The London School of Economics and Political Science

Overcoming the Governance Challenge in Private Investment Funds through the Enrolment of Private Monitoring Solutions

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

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Abstract

At the heart of any investment fund (whether public or private) is an investor protection concern that arises from the collectivized nature of the fund. In a bilateral arrangement, a client may negotiate 'bespoke' terms with a prospective investment manager. By contrast, an investment fund provides 'off the shelf' terms to prospective participants, many of whom may have relatively small percentage positions in the ultimate fund, although the sums of money they provide may often be very significant to them.

The governance challenge at the heart of all collectivized investment structures is most clearly seen in connection with private investment funds. Largely, the structure of such funds has been driven by the need to comply and obtain necessary exemptions under the financial regulatory rules, while simultaneously addressing a series of interrelated tax issues arising from various pieces of anti-avoidance legislation adopted over the years.

Three private monitoring solutions are identified which would enable fund investors to address more directly the problems arising from the governance challenge by facilitating a better flow of information from the fund manager to the investors:

(1) side letters, which provide a particular investor with further information and/or control rights with regard to the operation of the fund;

(2) improving the operation of the board of directors in either corporate-based funds or the general partner vehicle of limited partnership structures by the inclusion of independent directors; and

(3) listings of private investment funds on securities exchanges as a means of adopting ongoing compliance oversight.

Each approach recognizes the commercial contexts in which private investment funds operate by emphasizing voluntary steps that fund managers and investors can take incrementally. Further, each focuses on the provision of information as the means to overcome the investment protection concerns that arise due to the collectivized nature of the private investment fund.

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CONTENTS

Chapter 1
Introduction to the Governance Challenge in Private Investment Funds

1.1 Introduction

At the heart of any investment fund (whether public or private) is an investor protection concern that arises from the collectivized nature of the fund. In a bilateral arrangement, a client may negotiate 'bespoke' terms with a prospective investment manager and would retain the responsibility for overseeing the ongoing fulfilment of those terms. By contrast, an investment fund provides 'off the shelf' terms to prospective participants, many of whom may have relatively small percentage positions in the ultimate fund, although the sums of money they provide may often be very significant to them.

Investment funds [1] enable the collectivization of investment management relationships. Through a fund, the professional services of an investment manager can more efficiently be provided to a large number of prospective clients pursuing similar investment objectives.[2] In order to provide these services, an intermediate vehicle is placed between an investment manager and a group of potentially disparate participants which serves concurrently as (i) a means of pooling the investors' monies and (ii) a single client for whom a single investment objective can be pursued.[3]

For ongoing oversight of the investment manager, participants must rely on the governance mechanics of the legal entities used as funds, as supplemented from time to time by any additional contractual agreement of the parties. To the extent that particular vehicles have material differences in such mechanics, the ability of participants to protect their investments will vary. The use of one or more legal entities to intermediate between the manager and the clients can operate to diminish or impede the effectiveness of legal, equitable or regulatory remedies that otherwise might be available to a client in a bilateral relationship with the manager.

Governance concerns are only one of several factors that determine the ultimate structure of a private investment fund.[4] In addition to the commercial arrangements agreed between the

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1 For a history of investment funds over the centuries, see Jerry W. Markham, "Mutual Fund Scandals – A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments;" 3 Hastings Business Law Journal 67, 70-76 (2006).

2 The use of such vehicle provides access for certain investors with smaller sums to invest to managers who would not otherwise be commercially motivated to take them on as clients. Additionally, these vehicles can provide managers with administrative efficiencies where multiple clients wish to retain the firm to provide substantially similar services.

3 For a general discussion of financial intermediation and its regulation post-financial crisis, see Charles Whitehead, "Reframing Financial Regulation," 90 Boston University Law Review 1 (2010). As Whitehead observes, "[f]inancial intermediation helps bridge the gap between suppliers and consumers of capital, many of whom are located at a distance. In a frictionless world, the financial markets would allocate the kinds and amounts of capital that business require without the assistance (or cost) of an intermediary." Ibid. at 8.

4 In the UK, the US, and other countries with developed financial markets, public investment funds are subject to specifically tailored regulation, in addition to the general financial services regulatory regime. This further regulation is based on a recognition that by collectivizing the investment management relationships and interposing intermediate vehicles, the risks of fraud and malfeasance increase significantly. Primarily, the concern is focused on retail investors. Both the UK's approach to authorized collective investment schemes and the US's approach to registered investment companies apply substantive 'product-level' regulations to investment funds marketed on a retail basis. Very particular limitations are placed on what so-called 'mutual funds' can and cannot do. Only by complying with such requirements may these funds be made publicly available. See Section 3.4 below. As a general rule, non-retail investors have been provided with greater

parties, the particular legal structure selected for an investment fund will need to take into account the regulatory and tax impact of interposing such a vehicle between the parties.

The tax consequence of the entity being used as an investment fund must be examined and addressed. Unless the intermediary vehicle is broadly 'tax neutral' for the proposed investors, investors will be reluctant to participate. As a general rule, investors will want to be in essentially the same tax position as if they were to make the investments directly. In the case of public investment funds, which are marketed widely to retail investors, specific provisions of the relevant tax statutes typically provide for such treatment, subject to compliance with the rules imposed by the financial regulator. In the case of private investment funds, which are marketed on a limited basis only to sophisticated investors, however, the tax issues must be addressed structurally by selection of an appropriate legal vehicle and the inclusion of necessary provisions in the legal documentation.[5]

A private investment fund (whether a private equity fund or a hedge fund[6]) must, therefore, make use of a vehicle that is either (i) tax transparent (i.e., disregarded for purposes of any entity-level tax) or (ii) tax exempt. This requirement substantially limits the type of potential entities available for use. Historically, limited partnerships, which are generally tax-transparent in most jurisdictions,[7] and companies established in offshore jurisdictions, which are effectively tax exempt in those jurisdictions[8], have served as private investment funds.

Importantly, neither entity was originally developed specifically with the function of serving as a private investment fund. Their use as such has been driven by the needs of the parties for tax efficiency, rather than a genuine affinity for the history and governances of such vehicles. As a result, questions of governance that arise in connection with private investment funds must be analyzed and addressed in the context of the nature and limitations of the legal entity (i.e., limited partnership, offshore limited companies) that tax concerns mandate they adopt.

In sum, the problem that this thesis will address is how to enable investors in private funds, as private actors in the absence of government regulation, to significantly improve the governance structures of the funds in which they invest.

In this Chapter, I will discuss the scope of this thesis and the choice of law applicable to private investment funds. Then, I will describe the governance challenge that these funds face, in the

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flexibility and, in appropriate circumstances, they may participate in other investment funds on a private basis. See Section 2.5 below.

5 See Sections 2.6 and 2.7 below.

6 For a brief definition of private equity funds and hedge funds, and a discussion of their numbers and sizes, see Vijay Sekhon, "Can the Rich Fend for Themselves?: Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010," 7 Hasting Business Law Journal 1 at 4 (2010) ("Private equity funds generally acquire companies using leverage (i.e., debt) for the purpose of restructuring the companies . . . for their eventual sale or public offering of securities. On the other hand, hedge funds generally implement a wide array of investment strategies . . . to produce risk-adjusted positive returns from various market opportunities."). Industry research estimate that over 540 private equity funds raised approximately $600 billion between 2007-2009, while approximately 10,000 hedge funds had over $1.5 trillion in assets under management. Ibid. at 4-5.

7 See Section 2.3 below. Although an established feature in many jurisdictions, the tax-transparency of partnerships has not been without some good-natured doubters. See Larry E. Ribstein, "An Applied Theory of Limited Partnerships," 37 Emory LJ 855, 872 (1988) ("There may be substantial reasons why certain types of businesses should be taxed on a flow-through basis and others taxed as entities. But no reason appears why the tax approach should depend on the form of business the parties have chosen.").

8 See Section 2.4 below.

context of corporate governance generally, paying particular attention to the distinctions which exist between companies and partnerships. Next, I will analyze the role of the fund manager as the agent of the fund and the consequences of governance failures when they occur. Finally, I will discuss the legal and regulatory duties owed by fund managers and identify alternatives to centralized, top-down regulation for fund managers and fund participants.

In Chapter 2, I will describe the structure and operation or private investment funds, including both partnership and company fund structures, as well as relevant marketing and tax issues. In Chapter 3, I will analyze and critique the adequacy of financial regulation and private law to address the governance challenge. Chapter 4 will identify and examine the effectiveness of recent regulatory changes on both sides of the Atlantic to address concerns related to private investment funds. Next, in Chapter 5, I describe the function of self-regulation in private investment funds and the role of private actors in addressing the governance challenge.

In Chapter 6, 7 and 8, three private monitoring solutions are identified which would enable fund investors to address more directly the problems arising from the governance challenge by facilitating a better flow of information from the fund manager to the investors:

(a) side letters, which provide a particular investor with further information and/or control rights with regard to the operation of the fund;

(b) improving the operation of the board of directors in either corporate-based funds or the general partner vehicle of limited partnership structures through the increased involvement of independent directors; and

(c) listings of private investment funds on securities exchanges as a means of adopting ongoing compliance oversight.

By "private monitoring solutions", I am referring to different means by which to enrol private actors into the internal governance mechanisms of the fund vehicle by establishing a monitoring role, supported where necessary by appropriate changes in the fund documentation, and thereby reinforce the governance processes of the fund vehicle. This monitoring role can either be performed by the fund participant itself, in the case of side letters, or by a designated third party. In the case of independent directors, this role is being performed in connection with the particular fund on which board they sit, while in the case of securities exchanges, this role is being performed for all of the funds that are admitted to listing on that exchange.

Each approach recognizes the commercial contexts in which private investment funds operate by emphasizing voluntary steps that fund managers and investors can take incrementally. Further, each focuses on the provision of information as the means to overcome the investment protection concerns that arise due to the collectivized nature of the private investment fund. Importantly, all three approaches currently feature in the commercial practice of many investment funds, thereby providing an initial confirmation of their viability in implementation.

Finally, in Chapter 9, I conclude this thesis with a critical assessment of the private monitoring solutions, evaluating their effectiveness and discussing issues that arise in their implementation.

1.2 Scope and Choice of Law

In evaluating the private monitoring solutions proposed above, I will address what particular roles need to be fulfilled in order to address the governance challenge and then identify whether, and under what circumstances, prospective fund investors and their agents can perform such roles. Accordingly, I will analyze relevant regulatory provisions to determine the current frontier of the command-and-control control model of regulation in connection with private investment funds.[9] Also, I will survey relevant elements of the private law that impact on the relationships between funds, fund participants and fund managers, and which operate in tandem with regulation.[10] Finally, as this thesis takes a doctrinal and normative approach to these questions, focusing on an analysis of relevant legislation, regulation and case law, the relevant academic literature will also be identified and critically assessed.

In order to draw appropriate conclusions from the analysis herein, it is essential that the scope of inquiry match the actual present state of private funds as they currently exist in practice. The law and regulation applicable to private investment funds and their managers are uniquely linked to their history and current operations. The choice of law covered herein, therefore, is driven by the nature of the legal vehicles for the funds and the location of the fund managers providing advice. For the funds themselves, the legal vehicles chosen are either partnerships created under the laws of Delaware[11] or England and Wales, or limited companies established under the laws of offshore jurisdictions such as the Cayman Islands. As a result, other entities, for which there is a rich academic literature, such as UK companies established under Companies Act 2006, are not used for funds, and therefore such law and commentary are not directly relevant and so are not addressed herein. Important distinctions with the law of such legal vehicles in other jurisdictions will be considered where appropriate. However, the purpose of this thesis is not to provide, for example, a systematic comparison and evaluation of the Cayman Islands company law and the UK Companies Act 2006.[12]

The fund managers are established principally as authorized investment managers in onshore jurisdictions such as the US and the UK. Therefore, this thesis will consider the financial regulatory regimes in these countries as applicable to investment managers and investment advisors who have as their clients unregulated collective investment schemes.[13]

Private investment funds are currently the subject of great debate on a number of fronts, ranging from the appropriate amount of tax that they and their principals should pay to whether the retail investors should be granted more access to these funds (whether directly or indirectly through listed or authorized funds-of-funds). Some would even question their ability to deliver meaningful investment returns on a net-of-fees basis.[14]

Due to the breadth of their activities and significant growth in their sizes over the last decade, it is now difficult, if not impossible, to have detailed discussions or debate about any significant aspect of the financial markets without mentioning hedge funds and private equity funds.[15]

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[9] See Sections 3.3-3.7 below.

[10] See Sections 3.8-3.12 below.

[11] For an interesting discussion of the Delaware law issues surrounding private investment funds established in the US, see JW Vereet, "Dr. Jones and the Raiders of Lost Capital: Hedge Funds Regulation, Part II, a Self-Regulation Proposal," 32 Delaware Journal of Corporate Law 799, 804-805 (2007).

[12] Even where Cayman companies are used, fund structures go to great length to mimic key elements of partnership structure in the constitutional documents. See Section 2.4 below.

[13] See Sections 3.5 and 3.6 below.

[14] See, e.g., David Leonhardt, "Worth A Lot, but are Hedge Funds Worth It;" New York Times (May 23, 2007).

[15] Unfortunately, much of these discussions have been tainted by negative stereotypes and uninformed allegations about what private investment funds actually do. See Daniel Awrey, "The Limits of EU Hedge Fund Regulation;" Law and Financial Markets Review, 5:2 Law and Financial Markets Review 1, 2 (2011) ("It can be difficult to cut through the rhetoric and demagoguery which surrounds the debate over the debate over the regulation of hedge funds, private equity funds and other alternative investment vehicles.").

The focus of this thesis, however, is on the governance challenge present within private investment funds and whether the enrolment of private monitoring solutions can be effectively implemented at the level of fund documentation by agreement between the fund participants and the fund manager. Although the answer to this question is relevant to the other queries raised above, it is distinct from them.

Importantly, as the distinctions between hedge funds and private equity funds have become less obvious over the years, with both investment strategies and investment professionals crossing the frontier between these asset classes, it is more useful to discuss these issues broadly in connection with private investment funds in general.[16] Where relevant, however, differences between these types of funds will be highlighted.

Finally, an observation on the state and scope of the existing literature, as applicable to this thesis, might be useful at this point. The current state academic literature, whether doctrinal or theoretical, concerning hedge funds, private equity funds and other private investment funds is tentative and incomplete. Given the importance of these funds to the functioning of the modern financial markets, this omission should be addressed.

Although practitioners, with access to the confidential, uncirculated documentation related to private funds, have regularly published legal handbooks and practical guides, robust academic assessments have been rare. Much of the past literature has focused on areas where these funds impact other aspects of the financial markets (such as insider trading and takeovers) and consequently complement ongoing scholarship in those areas. But private funds are too important to be ignored. In recent years, overt attempts to alter the regulatory categorization or tax treatment of these funds has attracted academic comment, primarily in the US, but more scholarly attention is warranted.

This thesis takes an important step towards addressing this gap by positioning private investment funds, and the governance challenges faced by their investors, in a wider theoretical framework. By doing so, a rigorous analysis can be engaged in regarding where these funds sit in the regulatory landscape generally and how private actors may use other tools at their disposal to address shortcomings in both their legal structure and documentation, as well as the current regulatory response to them.

1.3 **The Governance Challenge**

By their collective nature, all investment funds (public and private) face potential investor inertia, ignorance and apathy.[17] As a result, a governance challenge that sits at their heart: how can the integrity of a professional relationship (i.e., the investment manager) be

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[16] As Andrew J. Donohue, Director of the SEC's Division of Investment Management has observed, "[a]lthough hedge funds, private equity funds and venture capital funds reflect different approaches to investing, legally they are indistinguishable. They are all pools of investment capital organized to take advantage of various exemptions from registration." Andrew J. Donohue, "Regulating Hedge Funds and Other Private Investment Pools", Speech to 3rd Annual Symposium on the Regulation of Investment Funds (Feb. 19, 2010).

[17] The long-standing approach followed by both in the US and the UK of special supplementary regimes applicable to "investment companies" and "collective investment schemes", respectively, demonstrates that special concerns arise in these funds above and beyond other financial transactions and relationships. See Section 3.4 below.

maintained where the ultimate clients (i.e., the participants in the fund) are distant and dispersed?[18]

The governance challenge in private investment funds exists on the boundary between a fund participant's rights and a fund manager's obligation. As that line necessarily traverses through the internal documentation and operation of the fund vehicles, financial regulators must approach their targets with a focus on how to best support the negotiating position of potential investors in obtaining the governance rights they may believe necessary - e.g., adequate information flows and effective means to directly or indirectly change the fund's course - without fatally undermining the core economic proposition that is being offered by the fund manager.

Investment funds are unique in that they are externally managed. In other words, they are established and operated by individuals and firms whose financial interests, and primary duties of loyalties, lie outside of, and apart from, the legal entity they have just formed. Unlike ordinary businesses established as companies, which possess executive and non-executive directors, as well as officers and employees,[19] the impact of the embedded conflict between fund and fund manager sits behind, and casts a shadow over, all aspects of day-to-day relations between the various parties.[20] The intersection of concerns over the "arms-length" nature of any decisions made in connection with the fund, with the position of trust that any investment manager assumes when he or she invests money on behalf of a client, creates fertile ground for the governance challenge faced by fund participants. These concerns may arise, for example, from approvals of derogations from investment restrictions, waivers for various violations of service agreements, or requests for further information to enable adequate oversight.

A fundamental characteristic of investment management (whether bilateral or collectivized) is its discretionary nature. Managers have wide discretion to invest the assets of their clients, subject to those basic restrictions agreed initially with the client and amended from time to time. Unlike non-discretionary advice provided to the client for him or her to action, an investment manager is typically empowered by the client to implement its decisions without reference back for approval. The investment manager issues buy and sell orders to third parties in relation to the client's portfolio, but typically makes no guarantees about ultimate returns. Losses to the portfolio are to the account of the client, absent claims for breach of either legal (e.g., contractual or tortious), equitable (e.g., fiduciary) or statutory (e.g., regulatory) duties.

As a result, a client's ability to monitor the actions and decision-making process of an investment manager (and thereby make appropriate decisions as to changing or terminating the mandate) is of paramount importance. In the case of investment funds, the participants are one step removed from the relationship with the manager due to the imposition of the

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18 See, e.g., Harry McVea, "Hedge Fund Regulation, Market Discipline and the Hedge Fund Working Group," Capital Markets Law Journal, Vol 4, no. 1, 63 (2008).

19 Of course, the road to the modern corporation, withs its current structure and operation, was a long one with many twists and turns along the way. See, e.g., Henry Hansmann, Reiner Kraakman and Richard Squire, "Law and the Rise of the Firm," 119 Harvard Law Review 1333 (2006). And at each step along that road, the law's recognition of certain entities and relationships was crucial to the next stage of development.

20 See, e.g., David Rosenberg, "Venture Capital Limited Partnerships: A Study in Freedom of Contract; 2002 Columbia Business Law Review 363 ("In a venture capital firm, organized as a limited partnership, the interests of the general parties and the limited parties are not always aligned.").

intermediary vehicle. Adequate monitoring of the investment manager, therefore, becomes fundamentally intertwined with the governance mechanics of the selected legal entity.

This governance challenge is most clearly seen in connection with private investment funds. In the case of public funds, many financial regulators have deemed such governance mechanics insufficient in themselves. Detailed product-level regulations are adopted to provide public monitoring solutions, which ensure that risks associated with conflicts of interest, lack of transparency, and mismanagement are adequately addressed.[21] In the case of private funds, the participants are expected to rely on their own ability to negotiate adequate levels of protection to address those risks.[22] As a consequence of limiting the extent to which private funds may be marketed and establishing particular status and/or size requirement in participants (e.g., investment professionals), the presumption of the regulator is that such investors have adequate negotiating leverage to address any governance concerns that they may have.[23] Absent special contractual terms, such investors will rely instead on the governance mechanisms of the fund vehicle (e.g., limited partnerships, offshore companies).

As noted above, the structure of such funds has been driven by the need to comply and obtain necessary exemptions under the financial regulatory rules, while simultaneously addressing a series of interrelated tax issues arising from various pieces of anti-avoidance legislation adopted over the years. Private investment funds must sail between this 'Scylla and Charybdis' in order to deliver to the parties an effective structural framework for their agreed commercial arrangements.

As a result, after 40 years of accelerating growth, private investment funds look and operate as they do largely in response to the financial regulation and tax requirement imposed on them by relevant onshore governments. The influence of onshore governments should not be downplayed. Onshore tax authorities establish the basis on which certain vehicles will be taxed and others left untaxed.[24] Onshore financial regulators determine who must be authorised and who may be marketed securities and what sorts of investment activities are forbidden.[25] As a result, the onshore governments play a key role in setting the priorities for, and delineating the options available to, the private investment funds.

Governance systems in private funds have evolved to the extent they have in the open space circumscribed by these tax and regulatory concerns. Unfortunately, these two sets of regulatory and fiscal provisions can operate to create a tension within the structure and operation of the fund. Where marketing restrictions on private investment funds attempt to ensure that participants have the standing and sophistication to ensure that their interests are protected, the relevant tax rules in numerous respects undermine this position by, for example, forcing investors to limit their role in a particular structure or mandating that a fund vehicle be operated in an offshore jurisdiction.

Moreover, private investment funds can take one of two legal forms: limited companies or partnerships. The governance challenge has slightly different characteristics depending on which is used. The governance challenge within limited partnerships centres primarily on

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[21] See Section 3.3 below.

[22] As a result, private investment funds are particularly well-suited to be analyzed in the context of alternative theories of regulation that look beyond centralized, top-dollar approaches. See Section 1.9 below.

[23] See Section 2.5 below.

[24] See Sections 2.6 and 2.7 below.

[25] See Sections 1.8, 2.5, 3.5 and 3.6 below.

restrictions imposed on limited partners with regards to involvement in the management of the partnership's business. Secondly, given the rise of limited liability entities serving in the general partners role, legitimate questions can be asked about how effectively the directors of such vehicles can simultaneously fulfil their own obligations to the general partner vehicle and that vehicles obligations to its fellow partners in the partnership.

The governance challenge within offshore limited companies centres primarily on the role that directors fulfil as an oversight mechanism on the actions and inactions of the fund manager. The directors are responsible for the management of the company, but delegate the bulk of that responsibility to the fund manager, retaining only a limited role of monitoring and evaluation. Although only a small role, it is essential to participants in a private investment fund that the individuals selected as directors have the past experience and current knowledge and information to fulfill the duties they owe to the company and its shareholders.

Often, private investment funds fail because their managers make poor investment decisions. However, many funds fall victim to frauds perpetrated by individuals within the fund manager. Recent cases of malfeasance that have arisen in the context of private investment funds include the making of false statements regarding a funds' investment objections and/or performance, misstatements concerning the risks of the fund, defective valuation practices and other issues concerning how the fund manager operates the fund.[26] Improved corporate governance can be seen as one way in which these incidents could have been either prevented or detected at an earlier stage.

Concerns over the governance challenge in private investment funds have an antecedent in earlier concerns raised over the standard of corporate governance in listed companies. The definition of corporate governance originally adopted in the Cadbury Report in 1992 is instructive when contemplating the governance challenge faced by investors in private funds:

> Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in the governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in the general meeting.[27]

Importantly, the governance challenge can be even greater in a private investment fund than in a typical company. An equity-holder in a vehicle typically has a collection of governance rights that allow it to participate in certain fundamental decisions that the vehicle undertakes. Supplementing this direct decision-making role is frequently the ability to select and replace

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[26] See Section 3.6 below.

[27] The Report of the Committee on the Financial Aspects of Corporate Governance (the 'Cadbury Report') at para 2.5 (1 December 1992). For a discussion of the genesis of the Cadbury reforms, see Paul L Davies, "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" (2001), available at http://ssrn.com/abstract=262959 ("As is often the case with company law reform, the Cadbury Committee was appointed as a result of a scandal, in this case the sudden descent into insolvency of major companies which had only recently issued annual financial statements which revealed nothing of the horror to come. However, the Committee concluded that the causes of these problems were not to be found in the narrow area of accounts and auditing, though it gave attention to the role of auditors, but reflected more widespread defects in the governance systems if large British companies."). In the aftermath of the recent financial crisis, it is correct to examine the governance of private funds with the same intensity.

those agents (e.g. directors, general partners) who are charged with making the remaining key decisions for the vehicle.[28] As private investment funds traditionally deny their participants these rights,[29] the position of an investor in such fund can be for most practical purposes not that of a true equity-holder, but rather no more than a glorified creditor awaiting payment of monies owed when due.[30]

1.4 **Corporate Governance**

The governance challenge in private investment funds can be seen as a need to improve the standard of corporate governance[31] in the legal vehicles that comprise them. Although traditional publicly-listed corporate vehicles differ in many respects from alternate business associations, like limited partnerships (and also in a few material respects from privately-held offshore companies), governance concerns exist in common across all of them. Differences in legal documentation and statutory requirements, however, must be acknowledged and reflected in the manner in which solutions to such governance issues are structured and implemented.

