction).[717] It is further stated that the CIS

[715] ibid Annexes 1, Art.1
[716] ibid Annexes 2, Art.
[717] Securities and Futures Commission, 'Circular on Mutual Recognition of Funds (MRF) between the Mainland

should meet the eligibility marketing requirements of the Host Jurisdiction, as this remains authorised by or registered with its relevant regulator, whilst obeying the sale and distribution applicable laws and regulations of the Host Jurisdiction.[718] Furthermore, the CIS should generally operate and be managed in accordance with the relevant laws and regulations in the Home Jurisdiction and its constitutive documents, while ensuring that CIS investors in both the Home Jurisdiction and Host Jurisdiction receive fair and equal treatment in respect of investor protection.[719]

It is clear that, with respect to consistency, Hong Kong SFC and China Securities Regulatory Commission ("CSRC") take an approach that maintains or even expands the set of applicable rules. The Hong Kong SFC circular addresses the requirements for a Recognised Mainland Fund and states that requirements under the CSRC remain in force; the same is valid for the approval of an eligible Hong Kong CIS for offering to the public in Mainland China.

The applicability of the MRF means that a Recognised Fund must comply with the Home Jurisdiction framework for eligibility and registration – as is the case for any CIS scheme discussed before in this research – and with the Host Jurisdiction rules for the local authorisation of registration, sale and distribution, and ongoing compliance. For example, a Recognised Mainland Fund will have to undertake the requirements described in the SFC Circulars on the matter, which provide a mapping of the applicable Handbook rules to be applied while mentioning acceptable standards in place at the CSFC to avoid duplicative standards.

Whether certain standards apply to the Recognised Fund, such as the limitation on being an equity fund, bond fund, mixed fund, unlisted index fund or a physical index-tracking ETF, the most relevant characteristic is the limitation of the assets of the Recognised Fund, as this may not be primarily invested more than 20% in Host Jurisdiction securities. Furthermore, the number of shares or units sold in the Host Jurisdiction shall not be more than 50% of the total NAV of the CIS.[720] Also, there is a need for the appointment of a legal representative or agent in each jurisdiction. This person or entity is responsible for the issuance and redemption of the Recognised Fund as well as for representing the fund to the local regulator – effectively carrying out some of the function expected of the CIS operator.

ASEAN CIS

The ASEAN CIS framework is part of the output of the ASEAN Capital Market Forum, an international initiative of the economies of Brunei Darussalam, Cambodia, Indonesia, Laos PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and

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and Hong Kong' (22 May 2015) art 1.

[718] ibid, Art 2 a,b,d.

[719] ibid, Art 2 c,e.

[720] ibid, Art 6 e,f and FAQ on SFC Circular.

Vietnam to foster the harmonization of rules and regulations regarding capital markets, including fund management and CIS standards. Of this group, the nationally competent authorities of Singapore, Thailand and Malaysia have opted for the cross-border public offers of ASEAN CIS, often conventionally referred as the Qualifying CIS, since 2014.

The passported CIS must simultaneously satisfy the Home Regulator requirements and the so-called Standards of Qualifying CISs, being a set of standards prescribing qualifications and prudential requirements for the CIS operator and the independent entity, as well as the requirements relating to approval, valuation, and operational matters, all of which are preconditions for applying to a Host Regulator to be approved for public offer, which is streamlined so it can be activated within 21 calendar days.[721]

Like other frameworks, the ASEAN CIS calls for the qualification of the CISs' assets. Eligible asset classes are limited to transferable securities, money market instruments, deposits and a limited number of units in other CISs. These assets are global and not limited to ASEAN countries' securities. The use of financial derivatives is allowed with the exception of complex ones, which in practice excludes credit derivatives. Some riskier CIS market practices are deliberately excluded, such as securities lending, being parties to repurchase transactions, and the direct lending of monies.

The CIS Operator of an ASEAN CIS is subject to supervision by the Home Regulator but is also required to appoint a specific type of independent reviewer. This entity must perform a compliance review of the operations of the Qualifying CIS and provide the information to the Host Regulator as well. Despite the clarity of the framework, as of July 2018 only 16 funds are recorded as ASEAN CISs; and only six have actually registered for sale in a Host Country.