As discussed above, corporate governance refers to the manner in which transparency and accountability is effectuated within the management of a company.[32] Standards in this area can be found in case law and statutes, as well as contractually in the company's organizational documents,[33] and also from non-legal sources, such as specialist committees appointed by governments or financial regulators to promote the development and adoption of best practices.

For traditional operating companies, corporate governance practice has been driven in the UK by the UK Code on Corporate Governance, issued by the Financial Reporting Council,[34] and in the US by the Public Company Accounting Reform and Investor Protections Act of 2002, commonly known as the Sarbanes-Oxley Act. Over time, certain corporate governance mechanisms have been specifically encouraged by regulatory intervention over other mechanisms, although it is unclear whether the most effective mechanisms have consistently

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28 For a discussion of the structure and operation of boards of directors, see Tamar Frankel, "Corporate Boards of Directors: Advisors or Supervisors?," 7 University of Cincinnati Law Review 501 (2009).

29 See Chapter 2 below.

30 During 2008, as a result of the "credit crunch" and associated market volatility, the "limited recourse" position of private fund investors was demonstrated repeatedly. For example, investors in numerous hedge funds received various one-sided restructuring proposals, often being presented on a "take it or leave it" basis, backed up by the threat of indefinite suspensions of redemptions if the restructuring does not occur, has revealed the weak position that fund investors frequently find themselves in when the governance challenge they face is fully revealed to them.

31 For an introduction to corporate governance in the context of traditional limited companies, see Henry B Hansmann and Reiner Kraakman, "The Basic Governance Structure" (ch), in Reiner Kraakman et al, The Anatomy of Corporate Law: A Comparative and Functional Approach (Oxford 2009); and Paul R Davies, Gowers and Davies' Principles of Modern Company Law (Chapter 14) (Sweet & Maxwell 2003).

32 See, e.g., Andrei Shleifer and Robert W Vishny, "A Survey of Corporate Governance," 52 Journal of Finance 737 (1997); David A Skeel Jr, "Governance in Ruins," 122 Harvard Law Review 588 (2004).

33 An important source of corporate governance is the contractual agreement between the members of the company by way of either the constitutional documents themselves or appropriate resolutions of the board of directors. As a result, shareholders and their appointed directors who have a desire to improve the standard of corporate governance within their company have adequate means to implement such ideas, at least in smaller companies.

34 Pursuant to Section 9.8.6 (5) of the Listing Rules, a UK listed company must make a statement in its annual report detailing how it has implemented the principles of the Combined Code.

received this preferred treatment.[35] For private investment funds, specifically, and offshore companies, generally, corporate governance has not been a prominent topic of discussion or reform.[36] Importantly, the doctrinal literature has identified aspects of "corporate governance" as they apply to entities other than traditional operating companies.[37] Unfortunately, however, there has been no critical legal assessment of governance structures specifically in the context of private investment funds. Although private fund partnership agreements have been credited by commentators with reducing agency costs[38] between the parties,[39] the effectiveness of these provisions is now being questioned.[40] Due to the limited rights that fund participants have to intervene in the investment process and challenge the decisions made by fund managers, agency problems may develop,[41] with fund managers pursuing their own self-interest instead of the interest of fund participants. Fund documentation, as currently drafted, provide only limited solutions to these problems, such as the use of incentive compensation to align the interests of fund managers with fund participants.[42]

The question of governance and private investment funds, when it does arise in academic literature, has predominately been focused on the manner in which hedge funds and private equity funds impact on the corporate governance of the portfolio companies in which they invest.[43] Little attention has been paid to date on the internal arrangements of these vehicles. Private funds embody an agency relationship where the agent (fund manager) has the discretion to make decisions that directly impact their principals' property (fund investors).[44] As a result divergent interests can develop between these parties. For example, a fund manager may decide to allocate an investment opportunity to another client who has contracted to pay higher fees than the fund, or the fund manager may withhold important information from the fund participants about the value of certain securities held by the fund (i.e., information asymmetry).[45] In the rich literature involving agency issues within corporate entities, academic commentators have championed the use of private contractual solutions to mitigate against agency costs.[46] Improving the legal documentation of private funds to enable more effective

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35 See, e.g., Jonathan Macey, Corporate Governance: Promises Kept, Promises Broken (Princeton 2008).

36 See Chapter 4 below.

37 See, e.g., Larry Ribstein, "Partnership Governance of Large Firms", 76 University of Chicago Law Review 289 (2009).

38 Agency costs refer to the costs incurred by a party in a principal-agency relationship to overcome the risks and expenses that arise from the principal's use of an agent.

39 See, e.g., Robert C. Illig, "The Promise of Hedge Fund Governance: How Incentive Compensation can Enhance Institutional Investors Monitoring," 60 Alabama Law Review 4 (2008).

40 See, e.g., Lee Harris, "A Critical Theory of Private Equity", 35 Delaware Journal of Corporate Law 259 (2010); Robert P. Barlett, III, "Venture Capital Agency Costs and the False Dichotomy of the Corporation", 54 UCLA Law Review 37 (2006).

41 See Section 1.5 below.

42 See Sections 2.4 below.

43 See, e.g., Ronald W. Masulis and Randall S. Thomas, "Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance," 76 University of Chicago Law Review 219 (2009).

44 See Section 1.6 below.

45 Given the current approach of regulating managers, and leaving private investment funds outside the reach of regulators, some regulatory measures can be imposed on the manager directly to address these concerns. See Sections 3.5 and 3.6 below.

46 See, e.g., Brian R. Cheffin, Company Law: Theory, Structure and Operation (1997); Ann E. Conaway, "Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law," 33 Delaware Journal of Corporate Law 789 (2008).

monitoring and enforcement by the fund participants themselves can be a solution to the problems identified herein, supplementing public enforcement mechanisms already in place.

Applying a traditional corporate governance analytical framework to private investment funds could begin by distinguishing between three functions in regards to each particular party:

(a) does the party have an interest in the fund?

(b) does the party have power over the fund?

(c) is the party empowered to act with respect to it?[47]

Similar to the positions of "owner" and "manager" in a traditional enterprise, the fund participant and the fund manager may be distinguished in part by their levels of activity, with fund participant typically remaining quiescent, while the fund manager take the active role. As a result, the same dichotomy of "owners without applicable control and the control without appreciable ownership"[48] emerges. Traditionally, parties to private investment funds have focused on aligning the interest of the fund participants and the fund manager by way of economic incentives. However, checks on the use (or misuse) of power may be established by other means, including political or social conditions.[49] Where the interests of control (i.e. fund manager) are opposed to the interest of ownership (i.e. fund participants), the owners are at risk.

1.5 Companies and Partnerships

As one commentator has observed:

> [D]efects in investor decision-making and information deficiencies, which can deter investors and damage the wider reputation of market investment, can also be countered through intermediation in the form of collective investment.[50]

Collective investments thus enable investors to access greater expertise and experience in making investment decisions. However, the legal vehicles that facilitate collectivization also bring with them their own additional governance concerns. As noted above, subtle distinctions in governance can be identified and evaluated when considering partnership-based private investment funds (Partnership PIFs) and company-based private investment funds (Company PIFs).

In a corporation, the law itself prescribes the creation of a management structure from which ownership and control are separate, with directors and officers of the corporation assigned specific roles to play.[51] In a partnership, a similar allocation is present in the distinction created between general partner and limited partners. The role of corporate law and partnership law is to establish a set of default provisions that parties can subsequently agree to alter and amend

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47 Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property (1932) at 112.

48 Ibid. at 113.

49 Ibid. at 114. These can include mechanisms in fund documents to temporarily remove control from the fund manager and place it in the hands of a third party, or to suspend investments by the fund for a certain period of time, which would be recognized by market counterparties as an indication that the fund manager has been sanctioned.

50 Niamh Moloney, EC Securities Regulation, (Oxford 2008) at 233.

51 Ibid. at 207.

to best fit the terms on which they wish to operate together.[52] As such, the "fill in the blank" function leaves adequate room for the contracting parties (fund participants and fund manager) to adapt aspects of these legal vehicles, such as their management structures and balance between ownership and control, to best suit their interests.[53]

Close (i.e., non-public) corporations, like partnerships, have much less separation between management and risk bearing than their public-listed kindred.[54] As a result, although informative, the existing literature on corporate governance in public companies would have only limited applicability to legal vehicles being used as private investment funds.[55] A better analogy to close companies, particularly in the context of private investments, would be limited partnerships. Many of the core economic terms of private funds, which originally grew out partnership structures, have migrated to corporate structures.[56] Although there may be limitations to this analogy if pushed to the extreme,[57] comparisons can be useful.

One key difference is that corporations have formal boards of directors, which are subject under the applicable companies law to specific rules about their composition, operation and responsibilities.[58] Partnerships, by contrast, can establish boards to perform an advisory function, but there is no requirement that they do so.[59] Another notable difference is that whilst many corporate statutes limit the ability to waive the fiduciary duties of loyalty and good faith, limited partnership statutes in the same jurisdiction may permit both to be significantly restricted or waived.[60] So despite a number of practical advantages that partnership have over corporations,[61] the use of limited partnerships as private fund vehicles is not without governance issues. For example, in Partnership PIFs, limited partnership law in both Delaware and England and Wales prevents the limited partners from participating in the

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52 See, e.g., Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (1991) ("[C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.").

53 Ibid. ("Corporate law – and in particular the fiduciary principle enforced by the courts – fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance. On this view corporate law supplements but never displaces actual bargains.").

54 Ibid. at 55. See also Ronald J Gilson and Reiner Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors," 43 Stanford Law Review 863 at 873 (1991) ("In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors in particular.").

55 Easterbrook and Fischel at 228 ("Risk bearing and management are separated in public but not in closely held corporations. The extent of this separation determines the governance mechanisms and legal rules that evolved in the two types of firms").

56 See, for example, the concept of equalization. See Section 2.4 below.

57 See Easterbrook and Fischel at 249-250.

58 See also Davies at 3 ("What was the corporate governance problem which Cadbury sought to address? Although it identified a number of problems, the central one might be thought to have been the domination of companies, not just by top management, but by a single over powerful managing director or chief executive officer (CEO).").

59 See Ribstein, "Partnership Governance" at 293-294.

60 Ibid. at 296-297. Contrast, for example, the approach in Delaware for corporations (Del Gen Corp Law Section 102(b)(7)) with its more liberal stance for partnerships (Del Code Annotated Section 17-1101(d)). See also Larry G. Ribstein, "The Uncorporation and Corporate Indeterminacy", 2009 University of Illinois Law Review 131, 144-45 (2009).

61 For a detailed comparison of corporations and partnerships, and the legal, regulatory and fax features of each, see Larry C. Ribstein, "The Uncorporations Domain", 55 Villanova Law Review 125 (2010).

decision-making process of the general partner. The consequence of stepping over this line is severe: the partner would risk losing his or her limited liability.[62] However, there still remains an ability to consult with and advise the general partner with respect to the partnerships business. As a result, Partnership PIFs can operate “advisory boards” which may serve as mechanisms for granting waivers and consents, upon the request of a general partner.

Unfortunately, the spectre of unlimited liability, which would make parties liable for the amount of any debts in excess of the fund assets, can still impede many fund investors from more active engagement in the governance of Partnership PIFs. These investors may find comfort in the reputational risk that the fund manager faces should current and prospective investors determine that they abused their discretion in pursuit of their own interest.[63] As a result, some fund investors may categorically decline to involve themselves in governance activities.

The private monitoring solutions proposed herein will therefore contemplate only the partial participation of fund investors, and not require that they act in concert or are required to reach unanimous decisions. These private monitoring solutions will provide for increased monitoring and enforcement mechanisms involving some fund participants who wish to address the governance challenge in the activities and decision making process of the fund manager prior to the discovery that bad acts have occurred. It is notable that there have been very few litigated disputes between fund managers and participants, outside of the hedge fund sector.[64] And where there have been litigation in hedge funds after the uncovering of bad acts, damages recovered have been small and inadequate.[65]

Further, these private monitoring solutions should be viewed as supplementing both the economic alignment of interest embedded in the profit sharing arrangements in private funds,[66] whether established as Partnership PIFs or Company PIFs, and the top-down regulation that emanates from financial regulators such as the SEC and the FSA.[67] In terms of agency cost, there are traditionally two methods that such costs can be reduced: (i) more directly aligning the interests of the agent with the principal, and/or (ii) appointing a monitor to oversee and discipline the agent.[68] Economic alignments are an example of the former, and top-down regulation is an example of the latter. In this context, the private monitoring solutions can be viewed as a further attempt to fulfil the monitor role, either by enlisting one or more fund investors, or independent directors or a third-party securities exchange.

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62 See Section 2.5.

63 See, e.g., Harris, “Critical Theory” at 288. In addition, fund investors may decline to intervene in governance mechanisms due to parallel concern about their own reputation among other fund managers in the market. To the extent that such investors is deemed “difficult” or “troublesome”, their opportunities to invest in other private funds may no longer be available to them.

64 Harris, “Critical Theory” at 293.

65 See Section 3.4.

66 For very favorable view of such economic incentives, see Illig, “Promise” at 76 (“The combination of a carried interest, coupled with a hurdle rate and direct equity stake held by managers, creates a clearly superior alignment of interests”) and Ribstein, “Partnership Governance” at 299 (“Managers’ investment incentives provided by pooling of ex ante passive investments and market scrutiny of individual deals through ex post debt financing reduce limited parties need to vote on or seek judicial review of the fund’s investments”).

67 See Sections 3.5 and 3.6.

68 See, e.g., Illig, “Promise” at 88.

1.6 **Fund Manager as Agent of the Fund**

The relationship between a fund and its fund manager is, among other things, an agency relationship.[69] The fund, as principal, delegates decision-making power to the fund manager, an agent.[70] Due to the risk that the interests of the parties may diverge, costs will be incurred by both parties to limit any such divergences. In the case of funds, the principal is itself a legal entity with its own matrix of agency relationships. As a result, the fund's agent (the fund manager) will have a distinct advantage in its transactions with its principal due to its more substantive existence. A fund manager will typically possess actual professional and administrative staff, which the fund will lack. A fund manager would also possess infrastructure, such as permanent office space and informational technology resources, that the fund will lack. Finally, the fund manager will both pre-exist and ultimately service the fund, in almost all cases. As one commentator has observed:

> A range of risks is generated relating to the agency costs which arise between investors in the fund and its managers and promoters who cannot easily be monitored by unsophisticated investors. Classic occasions for abuse, often reflecting conflict of interests, including the extraction of benefits through excessive costs and abusive trading practices, incompetence in fund management, and fraudulent diversion of assets from the fund...[71]

In the case of private funds, the principal will both be very dependent on its agent, and also potentially face significant procedural impediments and inefficiencies in conducting the corporate actions necessary to oversee and monitor the agent.[72] As has been observed by commentators:

> Agency problems arise because contracts are not costlessly written and enforced. Agency costs include the costs of structuring, monitoring and abiding by a set of contracts among agent with conflicting interests . . . Control of agency problems in the decision process is important when the decision makers who initiate and implement important decisions are not the major

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69 See Harris, "Critical Theory", at 5 ("The consequences of divergent interests are present in any agency relationship where the agent has discretionary power to affect the interest or property of the principles.").

70 See Verret, "Dr. Jones" at 816 ("The relationship between an investor and the investment adviser who manages the investor's money is essentially the same principal/agent relationship that underlies most all of corporate and financial law. The investor, as principal, contracts with the investment advisor, as agent, to manage the assets of the investor diligently for a specified fee or a specified percentage of the amount by which the adviser can make the investment grow.").

71 Moloney, EC Securities Regulation at 234. For examples of such "classic occasions for abuse," see Section 3.7 below.

72 See John Armour, Henry Hansmann and Reiner Kraakman, "What is Corporate Law" (ch), in Reiner Kraakman et al, The Anatomy of Corporate Law: A Comparative and Functional Approach (Oxford 2009) at 4 ("Indeed, much of corporate law can be usefully understood as responding to the three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies, including creditors and employees. All three of these generic conflicts may be characterized as what economists call 'agency problems.'").

> residual claimants and therefore do not bear a major share of the wealth effects of their decisions.[73]

Under the transaction cost theory,[74] a firm will adopt a governance structure that aligns with transaction-specific characteristics to reduce transaction costs and increase investment returns.[75] Governance, therefore, can be seen as an alternative to top-down regulation[76] to reduce agency costs that result from the appointment of managers, to whom investors delegate decision-making power, by means of proper alignment of incentives.[77]

When the separation of "ownership" and "control"[78] in a business organization is discussed, the focus is typically on those circumstances where important decision makers do not bear a substantial share of the ultimate effects of the decisions they make.[79] What is meant by "control" in the context of Company PIFs and Partnerships PIFs? In its simplest phrasing, control of an entity could mean the power to determine the business strategy of the entity and the necessary steps to achieve such strategy.[80] In a traditional company, control is vested with the board of directors[81] and then some, but not all, of this authority is delegated to officers.[82] In a private investment fund, such delegation is made by the board (or by the general partner of a partnership) to the fund manager. "Control" can be distinguished from "voice," an equally important concept when looking at governance issues. Voice refers to situations where

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73 Eugene Fama and Michael Jensen, "Separation of Ownership and Control", 26 Journal of Law & Economics 301 (1983) at 304.

74 See John Armour and Michael Whincop, "An Economic Analysis of Shared Property in Partnership and Close Corporation Law," 26 Journal of Corporation Law 983, 988 (2001) ("By characterizing organizations as contracts, which are costly to form and perform, economic analysis can justify legal rules to the extent that they reduce transaction costs. Law can reduce transaction costs by emulating those provisions that the parties might themselves contract for.").

75 Houman B. Shadab, "The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection," 6 Berkeley Business Law Journal 1, 32-33 (2009) .

76 See Verret, "Dr. Jones" at 816. ("Government regulation is one answer to remedy the ineffectiveness of agency models in which the cost/benefit combination of bonding, performance incentives, and asymmetries leads to aberrant agent behavior and high social losses."). See Section 1.9 below.

77 Ibid. ("Unlike public corporations, ownership and management in a hedge fund are not fundamentally separated. Hedge fund managers are typically substantial investors in the underlying funds that they advise."). The same can be said of other types of private investment funds, such as private equity funds.

78 See William W. Bratton, "Private Equity's Three Lessons for Agency Theory," 3 Brooklyn Journal of Corporate Finance and Commercial Law 1, 1 (2008) ("Agency theory posits that separation of ownership and control opens up a governance deficit.").

79 See, e.g.,Fama and Jensen.

80 See Cheffin at 44.

81 See Armour, Hansmann and Kraakman at 13 ("[C]orporate law typically vests principal authority over corporate affairs in a board of directors or similar committee that is periodically elected, exclusively or primarily, by the firm's shareholders. More specifically, business corporations are distinguished by a governance structure in which all but the most fundamental decisions are delegated to a board of directors...").

82 See Ibid. at 18 ("The relationships among the participants in a corporation are, to an important degree, contractual. The principal contract that binds them is the corporation's charter... The charter sets out the basic terms of the relationship among the firm's shareholders, and between the shareholders and the firm's directors and managers."). See also Frank H Easterbrook and Daniel R Fischel, "The Corporate Contract," 89 Columbia Law Review 1416, 1418 (1989) ("[T]he corporate structure is a set of contracts through which managers and certain other participants exercise a great deal of discretion that is 'reviewed' by other self-interested actors.").

investors have only relatively small stakes, but are able to combine them in order to wield a meaningful influence over the management of the entity.[83]

The decision making process itself can be broken down into two different elements:

(a) decision management, which covers initiation and implementation of decisions, and

(b) decision control, which covers ratification and monitoring of decisions.[84]

In private investment funds, decision management resides with the fund manager, who takes investment decisions on his own initiative. The question then becomes to what extent can decision control reside with fund participants and to what extent they have a voice in connection with such decisions, either before or after they are made.

1.7 **Consequences of Governance Failures**

In recent years, reports of fraud and other malfeasances involving private investment funds (especially hedge funds) have become increasingly common.[85] Underlying these incidents is the fundamental question of whether more effective governance mechanisms within the fund would have served to better protect investors over time.

An already eventful 2008 ended with the arrest of Bernard Madoff, and concurrent regulatory and criminal actions instigated against his firm, Bernard L Madoff Investment Securities, in connection with what is generally reported as perhaps the largest investment fraud in history, rumoured to be in an amount of up to $50 billion.[86] Although various investigations on the Madoff affair remain underway, the case provides a useful meter stick against which these concerns about the governance challenge in private investment funds - e.g., lack of adequate information about the nature and operation of the fund's activities and an inability to effect change in those activities going forward (either directly or indirectly through duly appointed agents) - can be analyzed and improved.

At a time such as this, when "increased regulation" is a high priority for financial market reformers who wish to prevent fraud on investors,[87] the SEC has admitted that it has received numerous reports of concern about Madoff and his firm, yet despite such warnings, failed to take necessary action. Any claims that further rules and regulations can in themselves serve an adequate deterrent to the repeat of such incidents must be thoroughly reflected upon in light of the systemic failure of SEC personnel to take heed of any one of the early indicators it received of Madoff's pyramid scheme.

Although well-reported and discussed in the mainstream and financial press, the Madoff affair is not the only case of fraud or malfeasance in the private investment funds arena that has unfolded recently. The SEC and other international regulators have in recent years pursued a growing number of enforcement actions against hedge funds that involved theft of assets,

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[83] See, e.g., Robert C. Illig, "What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight," 57 American University Law Review, 225, 234 (2007).

[84] Ibid. at 321.

[85] See Sections 3.7 and 3.12 below.

[86] See Section 3.2 below.

[87] See section 4.1 below.

fraudulent violations of securities held by the fund and false information provided to investors.[88] Civil lawsuits by investors are also becoming a recurring feature in US courts, and include claims involving misrepresentations of performance, misleading disclosures and improper valuations.[89] A brief survey of recent hedge funds cases in the US can serve to illustrate the scope of potential issues which effective governance must address in the private investment funds area. Importantly, neither the private equity industry nor the UK hedge fund sector has been immune to such incidents.[90]

However, the global reach of the Madoff affair is staggering, both in terms of the amounts of money at issue and the breadth of individuals and institutions involved. The question of whether effective multi-national coordination of financial regulators is possible is left unanswered here. Nonetheless, the absence of any substantive role by the SEC or its sister regulatory organizations in either the prevention or detection of the Madoff scheme serves as an unfortunate reminder of the practical limitations of imposed regulation.

The consequences of fraud and malfeasance on private fund investors can be severe, especially where fund participants are individuals.[91] The global financial markets have seen a dramatic increase in complexity in the past few decades.[92] Private funds have both driven that trend and been directly impacted by the complexity they have helped create. As commentators have observed:

> Among the many leitmotifs of the financial crisis is the failure of lawyers as regulators and gatekeepers . . . The Madoff Ponzi scheme personifies the "new" new era of economic catastrophe . . . Importantly, the scandal provides the best documented episode and case study of how lawyers and the SEC, a principal financial market regulatory agency operates mostly by lawyers, failed to understand the market they regulate and the nonlegal complexities surrounding their work.[93]

In light of the recent financial turmoil, traditional corporate governance models are being questioned anew.[94] After decades of debating the effectiveness and ineffectiveness of corporate governance mechanisms for listed companies,[95] it is timely and appropriate to now begin considering these questions in the context of private funds. Historically, top down

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88 See Section 3.7 below.

89 See Section 3.12 below.

90 See Section 3.3.

91 For a discussion of the "victim impact statements" filed in connection with the Madoff prosecution, see Felicia Smith, "Madoff Ponzi Scheme Exposes 'The Myth of the Sophisticated Investor'", 2010 Baltimore LR 215 at 234-235.

92 See Robert J. Rhee, "The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers," 35 The Journal of Corporation Law 101 ("In the past several decades, the financial markets have seen geometric growth in complexity. The junk bond market matured in the 1980s, the derivatives market saw explosive growth in the 1990s, and the new century witnessed the evolution of ever more exotic derivatives and financial instruments that directly connected Main Street to Wall Street."). Ibid. at 102.