Passporting schemes standards as soft law

The bilateral MRF between the Hong Kong SAR and Mainland China authorities does not appear to be currently open for multilateral participation and it is subject to specified quota restrictions. The ASEAN CIS has been launched but it has had limited success, arguably because of a burdensome registration process and competition from the UCITS offerings beyond the Asian region. The ARFP, designed to complement UCITS rather than compete with it, provides a good framework and a vast market for the existing master-feeder fund structures. Because the framework started in January 2019, it is yet to be tested.

Both the ASEAN CIS and the ARFP have similar IOSCO Principles-based requirements but they retain elements of complexities relating to the fragmented legal and taxation frameworks that come with operating across jurisdictions. Overall, the

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[721] Asean Capital Markets Forum, 'Standards of Qualifying CIS' (23 April 2018) <http://www.theacmf.org/ACMF/upload/standards_of_qualifying_cis.pdf> accessed 7 March 2019.

ARFP appears to be more flexible then the ASEAN CIS in terms of asset management flexibility, while being more economically attractive, given its diverse membership and wider backing.

The level of harmonisation of EU CIS standards, for UCITS and AIFs, is simply superior to those others because the EU framework benefits from being one common legislative system. However, the commonalities between all frameworks analysed in this research, including the passporting mechanisms, point to one emerging practice, a set of "unwritten rules" that are acceptable to all national authorities. The existence of these customary rules, and their taking similar form, indicates that the international standard levels are reaching a point of substance that allows for the acceptance of a different legal system in another country and for CISs to activate international marketing practices. If this is not reach by equivalency, the new passporting schemes implement different levels of applicable regulation or even common governance rules sets, as in the case of the ARFP.

It appears therefore that soft-law standards issued by SSBs eventually find their way into national legislation or the European Union's directives and regulations, giving them a particularly sharp, hard edge, whilst their *de facto* binding nature has recently been strengthened by means of increasingly rigorous peer reviews.[722] This mechanism of validation based on the SSBs standard can be interpreted as a reverse-engineered methodology promoting soft law into hard law.

Further evidence of this trend is found in the above analysis: all of the CIS frameworks aim to apply IOSCO Principles 24-28, and they accomplish this by answering the Key Questions in the IOSCO Methodology, which in turn is used in the IMF's FSAP. In reversing the questions into standards, there is clear evidence that these are considered sufficient for a common CIS set of rules that authorities find acceptable to allow for the marketing of foreign schemes. The soft law of the Methodology is therefore applied at law level to coordinate a common structure in national, hard law. However, even where rules are incorporated into financial sector assessments, monitoring of compliance may remain weak. Research indicates that FSAP participation was, for example, entirely voluntary for non-IMF and non-World Bank borrowers, and data provided to international SSBs is normally self-reported by national authorities and is subject to little verification.[723] More research on this topic may measure the extent of this phenomenon.

Conclusions

The internationalisation of the investment management industry, whose participants are increasingly using economies of scale, has brought with it a higher level of

[722] Emilios Avgouleas (n 648).
[723] Ibid 359.

standardisation of securities regulations. CIS rules have also evolved to accommodate the execution of regulated activities in different countries and under different jurisdictions. In this context, the IMF plays an indirect role in the universalisation of IOSCO standards for the securities industry through the FSAP.

If the IOSCO Principles are determined in an international context by a number of regulatory stakeholders, their generic nature allows for the adoption of different codes. However, the FSAP tends to elevate the IOSCO Methodology to a set of minimum standards. It does so indirectly, posing a number of questions regarding the requirements considered useful for the correct functioning of securities regulation. However, it is argued here that the same standards embedded in the requests function as minimum coding requirements to be internationally recognised as comprehensive. Hence, this Methodology may be approaching a soft law status rather than guiding principles.

The phenomenon described might evolve further and, perhaps, establish itself as a sample case for *lex financiera*. Further evidence of this trend is given by the CIS passporting schemes currently being launched worldwide. These are based on a level of standardisation similar to the CIS regulations and so, with the few regulatory modifications previously observed, they validate an international model that is emerging as prevalent. In turn, this may be used as the international standard for CIS investors to be reassured of their investment when transacting internationally.

Thesis Conclusions

Main findings

At the heart of this study is the quest to explore whether collective investment regulations are fit to protect investors. This research is based on the analysis of three sets of regulations across global financial centres and it aims to test whether these national regulations are implemented in such a way as to provide effective and unbiased rules from the point of view of the ultimate risk taker – the investor in the scheme.