93 Ibid. at 104.

94 Jill E. Fisch, "The Overstated Promise of Corporate Governance," 77 University of Chicago Law Review 923, 923 (2010) ("Corporate governance is in trouble.").

95 See, e.g.,John C. Coffee, Jr., "What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis", 9 Journal of Corp Legal Studies 1 (2009).

financial regulation of private funds have necessarily ignored their governance mechanisms and focused instead on those aspects of their operation (e.g., marketing to investors) which is easiest for them to regulate.[96] Both the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the Alternative Investment Fund Managers Directive (AIFMD), unfortunately, continues this trend.[97] The private monitoring solutions proposed above will instead focus on private solutions which can supplement these government-sponsored extensions of regulatory responsibility.

1.8 Legal and Regulatory Duties of the Investment Manager

A meaningful analysis of the manner in which the governance mechanism of private funds can be improved must include an understanding of the legal and regulatory obligations imposed upon the fund manager in the context of the services that it provides to the fund. Despite their reputation as being 'unregulated', numerous legal and regulatory issues arise in the structuring and operations of private investment funds, touching on a variety of substantive legal disciplines, in addition to a number of potentially relevant foreign jurisdictions.[98] To understand the legal and regulatory environment in which these funds operate, the larger policy concerns that resulted in the particular exemptions of which they are attempting to avail themselves must be identified and analysed.

Generally, those individuals and investment firms who launch private investment funds will attempt to minimize the extent of their regulation.[99] In the UK, this means they will not seek authorization for their funds, which would curtail their freedom of investment. Consequently, they will restrict their marketing efforts to certain permitted categories of institutions and individuals.[100] In the US, exemptions will be secured under the Securities Act of 1933 (the Securities Act), the Securities Exchange Act of 1934 (the Securities Exchange Act), the Investment Company Act of 1940 (the Investment Company Act), and the Investment Advisers Act of 1940 (the Investment Advisers Act). These exemptions are provided to address circumstances where regulation has been deemed unnecessary, either because of the sophistication of the individuals involved or because of the limited scope of activities conducted.[101] As a result of 'opting out' of the regulatory regime imposed on public funds, the extent to which private investment funds provide for investor protection concerns varies greatly from structure to structure. The question of the governance challenge that exists at the heart of all collective investment funds must be answered, therefore, in terms of the legal remedies that are found outside the product regulation regimes that have been established for mutual funds and other retail investment products.[102]

The relationship between an investment manager and his client differs in several important respects from the relationships between most other participants in the financial markets. As a

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96 See Section 2.5 below.

97 See Chapter 4 below.

98 See Sections 2.5, 3.5 and 3.6 below.

99 Dale Oesterle, "Regulating Hedge Funds," 1 Entrepreneurial Business Law Journal 1, 2 (2006) ("A hedge fund in the United States is defined by its niche in our federal securities acts. This is not randomly related to the flourishing of hedge fund industry. Hedge funds owe a substantial degree of their success to their freedom from federal regulations on their formation, organization and trading practices."). Similar observations have been made about other types of private investment funds as well.

100 See Section 2.5 below.

101 Ibid.

102 See Sections 2.3, 2.4 and 3.8-3.11 below.

result, the legal rights and duties of an investment manager also differ from that of other service providers.[103] Where many counterparties to a financial contract will have only an obligation to perform their contractual duties (e.g., delivering of a security, exchange of payments),[104] an investment manager will owe to his client both (i) a common law duty of care in tort,[105] and (ii) fiduciary duties.[106] An investment manager with discretion to implement its own recommendations for its client's investment portfolio owes a particular duty of care to such client.[107] A fiduciary duty of loyalty is also owed to the client, in addition to the duty of care, which provides a means to protect a client against conflicts of interest on the part of the investment manager, both as regards the investment manager's own interests and the interests of other clients. This fiduciary duty exists alongside a growing array of regulatory measures addressing conflict management in the modern financial services firm.[108]

Where an investment vehicle intermediates the relationship between the investment manager and the client(s), the analysis becomes more multifaceted and nuanced. To the extent that an investment manager contracts to provide services with respect to the assets of the participants in those vehicles, he will possess similar degrees of control and discretion over such assets as would be typically seen in bilateral client relationship. In case of a Company PIF, or a company is used as the general partner vehicle for a Partnership PIF, the directors of such a company will owe fiduciary duties to the company.[109] Such duties will directly affect the manager in which the board oversees the ongoing relationship between the fund and the fund manager.

The reality of fund managers who may be "judgement proof" with few assets available to fulfill successful damages actions against them, as well as the plethora of various fund management entities and multiple fund vehicles that can be involved in fund structures of substantial size (as is the case with the Madoff scheme), raises the legitimate question of who can fund participants look to for recourse when fraud or malfeasance is uncovered. Unfortunately, by this time often it will be too late. As discussed in Chapter 3, private law remedies and regulatory actions[110] that occur "after the fact" may provide investors with only a fraction of their original investment.

Proactive steps, therefore, should be taken to ensure that investors fully understand the current status and prospects of their fund, and are empowered to intervene effectively should

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103 See Sections 3.9-3.11 below.

104 See Section 3.11 below.

105 See Section 3.9 below.

106 See Section 3.10 below. The nature of this relationship can be seen as analogous in many key respects to that of professional advisors, such as lawyers and accountants, where an element of trust and dependence sits at the core of the interactions. Concepts of agency law frame this discourse, especially in the context of the broad discretion frequently exercised by the investment manager. See Section 1.6 above.

107 Pursuant to an investment management agreement, the client will typically confer on the investment manager the discretion to buy and sell the client's assets at such prices and in such amounts as the investment manager will determine to be in the best interests of the client. Such discretions can serve as the basis for the relationship of 'trust and confidence' required of a fiduciary. See Section 2.2 below.

108 See Sections 3.5 and 3.6 below.

109 See Section 2.4 below.

110 One central purpose of financial services regulation is to ensure that there are adequate levels of investor protection present in the financial market. Unsurprisingly, certain rules and guidance address behaviors and impose obligations in terms similar in practice to professional negligence and fiduciary duties. Accordingly, valid questions have been asked about how duties arising at general law (including fiduciary duties derived from equity) interact with regulatory obligations arising under statute. See Section 3.3 below.

the need arise. Addressing the governance challenge through private monitoring solutions, by implementing direct changes to the documentation and operation of the fund, can provide a more reliable means of protecting private fund investors from the risks they necessarily face, than relying on top-down “command-and-control” regulation by the state.

1.9 Alternatives to Centralized, Top-Down Regulation

One potential approach that could be taken to improve the governance mechanisms of private investment funds would be mandate particular governance structures by law or regulation.[111] However, to date legislators and regulators have consistently refused to take meaningful steps in that direction. As a result, private actors must consider steps they can take themselves to address these concerns.

In recent years, there has been an increase in the amount of financial services regulation in connection with the investment management industry, most recently seen with the adoption of the Dodd-Frank in the United States and the AIFMD in the EU.[112] However, centralized top-down regulation is only one aspect of a larger framework of relationships that provide the regulatory process for investment managers and their clients.[113] Interested parties, other than a national regulator, can become involved in, and contribute to, this process.

In the case of private investment funds, these parties may include the prospective and current fund investors themselves, either on a case-by-case basis or acting in a more coordinated and long-term basis. By enrolling these interested parties in the regulatory process, the national financial regulators would be better equipped to achieve their goals, especially in light of the primary factors limiting their success: namely, limited budgets, limited personnel and limited expertise.

This thesis will identify and critique the effectiveness and legitimacy of the different approaches (i.e., private monitoring solutions) that prospective and current fund investors can take to perform this role.[114] Knowledge and power within the financial services regulatory system is fragmented. The choice between state regulation and self-regulation is not “either/or”.[115] Under the command-and-control model, a set of legal rules is enforced by a government regulator using a variety of sanctions. This approach can be complimented by non-legal norms, such as non-binding guidance issued by the regulator on a general or ad hoc basis.

Traditionally, private investment funds have existed along the fringes of the command-and-control approach.[116] The limitations of command-and-control regulation and the growing complexity of the financial services industry have provided these funds with wide scope to operate. Recently, however, regulators in the United States and Europe have attempted to expand their reach to include either the fund managers or the fund themselves (or both).[117] Whether top-down regulation on its own will be adequate is unclear.

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111 This is the approach followed in the case of public investment funds. See Section 3.4 below.

112 See Chapter 4 below.

113 Julia Black, “Mapping the Contours of Contemporary Financial Services Regulation”, Journal of Corporate Legal Studies (Dec 2002).

114 See Chapters 6, 7 and 8 below.

115 Black, “Mapping” at 256.

116 See Section 2.5 below.

117 See Chapter 4 below.

Although formalized self-regulatory systems have not evolved around private investment funds, the potential for "stakeholder-led" self-regulation, by the fund investors themselves, to address regulatory concerns is also a potential solution.[118] Empowering fund investors to implement improved governance structures in the funds in which they invest could therefore be a means to this end. This thesis will also evaluate how the use of private monitoring solutions to address the governance challenge would support the pursuit of these regulatory goals. In particular, private actors can possess regulatory capacities which could complement those of public regulators.

Regulatory capacity has been described as "the actual or potential possession of resources plus the existence of actual or potential conditions that make it likely that those resources will be deployed . . . in such a way as to further the identified goals of the regulatory system . . ."[119] Those resources would include:[120] informal, expertise, financial and economic resources, authority and legitimacy, strategic position, and organizational capacity.

The regulatory regimes in both the UK and the US which excuse private investment funds from substantive regulation operate on the presumption that the select group of investors who are permitted to participate in these funds have some or all of the above traits.[121] Therefore, it is worthwhile to explore the extent to which fund investors who possess some or all of these resources can contribute to the hybrid regulatory process.[122] Importantly, different fund investors may possess different combinations of these resources, and therefore their contribution to the regulatory function may vary over time or with regard to different types of funds. This is particular so, given that in both the US and the UK, retail investors are precluded from participating in private investment funds.[123] Institutional investors and sophisticated individuals could play a meaningful role in the attainment of regulatory goals, particularly in relation to the governance challenge, and the private monitoring solutions proposed herein look to them to be enrolled in the monitoring process. A statute-based regulator, such as the SEC or the FSA, benefits from legal authority and legal legitimacy, as well as other benefits deriving from its strategic position as the authority which provides for registration and licensing of regulated forms.[124] Other participants, however, may have perceived authority and legitimacy, based on technical expertise, prior experience and/or relevant knowledge, which would enable them to perform a regulatory function.

Just as each regulated firm is an actor in a regulatory system, and as a result has a role which it must perform in order to ensure that regulatory goals are achieved, each individual or institution which transacts investment business with such firm is similarly an actor in the same regulatory system, potentially contributing to the ultimate attainment of these regulatory goals. In this light, a relevant question is how might the capacity of investors in private funds to assist national regulators in achieving their desired regulatory goals for such private funds be

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118 See Chapter 5 below.

119 Black, "Mapping" at 263.

120 Ibid.

121 See Section 2.5 below.

122 See Chapter 5 below.

123 See Section 2.5 below.

124 Black, "Mapping" at 266-67.

enhanced.[125] Different investors may have different capacities (and appetites) for performing such a role, and efforts to enroll them should recognize these differences.

A frequently cited example of collaboration between national regulators and market participants is standard setting.[126] Unfortunately, despite the rise in recent years of "Best Practices" documents in various asset classes of private funds,[127] the non-public nature of market for, and operation of, private funds necessarily limits the scope and implementation of these efforts, as compared to codes on mortgage lending or retail deposit taking, for example. However, behavior modification can be obtained by other means, based on the relationship between a fund investor and a fund manager, as well as between various fund investors in the same fund.

Enhancing the role of fund participants recognizes the fragmented nature of modern regulation regimes, and can reflect differences in formality and explicitness that exist among different categories of fund investors. As a result, pragmatic solutions can be identified and implemented involving such actors which will supplement and extend the reach of national regulators in achieving their goals. Applying the analytical framework of enrollment of the relationship of fund investors and fund managers in private investment funds will provide a tool to expose and evaluate private monitoring solutions to the governance challenge as an alternative to further top-down, command-and-control regulation from the SEC or the FSA. The success of fund investors in this context is also a success for these regulators in achieving their goals.

It is not necessary for the regulation of private investment funds to be tied exclusively to the state. There are other options.[128] By taking a decentered perspective[129] on the regulation of private investment funds, and recognizing that the SEC and the FSA are not in themselves the entire regulatory system, the private monitoring solutions presented herein will be shown to be complimentary to these traditional regulators, and not adversarial to them.[130] Five concepts sit at the heart of decentered regulation, each of which is found in the structure and operation of private investment funds: complexity, fragmentation, interdependencies, ingovernability and the lack of a public/private distinction.[131] As a result, private investment funds are a natural subject for a decentered approach to regulation.

This thesis will also analyze and critique recently adopted regulation (i.e., Dodd-Frank and AIFMD) and assess its impact of the private monitoring solutions proposed herein. A lengthy digression into the relative merits of "public interest" theory[132] and "public choice" theory[133] in

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125 See Section 5.3 below.

126 See e.g., Black, "Mapping" at 273.

127 See Chapter 5 below.

128 Julia Black, "Critical Reflections on Regulation", 27 Australia Journal of Legal Philosophy 2 (2002).

129 A decentered perspective is derived by causing a shift away from what has been the traditional center, or focus. In the case of regulation, the traditional focus is on the black-letter rules and regulations published by a state regulator, and the state regulators actions to enforce them.

130 See Section 5.11 below.

131 Black, "Critical" at 4.

132 Public interest theory is founded on the belief that government supervision of private activity is motivated by a desire to achieve certain identified goals. See Cheffins at 19.

133 Public choice theory assumes that lawmakers and regulators adopt and enforce legislation and regulations in order to maximize their own welfare. Ibid. at 20.

the realm of financial services regulation is not necessary to acknowledge the less contentious point that all forms of regulations are subject to potential deficiencies and/or unforeseen limitations.

As Cheffins said concerning company law, which is equally appropriate in the context of investment funds:

> To sum up, the law's role in company affairs is complicated. Clearly, legal rules do matter sometimes. Nevertheless, they are certainly not always of fundamental importance. Often company participants pay little attention to the state of the law. Furthermore, when they do, they are just as likely to be contracting around legal rules as complying with applicable doctrine.[134]

A private investment fund, like the company that often (but not always) finds itself at the heart of its structure, is a nexus of contracts which reflects a network of explicit and implicit bargains reached by the fund participants and fund manager.[135] The role of law[136] and top-down regulations is necessarily only one part of a larger array of factors that influence decision making. One basis on which regulation of market transactions can be justified is that such actions are necessary to avoid outcomes that are so unfair, either procedurally or substantively, as to require governmental intervention.[137] Another basis is that regulatory actions are necessary in order to increase allocative efficiencies.[138] The question of which of these is the better justification for the incremental regulatory expansion undertaken by Dodd-Frank and AIFMD is beyond the scope of this book.

The more relevant question for these purposes is to what extent can private ordering still be utilized to address the governance challenge, given that Dodd-Frank and AIFMD neither regulated private investment funds as we know them out of existence, nor did they, for once and for all, remove from them the risks that may arise from malfeasance, negligence, fraud or other bad acts (intentional or unintentional) on the part of the fund manager.

1.10 **Conclusions**

Balancing risk and reward in a commercial relationship is always challenging. In the context of investing, the risks can be particularly complex and interconnected. Private investment funds seek to generate economic returns against a background of external factors over which they have little direct influence, including market volatility, counterparty risks, liquidity crises and political uncertainty. However, the manner in which such a fund is governed is subject to certain parameters established and implemented by the fund managers and the fund participants.[139]

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[134] Ibid. at 31.

[135] For a discussion of the "nexus of contracts" characterization of companies, see Ibid. at 31-46.

[136] See Armour, Hansmann and Kraakman at 22 ("Default rules of corporate law do more than simply provide convenient standard forms, encourage revelation of information, and facilitate choice of the most efficient of several alternatives. They also provide a means of accommodating, over time, developments that cannot easily be foreseen at the outset.").

[137] Cheffin at 142.

[138] Ibid. at 127.

[139] See Section 2.2 below.

Where funds are not registered for public distribution[140] (as is the case with private investment funds such as hedge funds and private equity funds), investors are left to negotiate such limitations (if any) with the fund and its promoters. This thesis will therefore examine both the driving forces behind the established structures currently used for private investment funds (e.g., regulatory, tax)[141] and the governance challenges present in the two principal fund vehicles: the limited partnership[142] and the offshore exempt company.[143]

Private monitoring solutions can be contrasted with public monitoring solutions, which would include mandated governance regulations put in place by legislation or regulations. The detailed product-level requirements of the Undertakings for Collective Investment in Transferable Securities ("UCITS") directive is an example of public monitoring solutions.[144] The UCITS directive established a common, harmonised framework for retail investment funds across the EU. Despite significant new laws and rules addressing issues surrounding private investment funds that were adopted in the US and the EU in 2010, no attempt was made to address the internal governance of such vehicles.[145] As a result, in the absence of governmental action, private actors must address these issues themselves.

Each of the private monitoring solutions discussed herein address the governance challenge by redressing informational asymmetries between the parties (i.e., fund manager and fund participants) and by establishing legally enforceable conduct standards that apply to the fund manager and provide fund participants or their agents with causes of action which they can pursue at law or equity.

The private monitoring solutions proposed in this thesis are not based upon antipathy or animosity towards "top-down" regulation as a component of the overall regulatory enforcement landscape. The purpose of this thesis is not to demonstrate the relative superiority of private actors and private solutions over public regulation. Instead, this thesis recognizes, like much of the "New Governance" literature, that "top-down" regulation is only one element of a broader array of potential tools that can be effectively used to obtain identified regulatory goals. Further, this thesis recognizes that sophisticated investor can contribute, and have contributed, to regulatory failures in the past by either not conducting adequate due diligence or not acting upon such information in a prompt and credible manner. However, the private monitoring solutions acknowledge those potential deficiencies and operate as a means to remedy those shortcomings in certain circumstances. To the extent that the regulatory regime is altered at some time in the future to seek to address the concerns underlying the governance challenge, the implementation of the private monitoring solutions in the meantime would not impede or undermine such efforts.

As the role of a private fund is to collectivise a number of separate investment management relationships, a thorough analysis of the legal vehicles commonly used should be the starting point for any evaluation of potential solutions to the governance challenge. As discussed above, the governance challenge has slightly different characteristics depending on whether limited companies or partnerships are used as the legal vehicle. The following chapter will

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[140] See Section 2.5 below.

[141] See Sections 2.5-2.7 below.

[142] See Section 2.3 below.

[143] See Section 2.4 below.

[144] See Section 3.4 below.

[145] See Chapter 4 below.

analyze each of these in more depth, focusing in particular on material limits on information flow or impediments to a participant's ability to exercise its legal and equitable rights.

Chapter 2
Structure and Operation of Private Investment Funds

2.1 Introduction

A fund is an answer to a question. Invariably, that question will involve queries relating to the specific participants and their particular requirements. Despite the prevalence of well established 'market forms' for many types of private investment funds, each fund will be structured to address the unique requirements that derive from the tax treatment of the participants and/or the underlying investments, the regulatory status of the fund manager and the types of underlying investments being made.

To begin, it is worthwhile making a few observations about the modern private investment funds industry. Because of their private nature, there are no central repositories for information on, or documentation concerning, private investment funds. As a result, the best source of date are often either trade associations or private commercial firms who have been able to accumulate enough information upon which to make reasonable estimates. In the case of private equity funds, it is estimated that close to $2.4 trillion dollars were invested in these funds.[146] In 2010/2011, just under 70% of new funds were launched by managers based in the United States (50%) and the United Kingdom (11%).[147] In the case of hedge funds in 2010 it is estimated that there were approximately 6,800 hedge funds in existence,[148] managing over $2 trillion in assets.[149] The majority of hedge fund managers are based in the US, with the UK being the next largest country.[150]

Investors in private funds include a wide variety of institutional investors, such as public and private pension plans, charitable endowments and foundations, as well as family offices and other very high net worth individuals.[151] By participating in lightly regulated investment vehicles such as hedge funds and private equity funds, these investors face a number of particular risks, including lack of trading independence when a fund manager trades through an affiliated broker/dealer, investors being unable to redeem their investments in a timely manner, lack of audits by reputable independent accounting firms, investments in highly illiquid assts that are difficult to value and personal trading activities by personnel of the fund manager.[152]

Over the last three hundred years,[153] as investment funds have been established in different countries to pursue different investment objectives, one recurring feature that has remained is

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[146] The City UK, "Private Equity", Financial Markets Series (August 2011) (available at www.thecityuk.com/assets/Uploads/PrivateEquity2011.pdf).

[147] The 2011 Pregin Private Equity Funds Term Advisor, Preqin Ltd. (2011) at 12 (the "Preqin Study").

[148] David Ellis, "Hedge funds: They're back" (March 12, 2010) (available at money_cnn.com/2010/03/11/news/companies/hedge_fund/ndex.htm).

[149] Hedge Fund Research, Inc., "Hedge Fund Industry Extends Record Asset Level with 2Q Inflows" (July 19, 2011) (available at www.hedgefundresearch.com/pdf/pr_20110719.pdf).

[150] "Capitals of Capital", The Economist (August 31, 2006) (available at www.economist.com/node/7855479).

[151] For a very helpful introductions to the types of investors that participate in hedge funds and other private funds, the US trade association for hedge funds, the Managed Funds Association (MFA), has an interactive database that provides background information on the US investor universe. See www.managedfunds.org/hedge-fund-investor-map/#map.

[152] For example, the US Federal Bureau of Investigation (FBI) has published warnings over the risks of hedge funds. See www.fbi.gov/about-us/investigate/white-collar/hedge-fund-fraud.

[153] See Markhan at 69-75.

that existing legal structures are utilized out of necessity to deliver to fund participants the collectivisation of relationships that is required in order to entice the investment manager to undertake the mandate. Each investor in the fund is entitled to a portion of the proceeds from the fund in proportion to the amount of assets initially contributed, net of expenses and fees provided to the fund manager. The intermediation of a fund vehicle between the prospective clients and the investment manager is a "necessary evil" that the clients must endure as they typically lack the assets individually to retain the manager directly. As such, the fund vehicle must simultaneously appeal to the fund manager, to induce it to provide its services, and to the prospective fund investors, to induce them to entrust their money to it.

The governance structures available for private investment funds derive primarily from the choice of legal vehicle, together with the number, nature and demographics of the various fund participants.[154] As noted above, limited partnerships and offshore companies have become key vehicles of choice for private investment funds not because they reinforce or protect the rights of investors, or because they serve to mitigate against the governance challenge facing all collective investment structures, but rather because of certain tax and regulatory efficiencies.[155]

In the case of Partnership PIFs, limited partnerships are treated as tax transparent in many jurisdictions. As a result, there is typically no taxation at fund level (i.e., payable by the partnership itself) and partners are taxed as if they hold the portfolio of investments directly (e.g., including in their taxable income their pro rata share of the partnership's net income).[156] One of the primary virtues of partnerships is that it allows more flexibility in establishing capital accounts for each participant in the fund, thereby enabling their participation in the underlying investment activity to be tracked individually and directly, rather than indirectly through the holding of shares.

In the case of Company PIFs, companies offer a simple and familiar structure that can be easier to organize and operate than a limited partnership. However, since companies are frequently subject to entity level taxation in many onshore jurisdictions, 'exempt companies' are often established in familiar offshore jurisdictions, such as the Cayman Islands, Bermuda and the Channel Islands of Jersey and Guernsey. Company laws, even in such offshore jurisdictions, are generally more highly evolved than the law of partnership, and definitive answers to questions regarding the rights and obligations of parties are more easily obtained.

Importantly, neither entity was originally developed specifically with the function of serving as a private investment fund. Their use as such has been driven by the needs of the parties for tax

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[154] For a discussion of the impact of entity law on the value of a business enterprise, see, e.g., Robert Daines, "Does Delaware Law Improve Firm Value,?" 62 Journal of Financial Economics 525 (2001).

[155] Notably, the legal vehicles used as private investment funds have been particularly effective at delivering economic gains to both fund managers and fund participants. See, e.g., Rosenberg at 363-364 ("Venture capital funds introduced two mechanics crucial to the kind of successful entrepreneurship that has characterized the last twenty years of high-tech development: (1) they created an investment vehicle through which institutional investors were willing to inject large sums of capital into highly speculative, but potentially hugely remunerative, new businesses; and (2) they created a structure which allowed seasoned managers to draw on their experience to nurture young entrepreneurial companies into profitability.").

[156] See Harris, "Critical Theory" at 9. ("One legal advantage of private equity limited partnerships that is not necessarily available in the corporate form is that capital gains from investments are not taxed at the entity level as they are in the corporate form. Rather, income from investments in limited partnerships passes through directly to investors, where it is taxed as ordinary income. In addition to pass-through taxation, partners in such partnerships receive income that has been taxed at the lower capital gain rate of 15%, as opposed to the higher rate or ordinary income of 35%, which is standard for the corporate form.").

efficiency,[157] rather than a genuine affinity for the history and governances of such vehicles. As a result, questions of governance that arise in connection with private investment funds must be analyzed and addressed in the context of the nature and limitations of the legal entity that tax concerns mandate they adopt.

Generalizing about private investment funds can be very difficult at times. They vary greatly in size and complexity from small entrepreneurial start-up funds to complex fund structures with billions of dollars in assets.[158] They differ in terms of the assets in which they invest, the strategies that they pursue, the legal form in which they are structured and the types of investors from whom they seek contributions. Regardless, sufficient structural similarities exist between the different types of private investment funds that a broad description can be given of how they are established and operated.[159] Unfortunately, governance investor protection concerns are addressed, if at all, at late stages of negotiations between the parties, after issues such as the economic arrangements between the parties and the investment objective of the fund will take priority and often will consume most of the negotiations. Investors can, and should, do better.

In this Chapter, I will describe how the relationship between fund managers and fund participants is documented, and in particular the issues that arise when using either partnerships or limited companies as private investment funds. Next, I will analyze the marketing restrictions applicable to such funds, and the limitations that are in place to limit participation to non-retail investors. Finally, I discuss the manner in which these funds are taxed, identify how these rules impact the structure and operation of private investment funds.

2.2 Documenting the Relationship between the Fund Manager and Investors

Any analysis of the legal and equitable duties owed by a fund manager to an investor in a private investment fund will begin with a thorough reading of the written documentation entered into as part of the establishment of the fund. Accordingly, the law of contract will be central to the structuring and operation of any private investment fund.[160] In addition to breach of contract claims, such documentation will be relevant to assessing the common law duty of care in tort [161]owed to the investor and any limitation on the fiduciary duties of the fund manager.[162]

The key documents include the following:

(a) the offering memorandum provided to investors to explain the structure and goal of the fund;

(b) the constitutional documents of the fund, which will depend on the type(s) of vehicle(s) used;

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157 For a thorough discussion of the role of taxation in the structuring of the payment of carried interest, see Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds", 83 New York University Law Review 1 (2008).

158 See, e.g., "A Guide to the Hedge-Fund Elite", New York Magazine (Apr. 9, 2007), available at nymag.com/news/features/2007/hedgefunds/303421.

159 See Section 2.2 below.

160 See Section 3.11 below.

161 See Section 3.9 below.

162 See Section 3.10 below.

(c) the subscription application between the prospective investor and the relevant fund vehicle; and

(d) the investment management agreement, between the fund manager and one or more fund vehicles.

The offering memorandum outlines key information about what the fund can and cannot do.[163] When funds are structured as 'blind pools', investors in these funds rely on the fund manager to identify successful investments without retaining for themselves the ability to decide whether or not to participate in a particular investment. Although a fund manager's discretion may be quite broad, limits are typically agreed by reference to detailed 'investment restrictions' contained in the offering memorandum. These restrictions can include diversification and concentration limits on the fund, imposing discipline on the manager providing confidence to the investors that the investments will be of a type, size, and sector as previously agreed.

The type of legal entity used will dictate the form of the constituent documents of the fund. Whether a limited partnership agreement for a Partnership PIF or memorandum and articles of association for a Company PIF, similar issues are addressed, such as:

(a) the grant of sufficient authority to the fund manager to invest the assets of the fund;

(b) the calculation of any performance allocation and/or management fee;

(c) the process by which fund interests are issued, valued and redeemed, including any ability of the fund manager to compel redemptions under predetermined conditions;

(d) the allocation of initial and on-going expenses as between the fund and the fund manager;

(e) governance issues relating to investor voting and the process by which the constituent documents may be amended from time to time; and

(f) limits on the fiduciary duties otherwise applicable to the fund manager.

Subscription documentation will vary in length and content based on the type of investors sought and the jurisdictions in which they are located.[164] In addition, the subscription documentation, completed and signed by the investor, is the principal means by which a fund manager can obtain the necessary representations, warranties and indemnities it requires to protect itself and bind the investor to its future obligations.

The investment management agreement, establishing the scope and terms of the engagement of the fund manager, will be relevant in determining the scope of the duties (including fiduciary) owed to the private investment fund as client. A fund could claim for the breach of either an

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[163] Although private funds can be structured to avoid many affirmative requirements that could otherwise be imposed by financial regulatory regimes on retail mutual funds, the application of far-reaching antifraud rules, such as Rule 10b-5 in the United States, which prohibits material misstatements or omissions in connection with the sale of securities (e.g. limited partnership interests or shares in an offshore company), will mean that most well-drafted offering memoranda will contained detailed and extensive disclosure for prospective investors.

[164] See Section 2.5 below.

express or an implied term in the investment management agreement.[165] In the case of the former, any absolute obligations on the investment manager, or an obligation to use 'best endeavours', could be the basis for a claim against the fund manager. In the case of the latter, an implied term that imposes a duty on a service provider to exercise reasonable skill and care may also be actionable.

Importantly, there is ample room throughout the documentation identified above to adequately address the governance challenge present in private investment funds. However, any discussion of appropriate steps to take must take place in light of the current commercial realities in this industry. Until recently, the perception has been that fund managers who are able to deliver consistently strong investment returns are able to raise any further required capital from their existing investors.[166] A central feature of the Madoff scheme, for example, was the perceived exclusiveness of the opportunity and the fact that the funds were generally "closed" for further investment.[167] As a result, in the perceived difficulty in gaining access to desired funds, investors may be less willing or unable to negotiate adequate levels of protection in the fund documentation to fully address the governance challenge.

To implement changes in fund documentation, it is important to understand, and work within, the key distinctions that exist between Partnership PIFs and Company PIFs. As noted above, the choice of law covered in this thesis is driven by the nature of legal vehicles actually used for private investment funds. Over the last several decades, the legal vehicles selected by fund managers and fund investors have primarily been partnerships created under the law of either Delaware or England and Wales, or limited companies established under the laws of an offshore jurisdiction, such as the Cayman Islands.

2.3 Partnership PIFs

Partnerships, established under the laws of England or Delaware, are frequently used in the structuring of private investment funds.[168] The benefits of partnerships include:

(a) flow-through tax treatment;

(b) flexible remuneration arrangements for general partners; and

(c) flexible internal governance and control.[169]

Unlike a general partnership which requires no formal documentation or filings and is created whenever two or more persons carry on a business for profit as co-owners, a limited

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165 See Section 3.11 below.

166 See Financial Services Authority, Discussion Paper DP06/6: Private Equity - A Discussion of Risk and Regulatory Engagement (November 2006) ("DP06/6") at 22.

167 See Section 3.2 below.

168 See DP06/6 at 17. As commentators have noted, "organizing as a limited partnership affords to the hedge fund manager overwhelming flexibility in managing its internal affairs and carrying out its investment strategy." Shadab at 6. See also Rosenberg at 365 ("[T]he limited partnership under Delaware law is uniquely suited to create . . . incentives and satisfy the needs of all parties (including passive investors and venture capitalists) involved with venture capital funds.").

169 See Ibid. at 376 ("What distinguishes limited partnership law in the venture capital context is not so much the limitations it imposes on the parties to a venture capital limited partnership contract, but rather the broad freedom it gives the parties to craft an agreement that allocates duties and risks in a way that satisfies both investors and venture capitalists"). See also Anita K. Krug, "Institutionlization, Investment Adviser Regulation and the Hedge Fund Problem," 63 Hastings Law Journal 1 (2011).

partnership is available only by statute, upon satisfaction of a number of formalities. The primary benefit of a limited partnership over a general partnership is it permits an investor who is a limited partner to participate in the profits of the partnership without personal liability for the obligations of the partnership.[170]

The affairs of the partners are governed by the partnership agreement, the scope and contents of which are negotiated by the general and limited partners.[171] The partnership agreement constitutes the partnership and establishes the parameters of the relationships among the limited partners and between the limited partners and the general partner.[172] These agreements can vary widely in their level of detail and breadth of subject matter, depending on the number of investors, any special needs or requirements of particular investors, and the complexity of the commercial arrangements involving the general partner and its remuneration.[173]

Every limited partnership must have a general partner.[174] A general partner may be either an individual or, more commonly in private investment funds, a limited liability legal entity, which may be specifically organized for this purpose.[175] The right to manage a limited partnership belongs solely to the general partner and not to the limited partners. Limited partners may be deemed to be general partners and lose the benefit of their limited liability if they participate in the management of the partnership. Where this line is ultimately drawn varies significantly from jurisdiction to jurisdiction. The general partner owes a duty of good faith towards the

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170 See Rosenberg at 379. ("In a general partnership, all members act as principals in the firm and therefore have a right to act on behalf of the partnership to conduct business and make managerial decisions. In a limited partnership, only the general parties have the power to make day-to-day decisions regarding the conduct of the business. Since the general partners make the decisions that essentially determine the fate of the business, traditionally they were exclusively responsible for the debts of a business organized as a limited partnership.").

171 A limited partnership has two categories of partner: (a) general partners, who have control over the management of the partnership and unlimited liability for the debts and obligations of the partnership; and (b) limited partners, who are passive investors in the activities of the partnership and whose liability to the partnership is limited to their capital contributions.

172 See Ibid. at 380 ("Most discussions of venture capital limited partnership contracts emphasize the importance of two aspects of the contract establishing the fund: (i) the compensation system that is designed to give the general partners the proper incentives to act in the best interest of investors; and (2) the extensive use of covenants imposing restrictions on the type of activities that general partners can engage in to ensure that they act in the best interest of investors."). See also Joseph A. McCahery and Erik P.M. Vermeulin, "The Contractual Governance of Private Equity Funds," (2008), available at http://iccwbo.org.

173 See Shadab at 7 ("The wide-ranging flexibility of the law of limited partnerships, LLCs, and other forms of uncorporate governance serves as a virtually blank slate upon which particular business entities may write their operating agreements . . . [L]imited partnership and LLC law is "enabling," as opposed to mandatory, meaning that companies may choose the details of their own governance structures from a default set of 'off-the-rack' rules provided by . . . statute.") See also Harris, "Critical Theory" at 7 (a private equity limited partnership agreement is "a long, complicated, and heavily negotiated document that frequently runs over 100 pages and covers such things as distribution, liquidation, and compensation.") and Rosenberg at 381 ("The agreements can be terribly complex, often extending for hundreds of pages.").

174 Limited Partnerships Act 1907, Section 4(2). The need to nominate or establish an entity to serve in this role has been a drawback to using partnerships. The rise of limited liability companies (LLCs) in the US and limited liability partnerships (LLPs) in the UK reflects an attempt by legislatures to provide a vehicle with the flexibility of a traditional limited partnership, but without the formal requirement for a general partner.

175 The domicile, tax status, and internal structure of the fund manager and its principals frequently drive the choice of general partner, and may take the form of companies, limited partnerships, or other vehicles. These entities will be owned either by the fund manager or the individual principals of the fund managers.

limited partners in a limited partnership, just as all partners owe such duties to their fellow partners in a general partnership.[176]

English limited partnerships are governed by both the Partnership Act 1890 (the 1890 Act) and the Limited Partnership Act 1907 (the 1907 Act). While the 1890 Act focuses on general partnerships,[177] the 1907 Act provides for modifications in the case of limited partnerships. As a general rule, partners have unlimited personal liability for the obligations of the partnership. If the assets of the partnership are insufficient to cover outstanding liabilities, then the personal assets of the partners will be available to the creditors. Further, liability for partners is joint and several.[178] Each partner is therefore liable for the acts of the other partners. The 1907 Act provides that partners may form limited partnerships in which one or more partners have limited liability,[179] so long as one partner has unlimited liability. Such partnerships must be registered.

Since under the 1907 Act a limited partner may not take part in management,[180] the limited partnership is a useful vehicle for investors who do not wish to take an active role in the management of their funds. They may use it to create an investment fund under the control of a general partner who alone has unlimited liability for the partnership's obligations. The limited partner is only liable to the extent of his capital contributions (if any), provided he does not take part in the management of the partnership business.[181]

This limitation on involvement in management contributes to the governance challenge in private investment funds established as limited partnerships by potentially reinforcing in investors a reluctance to become too directly involved in decision-making processes, particularly in regards to contentious matters. However, other jurisdictions, such as Delaware

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176 See Blisset v Daniel, [1853] 10 Hare 493: 'The utmost good faith is due from every member of a partnership towards every other member...'

177 The 1890 Act and relevant case law apply to limited partnerships as well as general partnerships. 1907 Act, s 7.

178 s9 of the 1890 Act and s3 of the Civil Liability (Contribution) Act 1978.

179 The 1907 Act generally limits the liability of a limited partner to the amount of his contribution. Section 4(2) achieves this by providing that the limited partners '… shall not be liable for the debts or obligations of the firm beyond the amount so contributed'.

180 Section 6(1) of the 1907 Act provides:

> A limited partner shall not take part in the management of the business, and shall not have power to bind the firm:
>
> Provided that a limited partner may by himself or his agent at any time inspect the books of the firm and examine into the state and prospects of the partnership business, and may advise with the partners thereon.
>
> If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.

181 For a discussion of the operation of limited liability and its benefits, see Armour, Hansmann and Kraakman at 10 ("The corporate form effectively imposes a default term in contracts between a firm and its creditors whereby the creditors are limited to making claims against assests that are held in the name of ('owned by') firm itself, and have no claim against assets that the firm's shareholders hold in their own names."). The practical benefits of limited liability in the real world has been criticised as potentially illusory. See Richard A. Booth, "The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships," 32 Wake Forest Law Review 79, 88 (1997) ("[L]imited liability is of doubtful benefit. It matters little to small companies who cannot really have it and it matters little to big companies who do not really need it.").

in the US, have addressed these concerns, and Delaware is now the preeminent jurisdiction for Partnership PIFs in the US.[182]

There are a number of significant advantages from using a Delaware limited partnership for a private investment fund instead of an English limited partnership. Most importantly, the limited partners of a Delaware limited partnership benefit from a greater 'safe harbour' in relation to their participation in the affairs of the partnership. As a result, partners can exercise greater control without loss of limited partner status. Unlike English law, Delaware law expressly provides for the exercise of certain enumerated rights and powers by limited partners that will not constitute participation in the control of the partnership's business which might otherwise prejudice a limited partner's limited liability.[183] Underlying this approach is an acknowledgement that questions of 'management' within the vehicle are primarily internal issues that do not undermine the positions of third parties.

Accordingly, a Delaware limited partnership agreement can be drafted that would afford particular limited partners significant protection with respect to partnership governance without subjecting that limited partner to liability as a general partner.[184] The limited partnership agreement could restrict the general partner from taking certain actions while requiring the consent of the limited partners, or even a particular limited partner individually, to take other actions. Mechanisms such as this can provide investors with effective means of oversight and accountability to overcome the governance challenge embedded in private investment funds structured as limited partnerships.

The contrast between the shortcomings of English limited partnerships, and the certainties provided by Delaware, have been widely noted. For example, the 2003 Joint Report of the Law Commission of England and Wales and the Scottish Law Commission (the Joint Report) acknowledged that the 1907 Act has not been regarded as a model of draftsmanship and included this particular concern as part of its considerations. The 1907 Act provides current and prospective limited partners little guidance as to the types of activities that may constituent 'management'. Considering the severity of the consequences for taking part in 'management' - the loss of limited liability - in the face of uncertainty partners have overwhelmingly taken the

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182 See, e.g., Rosenberg at 366 ("The ability of the [venture capital] industry to rely on regulation as its primary enforcement mechanism depends largely on the unique nature of the limited partnership form and on the flexibility made available to the parties by Delaware's Revised Uniform Limited Partnership Act.").

183 DRULPA Section 17-303 provides that the following will not act to remove limited liability: being an independent contractor or transacting business with the partnership; being an officer, director, stockholder, limited partner, member, manager, employee, or agent of any entity that is a general partner of the limited partnership; consulting with or advising the general partner or any other person regarding any matter, including the business of the limited partnership, or acting to cause the general partner or any other person to take or refrain from taking any action, including by proposing, approving, consenting, or disapproving, by voting or otherwise; acting as a surety, guarantor, or endorser for the limited partnership or a general partner; calling, requesting, attending, or participating at a meeting of the partners or the limited partners; serving on a committee of the limited partnership, the limited partners, or the partners; and taking any action or causing the taking or refraining from the taking of any action concerning the dissolution or continuation of the partnership; the disposition of partnership assets; the incurrence, renewal, payment, or discharge of indebtedness; the admission, removal, or retention of any partner; the amendment of the partnership agreement or the certificate of limited partnership; or other matters set forth in the partnership agreement or in any other agreement or in writing.

184 In England, these controls can be incorporated indirectly into a fund structure through a variety of different mechanisms, including a shareholders' agreement at general partner level and the adoption of a consultative committee of the limited partners, often known either as an 'advisory board' or an 'investment committee'. However, typically only a subset of limited partners are in a commercial position to negotiate such rights at the general partner level. The remaining limited partners will remain subject to the ambiguities of the 1907 Act and the governance challenges that they present.

side of caution. The Joint Report recognizes this lack of clarity as a major defect in the 1907 Act, and recommends that a 'safe harbour' be established by statute that will clearly identify those activities which a limited partner may undertake.[185] Unfortunately, no legislation implementing the Law Commission's proposals have been forthcoming. There are strong arguments, however, to support the Law Commission's views.

The limited partnership has proven itself very useful over the years as a means for collective investment. As commentators have observed:

> The limited partnership has long been a major investment vehicle. It began in the nineteenth century as a way to achieve limited liability without incorporation. Later it came to be used widely as a tax shelter vehicle, mostly by wealthy investors and entrepreneurs.[186]

The limited partnership can be seen as a form of contract, as well as a form of business organization.[187] As a business organization, limited parties exercise far less control than shareholders of a corporation, being analogized at times to "disguised creditors."[188] As a form of contract, the participants enjoy great latitude to establish the commercial terms and liability preferences between them that they feel are most important under the particular circumstances, without being bound to follow the statutory or judicial biases that accompany company law. Historically, this has meant that many partnership agreements have lowered duties owed by general parties to limited partners,[189] but this is an arrangement that is not mandated by the law and is within the scope of terms that can be negotiated by the parties.

A valid question can be raised regarding what differences, if any, should exist in the governance of partnerships as opposed to companies. It has been observed that:

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185 See para 4.33 of the Joint Report. This safe harbour would include: (a) consulting and advising the general partner on the activities of the partnership; (b) investigating, reviewing or approving the partnership's accounts or affairs; (c) being a contractor, agent, or employee of the partnership or a general partner; (d) being a director of or a shareholder in a corporate general partner; (e) approving or disapproving of any of the following: (i) winding up the partnership, (ii) amending the partnership agreement, (iii) changing the nature of the activities of the partnership, or (iv) transactions involving actual or involving potential conflict of interest of the general partner. These clarifications would address the governance challenge by providing legal certainty to investors in UK private equity and real estate funds that they can maintain an adequate level of on-going supervision over their investment arrangements. Importantly, it demonstrates the potential utility of directly addressing the underlying laws of the vehicles themselves rather than taking further recourse to the financial services regime.

186 See Ribstein, "Applied Theory" at 837.

187 See, e.g., Rosenberg at 374 ("By giving 'maximum effect' to the terms of the limited partnership agreement, Delaware law allows venture capitalists essentially to craft the terms of their relationship with investors, subject only to the give and take of negotiation and not to the default provisions of Delaware law."). See also Robert C. Illig, "The Dual Nature of Private Law: Private Investment Funds, the Crash of 2008, and Why We Contract," (2010), available at http://works.bepress.com/robert_illig/8; and Joseph A. McCahery and Erik P.M. Vermeulen, "The Contractual Structure and Regulation of Private Equity Funds and Hedge Funds," Regional Comparative Advantage and Knowledge Based Entrepreneurship Working Paper (2008).

188 See, e.g., Rosenberg at 384 ("Much of the literature on venture capital firms places emphasis on the powerlessness of the investors in a venture capital limited partnership. To a great degree, this imbalance of power derives from the very nature of limited partnerships themselves.").

189 See, e.g., Ibid at 390 ("By using Section 17-1101 of the DRULPA, the parties may agree to waive the fiduciary duties provided by Delaware's default rules under common law. Thus, other than those actions explicitly prohibited by the limited partnership agreements, the venture capitalists have extremely limited duties towards the limited parties."). See also James C. Spindler, "How Private is Private Equity, and at What Cost?," 76 University of Chicago Law Review 309 (2009).

> The principal question regarding limited partnership governance is whether the limited partner's role should differ from that of corporate shareholders, who are also passive, limited liability owners. The critical difference between limited partners and shareholders follow from differences in the management of the two different business forms. In the corporation, management is in the hands of executives who are not necessarily owners of the corporation. Shareholders monitor management through a board of directors that serves as the agent of the shareholders . . . In the limited partnership, by contrast, management is in the hands of general partners who are themselves owners and not merely agents of the limited partners. Because of their equity interest and guarantee, removal of the general partners can be costly.[190]

This tension between the limitations on the activities of limited partners and the potential for entrenchment by the general partner frames the analysis of the governance challenge in Partnership PIFs. As one commentator has noted:

> By default, investors in private limited partnerships have limited rights to participate in day-to-day operations or challenge decisions of fund managers. As a result of this set of default legal rules, investors in these funds face a familiar agency problem.[191]

2.4 **Company PIFs**

Funds established in offshore jurisdictions are often structured as limited companies that issue shares to investors.[192] The constitutional documents of a Company PIF will generally consist of its memorandum of association and articles of association. The articles of association will deal with matters related to the internal workings of the company and authorize the directors to transact the business of the company.

The directors are responsible for the management of the company and may accordingly exercise all the power of the company, absent explicit restrictions in the memorandum and articles. All companies, as artificially created legal persons, must act through their agents.[193] In the case of Company PIFs, which typically lack executive officers and employees, such agents will predominantly be the directors themselves.

The duties and obligations of directors of Company PIFs are governed by two sources of law:

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190 Ribstein at 880-881. Despite the cost barrier to general partner removal, it is important that some removal power remains in order to address the potential agency cost problems. Ibid. at 882.

191 See Harris, "Critical Theory" at 1.

192 Importantly, Company PIFs often mimic the partnership governance structure by granting the investment advisor or an affiliate so-called "founder shares", which grant their holder "general partner-like" powers of control. As a result, over-analogizing Company PIFs to traditional operating companies will be unproductive, since many of the concepts and economic relationships that have been established in Partnership PIFs have been transposed to Company PIFs.

193 The board of directors exercise delegated authority as agents of the shareholders to manage the enterprise in accordance with the memorandum and articles of association, the provisions of company and other applicable laws in the jurisdiction in which it is established.

(a) the companies law of the jurisdiction of incorporation (e.g. the Cayman Islands); and

(b) the relevant common law.

In recent years, the Cayman Islands has established itself as one of the most popular jurisdictions for the establishment of offshore private investment funds. As such, their companies law are of particular relevance to questions concerning private investment funds and the governance challenge faced by investors.[194]

Other than compliance with administrative requirements, the Companies Law of the Cayman Islands is silent on directors' duties. The more prescriptive source of law governing duties and obligations of directors of companies incorporated under the laws of the Cayman Islands is the common law, which draws upon English and other cases as well as cases in the Cayman Islands courts.[195]

Although Cayman law is based on English common law,[196] the Companies Law 1998 of the Cayman Islands is not easily mistaken for the Companies Act 2006, recently implemented in the UK. The differences are immediately apparent and material. Like many company statutes in other common law offshore jurisdictions, the Cayman statute is a remnant of jurisprudence from an earlier generation. Many of the renovations implemented in the UK in 1986 and 2006 find no comparable development in these offshore jurisdictions. As such, much of the academic literature in the UK addressing corporate governance and other aspects of the modern British company will not be directly applicable to considerations of offshore companies, either generally or in the specific context with which they are discussed herein. Under the common law, which forms the foundation for company law in the Cayman Islands, a director's duties to the company can be divided into the fiduciary duties which arise because of the nature of the role of a director, and the duties of skill and care in the performance of the director's duties. Importantly, directors' duties are owed by each director individually.