This research methodology adopted meant this study had three main areas of research shared across six chapters. The first part determined the status of the CIS, its social relevance and, more importantly, the specific fiduciary duties expected of investment managers and other relevant parties. The second area addressed the entities involved in the governance of the CIS individually, identifying their main duties toward the CIS investors and relevant court cases. The third area of interest addressed the validation of these rules at the international level and the way they are scoped out. In order to create a complete view of the study's findings, the conclusions are presented in areas of research, connecting the effectiveness of individual frameworks to the multiparty system created by the governance structure of a CIS and by the international standard setting process.

The validity of rules occurs at different levels. Despite the intention of designing investor rights based on the duties of the operators and third parties, analysis of the operational model for the CIS reveal some gaps between its intent to limit risks and the rules that are *de facto* applied, leaving room for agencies to benefit at the expense of investors. The identified gap is not due to the lack of principles of fairness around governance of the CIS parties involved. Rather, it points at the dynamic CIS relationships, set against complex and changing market environments, involved which necessitate a regulatory trend of requiring more and more specification in order to create a safe environment for investors.

Effectiveness of fiduciary duties

The idea of requiring parties involved in the management of the CIS to owe fiduciary duties is to provide the "legal Polyfilla" to plug the gaps[724] inevitably created by the requirement to have multiple parties involved in the management of the CIS. Alongside providing a higher standard of conduct in all the jurisdictions considered here, they also introduce elements of prudent and ethical management to CIS

[724] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) paras 3.1.

governance.

This study's findings, based on research into executive policymaking and review of court cases, conclude that the identification of the duties of care and loyalty for a party in the governance of the CIS implies a fiduciary duty. Evidence derived from regulations suggest that, in CIS-related cases, this approach is valid despite not being clearly stated or uniquely implemented for all parties.

The hesitance, by courts and governmental entities alike, in attributing fiduciary duties may be related to the economic implications that this has in the case of disputes between CIS governance parties. In applying an economic model for fiduciaries, the presumption that overhangs and unduly influences policymakers and judicial findings is that, when acting as economic agents, they are to reach the most favourable financial output for the CIS. Therefore, any precarious choice leading to shortfalls in the CIS yield may be intended as breaching the fiduciary trust, implying a clear, quantifiable economic deterioration of the CIS investors' assets. The empirical findings suggest that governance and regulation are not yet brave enough to consistently articulate such a strict standard.

Given the relevance of fiduciary duties in the CIS context, it was further found that these apply, directly or indirectly, to the main parties involved in CIS governance. The operators are, first and foremost, considered to be key, and their role is unequivocally that of agents charged with fiduciary tasks. This research has indicated that this interpretation is, despite the regulatory understatement, not a matter disputable in court.

The other main parties, being the CIS independent entity types explored in this study, are CIS directors/trustees and CIS depositaries/custodians. In the first case, directors or trustees of a company are subject to the strict and well-developed standards expected of them in each jurisdiction under the applicable company or trust law. The interpretation therefore varies depending on the jurisdiction and no definite answer can be given if they are to be intended as fiduciaries, and to whom. In the case of the US, which adopts the CIS directors as the CIS independent entity, the duties of loyalty and care are due in both Maryland and Delaware, the states with the highest concentration of registered mutual funds.

Given that common law systems tend to provide the reassuring fiduciary status for third parties in the CIS context, for the case of the depositary/custodian the debate focusses mainly on the differentiation between the duties owed to the CIS and those owed to its shareholders.

The example of the UK is particularly pertinent. It was found that the Law Commission made a distinction between CISs registered as unit trusts and those registered as companies. In those experts' view, if a CIS is an open-ended investment company then it is unlikely to give rise to fiduciary duties on the part of investors: the duties exist, but are rather assigned to the CIS itself, in contrast to those set up under

trust law. Such a distinction implies that the investor in a company structure is buying a scheme's profits as opposed to

> *"instructing another to invest on their behalf. It is therefore difficult to find a fiduciary relationship, as the obligations to investors are essentially arm's length and are governed by contract and company law. The duties of company directors are generally owed to the company as a whole, not to shareholders."*[725]

This research finding points at an inherent contradiction between such potentially conservative interpretations and the rules that are in place, undermining the latter's intended effectiveness. In fact, under the FCA rulebooks the exact same functions are carried out by the CIS operator or the appointed depositary independently of their legal status. Further, in a UK public fund, the trustee-depositary principles point towards acting in the interests of the unitholders or investors, which is in direct contradiction of the Law Commission's interpretation. Furthermore, it is indicated that, as a general obligation, the CIS operator and the depositary must, in the context of their respective roles, act in the interest of the investors or unitholders,[726] even specifying that the depositary must reasonably ensure the safety of the CIS investors' assets.

In the case of Hong Kong, the fiduciary duties of the custodian can be inferred from the text used, which suggests that the same interpretation of a fiduciary relationship under trust law might be applicable to the company format, despite the fact that the mutual fund corporation is not governed by trust law. However, this regulatory framework does not mention any duties toward the unitholders or investors. The fiduciary status, if the such an inference applies, would only exist in respect of the entity constituting the CIS and not the investors.

It is settled that the independent entity is, at a minimum, a fiduciary to the CIS who is required to verify the actions of another fiduciary, the CIS Operator, creates a fiduciary to a fiduciary. This results in unnecessarily adding an additional layer of complex legal duties in an area where the rights and obligations of CIS entities is already unclear.

Effectiveness of governance rules for a CIS

The effectiveness of governance rules is the most relevant tool for assessing the level of protection granted to CIS investors in this research context, serving the purpose of identifying the risks to which investors are subject. The international standard for the correct governance of a CIS structure focuses on the CIS operator, as the manager or

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[725] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Consultation Paper 215, 2014) paras 12.53.
[726] FCA Handbook COLL Collective Investment Schemes (COLL) r 6.6.4 (3).

main agent of the CIS, and the CIS independent entity, a third-party carrying out the prescribed oversight function to guarantee the correct execution of activities by the agent.

This study observed that the UK and Hong Kong authorities have adopted models for the CIS independent entity that provide strong requirements to mitigate potential conflicts of interest between a CIS and its operator while enhancing the duties of the independent entity. This means requiring the safekeeping of CIS assets by the independent entity, surpassing the IOSCO standards for which there is no absolute avoidance of the CIS assets being held by the CIS operator. In the UK and Hong Kong context, the depositary/custodian, which is also a prudentially supervised financial firm, is tasked with both the oversight function and the safekeeping of the assets.

This is in contrast to the US model, in which the CIS directors – individuals forming the board of the mutual fund – are responsible for the independent oversight function. Within the CIS board, a number of directors must be independent; despite not being required to be the majority, they are responsible for key governance checks such as management of conflicts of interest with the CIS operator.

In comparing the two models, this study has confirmed that the depositary model proposes a firmer implementation and more effective set of rules, mainly by reinforcing the strict separation of the agent's duties from the oversight function, and isolating the potential risks. For example, the assignment of the safekeeping of the assets implies that investment transactions are carried out with the *ex-ante* verification of the suitability of the investment for the CIS performed by the depositary. While such verification is also observed in the US, it takes place periodically and on an *ex-post* basis. Furthermore, CIS directors in the UK have limited personal liability, based on the so-called business judgement rule, in contrast to the depositary model, which requires a prudentially capitalised financial firm to be the independent entity. These are both examples of existing rules that are less effective.

This is not to say that adding limitations to a CIS operator or third party watchdogs in the governance of a CIS implies a regulatory improvement. The effectiveness of the rules should also take into account the best result for the CIS investors in terms of the economic output. In the case of governance, these are usually transmuted into the costs charged to the CIS for the operationalisation of the applicable rules. It is argued in this research that the recently proposed UK system for CIS directors represents over-action of this sort. Its regulatory proposition aims to standardise the role of the board of a UK CIS in a manner not dissimilar from that of the US. However, two important characteristics of a CIS director's role may render this British evolution inappropriate.

On one hand, a possible overlap between the roles of director and depositary may be at hand in the UK, should the national legislator favour responsibilities that are similar to those in the US. CIS directors in the US perform the independent oversight function in the CIS governance, while this role is assigned to the depositary in the UK. An

overlap of functions, or a sharing of duties, may be an extra cost for CIS investors in return for little benefit.