2.4.1 ***Fiduciary Duties***

A director is in a fiduciary relationship to the company, stemming from his role as an agent. The fiduciary duties may be described as being those of loyalty, honesty, and good faith to the company. The standard is similar to that owed by a trustee to the beneficiaries of a trust, although a director is expected to take commercial risks on behalf of the company in pursuit of financial gain. The directors must act in what they consider is the best interest of the company, and not for any other purpose.[197] As a subjective test, the court should only interfere

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[194] Notably, the Cayman Islands, and other offshore financial jurisdictions have received increased attention (largely negative) from onshore governments in recent years. A report to the US Congress by the General Accounting Office (GAO) began on its first page by identifying that the office building for a prominent Cayman law firm served as the mailing address for 18,857 companies incorporated under Cayman law. General Accounting Office, "Cayman Islands – Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist," GAO-08-778 (July 2008) ("GAO Report").

[195] The Cayman Island Monetary Authority has issued a Statement of Guidance on Corporate Governance, as well as (i) a Board of Directors Code of Conduct and (ii) a Conflict of Interest Code.

[196] See, e.g., GAO at 26. Importantly, however, the ongoing "constitutional" relationship between the UK and the Cayman Islands has not been without its share of stumbling blocks and conundrums. See, e.g., Suzanne Wollard, "The British Overseas Territories: Does Mother Know Best? A Cayman Islands Perspective," 26 Commonwealth Law Bulletin 1300 (2000).

[197] See Re Smith and Fawcett Ltd, [1942] Ch 304. A director is a fiduciary and has a responsibility for the success of the company's business. Item Software (UK) Limited v Kouroush Fasshihi, [2004] EWCA Civ 1244 at 41. Argentine Holdings (Cayman) Limited v Buenos Aires Hotel Corporation SA, [1997] CILR 90.

if it determines that no reasonable director could have concluded that a particular course of action was in the best interests of the company.[198]

Directors must not place themselves in a position in which there is a conflict between their duty to the company and their personal interests.[199] This obligation may be varied by the articles of a company, permitting the director to vote on a matter in which he has an interest, provided that he has disclosed the nature of this interest to the board. The directors must exercise their powers for the purpose of which they were conferred and not for an improper or collateral purpose. Directors must also avoid placing themselves in a position where their personal interests conflict with the interests of the company unless the company gives informed consent. This duty can cause particular difficulties where a director is a director of a number of companies (which is common in private investment funds) and a conflict arises as between his duties to each company. Such director should not participate in a decision that gives rise to the conflict of interest. Where the conflict is to continue for some time, he may need to resign from one or more of his directorships.

2.4.2 *Duties of Care, Diligence, and Skill*

A director's relationship to the company that he serves is analogous to that of an agent to his principal. The duties of an agent generally include a duty of care, skill and diligence and the duties of a fiduciary. Importantly, an agent is bound to carry out the instructions of his principal and, where the instructions are incomplete, an agent must act reasonable in the best interest of his principal. [200]

The duties of care, diligence, and skill have been traditionally regarded as subjective. A director is obliged to exhibit only such skill as he actually possesses, and not such care and diligence as would be displayed by a reasonable man in the circumstances.[201] As in the case of the director's fiduciary duties, the duties of care, diligence, and skill are owed to the company itself and not, to individual shareholders or other parties. Importantly, the directors can, subject to the articles, delegate specific tasks and functions to other parties (e.g. fund manager, administrator), and they are entitled to trust the competence and integrity of such parties to a reasonable extent. The directors remain responsible, however, for the supervision of such tasks and functions delegated by them.

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198 See Charterbridge Corp v Lloyds Bank, [1970] Ch 62. Courts will typically consider the principal purpose for which the directors acted and whether that was a proper purpose. They are not typically concerned with the commercial merits of the decision in itself.

199 See Phyllison Ltd v GH Ltd, [1992-93] CILR 160; Bhullar v Bhullar, [2003] 2 BCLC 231.

200 Whatley v Phillips & Co. Ltd, [2007] All ER 43.

201 The three tests laid down in the leading English case on the standard of care, which would continue to control in the Cayman Islands, are as follows:

(a) a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience;
(b) a director is not bound to give continuous attention to the affairs of the company; and
(c) in respect of all duties that, having regard to the exigencies of business and the articles, may properly be left to some other manager, a director is generally justified in trusting an official or manager to perform such duties honestly.

Per Romer J in Re City Equitable Fire Insurance Co Ltd (No 1), [1925] Ch 407. Although more recent English cases have found that the duty of care has both an objective and a subjective component, it is not clear that Cayman courts will follow such developments. See Re D'Jan of London Limited, [1993] BCC 646.

2.4.3 ***Scope of Duties***

The duties of a director are owed to the company.[202] Usually, the 'interests of the company' may be equated to the interests of the company's shareholders. Once a company is insolvent, the directors must consider the creditors' interests as part of their duty to act in the interests of the company.[203] These duties are not owed to other companies with which the company is associated, to the other directors, or to individual shareholders. As a result, typically only in exceptional circumstances may a minority shareholder enforce the rights of a company.[204] Directors must often balance the different interests of different classes of current shareholders, and of current and future shareholders.

If a director breaches his fiduciary duty or duty of care, he may be personally liable to the company in damages. The measure of damages will be either the loss suffered by the company or the improper profit made by the director.[205] Directors may also incur contractual or tortious liability directly to third parties, where they make negligent misrepresentations, and criminal liability, where they are knowingly involved in the issue of accounts which are materially misleading or false. A director, however, is not a guarantor of the commercial success of a company (or the investment success of a fund vehicle). Courts will typically require that the director act honestly and reasonably in what he considers the company's best interest. [206]

2.5 **Marketing Restrictions**

Whether established as Partnership PIFs or Company PIFs, the legal vehicles used to structure private investment funds must also be operated in such a way as to remain in compliance with tax rules and financial regulations. Marketing restrictions determine who is, and who is not, permitted to participate in a private investment fund. The principal effect of these restrictions, in both the US and the UK, is to exclude retail investors.[207] As a result of limiting Partnership PIFs and Company PIFs to non-retail investors and deciding as an explicit policy choice not to subject it to product-level regulation like public investment funds,[208] the state explicitly places primary responsibility for the investment decision on the prospective investor.

Marketing restrictions operate in conjunction with tax rules[209] to determine the structure and operation of private investment funds, but to countervailing effect. As noted above, on the one hand, the financial regulatory regime attempts to exclude retail investors who may not have the knowledge or experience required to negotiate adequate protections from participating in

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202 See Schultz v Reynolds and Newport Limited, [1992-93] CILR 59.

203 See Prospect Properties Ltd v McNeil & Bodden, [1990-91] CILR 171.

204 See Foss v Harbottle, [1843] 2 Hare 461.

205 See Pedro Devs Ltd v Zuiderent and Spotts Dev Ltd, [1990 - 91] CILR N7. Other remedies may also be available including, for example, an injunction or declaration against directors proposing to take improper action, damages in negligence for breach of the duty of care, rescission of a conflict with the company, and restoration of company property in the hand of the directors.

206 See Re Smith & Fawcett Ltd, [1942] Ch 304.

207 As discussed above, the overwhelming majority of hedge funds and private equity funds remain based in either the US or the UK. As a result, this thesis will focus on the marketing restrictions in place in these countries when evaluating how those restrictions impact the governance challenge.

208 See Section 3.4 below.

209 See Sections 2.6 and 2.7 below.

private investments, while on the other hand, in order to prevent these vehicles from being instruments of tax avoidance, the fiscal authorities often impose ownership restrictions or require management and control of these vehicles to be conducted in such a way as to impede solutions to the governance challenge. In order to avoid the substantive investment restrictions contained in the product-orientated regulations applicable to public investment funds that are available to retail investors,[210] private investment funds are typically marketed only to certain designated categories of investors. Such categories of acceptable investors are intended by financial regulators to ensure that the participants in these funds have the ability to understand the risks involved in such investments and to negotiate such levels of investor protection as they deem sufficient.

What makes private investment funds "private"? The answer is a series of affirmative decisions taken by the proposed fund's sponsors, and explicitly agreed to by prospective investors, to operate within designated exemptions to securities laws and financial regulations.

In the UK, the manner in which a private investment fund can be marketed depends on whether or not it is deemed to be a collective investment scheme (CIS).[211] Falling within this definition raises significant impediments to the marketing of a private investment fund, where authorization for retail distribution is not obtained. Where a vehicle is deemed not to constitute a CIS, an authorized person (or, subject to the approval of an authorized person, an unauthorized person) may in principle market interests in that vehicle to any investor in the UK, regardless of whether they are an institution or a private individual, subject to the COB rules as they apply to different categories of investors under the FSMA.[212] If the entity falls within the definition of a CIS, then such an investment may generally not be promoted to private customers by either an authorized or an unauthorized person.[213]

Section 238 of the FSMA establishes a general prohibition on the promotion of CIS in the UK by persons authorized under the FSMA. Exemptions are immediately provided for regulated CISs, and further exemptions may be provided by either Treasury order or rules of the FSA for unauthorized CISs.[214] Generally, an authorized person who wishes to communicate or approve a financial promotion, which is not otherwise covered by an exemption in the Financial Promotion Order, must comply with the rules contained in COBs 4[215]. However, in the case of an unregulated CIS, an authorized person is prohibited from either communicating a financial

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[210] See Section 3.4 below.

[211] Although with the arrival of UCITS, MIFID and AIFMD, much financial regulation in the UK ultimately derives from European legislation, there is not yet a Europe-wide private placement regime for private investment funds. As such, the domestic rules and regulation in the UK govern.

[212] s21 FSMA.

[213] s238 FSMA.

[214] Importantly s238 FSMA, is directed at authorized persons only, in an attempt to limit their otherwise broad ability to market securities for which they issue or approve financial promotions. The ability of an unauthorized person to issue a financial promotion, whether in connection with an unregulated CIS or any other security, is governed entirely by s21 FSMA, and the Financial Promotion Order.

[215] However, if the business falls within the scope of MiFID, it does not matter that there would be an exemption in the Financial Promotion Order; the FSA rules apply.

promotion[216] or approving a promotion relating thereto,[217] subject to two categories of exemptions.[218]

Under the Promotion of Collective Investment Schemes (Exemptions) Order (the Scheme Promotion Order),[219] exemptions are established for high net worth investors (which is based on an objective measure of the individual annual income or wealth) and for sophisticated investors (which requires a subjective determination that the individual appreciates the risks associated with certain categories of investments) to be marketed unauthorised CISs. In addition, the FSA-adopted rules are more restrictive than the exemptions contained in the Scheme Promotion Order. The most useful categories of exemptions under COBs 5.9.1R (4) for the marketing of unauthorised CISs include:

(a) an authorized person can promote to a person who is or has been in the last 30 months a participant in the same or a substantially similar unregulated CIS;

(b) an authorized person can promote an unregulated CIS to a person for whom the firm has taken reasonable steps to ensure that investment in a scheme is suitable and who is an established or newly accepted customer of the firm;[220] and

(c) an unregulated CIS may be promoted to an eligible counterparty or a professional client.

The US approach to the marketing of private investment funds provides an instructive counterpoint to the UK system. Exemptions must be secured under both the Investment Company Act of 1940, for the fund vehicle itself, and the Securities Act of 1933, for the marketing of the fund's interests. Absent an exemption, most private investment funds would fall within the definition of 'investment company'[221] and be required to register with the SEC, pursuant to the Investment Company Act. Registered funds are subject to a number of constraints incompatible with many investment strategies pursued by private investment funds.[222] Private investment funds typically make use of the exemptions provided by Section 3(c)(1) and Section 3(c)(7) and forgo registration, and the substantive restrictions that this entails.

Section 3(c)(1) is the elder and more common of the two exclusions from the definition of 'investment company'. The requirements are twofold:

(a) the interests in the fund must be privately placed to investors; and

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216 s238 FSMA.

217 s240 FSMA.

218 Violations of these prohibitions would be actionable by a private person who suffers a loss: FSMA, s150. In addition, the authorized person could also face very severe consequences under the FSA's rules.

219 The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) Exemptions Order 2001, SI 2001/1060.

220 Such a customer would be one with whom the authorized person has entered into a written agreement without contravening FSMA, s238 or 240 or any COBs rule applicable to the firm.

221 Under Section 3(a) of the Investment Company Act, 'investment company' includes any vehicle engaged in the business of investing in securities.

222 See Section 3.4 below.

(b) the fund must not have in excess of 100 investors.[223]

Section 3(c)(7) focuses on the status of investors in the fund, rather than their number. The requirements are twofold:

(a) as with Section 3(c)(1), the interests in the fund must be privately placed to investors; and

(b) the fund may only have as investors:

(i) 'qualified purchasers'; and

(ii) 'knowledgeable employees' of the fund manager.

Section 3(c)(7) was promulgated to allow for an unlimited number of 'qualified purchasers' to invest in a fund, subject again to their not being a public offering of the fund's interests.

When marketing a private investment fund to US investors, not only must exemptions be secured in connection with the fund's potential status as an 'investment company', it is also necessary to ensure that each offer and sale of interests in the fund is exempt from registration under the Securities Act. Whether constituted as a limited partnership, a unit trust, or a company, the interests of a fund will fall within the definition of a 'security'. Absent a suitable exemption, the offer and sale of such interest will require registration with the SEC.[224]

Private investment funds generally avoid the registration requirements by relying on the exemption provided by Section 4(2) of the Securities Act. This exemption covers transactions by an issuer not involving any public offer.[225] Due to some ambiguities with regard to applying this section in practice, the SEC promulgated Regulation D as a safe harbour.

A fundamental concept within Regulation D is the 'accredited investor'.[226] Provided that the other provisions of Regulation D are complied with, an unlimited number of accredited investors may invest in a fund without sacrificing the private placement exemption provided by

223 The question, however, of how to count up to 100 for the purposes of Section 3(c)(1) is subject to numerous rules and interpretation. In certain circumstances beneficial owners of separate funds may be aggregated under the principle of integration, where the two vehicles are in effect a single fund. Similarities in investor profiles and investment strategies will be relevant factors in this analysis. Importantly, the staff of the SEC have stated that onshore and offshore funds with similar investment objectives would not be integrated where the vehicles address investors with materially different tax positions.

224 The purpose of the Securities Act is to provide for the adequate disclosure of information to investors when offers are made to the public. Exemptions to the registration requirements are available to certain offers and sales that either occur in the secondary market or constitute private placements.

225 The requirement that no general solicitation or general advertising occur during the marketing period means that the following can cause the exemptions to be lost: (a) advertisements or articles published in a newspaper or magazine; (b) interviews or notices broadcast on television or radio; and (c) seminars open to the general public. Rule 502(c). Where a fund or one of its placement agents has inadvertently conducted a general solicitation as general advertisement, a cooling-off period is usually imposed. The length of such period can vary from two to six months, depending on the circumstances. Such conduct may also threaten exemptions for the fund under the 1940 Act and the fund manager under the Advisers Act.

226 There are a number of different exemptions under the US securities laws for wealthy individual, of which "accredited investor" is the most familiar. See Sekhon at 1 ("The federal securities laws are littered with exemptions for wealthy investors. The rationale underlying these exemptions is that wealthy investors can "fend for themselves" because they either possess sufficient financial sophistication to make informed decisions or can acquire the services of advisers who possess such sophistication.").

Section 4(2). In addition, up to 35 persons may invest in the fund who are not 'accredited investors' provided they are 'sophisticated investors'.[227] Underlying the "accredited investor" exemption in the Securities Act is the belief, that sophisticated investors have the resources and financial expertise required to obtain and evaluate the information necessary to make their investment decisions.[228] In short, they can "fend for themselves." A similar belief serves as the rationale behind the categories of exceptions for scheme promotion in the UK. Some critics[229] have argued that the fact that so many sophisticated investors fell victim to Madoff's Ponzi scheme is compelling evidence that in fact such investors are either unable or unwilling to protect themselves.[230] If this is correct, continuing to provide a private placement exception to enable marketing of investments to such persons would ultimately be counter-productive if they lack the presumed ability to fend for themselves.[231]

Although a comprehensive survey and critique of the growing literature of behavioural finance is beyond the scope of this thesis, it is worthwhile to make certain observations about how some of these concepts would apply to investors in private funds. Behavioural finance focuses on the manner and extent to which cognitive and emotional factors impact an individual's investment decisions.[232] This school of thought focuses on how people actually think while they are making financial decisions, rather than assuming that they comply with abstract presumptions. In particular, the use of heuristics, or "rules of thumb", and framing decisions involving anecdotes and stereotypes play a key role in understanding market anomalies that classical economic models cannot explain. Classic models are based on the assumption that economic agents will behave rationally in all cases.

In the case of private investment funds, a proponent of behavioural finance would claim that investors may succumb to systematic errors, based on their over-reaction (or under-reaction) to new information. These systematic errors could result from common factors such as overconfidence, limited attention or loss aversion. Overconfidence can lead to lack of diversification and overconcentration, while loss aversion could result in taking an unnecessarily conservative position that leads to loss of investment returns.[233] Academic studies have shown, for example, that hedge fund investors tend to allocate new money to funds based on long-term performance, while redeeming money from funds based on short-

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227 A 'sophisticated investor' is a person who has 'such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of prospective investment'. Rule 506(b)(2)(ii). A person could also qualify as a 'sophisticated investor' if, together with a 'purchaser representative', he met this qualification. Should offers be made to non-accredited investors, the requirements for mandated disclosure are more stringent. If only accredited investors are targeted, disclosure in the offering documentation is driven primarily by market practice.

228 See Smith at 243 ("The private-offering exemption" is practically sacrosanct in federal securities law.")..

229 Ibid.

230 Among Madoff's victims were celebrities and hedge fund managers, as well as sizeable pension funds and charities. All would have had to certify themselves as accredited investors in order to be permitted to invest in the fund.

231 Ibid. at 231. ("Madoff's tragic, historic, and unprecedented investment duplicity strongly evinces that policy makers should reexamine the wisdom of continued reliance on the statutory model of sophisticated investors being left to fend for themselves.").

232 See, e.g., Greg B. Davies and Arnaud de Servigny, Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory (McGraw Hill 2012); Karin Knorr-Cetina and Alez Prada, The Sociology of Financial Markets (Oxford 2004); Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (Oxford 2000).

233 See, e.g., Donald C. Langevoort, "Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harm)," 146 University of Pennsylvania Law Review 101 (1997).

term factors.[234] Clearly, many of the so-called "gatekeepers" at a variety of financial firms did a poor job of perceiving and managing risk in the months and weeks leading up to the global financial crisis.[235]

However, conceding that individuals may not always be acting in a fully rational manner when considering an investment decision is not the same thing as saying that they are incapable of making any such decisions on their own behalf. In the case of retail investors, the consequences of cognitive-based errors should be a concern for regulators, and comprehensive product-based regulation can be seen as a means for addressing these potential shortcomings. In the case of non-retail investors, although they may potentially suffer from similar cognitive gaps or omissions as retail investors, they possess the ability and the means to appoint agents to assist them with these concerns. As a result, the state can make a policy determination that such services do not need to be provided exclusively by the public purse. While a retail investor's potentially irrational choice should be mitigated by regulatory intervention within certain predetermined bounds, the non-retail investor can be left to pursue his or her irrationality to its foreseeable or unforeseeable ends, if the decision is taken not to retain knowledgeable and informed agents to correct such irrationalities. The observations of behavioural finance can make important contributions to better preparing those sophisticated investors who choose to participate in private investment funds to understand their decision-making processes, but they do not go so far as to eliminate from such investors any role in that process themselves.

The adoption of the Dodd-Frank amendments to the existing US financial regulatory regime represents an attempt by Congress to address some, but not all, of the concerns identified by critics of the policies that led to the 2007-09 financial crisis. Among the elements of Dodd-Frank is the requirement that substantially all managers of private funds are now required to register with the SEC as investment advisors. Dodd-Frank largely ignored the issues of investors suitability specifically, or fund governance generally.[236]

Given the significant increase in income and wealth since the original adoption of the accredited investor standard, the SEC has begun to slowly question the uniform ability of every member of this group to have the means to "fend for themselves."[237] Ultimately, as part of Dodd-Frank, the net worth test for individuals to qualify as accredited investors was amended to exclude a natural person's primary resource from such calculations.[238] Perhaps this small change is indicative of the speed and scale with which the SEC intends to act in this area. The SEC is further mandated to periodically review the numeric threshold set for accredited investors, but has to date not published any significant guidance on how it intends to approach any revisions.

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234 See, e.g., Guillermo Baquero and Marno Verbeek, "A Portrait of Hedge Fund Investors: Flows, Performance and Smart Money." ERIM Report Series Research in Management (2005), available at www.erim.eur.nl.

235 See, e.g., Donald C. Langevoort, "Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to Psychology, Culture and Ethics of Financial Risk Taking," 96 Cornell Law Review 1209 (2011); Donald C. Langevoort, "Theories, Assumptions and Securities Regulation: Market Efficiency Revisited," 140 University of Pennsylvania Law Review 851 (1992).

236 See Chapter 4 below.

237 As Smith observed, "[t]he Commission questioned the ability of this expanded class of accredited investors to understand the complexity and risk of privately offered pooled investment vehicles, including the lack of publicly available information about the investment, undisclosed conflicting interests, complex fee arrangements and higher risk structure." Ibid. at 271.

238 Dodd-Frank Section 413(a).

As noted above, this thesis will suggest instead that what such investors require is practical legal tools[239] by which they can secure adequate participation in the governance of the funds in which they participate. Private fund investors have both the incentive and the means to look after their interests. The private monitoring solutions proposed herein enable them to do so.

The question of whether any objective, numerical standard to qualify as an accredited investor should be higher (and if so, by how much) is an interesting question, but not one directly relevant to the subject addressed herein. Regardless of where the line is drawn, there will be a significant number of people just above, and just below, such line. This is ultimately the function of the line. Provided the line is not drawn at an arbitrarily high level to, in practice, prohibit any investors from qualifying, the mere acceptance of an objective threshold does not guarantee any certainty that a particular qualifying investor will have the particular skill and experience to invest in a particular fund.

The purpose of the private monitoring solutions proposed herein is to provide such qualifying investor the means by which to utilize the skills and experience they actually possess to influence the governance of the funds in which they invest to their maximum advantage.

2.6 **UK Taxation of Private Investment Funds**

As a result of various tax rules applicable to private investment funds, investors in many offshore private investment funds may be kept to relatively small percentage ownership. Such dispersed ownership can impede oversight and accountability in such funds, increasing the governance challenge facing investors. Further complicating matters is the prohibition on using partnerships for many trading strategies.

The primary advantage of using a UK limited partnership as a private investment fund is that it is treated as a tax transparent vehicle for both UK income and capital gains tax purposes. In the case of income, the UK legislation provides that the partnership will not itself be treated as an entity separate and distinct from the persons who are partners, so that the income of the partnership will be treated as income of the partners directly.[240] Equally, in the case of capital gains, any partnership dealings will be treated as dealings by the partners themselves, who will be separately assessed on any gains.[241]

For entities that are otherwise deemed to be companies for purposes of UK tax laws, a number of further issues arise that are particularly relevant with regards to offshore vehicles being used as private investment funds.

Generally, a non-UK incorporated company will not be subject to UK tax[242] unless the relevant company is either 'managed and controlled' in the UK or it carries on a trade in the UK through a 'permanent establishment'. Where a fund is established as an offshore company, it will be, therefore, essential that the vehicle be managed and controlled in such a way that it will be treated as neither resident in the UK for UK tax purposes nor as carrying on a trade in the UK through a permanent establishment. Unfortunately, a direct effect of these rules is to distance

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239 As Smith observed in connection with the Madoff investors, "[w]hat the Madoff fraud seemingly exposed was an astonishing lack of critical diligence by numerous sophisticated investors."

240 ICTA 1988, s111 (1).

241 TCGA 1992, s59.

242 Exemptions are made, however, for withholding taxes on interest and other limited categories of income received from the UK, and which have a UK source.

investors from the governance of these funds, thereby increasing the governance challenges presented (both literally and figuratively) by those structures.

In order not to be treated as resident in the UK, the affairs of an offshore company being used as a private investment fund must be conducted so that the central management and control of the fund is not exercised within the UK. Central management and control involves the formulation of the key strategic policies and decisions, rather than the day-to-day operations of the company. In a company, central management and control is typically vested with the board of directors;[243] however, it also needs to be established that under the company's constitutional documents (e.g., the Articles of Association) central management and control rests with the directors, and that in practice the directors exercise that power and do so outside the UK.