On the other hand, there is no equivalent to the business judgement rule in the UK. Common law cases show that, despite the approach taken by the UK courts in reviewing the management's decision-making process being similar to that of the US courts, the review of business decisions must be made in light of the director's duty of care towards the company. The main difference lies in the gross negligence standard in use: whilst in the US there is review of decisions that do not derive from gross negligence by the director, in the UK this standard is considered to be higher, including all decisions that are intended as reasonably diligent.

Similar ineffectiveness is observable at the level of the rules designed to contain operational risks. This is the case for the US valuation of the CIS, for which the CIS directors are responsible in two distinct management activities, discussed in the following paragraphs.

The first is that of the valuation of a CIS. Despite not requiring directors' skills to be commensurate with the level of complexity of the CIS's investments, they are tasked to review the investment strategy and execution, and may require external expertise. This creates a paradox in the sense that the more complex CISs, in terms of investments, are also those that are more vulnerable to misevaluation, which is only made worse given the inability of the oversight entity to competently carry this out its regulatory obligation. Furthermore, an inflated valuation, fraudulent or not, is equivalent to higher economic benefits for the CIS operator, which receives performance benefits.

Another ineffective application of rules in respect of the oversight role of US CIS directors is that of the verification of the asset suitability and the best execution of transactions. As many CISs have limitations regarding the eligibility of investments, the assets are to be congruent with the policies disclosed on the matter and are to be transacted at fair prices. CIS directors, however, execute both functions *ex-post* after the transaction, often after a cost-free remediation time has passed, as evidenced in certain court cases.

On the international rules making

The aim of all securities regulators is to design and enact regulations to protect investors. In the case of CIS regulations, the task is more sensitive and socially relevant as it addresses schemes and investment products constructed mainly for retail, non-professional investors.

This research, based on regulations in different countries, has evidenced a common trend in implementing certain standards that are transforming each national

framework and increasing the regulatory convergence between different jurisdictions. This is partly due to the implementation of IOSCO (the international standard-setting body for securities regulators) Principles, which are determined in an international context by a number of regulatory stakeholders. IOSCO members, comprising the vast majority of CIS regulators worldwide, use the IOSCO Methodology, which is also employed by the IMF as part of its FSAP, to develop the key questions with which to test the implementation of international standards at the national level.

This study has identified a relevant aspect of the circuitous regulation-setting process described. It partially validates the idea of the regulatory system's effectiveness rather than that of referencing a set of rules considered to constitute a minimum standard. This is not akin to the impossibility of creating a "one size fits all" approach, but refers rather to the possibility of establishing a CIS regulatory framework with balances coming from different parties, therefore promoting the idea that the effect is more important than the actual rule. However, the IOSCO Methodology does not make use of case law and so, whilst rules may be paired with courts' interpretations on key risk matters brought forward by regulators, the analysis may not fully appreciate the ultimate effects in the regulatory framework.

On the use of the IOSCO Methodology for FSAPs by the IMF's representatives, the findings of this research have highlighted how the set of questions may account for the minimum textual rule-setting requirements for a national CIS framework to be internationally recognised as comprehensive. Given the evidence of similarities across jurisdictions, it is possible that the IOSCO Methodology may indirectly provide standards that resemble soft law rather than guiding principles. Also, the adoption of CIS passporting schemes worldwide hints at a level of similar standardisation of CIS regulations that allows for the prevalent international model. If this is correct, the Principles-to-Methodology-to-FSAP phenomenon may be a catalyst for a form of *lex financiera*.

Recommendations

CIS legal frameworks exist to protect investors. Their level of effectiveness guarantees not only fair principles and rules in an important area of securities regulation, but also the trust and confidence of many investors who prefer these vehicles for their wealth management. Regulators can accomplish this by ensuring the congruence of the rules with the scope to protect the investors, creating an effective regulatory framework in different ways.

Enhancing CIS related policy for principles and fiduciaries

Firstly, regulators engaging in developing or improving CIS regulations need to balance the capacity of a principle to generate the correct and desired actions by the

CIS operator *vis-a-vis* the rule that is imposed on them. Because of the high level of standardisation of CIS regulations, the legal framework may result in a number of strict prescriptions that do not achieve the task to mitigate potentially negative outputs for the CIS. This inevitably risks emptying the significance of the generic fairness principles expected of the agents managing the CIS.