Central management and control is normally exercised by the board of directors of the fund but it could in appropriate circumstances be exercised by any other person (e.g., the fund manager). In identifying where the central management and control of a fund is exercised, the starting point is its board of directors. Normally, the fund's constitution will give the board the relevant powers and, in considering where the fund is taxable, the location of its board meetings is a good place to begin. However, two further questions will be immediately relevant:

(a) does the board have any real discretion or is it only allowed to take decisions within narrow parameters set down by (for example) the promoters of the fund?

(b) is the board truly taking decisions when it meets?

The appointment of a fund manager does not contravene this principle provided that the duties delegated do not amount to 'central management and control'. The board must retain the overall responsibility for the setting and regular review of the fund's investment policies and strategies, and for determining whether the fund should appoint new investment managers.[244]

In addition, the 'investment manager exemption' ensures that provided certain conditions are met an offshore hedge fund managed from the UK will generally not be subject to tax in the UK on its profits other than in respect of tax deducted at source, such as withholding tax on UK source annual interest.

The general rule is that a non-resident person is subject to UK taxation on 'trading' profits that arise through an agent in the UK. In the context of private investment funds, this means that in the absence of an exemption, the 'trading' profits of a hedge fund could be taxable due to the activities of the UK-based fund manager. Non-trading funds (which includes funds-of-funds) are not subject to UK tax other than in respect of withholding taxes.

What constitutes 'trading' is a fact-driven question not benefiting from definitive statutory definition. It is generally believed that frequent transactions, use of leverage and short-term motivations of a hedge fund would support a claim of 'trading'. Satisfying the investment

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[243] De Beers Consolidated Mines Ltd v Howe, [1906] AC 455.

[244] The UK tax authorities may be sceptical that board meetings are anything more than a rubber-stamping process if a majority of a board of directors are UK resident and are not themselves resident in the jurisdiction where board meetings regularly take place. They may also be sceptical that board meetings are the real decision-making forum if the board lacks members with expertise and experience so it cannot reach reasoned and well informed decisions on matters relating to the fund's investment policies and strategies.

manager exemption ensures that the profits of the offshore fund remain outside UK taxation, with only the fee income of the fund manager generated by the trades falling within the UK tax net.[245]

Broadly, the fund manager must deal with the fund on an arm's length basis to be deemed independent. This requires that the fund is either widely held or does not account for more than 70% of a UK manager's business (for newly launched funds, this condition must be met within 18 months of launch to enable managers to build new business). The manager must not have a greater than 20% interest in the fund (measured over a five year period).

Also, certain UK resident companies may also be subject to tax on the undistributed profits of non-UK resident companies which are 'controlled' by UK persons and persons connected with them.[246] These provisions subject UK companies that are deemed to be interested in at least 25 percent of the profits of a non-resident company to UK corporation tax in respect of undistributed profits of the fund, and in essence is an anti-deferral mechanism.

A fund will be categorized as a controlled foreign company where the fund is controlled by one or two shareholders each owning (together with any associated persons), broadly, at least 40 percent of the shares in the fund, and where one shareholder is UK resident. Persons who are treated as 'associated' with each other for these purposes includes two or more companies, one of which controls the other(s), or all of which are under common control.

Finally, unlike the offshore funds rules and controlled foreign companies regimes, Section 13 of the Taxation of Chargeable Gains Act (TCGA) counters the avoidance of capital gains tax charges by shareholders of closely held non-UK resident companies. If at any time when a capital gain accrues to an offshore company (such as on a disposal of any of its investments), the company is itself controlled by a sufficiently small number of persons so as to render the offshore company a body corporate that would, were it to have been resident in the UK for taxation purposes, be a 'close' company for those purposes,[247] then the provisions of Section 13 could subject to a UK resident shareholder to tax at the time the gain arises in the offshore company. If Section 13 applies, the UK resident shareholder is treated for the purposes of UK taxation as if a part of any chargeable gain accruing to the company had accrued to that shareholder directly. However a Section 13 tax charge is only imposed on UK resident shareholders owing at least 10 per cent[248] of the share capital of the offshore fund.

As a result, the net effect of UK tax rules is to promote a dispersal of ownership by limiting high levels of ownership concentration in the hands of one or more fund participants. Although the marketing restrictions applicable to private investments funds operate to ensure that retail investors are excluded from these funds, and therefore the non-retail investors should have access to the expertise and knowledge to adequate review and negotiate, if necessary, the fund documentation, the tax rules operate to prevent either a small number of large investors

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245 To benefit from this exemption, a fund manager must fulfil the following conditions: (a) the fund manager must carry on a business of providing investment advice; (b) the transactions in connection with the fund must be carried out in the ordinary course; (c) the fund manager must be independent of the fund; (d) the fund manager and connected persons must not be entitled to more than 20 percent of the profits arising out of the transaction (the '20 percent test'); (e) the fund manager must receive customary remuneration of its services; and (f) the fund manager must not act for the fund as an agent in relation to any other income.

246 ICTA, s747-56.

247 Close company is defined for these purposes under ICTA, s416. See also TCGA 1992, s13(x).

248 However, no s13 charge is imposed on UK individual shareholders which are not also UK domiciled. See TCGA, s13 (z).

or a single control investor, who might be able to exert exceptional influence on the fund manager.

2.7 US Taxation of Private Investment Funds

As in the UK, the implication of the US tax rules designed to limit tax avoidance also require investors in many offshore private investment funds to have relatively small percentage of ownership in funds. Again, such dispersed ownership can impede oversight and accountability in such funds, increasing the governance challenge facing investors.[249]

An organization, whether or not organized under US law, that is classified as a partnership for US federal income tax purposes is not subject to federal income tax itself, although it must file an annual information return with the US taxing authorities if it has certain US-source income and/or US partners.[250] Each US limited partner[251] will be required to take into account in computing his federal income tax liability his distributive share of a partnership's income, gains, losses, deductions, credits, and tax preference items for any taxable year of the partnership ending with or within the taxable year of such limited partner without regard to whether he has received or will receive a cash distribution from the partnership. Each item generally will have the same character and source (either US or foreign), as though the limited partner realized the item directly.

Income recognized by limited partner that is a tax-exempt entity is exempt from US federal income tax except to the extent of the entity's 'unrelated business taxable income' (UBTI). UBTI generally does not include dividends, interest, and gains from the sale of property that is neither inventory nor held for sale to customers in the ordinary course of business.[252] The general partner will frequently undertake to use reasonable efforts to conduct the affairs of a partnership (including the structuring of any borrowings, guarantees, and undertaking) so as to minimize the amount of UBTI incurred by a tax-exempt investor. Typically, UBTI is 'blocked' by the interposition of a corporate entity between the US tax-exempt investor and the partnership, thereby transforming UBTI into dividend income. The interposition of a blocker entity between the fund and the tax-exempt entity, however, further distances the tax-exempt investor from the governance of these funds, thereby increasing the governance challenges presented by these structures.

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[249] See, e.g., Rosenberg at 386 ("The need to retain flow-through taxation status of limited partnership can impose great restrictions on the ability of the limited partners to protect their investments. For example, if the limited partners decide that they no longer want to continue investing in a disappointing venture capital fund, they might attempt to sell their interest in the fund in the secondary market. While such a sale is legal (if allowed by the limited partnership agreement), it could jeopardize the flow-through taxation status of the partnership by causing it to meet the requirements of a publicly traded partnership under IRS regulations.").

[250] If the ownership of a partnership is widely held, and it were to be treated as a 'publicly traded partnership', however, it could be subject to US income tax in its own right as a corporation. Typically, the general partner will undertake to ensure that the partnership will not be treated as a publicly traded partnership taxable as a corporation and obtain certain representations and undertakings from each limited partner in order to maintain the absence of such status.

[251] US partnerships, and non-US partnerships with US partners and/or certain US-source income, must file a Form 1065 ('US Return of Partnership Income') for informational purposes. A Schedule K-1 ('Partner's Share of Income, Credits and Deductions') is included for each partner. Partnership agreements typically require that the Schedule K-1s be produced and circulated to partners within a predetermined period after the end of the tax year.

[252] A tax-exempt entity deriving gross income characterised as UBTI that exceeds US$1,000 in any taxable year is obligated to file a federal income tax return, even if it has no liability for that year as a result of deductions against such gross income, including an annual US$1,000 statutory deduction.

US Treasury regulations provide a largely elective regime for determining whether a business entity will be taxed as a partnership or as an association taxable as a corporation. Under this regime, certain business entities are treated as *per se* corporations for federal tax purposes and may not elect to be taxed as partnerships. All other business entities generally may choose their classification by filing a 'check the box' election with the IRS. Non-US entities that are eligible to elect their status and which have at least two members, at least one of which is personally liable for the debts of and claims against the entity, are generally classified as partnerships by default, without having to make an affirmative election.

If a US person owns at least 10 percent of the voting stock of a non-US corporation, the US person may be considered a 'US Shareholder' with respect thereto. If US Shareholders in the aggregate own more than 50 percent of the voting power or value of the stock of such corporation, the non-US corporation would be classified as a 'controlled foreign corporation' (a CFC). A number of complex attribution rules apply for purposes of determining ownership of stock in a non-US corporation for purposes of the CFC rules.

If the corporation qualified as a CFC for an uninterrupted period of 30 days or more during the taxable year, the US Shareholders of the CFC would generally be subject to current US tax on certain types of income of the foreign corporation (e.g., dividends, interest, certain rents and royalties, gain from the sale of property producing such income, certain income from sales and services) and, in certain circumstances, on earnings of the CFC that are invested in US property, regardless of whether they are in receipt of cash distributions from the CFC. In addition, gain on the sale of the CFC's stock by a US Shareholder (during the period that the corporation is a CFC and thereafter for a five-year period) would be classified in whole or in part as a division.

US tax law also contains special provisions dealing with 'passive foreign investment companies' (PFICs). A PFIC is defined as any foreign corporation if either:

(a) 75 percent or more of its gross income for a taxable year is 'passive income'; or

(b) 50 percent or more of its assets in any taxable year produce or are held for the production of 'passive income'.[253]

The PFIC provisions of the Code impose potentially punitive income tax treatment (an interest charge and re-characterization of net capital gains as ordinary income) on gains from the sale of, and on certain distributions with respect to, the shares of a PFIC owned directly or indirectly by a US taxpayer. There are no minimum stock ownership requirements for PFICs that must be met by a US shareholder in order to be subject to these rules.

Once a corporation qualifies as a PFIC it is, subject to certain exceptions, always treated as a PFIC, regardless of whether it satisfies either of the qualification tests in subsequent years. Any gain on disposition of stock of the PFIC as well as income realized on certain 'excess distributions' by the PFIC, would be treated as though realized by the shareholder rateably over his holding period in such stock. In addition to the tax on such gain or income as ordinary income, an interest charge would be imposed on the US person on the tax deferred from prior years in which the corporation was a PFIC.

A US person may elect under the Code to treat the PFIC as a 'qualified electing fund' (a QEF election). In lieu of the foregoing treatment, such person would be required to include in

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[253] s1297(a) of the Code.

income each year a portion of the ordinary earnings and net capital gains of the PFIC, even if not distributed. In order to make such election a US person would, among other things, be required to supply the IRS with an annual information statement provided by the PFIC. Alternatively, an election may be made in the case of certain 'marketable stock' to 'mark to market' the stock of a PFIC on an annual basis. Pursuant to such an election a US person would include in each year as ordinary income the excess, if any, of the fair market value of such stock over its adjusted basis at the end of the taxable year, and could deduct the excess, if any, of its adjusted basis for the stock over its fair market value, but only to the extent of any net mark-to-market gain included in income in prior years.

As noted above, tax rules such as these that prohibit either small numbers of large investors or a single control investor from taking a position in a private investment fund establishes a functional limit on the potential effectiveness of negotiations with the fund manager.

2.8 **Conclusions**

When prospective investors are contemplating an investment in a particular fund, their analysis will primarily (if not exclusively) focus on the talent and abilities of the fund manager. The assembled wisdom and experience of other fund participants will be an overwhelmingly secondary concern, if it is even expressly considered at all. Similarly, each investor will expect only limited circumstances where management of the fund can be materially changed by action of the other investors. Instead of control, the governance issues that arise in private funds are focused around the need for the fund manager to be held accountable to fund participants as they exercise their broad discriminatory authority.[254]

The legal vehicles which predominantly serve as private investment funds - i.e., limited partnerships and offshore companies - have established their prime position not due to any inherent advantage or benefits to be found in their internal governance structures. In general, both the limited partnership and the offshore company offer tremendous flexibility for fund managers to significantly limit the influence and oversight of participants, while facilitating the ability of managers to exercise control. Accountability can be significantly curtailed by fund documentation that provides only limited options to concerned investors.

The typical choice between either doing nothing or attempting to suspend the manager or terminate the fund is often too stark to address any situation other than the most dire and catastrophic. Simple problems can often be better solved by simple solutions than with extreme solutions. Where investors have recourse only to extreme solutions, fund managers may feel immune to investor sentiment when making important decisions for the fund.

The tension between the two principal regulatory forces - i.e., tax rules designed to protect tax receipts by prohibiting structures that avoid taxes payable, and marketing rules that seek to ensure the wider retail markets are protected from investment vehicles not fully vetted by regulators - neither addresses nor promotes solutions to the governance challenge. However, this tension is indicative of the conflicting drivers that operate to fashion private investment funds within the vacant spaces created by various legal and regulatory regimes, whether onshore or offshore.

As a result, investors will have to fall back on the effectiveness of the legal and regulatory duties to which the fund manager is subject to protect their position. The next chapter will therefore identify, analyze and critique the duties as they arise in the principal jurisdictions

[254] See Section 1.6 above.

where fund managers are located: the US and England and Wales. If they are inadequate to provide for effective governance of private funds, we will then have to look elsewhere to supplement them.

Chapter 3
Adequacy of Financial Regulation and Private Law to Address the Governance Challenge

3.1 Introduction

As we saw in the previous chapter, the legal structure of private investment funds, and the interests and rights of investors, are driven by the need to navigate tax and marketing restrictions. The combined impact of these requirements creates a fundamental tension: although investment funds can be marketed to sophisticated or professional investors, the implications of the legal vehicles used and the relevant tax laws are such that investors can be impaired in exercising the very expertise and experience on which the marketing rules and client classifications are based.

As a result, a central plank of investor protection is the duties imposed on the fund managers by regulatory rules and common law. A fund manager is appointed by one or more fund vehicles to determine the fund's investment strategy for the benefit of numerous fund participants. However, in recent years, reports of frauds and other malfeasances by fund managers have become increasingly common, prompting serious questions as to the adequacy of the applicable rules and duties, and of their enforcement, either through private law or through regulatory enforcement.

Regardless of the regulatory status of such funds, their investment managers will often be regulated under the applicable financial services regime[255] in the country in which they operate. In addition, such managers have to date typically operated from common law jurisdictions which impose on them fiduciary and other duties to the investors in their funds under the general law as a result of the discretion that exists in the relationship. In the absence of substantive product-level regulation,[256] the role of such regulatory and common law duties in securing investor protection is of primary importance.

In this chapter, I will analyze the adequacy of financial services regulation to address the governance challenge, by contrasting the product-level regulation of public investment funds with the approach taken by each of the SEC and the FSA. Next, I will critique the adequacy of the private law to address the governance challenge, including discussions of the duty of care, fiduciary duty and contract law.

3.2 The Madoff Debacle

The US has been a rich source of case studies for governance failures in private investment funds. Although hedge funds and private equity funds are not registered under the Investment Company Act, they and their advisers (regardless of whether the advisers are registered under the Investment Advisers Act) are subject to the antifraud provisions of the US federal securities laws. In recent years, the SEC has instituted a significant number of actions alleging fraud in relation to private investment funds (especially hedge funds), with no indication that the numbers will decline. Given the structural similarities between hedge funds and other types of

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255 See Julia Black, "Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes." 2 Regulatory and Governance 1, 9 (2008) ("A regulatory regime is the set of interrelated units which are engaged in joint problem solving to address a particular goal; its boundaries are defined by the definition of the problem being addressed, and it has some continuity over time.").

256 See Section 3.4 below.

private investment funds, such as private equity funds and venture capital funds, an analysis of investor protection failures in hedge funds can provide insights of more general application.

As noted above, the Madoff affair provides a useful meter stick against which these concerns about the governance challenge in private investment funds - e.g., lack of adequate information about the nature and operation of the fund's activities and an inability to effect change in those activities going forward (either directly or indirectly through duly appointed agents) - can be analyzed and improved. The Madoff affair is instructive because its scale and its scope provide ample examples of alleged failures in reporting, oversight and governance mechanisms which investors could encounter in connection with any participation in such vehicles, whether hedge funds, private equity funds, real estate opportunities funds or other more esoteric investment pools.

On 11 December 2008, the SEC filed an emergency action in the Southern District of New York to halt the ongoing fraudulent activities of Bernard L. Madoff and his firm, Bernard L. Madoff Investment Securities (BMIS).[257] The SEC's complaint alleged that Madoff informed two senior employees that his investment advisory business was a fraud and that he had for some time been paying returns to certain investors with principal received from other investors, estimating his losses to be at least $50 billion. The complaint charged Madoff and his firm with violations of the anti-fraud provisions of the Securities Act, the Exchange Act and the Investment Advisers Act. In the words of Andrew M. Calamari, Associate Director of Enforcement in the SEC's New York Regional Office, "Our complaint alleges a stunning fraud that appears to be of epic proportions". [258]

Liability and recovery in a private investment fund is primarily viewed as between fund manager and the participants in the fund. However, fund participants who benefited from fraudulent activity and are able to withdraw monies from the fund before the fraud was detected can also be liable to return some or all of their gains, even in the absence of any knowledge of, or a role in, the fraudulent activity.[259] As the Madoff affair unfolded, the issues of whether "winners" should be required to give up their gains to "losers" was clearly on the table.[260] Importantly, not all victims of fraud, either generally or specifically in the context of private investment funds, necessarily suffer losses equally.

The Madoff affair has also demonstrated that many investors who ended up exposed to Madoff, whether with their knowledge or without, by way of various feeder funds or funds-of-funds, believed that in exchange for the fees they were paying their intermediary fund manager, they were receiving from these agents a service, provided by a competent professional in fulfilment of the fund managers various legal and equitable duties. In hindsight, this appears not to be the case.

Conflicts of interest[261] abound in these relationships, as well. In one example that came to light as a result of the Madoff scandal, a Swiss private bank acted as investment manager,

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257 <u>SEC v Bernard L. Madoff</u>, 08 Giv. 10791 (SDNY 11 Dec 2008).

258 http://www.sec.gov/news/press/2008/2008-293.htm.

259 For example, in the <u>Bayou</u> litigation, a US bankruptcy court held that fund investors who received withdrawal proceeds from the fund prior to its collapse could be required to return such proceeds as part of the bankruptcy liquidation. See Section 3.11 above.

260 Alex Berenson, "Even Winners May Lose with Madoff", New York Times (19 December 2008).

261 A conflict of interest can occur where the investment manager or its principals have an existing or prospective commercial relationship which may create incentives to place their interests above the interest of their client,

custodian and leverage provider to one of the largest feeder funds into the Madoff scheme, earning separate fees for each service, while allegedly failing to conduct vigorous independent due diligence and instead relied on Madoff's reputation on Wall Street and his status as a registered firm with the SEC.[262] Importantly, many potential investors approached in connection with possibly investing in the Madoff scheme declined to participate in his scheme, when due diligence requests and follow-up questions were not satisfactorily answered.[263] The failure of the SEC to act upon clear and detailed information it was presented in connection with Madoff raises material concerns about any presumptions that financial regulators are better placed than investors in private investment funds to monitor the activities of fund managers.

In recent months, "increased regulation" has once again become a common battle cry for financial market reformers who wish to prevent rampant fraud on private fund investors.[264] However, a closer inspection of the SEC's repeated failures during the Madoff affair make for discouraging reading. In a statement issued on 16 December 2008, the SEC admitted that it had missed repeated opportunities to uncover the Madoff Ponzi scheme. SEC Chairman Christopher Cox stated:

> Our initial findings have been deeply troubling. The Commission has learned that credible and specific allegations regarding Mr. Madoff's financial wrongdoing, going back to at least 1999, were repeatedly brought to the attention of the SEC staff, but were never recommended to the Commission for action. I am gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them.[265]

As a result of these perceived failings, Chairman Cox authorized a full and immediate review of the past allegations regarding Madoff, including the internal policies at the SEC during this time and all staff contact and relationships with the Madoff family.[266]

Some of the potential oversights by the SEC are particularly notable. For example, Madoff's firm appeared to possess far fewer assets than the $17 billion he publicly claimed to be managing.[267] Also, it appears to be impossible in practice for the sums of money involved here to actually be invested pursuant to his claimed investment strategies because the underlying market for such investments was insufficient to handle the necessary trades.[268]

These admissions demonstrate the natural incompleteness of financial regulation as the sole means to address the governance challenge in private investment funds.[269] Madoff was well known to the SEC, and his brokerage firm and investment advisory firm were registered with

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thereby violating the fiduciary obligations owed to the client by the investment manager. Conflicts of interest can be actual, apparent or potential.

262 Nelson, D Schwartz, "Madoff Dealings Tarnished a Swiss Private Bank", New York Times (24 December 2008).

263 See Section 9.4 below.

264 See Chapter 4 below.

265 http://www.sec.gov/news/press/2008/2008-297.htm.

266 Ibid.

267 Alex Berenson, "Authorities Ease Madoff's Bail Terms", New York Times (18 December 2008).

268 Ibid.

269 See Section 1.9 above for a discussion of alternatives to top-down centralized regulations.

the SEC and subject to their oversight. The SEC had been informed over the past decade of concerns and allegations involving Madoff. He was a known quantity to the SEC and yet the SEC failed to uncover that he was engaged in one of the most basic of investor frauds – the classic Ponzi scheme.

The global casualty list from the Madoff affair is also informative. With victims as far afield from New York and Palm Beach as London, Geneva, Dubai and Hong Kong,[270] the ability of one national financial regulator to adequately monitor the interwoven web of vehicles, bank accounts and agreements is questionable.

The parties with the most direct interest in seeing that the behaviour of the fund manager is adequately monitored are the investors themselves. Properly equipped, these investors could play an important role in a decentralised regulatory regime by assisting the top-down command-and-control financial regulator achieve their regulatory goals.[271] Providing them effective means for overcoming the governance challenge in private investment funds — first, by ensuring that the fund manager provides participants with timely, complete and accurate information on the status of the fund, and second, by giving participants the means, either directly themselves or indirectly through their appointed agents (e.g., directors, general partners), to initiate changes to the operation and course of action of the fund — will enable them to better protect their rights and help avoid outcomes similar to the Madoff affair.

3.3 Adequacy of Financial Services Regulation to Address the Governance Challenge

As explained in Chapter 1, the governance challenge in private investment funds exists on the boundary between a fund participant's rights and a fund manager's obligation. As that line necessarily traverses through the internal documentation and operation of the fund vehicles,[272] financial regulators must approach their targets with a focus on how to best support the negotiating position of potential investors in obtaining the governance rights they may believe necessary without fatally undermining the core economic proposition that is being offered by the fund manager. Even where the funds they manage are unregulated, investment managers of private investment funds that are authorized or regulated as investment advisors or managers can owe regulatory duties arising under the financial services regimes of FSMA and EU legislation in the UK, including the Markets in Financial Instruments Directive (MiFID), and the Investment Advisers Act in the US.

In the case of public investment funds, comprehensive product-level regulations have been adopted (i.e., public monitoring solutions) to ensure that risks associated with conflicts of interest, lack of transparency and mismanagement, as well as portfolio risk, are adequately addressed. In the case of private investment funds, the participants are expected to rely on their own ability to negotiate adequate levels of protection to address those risks. As a consequence of limiting the extent to which private funds may be marketed and establishing particular status and/or size requirement in participants (e.g., sophisticated investors), the presumption of the regulator is that such investors have adequate negotiating leverage to address any governance concerns that they may have.[273] The reach of regulators in the area

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[270] See, e.g., the "victims list" made available by the Wall Street Journal on March 6, 2009, located at wsj.net/public/resources/document/st-madoff_victims_20081215.html.

[271] See Section 1.9 above.

[272] See Section 2.2 above.

[273] See Section 2.5 above.

of private investment funds, therefore, is limited and, more importantly, indirect. Regulators must typically make do with the powers they are able to exercise at the level of the authorized fund manager.