If principles are designed to pursue CIS investors' interests, then prescriptive rules should be simplified or delegated to specific cases. Generality in rules should be avoided in the context of a CIS governance framework. Regulators instead should align compliance requirements imposed on CIS governance parties to rules capable of being interpreted and applied by national courts.

Secondly, fiduciary standards pertaining to some if not all the key parties involved in CIS governance should be clearly stated in the applicable regulations. Standards should be proportionally attributed to the CIS operator and to the one or more entities carrying out the role of independent entity. Furthermore, regulators should ensure that these fiduciary duties are directly linked to actions and the effects of such actions — in particular economic losses incurred through breaches or mismanagement, and enforcement cases should pursue this approach.

Regulators should apply fiduciary standards strictly and directly to the fund's stated objectives, rather than relying exclusively on the applicable contractual terms of the scheme's constitution. In doing so, the direct fiduciary duties owed by the CIS governance parties to the CIS investors should be taken into account, in a proportional manner, namely that applicability of these duties should have an inverse relationship to the level of sophistication of the eligible investors.

Prescriptive rules on CIS Governance activities and liabilities

Thirdly, regulators should reach a fair balance, based on potential liabilities, when allocating duties between the CIS operator and the independent entity. A good method to accomplish this would be to design the framework from the point of view of the CIS investor, which implies managing the CIS operator's conflicts of interest strictly. Whilst some leniency may be allowed to avoid excessive costs being charged to the CIS, the liabilities of the parties involved should not be a factor in determining the ownership of duties.

These duties should address in particular, the full disclosure of the variations of the economic output, including variations in the management charges and fees to the CIS which is inevitably linked to CIS performance. When possible, rules on complete avoidance of conflict of interests should be enacted, as a general catch-all but also to address particular scenarios such as those evidenced by recent court cases and regulators' enforcement actions.

Fourthly, the independent oversight function should always be paired with that of the

safekeeping of the assets in order to guarantee better operational oversight of the transactions executed by the CIS operator. If this does not happen, the governance of the CIS should be set up in such a way as to allow the oversight function to verify pre-trade the congruence of the investment decision with the investment management limits provided in the CIS constitutive documents. Furthermore, the entity entrusted with these functions should have the financial ability to cover losses occurring from its mismanagement as well as knowledge and expertise in line with that needed to verify CIS matters. Any limitation, by way of law, of personal liabilities should not hinder the ability of the CIS to be restored economic losses should individual parties' mismanagement have produced these.

Internationalisation of CIS policy making

Fifthly, the analysis of the implementation of international standards should take into account the overall legal framework, including the ability of CIS investors to pursue legal action within and outside the jurisdictional boundaries of the established scheme. In this context, the ability of regulators to directly reach CIS governance parties abroad should be based on cross-border, soft law arrangements. Given that the current framework of Memoranda of Understanding between national regulators may not be sufficient, it is suggested to enhance those accords and improve transparency in, and the capacity of, regulators to rely on each other.

In order to pre-empt negative consequences (should the voluntary collaboration between parties fail) and bolster soft law arrangements, regulators should consider establishing *super parties* to manage conflicts, improves collaboration and raise standards for the international exchange of information. In this sense, the framework for international trade under the World Trade Organization may be a good standard to follow. Indeed, why should organisational structures for the international flow of funds differ from the international flow of goods and services in the international fora? Arguably, a treaty-based system of organising transnational relations would indeed promote stronger international standards. Whilst still requiring political support, academic analysis suggests the creation of a World Financial Organisation has found support from the emerging needs of international CIS operators and markets.

On the matter of the current international analysis of a jurisdictions' standards, these should be improved via the creation of stricter requirements than those of the IOSCO Methodology, and cyclically analysed by independent parties such as the IMF. Within the current FSAP activities, an IMF's country assessment may result in unfair grading if the effectiveness of the rules is not taken into account, via action taken by the regulator in the form of enforcement actions or case law. Therefore, an accurate analysis by the IMF, in the FSAP context, should also consider the effects of regulation rather than the mere implementation of prescriptive rules.

Lastly, the findings of this study suggest that, on a standalone basis, the regulations

of CIS operators are comprehensive in coverage but ineffective in some aspects, particularly when economic benefits arise from conflicts of interest between the parties. The suggested solutions may be simple, but introduce a higher level of efficacy to CIS regulations, rebalancing the current structures toward CIS investors.

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