Through both rules and regulations of direct application to fund managers and the indirect influence that can be exerted on regulated firms through the adoption and promotion of "best practices" on a voluntary basis,[274] financial regulators can significantly impact the day-to-day environment in which private investment funds operate. However, such influences can be exercised by such regulators only within the natural limitations that exist due to limited resources and competing agendas and needs across the financial landscape.

3.4 **Public Investment Funds**

Many retail investors participate in the financial markets by way of public investment funds, known as "mutual funds" or "collective investment schemes"[275], which are registered with the national financial regulator and subject to detailed requirements on what they can do with investors' money.[276] They make take the legal form of unit trusts, companies, or limited partnerships. Public investment funds have traditionally been subject to intensive regulation, due to the participation in these funds of unsophisticated retail investors. As one commentator has observed:

> It has long been recognized that collective-investment schemes should be regulated in the interests of investor protection, particularly as collective-investment schemes are often directed at unsophisticated and inexperienced investors who do not exercise control over the investments made by the scheme or the scheme assets: the regulation of those who control large pools of liquid capital is usually irresistible to regulators fearful of abuse.[277]

As a result of these concerns, elaborate product-level requirements have been imposed on retail funds in many countries, including the UK and the US. Both retail and non-retail investors have access to publically regulated investment funds, such as mutual funds or UCITS,[278] if they so wish. Only non-retail investors may elect to participate in private investment funds, and should they decide to do so, such investment must be made in the knowledge that the financial regulator has not taken on responsibility, or allocated any resources, to ensure that such funds are what they purport to be.

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274 See Chapter 5 below.

275 "Collective investment scheme" is a British term that refers to open-ended investment vehicles. See Moloney, EC Securities Regulation at 231 ("A collective-investment scheme is a popular form of investment vehicle which allows investors with limited funds to access the capital markets through a fund which pools investors' funds and spread risk across a range of investments according to defined asset-selection and risk criteria.")

276 For a detailed discussion of these requirements, see Niamh Moloney, How to Protect Investors: Lessons from the EC and the UK, Chapter 3 (Cambridge 2010).

277 Moloney, EC Securities Regulation at 234.

278 Moloney, How to Protect Investors at 134 ("Product design regulation, typically linked to the authorization of the product for public marketing and so associated with segnatation-based regulation, is one of the three areas of retail market protection along with the regulation of distribution and disclosure.").

As opposed to the product regulations which are mandated for funds in which retails investors may participate,[279] non-retail investors must research and negotiate fund terms, and ultimately decide on their participation (if at all), themselves.

Common to both types of funds, however, are issues of disclosure and the utility of disclosure as a regulatory tool. As one commentator observed:

> Disclosure interferes only to a limited extent with the autonomy of the investment firm and the investors. It can empower investors to achieve their investment objectives and support regulatory efficiencies by accommodating asymmetric investor ability.[280]

While much of securities regulation generally, and the indirect regulation of private investment funds specifically, has tended to be based in large part on disclosure requirements, in the case of public investment funds, regulators have preferred interventionist asset allocation rules, which explicitly constrain what these funds can do.[281] Traditionally, financial regulators were reluctant to apply detailed, invasive regulation on private investment funds,[282] although by 2010, in the aftermath of the global financial crisis, both the US and the EU generally moved towards an incremental increase in the regulation of private fund managers although did not go so far as to impose product-level restrictions on the funds themselves.

Important distinctions exist between public funds and private funds, including in their management and governance structure. As one commentator observed, when comparing mutual funds[283] to hedge funds:

> Unlike mutual funds, which must comply with detailed requirements for independent boards of directors, and whose shareholders must explicitly approve certain actions, domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management.[284]

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[279] Ibid. at 1420 ("CIS product regulation requires the regulator to make choices concerning the structure and engineering of financial products which are likely to be made more efficiently by the industry."). See also Nathan D. Lobell, "The Mutual Fund: A Structural Analysis," 47 Virginia Law Review 181 (1961).

[280] Maloney, How to Protect Investors at 290-291. For a discussion of limitations to the effectiveness of disclosure, see Section 6.7 below.

[281] See Ibid. at 235. ("Collective-investment regulation for the retail markets is typically based on prescriptive asset-allocation rules, or portfolio-shaping rules, which are considerably more interventionist and paternalistic than the disclosure strategies often employed in securities regulation."). See also Donald C. Langevoort, "The SEC as a Lawmaker: Choices about Investor Protection in the Face of Uncertainty," 89 Washington University Law Review 1591 (2006).

[282] As Moloney observed in 2008, "[t]he Commission appears similarly reluctant to impose regulation on the institutional market for alternative investments and, in particular, on the high profile hedge fund and private equity sectors . . ." Moloney, EC Securities Regulation at 333. However, Moloney concluded that ultimately concerns over hedge fund transparency and their impact on market stability, and persistent criticisms of private equity, could lead to EC regulation. Ultimately, the adoption of AIFMD in 2010 proved this view correct. See Chapter 5 below.

[283] For a short description of mutual fund structure and operation, see Martin E. Lybecker, "Enhanced Corporate Governance for Mutual Funds: A Flaws Concept that Deserves Serious Reconsideration," 83 Wash Uni Law Quarterly 1045, 1045-1052 (2005). As Lybecker observes, "[m]utual funds are the most popular retail investment in America, a testament to the simplicity and transparency of the mutual fund concept."). Ibid. at 1046. For a discussion of EU public funds, and in particular UCITS, see Moloney, How to Protect Investors.

[284] See Markham at 101-102.

Until recently, claims have been made that hedge funds had adequately addressed potential conflicts of interest without such intrusive devices.[285] However, it is unlikely that such assertions would be accepted on its face in the years following the 2007-09 financial crisis.

3.5 **FSA Regulation**

In connection with private investment funds, the FSMA addresses two principal regulated activities:

(a) management of an investment portfolio with discretion; and

(b) establishing and operating a CIS.

Under the FSA rules, the 'operator' of a CIS is the person responsible for the management of the property held for or within the scheme. Establishing, operating or winding up a CIS is a regulated activity under the Act, and any person wishing to act as an operator must be authorized by the FSA. In the case of a Partnership PIF, the usual structure would be for the general partner (which is usually no more than a shelf company in view of its potential liabilities as a general partner) to appoint an appropriate FSA regulated person to be the manager of the partnership.

A CIS includes any arrangement with respect to property whose purpose or effect is to enable persons taking part in the arrangements to participate in the profits or income arising from the acquisition, holding, management, or disposal of the property.[286] The arrangements must be such that participants do not have day-to-day control over the management of the property,[287] whether or not they have the right to be consulted or give directions. Such arrangements must have either or both of the following characteristics:

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; or

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

The limitation on the participants' day-to-day control[288] over the property gives rise to the concept of management by another person.

Unless considerable effort is exerted otherwise, private investment funds will typically fall within the definition of unregulated CIS. For example, limited partnerships formed for investment purposes (such as most private equity funds and many real estate funds) will

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[285] Ibid. at 155. ("Hedge funds have become one of the most successful investment mediums in the country without SEC regulation. The hedge funds have conflicts of interest but have dealt with them adequately without a mandated number of outside directors.").

[286] FSMA, s235 and SI 2001/1062 (as amended by SI 2001/3650). The definition is similar to the definition formerly contained in s 75 of the Financial Services Act 1986.

[287] Importantly, the property to which the arrangements relate need not be limited to securities. Arrangements with regard to real property or cash, among other things, may give rise to a CIS.

[288] Section 235(2) makes a distinction between 'day-to-day control' and 'the right to be consulted or to give directions'. Making this distinction in practice can prove difficult. The issue of whether participants have the necessary control over the management of the property to bring the arrangements out of the definition of a CIS, rather than limited consultation or direction rights, is a fact-driven enquiry to determine where on the continuum of control a particular arrangement falls.

generally constitute a CIS under Section 235 of the FSMA, when it is operated by way of business, as the limited partners cannot have day-to-day control of the management of the partnership property without losing their limited liability.[289] The nature and/or location of the property held by the limited partnership is not relevant to this analysis.

A fund manager will generally need authorization from the FSA if it carries on regulated activities in or from the UK.[290] As most clients of private fund managers will be classed as professional clients or eligible counterparties, COBs regulation of their activities is generally light. Importantly, the fund is generally the customer of the manager/operator, rather than the investors in the fund.[291] Under COBs 18.5.3R (2), references to a 'customer' are construed as references to any scheme in respect of which the operator acts or intends to act and which benefits from the operator's activity. Therefore, the customer of the manager is the limited partnership itself, for example, and not each partner of the limited partnership.

However, under COBs 18.5.3R (2), when the manager is required to provide information to, or obtain consent from, a customer, the manager must ensure that the information is provided to, or consent obtained from, the partners in the limited partnership. This requirement applies only to unregulated CISs and is usually dealt with by inserting a reference to the relevant matter in the limited partnership agreement.

Where the manager or general partner appoints a specialist investment adviser, the investment adviser will be acting as an agent for the limited partners, who may each become clients of the investment adviser, as the definition of 'client' includes indirect clients. However, COBs 2.4.3R permits the investment adviser to treat the manager as its client if it reasonably believes that the manager is an authorized person in respect of the investment services provided.

The fund manager must determine into which category of client a private investment fund falls, as this is a requirement under the FSA Rules, and is necessary to establish the extent of the duties owed to the client under the FSA Rules. Retail clients are given the most regulatory protection and eligible counterparties the least. If a private investment fund can be treated as an professional client, or if it elects to be treated as such under FSA rules, some of the rules can be either modified or excluded altogether.[292]

In particular, treatment as a professional client would lead to fewer protections under the FSA regime than would be due to a retail client. For example, a professional client will receive fewer informational disclosures from the fund manager. In addition, where the fund manager

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289 Partnership Act 1890, s 1. Limited Partnership Act 1907, s4. Interestingly, this would not be the case for a limited liability partnership ('LLP') established under the Limited Liability Partnership Act 2000, as members may have day-to-day control of property.

290 General COBs requirements include provisions on such matters as: client categorization, providing information to clients, suitability, best execution and conflicts of interest management. A limited set of the rules in COBs applies to activities performed by the operator of a fund in relation to that operation and there are relevant modifications for some other activities. There are also special provisions in COBs 18.5 regarding content of the scheme documents and statements which need to be supplied to fund investors, although these provisions are generally relevant only for funds containing investors classed as retail clients.

291 See DP06/6 at 18.

292 In order to be treated as an professional client the private investment fund must be either:

(a) an unregulated CIS;

(b) a vehicle which meets the large undertaking requirement in COBs 3.5.2R; or

(c) a retail client, classified as a professional client by the manager in accordance with COBs 3.5.3R.

determines that a product or service is appropriate for a professional client, the fund manager can assume that such client has the necessary knowledge and experience to understand and evaluate the risks involved in such product or services. Also, a professional client is not entitled to compensation under the Financial Services Compensation Scheme.[293]

Clearly, the distinctions between professional clients and retail clients are material ones and an important component of financial regulation in the UK, as harmonized by MiFiD. In addition, where the line is drawn between who is a retail investor and who is not a retail investor is a matter of public debate. However, where such line should be drawn is not within the scope of this thesis. This thesis presumes that such a line will continue to be drawn, as these have been no credible proposals for the "retailization" of the entire investment community regardless of size or experience or sophistication. As such, a significant number of potential investors will be categorized as non-retail, exempted from certain mandated protections and consequently permitted to invest in private investment funds. Therefore, the private monitoring solutions advocated for herein establish tools and constructs for such investors to adequately protect themselves in the absence of direct government regulation of these funds. The practical importance of these solutions exists independent of the size of the pool of non-retail investors who may invest in these funds, and would not be impaired or comprised should such pool be contracted by 10% (or by 50%) due to the raising of the definitional bar.

In sum, while the private investment fund itself sits outside the reach of the FSA, a fund manager will be an authorized firm that must comply with applicable UK and European law. However, the manner in which a fund is structured and documented, and the potential recourse that fund participants would have against a fund manager for wrongdoing, would be dependent on other legal avenues. Although the minimum behavioural standard established for fund managers by financial regulation is a necessary component of investor protection, it is not sufficient in itself to address all investor protection concerns, including the governance challenge.

3.6 **SEC Regulation**

The SEC regulates investment advisers and managers primarily under the Investment Advisers Act and the rules adopted under that statute.[294] The Investment Advisers Act is intended to protect investors whose assets are managed by investment advisers either directly in regards to their own individual portfolio, or indirectly in connection with pooled vehicles.[295] In response to the 2007-09 financial crisis, the US Congress adopted the Dodd-Frank amendments to the financial regulatory regime. These changes are discussed in Chapter 4 below.

One of the central elements of the US regulatory programme is the requirement that a person or firm meeting the definition of 'investment adviser' under the Investment Advisers Act register with the SEC, unless exempt from registration. A person or firm is generally required to register with the SEC if he or it is:

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[293] In addition, there are other protections to which professional clients are not entitled, but these are not typically an issue in investment management relationships, such as best execution and client money rules.

[294] For a general introduction, see Joshua E. Broaded, A Survey of Regulations Applicable to Investment Advisers," 12 Duquesne Business Law Journal 27 (2009).

[295] See SEC v Saltzman, 127 F Supp 2d 660, 669 (ED PA 2000).

(a) an 'investment adviser' under Section 202(a)(11)[296] of the Investment Advisers Act; and

(b) not otherwise exempt from SEC registration.[297]

A person or firm must satisfy all three elements to be regulated under the Investment Advisers Act.[298]

Section 206 of the Investment Advisers Act prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business.[299] As a fiduciary, an investment adviser owes its clients undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent.[300] Section 206 applies to all firms and persons meeting the Investment Advisers Act's definition of investment adviser, whether registered with the SEC, a state securities authority, or not at all. As commentators have noted:

> The antifraud provisions of Section 206 have served for more than forty years as the basis for seemingly countless actions against investment advisors. Lurking behind the use of provisions in this way is their breadth and the relative ease with which the SEC can prove that an investment adviser has violated them.[301]

In addition to the general anti-fraud prohibition of Section 206, specifications under the Investment Advisers Act regulate, respectively: investment adviser advertising;[302] custody or possession of client funds or securities;[303] the payment of fees by advisers to third parties for client referrals;[304] and disclosure of investment advisers' financial and disciplinary backgrounds.[305]

Rule 204-3 under the Investment Advisers Act, commonly referred to as the 'brochure rule', generally requires every SEC-registered investment adviser to deliver to each prospective advisory client a written disclosure statement, or 'brochure', describing the adviser's business

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[296] Section 202(a)(11) of the Advisers Act generally defines an 'investment adviser' as any person or firm that: (a) for compensation; (b) is engaged in the business of; or (c) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.

[297] For discussion of the current exemptions under Dodd-Frank, see Section 4.2 below.

[298] There are currently approximately 11,000 investment advisors registered with the SEC, an organization with a staff of 3,500 persons.

[299] Importantly, Section 206 applies to all investment advisers, whether registered or unregistered. See SEC v KL Group LLC, Litigation Release No 19117 (3 March 2005).

[300] In SEC v Capital Gains Research Bureau,Inc 375 US 180 (1963), the US Supreme Court held that, under s206, advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them.

[301] Barry P. Barbash and Jai Massari, "The Investment Advisers Act of 1940: Regulation by Accretion," 39 Rutgers Law Journal 627, 630 (2007-08).

[302] Rule 206(4)-1.

[303] Rule 206(4)-2.

[304] Rule 206(4)-3.

[305] Rule 206(4)-4.

practices and educational and business background. The information required by the brochure rule is included as Part II of Form ADV, the registration form for investment advisers.[306]

In reaction to the increased perception of fraud and malfeasance in hedge funds, on 11 July 2007, the SEC adopted the new anti-fraud Rule 206(4)-8, that prohibits advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors in those pools, or (ii) otherwise defrauding them. The SEC enforces the rule through administrative and civil actions against advisers under Section 206(4) of the Investment Advisers Act. There would be no private cause of action against an adviser under the rule.

Any investment adviser to a pooled investment vehicle is covered by the rule, including advisers that are not registered or required to be registered under the Investment Advisers Act. The rule does not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in pools that are excluded from the 1940 Act definition of investment company under Section 3(a) by reason of either Section 3(c)(1) or 3(c)(7) of the 1940 Act.[307]

The wording of the rule, which is similar to that in many other US antifraud laws and rules, prohibits false or misleading statements of material facts by investment advisers. Unlike rule 10b-5 under the Exchange Act and other rules that focus on securities transactions, however, rule 206(4)-8 is not limited to fraud in connection with the purchase and sale of a security. Accordingly, rule 206(4)-8(a)(1) prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities.[308]

Fund participants have certain avenues of direct recourse under the regulatory regime against fund managers for malfeasance on an "after-the-fact" basis. Similar to the position in the UK discussed above, the SEC rules and regulations establish a minimum behavioural standard for fund managers, but does not go so far as to mandate structural or governance parameters for private investment funds.

3.7 Effectiveness of Regulatory Enforcement Actions

While the FSA to date has limited its enforcement activities involving private funds to isolated cases of market abuse and insider trading,[309] the SEC's primary mission is to protect investors and the integrity of US financial markets through the enforcement of the federal securities

[306] To comply with the brochure rule, an investment adviser either may deliver Part II of Form ADV, or another document containing at least the information disclosed in Part II of Form ADV. For a discussion of limitations to the effectiveness of disclosure, see Section 6.7 below.

[307] See Section 2.5 above.

[308] Private placement memoranda, requests for proposals, account statements, and any other form of communication are covered by the proposed rules on an ongoing basis. Importantly, however, proposed rule 206(4)-8 would not create a fiduciary duty to investors or prospective investors in the pooled investment vehicle not otherwise imposed by law.

[309] The most high profile case that the FSA has pursued so far was against Philippe Jabre of GLG who received a fine of £750,000 for insider trading in August 2006. Other cases, such as Steven Harrison of Moore Capital (September 2008), Simon Treacher of Blue Bay Asset Management (February 2010) and Anjam Saeed Ahmad (June 2010), led to lesser fines, but each expressly excluded any criticisms of these individual's employers.

laws.[310] Although private investment funds are not subject to the detailed, prescriptive requirements (and fiduciary safeguards) of retail mutual funds, they remain subject to the anti-fraud provision of the federal securities laws, which include Section 10(5) of the Exchange Act and Rule 10(b)-5 thereunder, Section 17(a) of the Securities Act, and Sections 206(1) and 206(2) of the Investment Advisers Act and Rule 206(4)-8 thereunder.[311]

In recent years the SEC has instituted a significant number of enforcement actions against hedge funds.[312] The fraud charged against fund managers has been similar to the types of fraud charged against other types of investment advisers.[313] The majority of the cases instituted by the SEC have involved charges under the Securities Act, the Exchange Act, and the Investment Advisers Act.[314]

The SEC's focus has historically been on protecting investors and those aspects of private investment funds which raise investor protection issues.[315] Recent enforcement actions brought by the SEC have focussed on materially false or misleading statements regarding investment strategies the fund will pursue, the experience and credentials of the fund manager,[316] the risks associated with an investment in the fund, the performance of the funds advised by the fund manager,[317] the valuation of the fund, and practices the fund manager follows in the operation of its investment business, such as how the fund manager allocates investment opportunities.

Although many private investments funds fail because they make poor investment decisions, a number of funds fall victim to intentional fraud committed by individuals associated with the fund manager, which may have started from the launch of the fund or may have begun later in an attempt to earn back or hide significant losses. Often the frauds operate as "Ponzi schemes"[318] in which further money is taken in from current or new investors which can be used to create the appearance of success and profitability.

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310 Linda Chalman Thomson, Daniel M. Hawke & Pauline E. Calonde, "Hedge Funds: An Enforcement Perspective", 39 Rutgers Law Journal 541, 541 (2008).

311 Ibid at 555. Similarly, private investors in the UK may have recourse under section 150 FSMA, although its invocation is not as frequent as private rights of action in the US. See, e.g., Iain MacNeil, "The Evolution of Regulatory Enforcement Actions in the UK Capital Markets: A Case of 'Less is More'?", 2(4) Capital Markets Law Journal 345 (2007).

312 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No 2333. (2 December 2004).

313 See Markham.

314 Potential securities law violations come to the SEC's attention through either complaints from disgruntled employees or investors. Matters may be referred to the SECs Enforcement Division by their Office of Compliance, Inspections and Examinations (OCIE), where issues arise as part of a periodic examination. However, OCIE's coverage of private investment funds is limited to those with fund managers registered under the Investment Advisers Act.

315 It can be useful in certain contexts to distinguish between public and private enforcement actions. See, e.g., MacNeil at 360 ('The respective roles of public and private enforcement are an important characteristic of the enforcement regime for capital markets. Public enforcement tends to focus on punishment and deference, whereas private enforcement tends to focus on restitution and compensation.") I discuss the effectiveness of private litigation by investors in Section 3.11 below.

316 See SEC v EPG Global Private Equity Fund, Litigation Release No 18577 (17 Feb 2004); SEC v Peter W Chabot, Litigation Release No 18214 (3 July 2003).

317 See In the Matter of Evan Misshula, Investment Advisers Act Release No 2524 (21 June 2006).

318 A "Ponzi scheme" can be described as "a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those

An important characteristic in many cases is the great extent the violators go to conceal their fraud. Fund managers may create false documentation in an effort to hide their fraud, including account statements and other reports to customers. To the extent that fund investors are able to oversee more fully the activities of the fund manager, the possible scope for such concealment can decrease.

The current financial turmoil unleashed by the current "credit crunch" and subsequent period of economic distress has served to increase and accelerate SEC enforcement action against hedge funds and other private investment funds. These cases demonstrate a recurring pattern of fund managers engaging in fraudulent activities without adequate oversight by the fund investors. Many recent claims involve misrepresentations by fund managers as to performance of their fund.[319] In other cases, fund managers engaged in trading that was different from, and often riskier than, what had been disclosed to fund participants.[320] In some instances, however, the cases involved nothing more complex than simple fraud and theft.[321] A common theme in a number of these enforcement actions has been false reporting and manipulated valuations.[322]

One could argue that regulators can address some of the governance concerns identified above by regularly conducting a small number of very well publicized enforcement actions in order to address the more serious malfeasances that could result from governance failure, under the exceptional broad scope of either Section 206[323] or Rule 206(4)-8.[324]

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investments to pay for high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors." Hirsch v Arthur Anderson & Co., 72 F3d 1085, 1088 (2d Cir 1995).

319 In SEC v Coadum Advisors, Inc*.,* the SEC filed complaints against two individuals who controlled a group of six fund vehicles. In connection with a securities offering, the companies raised $30 million from 150 investors by misrepresenting how the money would be invested. They also misrepresented the supposedly earned profits, made $3 million in loans to themselves and disbursed $5 million to related parties. Litigation Release No. 20475 (4 March 2008). The defendants were ultimately found guilty. Litigation Release No. 21406 (3 February 2010). See also SEC v Balboa, No 11-CV-08731 (SDNY 2011).

320 In SEC v Thompson Consulting, Inc*.,* the SEC instituted an enforcement action against a fund manager and its three principals. Defendants engaged in much riskier trading strategies than disclosed to investors and improperly transferring money from the hedge fund to the account they managed for an individual client to make up for that individual's losses. Litigation Release No. 20444 (29 January 2008). The defendants were ultimately found guilty. Litigation Release No. 21628 (18 August 2010). See also SEC v Rooney, No 11-CV-08264 (ND Ill 2011).

321 In SEC v Northshore Asset Management*,* the SEC received final civil judgment against individual defendants who acquired control of two hedge funds, then systematically drained the funds for personal use and self-dealing investments. The defendants misrepresented their actions and concealed material facts from current and incoming investors, including that one defendant had been previously charged with unrelated investment advisers fraud. Litigation Release No. 20632 (1 July 2008).

322 In SEC v Daniel N. Jones and Azure Bay Management, LLC*,* the SEC received final civil judgment by consent against the individual defendant and LLC manager of a hedge fund, The Addington Fund LP. The individual defendant lied about sizable fund losses, submitting false financial statements and performance reports to investors while continuing to take substantial fees on the supposed gains. Litigation Release No. 20727 (19 September 2008). See also SEC v Kapur, No 11-CV-08094 (SDNY 2011); SEC v Southridge Capital Management, Litigation Release No 21709 (25 October 2010); SEC v Mannion, Litigation Release No 21699 (19 October 2010).

323 See Barbash and Massari at 631 ("Armed with Section 206, the SEC over time has used its enforcement authority to bring a wide array of cases against investment advisors and in the process has set substantive standards for advisors generally."). See also Arthur B. Laby, "Fiduciary Obligations of Broker-Dealers and Investment Advisers," 55 Villanova Law Review 701 (2010).

However, there are significant limitations to "rulemaking" by enforcement actions. Since the cases typically involve outlandish or egregious conduct, the remedies dispensed may be more onerous and inflexible then in cases of less extreme conduct.[325] Also, since each enforcement action is tied to a very particular set of facts, any "rules" that are produced will often be incomplete or difficult to apply in other circumstances.[326] Moreover, where the decisions are made by regulators rather than courts, they can be of limited precedential value as regulators are not bound by the strict rules of precedent which apply to courts in common law jurisdictions in making their decisions.

3.8 **Adequacy of the Private Law to Address the Governance Challenge**

Underlying the financial regulatory system described above, which has become the primary focus of attention when debating what to do about problems which have arisen in the financial services industry, is a much older system of private law that addresses many aspects of the relationship between an investment manager and its clients. Prior to the development of a more comprehensive system of financial services regulation, the private law provided the primary basis for resolving disputes when they arose. The increased use of intermediary vehicles as private investment funds, however, has meant that in many circumstances these potential remedies have ceased to be sufficient to address the governance challenge.

Investment managers owe legal duties to their clients arising under contract, tort, and as fiduciary duty from the provision of investment management services, subject to contractual limitations thereto. Where the client is a private investment fund, participants in that vehicle must rely on the governance mechanisms therein in order for redress to be sought against a fund manager who has breached such duties. Private law remedies which might be adequate in a bilateral relationship between a single client and a directly appointed investment manager pursuant to a negotiated agreement between the parties can be undermined by the complexity of the fund structure adopted by the fund manager, as well as the key fund documentation.

The investment manager possesses discretion for day-to-day investment activity, portfolio construction, and risk management/control of the fund. The nature of the relationship between a fund and its investment manager can be seen as analogous in many key respects to that of professional advisors, such as lawyers and accountants, where an element of trust and dependence sits at the core of the interactions. Concepts of agency law frame this discourse, especially in the context of the broad discretion frequently exercised by the investment manager.

A sample of potential private law causes of action available to disgruntled investor in private investment funds can be seen in the various lawsuits emerging from the Madoff affair.[327] For example, on 19 December, 2008, a class action lawsuit was filed in New York State Supreme Court in Manhattan against the funds-of-funds firm Fairfield Greenwich Group, one of the

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324 See Barbash and Massari at 651 ("The relative simplicity of Rule 206(4)-8 belies its potential scope. The Rule's reach appears to be virtually unlimited in terms of the written materials prepared by, and conduct engaged in by, advisors that could be prohibited under the Rule."). See also Christopher D. Barnstable-Brown, "Investment Advisors Act Rule 206(4)-8: Antifraud for the Masses," The Investment Lawyer, Vol 15, No 4 (April 2008).

325 Barbash and Massari at 654.

326 Ibid.

327 See Section 3.2 above.

largest investors in the Madoff scheme.[328] The complainant alleged that the various defendants breached fiduciary duties owed to the plaintiffs and committed negligence in connection with their management of the plaintiff's investments. In connection with the fiduciary duties claims, the plaintiffs alleged that the defendants failed to act with loyalty and in good faith towards the plaintiffs, failed to take reasonable steps to oversee and preserve the plaintiff's investments, failed to perform necessary due diligence and maintain oversight and transparency for investments, and failed to exercise generally the required degree of prudence, caution and good business practices. In connection with the negligence claim, the plaintiff alleged similar failures amounting to a breach of the duty of care they were owed by the defendant in tort.

Notably, litigation involving investment managers has been surprisingly rare in both the US and the UK,[329] leading to an unhelpful lack of decided cases involving the question of private law duties of investment managers. Reasons suggested in the past for this anomaly include that the burden of proof is perceived to be high and that the time required to litigate such claims means that significant gains and losses could be experienced in the client's portfolio before a final judgement is rendered.[330] Perhaps a (minor) benefit of the Madoff litigation will be a more fuller analysis of how the general legal and equitable principles discussed below apply to investment managers generally and private fund managers specifically.

3.9 The Duty of Care

Where a client relies on the expertise and skills of an investment manager, there will be a duty of care to manage the client's investments as a reasonable investment manager would.[331] An investment manager will thereafter be liable for acts of negligence where there is a duty of care (which may arise from a contractual relationship with the client), a breach of that duty and a loss that is reasonably foreseeable.[332] Negligence is the failure by a person to observe a recognized duty of care to another party, resulting in damages to that party. A duty of care arises where there exists:

(a) a risk of harm foreseeable to a reasonable person;[333] and

(b) a legally recognized relationship of proximity between the parties.[334]

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328 Index No.08/603769, Supreme Court of the State of New York, County of New York (19 Dec 2008). The named plaintiffs were investors in Fairfields largest fund, Greenwich Sentry, L.P., a Delaware limited partnership (Sentry), which had significant assets invested with Madoff. The plaintiffs were limited partners in Sentry. Various Fairfield entities served as the general partner and investment advisers to Sentry.

329 As discussed above, the overwhelming majority of hedge funds and private equity funds remain based in either the US or the UK. As a result, this thesis will focus on the private law duties in place in these countries when evaluating how these duties impact the governance challenge.

330 Robin Ellison, "Asset managers: What is the duty of care?", *Pensions* vol. 9, 1, 14-21.

331 Ibid.

332 Ibid. See, e.g., Nestle v National Westminster Bank [2002] WTLR 795.

333 See Glasgow Corporation v Muir, [1943] 2 All ER 44.

334 See Caparo Industries plc v Dickman, [1990] 1 All ER 568 at 573. In Caparo, the court held that auditors owe no duty of care to the public at large who rely on audited accounts when buying shares in a company. A more recent case on this point of proximity is HM Commissioners of Customs and Excise v Barclays Bank plc, [2006] UK HL 28, in which a bank that received a notice of a freezing injunction was held not to owe a duty of care to the party who sought the injunction to prevent the dissipation of assets covered by the injunction and within its control.

A recent case involving an investment fund is particularly relevant to the latter element of proximity. In Riyad Bank v Ahli United Bank (UK) plc,[335] the court held that, despite the lack to the latter element of proximity of a direct contractual relationship between the parties, an advisor can be liable to the ultimate recipient of the advice for such advice, dependant on the facts of the relationship.

The leading authority on the duty of care owed by persons acting as advisers is Hedley Byrne v Heller Partners.[336] For determining the duty of care owed by a professional, the test of what could be expected by a reasonably competent professional will be based on a measure of competence that is dependent on:[337]

(a) whether the professional had specialist expertise;

(b) the nature of the business; and

(c) field of practice of the individual.

Where the professional is regulated, such regulations may be relevant to these determinations.[338]

An investment manager with discretion to implement its own recommendations for its client's investment portfolio owes a particular duty of care to such client.[339] Often, the agreed level of care will be explicitly described in the contract between the two parties.[340] However, despite such qualifications, the investment manager retains an obligation to use reasonable care and skill in the course of its activities, creating the basis for a claim of negligence by a client who suffers a loss in circumstances where such care and skill were not used.[341] A claim of negligence will require more than simply one or more poor investment decisions.[342] In the financial services area, the legal standard against which an investment manager would be held is the level of care and prudence that the ordinary skilled person in that field would use in such

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335 [2006] EWCA Civ 780.

336 [1964] AC 465.

337 Seymour v Ockwell, [2005] EWHC 1137.

338 Ibid.

339 See Henderson v Merrett Syndicates, [1995] AC 145. The principles underlying such duty traced back to Hedley Byrne & Co Ltd v Heller & Partners Ltd, [1964] AC 465, the seminal case on the duty of care owed by advisers. Lord Morris laid out the origination of such duty of care where 'in a sphere in which a person is so placed that others could reasonably rely upon his judgement or his skill or upon his ability to make careful enquiry, a person takes it upon himself to give information or advice to ... another person who, as he knows or should know, will place reliance on it, then a duty of care will arise'.

340 Rarely will an investment manager intentionally undertake a strict duty to ensure that the client will receive a particular outcome as the result of the services provided. Typically, the firm will undertake a qualified duty to seek to achieve an agreed outcome (e.g., outperforming an agreed benchmark), without any guarantee on its part that it will occur.

341 See also FSA Principle 2: 'A firm must conduct its business with due skill, care and diligence.'

342 Stafford v Conti Commodity Services Ltd, [1981] 1 All ER 691 at 698, where Mocatta J states that: 'losses in the ordinary course of things do occur even if proper care is used when one is dealing ... with the best advice in the world, in such an unpredictable market as this, it would require exceedingly strong evidence from expert brokers in relation to individual transactions to establish negligence on the part of defendants.' Importantly, '[a]n error of judgment, if there is an error of judgment, is not necessarily negligent …' [1981] 1 All ER 691 at 697.

circumstances.[343] An investment manager must possess and use the necessary skills required to perform its duties to its client. Further, it must not act for a client where it does not possess such skill.[344]

Although not necessarily conclusive, the common practice of practitioners in such a specialized field will serve as a significant factor to courts in determining the duty of care owed. A regulatory regime can also be relevant to the determination of a duty of care at common law, even where the duty of care owed by a regulated firm is not the same as the duties owed under the applicable regulatory regime.[345] Regulations can provide evidence of what is expected of a regulated firm in many circumstances.[346]

Since many claims against an investment manager will be for liability for pure economic loss in the absence of actual physical harm, a potential plaintiff will need to demonstrate that there is a special relationship between the parties which establishes a duty of care in relation to that particular type of loss. The general rule in negligence is that pure economic loss is not recoverable for a variety of historical reasons, including concerns over unlimited liability and a desire to foster a competitive market with certainty for participants. One significant exception has been made to this doctrine. In Hedley Byrne, the House of Lords also extended the liability of professional advisers, including in the financial services industry, to include negligence in the provision of such services within a special relationship between the parties, even in the absence of physical damage. As a result, the potential now exists for one party to bear the economic losses of another party where the relationship between them is such that there is a voluntary assumption of responsibility similar in some respects to contract.

In the US, however, pure economic loss is not recoverable in a common law tort claim for damages. Under this approach, where there is a contract between two parties, and the only damages suffered is economic loss, then the courts do not seek to undo their agreement and recovery by the plaintiff must be sought under the contract.[347] In the absence of personal injury or physical damage to property, the economic loss doctrine will prevent a client from recovering from an investment adviser for negligence.[348] Courts have held that the loss of value in a security does not amount to property damage, and is pure economic loss.[349]

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343 Bolam v Friern Hospital Management Committee, [1957] 1 WLR 583 at 586, where McNair J states '[h]ow do you test whether [an] act or failure is negligent? In an ordinary case it is generally said you judge it by the conduct of the man on the top of a Clapham omnibus. He is the ordinary man. But where you get a special situation which involves the use of some special skill or competence, then the test as to whether there has been negligence or not is not the test of the man on the top of the Clapham omnibus, because he has not got this special skill. The test is the standard of the ordinary skilled man exercising and professing to have that skill.'

344 Fine's Flowers Ltd v General Accident Assurance Co of Canada, [1977] 81 DLR (3d) 139 at 149 where Wilson J A states: '[i]t goes without saying that an agent who does not have the required skills to understand the nature of his client's business ... should not be offering this kind of service.'

345 Seymour v Ockwell, [2005] EWHC 1137.

346 In the financial services area, the FSA Handbook can be seen, in certain instances, as a codification of pre-existing good practice, although in certain areas the regulator has attempted instead to artificially change such practice in light of overriding public policy concerns.

347 See Bay State-Spray v Caterpillar Tractor Co., 533 NE2d 1350 (1989).

348 See Schuster v Dacey, 2008 WL 2415190 (Mass. 9 June 2008).

349 See Interstate Securities Corp. v Hayes Corp., 920 F2d 769 (1991).

3.10 **Fiduciary Duties**

A fiduciary duty of loyalty is owed by an investment manager to the client, in addition to the duty of care,[350] based upon the legitimate expectation by the client that the investment manager will be loyal and faithful in its actions as agent in regards to the client's portfolio.[351] Assumption of responsibility for the affairs of another person is a central requirement for the establishment of fiduciary obligations.[352] The purpose of these obligations is to provide a means to protect a client against conflicts of interest on the part of the investment manager, both as regards the investment manager's own interests and the interests of other clients. This fiduciary duty sits alongside a growing array of regulatory measures addressing conflict management in the modern financial services firm.[353]

3.10.1 ***The Nature and Scope of Fiduciary Duties***

As a general rule, courts are reluctant to interfere with commercial arrangements between sophisticated parties of comparable bargaining power.[354] The commercial world, in which the financial services industry and private investment funds reside, is governed predominantly by contract. Commercial transactions often lack a fiduciary element not because the underlying transaction is commercial, but rather because the parties to that transaction each recognize that the other party is acting in its own self-interest.[355]

As a result of the trust and dependence involved in the relationship between an investment manager and a client, however, the investment manager will be deemed a 'fiduciary' of the client, resulting in a duty of loyalty being owed. Such duty could be the basis for a claim by the client[356] in addition to claims of negligence and/or breach of contract.[357] Importantly, not every claim arising out of a fiduciary relationship will give rise to a claim for breach of fiduciary duty and a thorough examination of the full nature of legal and equitable relationships will be required. [358]

To identify an investment manager as a fiduciary, therefore, is simply the first step in a larger analytical process:

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350 Bristol & West Building Society v Mothew (t/a Stapley & Co), [1996] All ER 698: 'It is obvious that not every breach of a duty by a fiduciary is a breach of fiduciary duty.'

351 For a general discussion of fiduciary duty, see Tamar Frankel, "Fiduciary Law", 71 Cal Law Review 795 (1983).

352 See Hancock v Smith, [1889] 41 Ch.D 456.

353 See Sections 3.3-3.6 above.

354 See Citibank NA v MBIA Assurance SA , [2006] E.W.H.C. 3215.

355 Christa Bond, 'Conflicts of Interest in Financial Services and Markets', JIBLR 2006, 21 (12) at 678.

356 See, for example, Clarke v Nevins Capital Management, LLC, US Dist LEXIS 3158, 60-62 (SDNY 2005); Phoenix Four, Inc. v Strategic Resources Corporation, US Dist LEXIS 6512, 24-25 (SDNY 2006).

357 Importantly, the line between fiduciary duties and other legal duties is important in theory and in practice. Famously, in Bristol & West Building Society v Mothew (t/a Stapley & Co), [1996] 9 All ER 698 at 710, Millet L J states that 'it is obvious that not every breach of duty by a fiduciary is a breach of fiduciary duty.' See also Henderson v Merrett Syndicates, [1995] AC 145, where Lord Browne-Wilkinson states that '[t]he liability of a fiduciary for the negligent transaction of his duties is not a separate head of liability but the paradigm of the general duty to act with care imposed by law on those who take it upon themselves to act for or advise others ...'

358 Lac Minerals Ltd v International Corona Ltd, [1989] 2 SCR 579.

> To say that a man is a fiduciary only begins analysis; it gives direction to further enquiries. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect does he fail to discharge his obligations? And what are the consequences of his deviation from duty?[359]

At general law under the rules of equity,[360] a fiduciary is a person who acts for another in situations that 'give rise to a relationship of trust and confidence', giving rise to 'the obligation of loyalty'.[361] The Law Commission[362] has provided a definition of fiduciary relationship that has particular resonance in the investment funds context:

> Broadly speaking a fiduciary relationship is one in which a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretionary power that affects the interest of the other who depends on a fiduciary for information and advice.

Further, they summarized the duties owed by a fiduciary[363] into the following four rules:

(a) the 'no conflict' rule, whereby a fiduciary must not place himself in a position where his interest conflicts with that of his customer;[364]

(b) the 'no profit' rule, whereby a fiduciary must not profit from his position at the expense of his customer;[365]

(c) the undivided loyalty rule, whereby a fiduciary owes a loyalty to his customer not to place himself in a position where his duty to one customer conflicts with his duty to another; and

(d) the duty of confidentiality, whereby a fiduciary must only use information obtained in confidence from his customer for the benefit of that customer.[366]

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359 SEC v Chenery Corp, 318 US 80 (1943) at 85-86.

360 Interestingly, neither the FSMA nor the FSA Rulebook explicitly state that an investment manager is, or should be considered, a fiduciary. Instead the financial services regime applies numerous obligations on investment managers that are similar in scope and form to the duties owed by fiduciaries (e.g. good faith, conflicts of interest).

361 Bristol & West Building Society v Mothew, [1998] Ch1 at 18. Millet LJ provides a useful definition of fiduciary that is readily understandable in the context of discretionary investment management. 'A fiduciary is someone who has undertaken to act for or on behalf of another person in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.' See also Arklow Investments Ltd v Maclean, [2000] 1 WLR 594.

362 The Law Commission, Fiduciary Duties and Regulatory Rules, Report No 236, December 1995, para 1.3.

363 Bristol & West Building Society v Mothew, [1998] Ch. 1 at 18 where Millet LJ also provides a succinct description of a fiduciary's duties: 'A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or for the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations.'

364 See Bray v Ford, [1896] AC 44.

365 See Re Second East Dulwich, [1899] 68 LJ Ch 196.

366 Fiduciary Duties and Regulatory Rules, at para 1.4. An investment manager may also owe a duty to a former client to maintain confidentiality after the relationship has otherwise finished. As a result, an investment manager who subsequently wants to advise a new client with an adverse interest to a former client must

The fiduciary duties are owed by the investment manager to manage its clients in addition to the duty of care discussed above. Cases such as Henderson and Bristol and West Building Society recognized the fundamental distinction between duty of care, on the one hand, and the duty of loyalty owed by a fiduciary, on the other hand. Importantly, fiduciary duties stem from the 'trustee-like' relationship of trust that one party has with another. Even where the relationship is initiated and governed in part by a contract, a fiduciary obligation is of a different character from the obligations arising out of the underlying contract.[367] A similar view is held under US law:

> A fiduciary relationship 'exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relationship'. Such a relationship, necessarily fact-specific, is grounded in a higher level of trust than normally presented in the market place between those involved in arms-length business transactions.[368]

Although the economic loss doctrine limits the potential claims against US investment managers in tort, claims for breach of fiduciary duty are frequently successful in place of breach of contract claims under the various written agreements. US courts have held that investment managers can be liable for breach of fiduciary duty claims, even where the same conduct in question would support a breach of contract claim.[369]

3.10.2 *Limitations on Fiduciary Duties*

Fiduciary duties can be limited in effectiveness by either contractual or structural means. Contractual approaches include modifying the scope of fiduciary duties by agreement, either by exclusion clauses or disclosure and consent. Structural approaches include organizing a business in such a way as to prevent the duties being breached, for example by using Chinese Walls.[370]

Where a fiduciary relationship is also governed by a contract, those terms may affect the scope of the fiduciary duties owed.[371] In particular, a clearly drafted exclusion clause can successfully limit the scope of fiduciary duties. The terms of the contract between the investment manager and the client, therefore, plays a central role in defining the boundaries of the fiduciary relationship.[372] Pursuant to an investment management agreement,[373] the client will typically confer on the investment manager the discretion to buy and sell the clients assets at such prices and in such amounts as the investment manager will determine to be in the best

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ensure that there is no risk of disclosure or misuse of confidential information pertaining to the former client. See, eg, Prince Jefri v KPMG, [1999] 2 WLR 215.

367 Goldcorp Exchange Ltd, [1995] 1 AC 74. See also Bristol and West Building Society v Mothew, [1998] Ch 1 at 18 (A fiduciary 'is not subject to fiduciary obligations because he is a fiduciary; it is because he is subject to them that he is a fiduciary').

368 EBCI Inc v Goldman Sachs, 5NY3d 11 at 19, citing Restatement [Second] of Torts s874, comment a.

369 Bullmore v Bank of America Securities, 485 F.Supp 2d 464 (2007).

370 See Jay Ze, 'Underwriters and Fiduciary Duties', JBL 2007, MAR at 155.

371 Kelly v Cooper, [1993] AC 205 at 215, where Lord Browne-Wilkinson states: 'the scope of the fiduciary duties owed by the defendants to the plaintiffs (and in particular the alleged duty not to put themselves in a position where that duty and their interest conflicted) are to be defined by the terms of the contract of agency'.

372 See Section 3.11 below.

373 See Section 2.2 above.

interests of the client. Such discretions can serve as the basis for the relationship of 'trust and confidence' required of a fiduciary.[374]

Where an investment vehicle intermediates the relationship between the investment manager and the client(s), the analysis becomes more multifaceted and nuanced. To the extent that an investment manager contracts to provide services with respect to the assets of the participants in those vehicles, he will possess similar degrees of control and discretion over such assets as would be typically seen in bilateral client relationship.

In order to establish whether and to what extent a person is in a position of trust with regards to another, it must be determined what that person was retained to do and on what terms.[375] As first laid out in Hospital Products Ltd v US Surgical Corporation: [376]

> That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with and conforms to them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.

Alternatively, disclosure and consent can serve in place of specific contractual exclusions as a manner in which fiduciary duties can be limited. As a result, obtaining informed consent (which is ultimately a question of fact) after disclosing a conflict of interest would allow a fiduciary to act in a manner that would not otherwise be in compliance with its fiduciary duties.[377]

In sum, although fiduciary duties are imposed by law, rather than by agreement between the parties, courts consider all of the facts and circumstances surrounding the relationship, including the terms of any underlying contract (e.g., investment management agreement) in order to determine the scope of any fiduciary duties.[378] There is a very close relationship between duties of care under a contract or at tort, which may be owed by a fiduciary, and fiduciary duties themselves, although the courts are now clear that there is not a fiduciary duty of care in its own right.[379] However, although remedies for breach of contract and tort may well be available, as discussed below, remedies for breach of fiduciary duties are often more attractive, including rescission, equitable compensation or damages, account of profits, or an injunction.[380]

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374 See Ata v American Express Bank Limited, [1998] EWCA Civ 1015.

375 See Beach Petroleum NL v Kennedy, [1999] 48 NSWLR 1 and Breen v Williams, [1996] 186 CLR 71.

376 [1984] 156 CLR 41 at 97, and cited with approval by Mason J in Kelly v Cooper [1993] AC 205.

377 See Farrington v Rowe McBride & Partners, [1985] 1 NZLR 3. However, for a discussion of limitations to the effectiveness of disclosure, see Section 6.7 below.

378 As a result, although there is no requirement that a contract must explicitly state that one party is subject to fiduciary duties in order for that party to be subject to such duties, any contract between these parties will need to be considered in order to determine the existence and extent of any fiduciary duties. See Christa Bond, 'Conflicts of Interest in Financial Services and Markets', JIBLR 2006, 21(12) at 679.

379 Bristol and West Building Society v Mothew, [1998] Ch1 at 16C-18F.

380 Ibid, at 141.

Fiduciary duties can thus be an effective means of recourse for clients to ensure that the investment manager providing them with professional services does so in fulfilment of certain recognized standards. Unfortunately, in the case of a private investment fund, the fund vehicle itself intermediates the relationship between the investment manager and the ultimate participants. The fund itself, whether a limited partnership or an offshore company, must take the steps required to enforce any such claims.

The participants in the fund must therefore necessarily rely on the governance mechanisms of such vehicles in order for such actions to be commenced, bringing us back to the governance challenge.

3.11 **Contract**

Private investment funds are also regulated by the contractual arrangements between the fund vehicle and the fund manager (or an entity established and controlled by the fund managers). In practice, therefore, a frequent claim to be made against a fund manager will be for breach of an express or implied term in the investment management agreement. Often, the fund manager may face concurrent liability in both tort (under a claim of negligence) and contract, as well as breach of fiduciary duty.

When considering a claim against a fund manager based on an express term, a key question will be whether the clause imposes an absolute obligation on the investment manager or an obligation to use best endeavours. An investment management agreement will often be drafted, therefore, to ensure that no undertakings are given with regards to performance or result. Further, the agreement will often contain a clause setting out clearly the duties of the investment manager and the level of care it is accepting.

Importantly, a professional adviser — such as a fund manager — can have duties arising concurrently in contract and tort.[381] As a result, an exclusion clause in an agreement between a fund manager and the fund can operate to exclude or modify a tort or other claim (such as fiduciary duties). A key element of the contractual documentation entered into between the fund manager and the fund participants will be the standard of care applied to the manager in the fulfilment of its obligations under the agreements. Often, an investment manager will seek to limit the standard of care owed to "wilful misconduct" or "gross negligence".[382] US courts have found that instances where an investment manager made improper or unsuitable investment decisions did not amount to "wilful misconduct" or "gross negligence" and therefore did not amount to breach of contract.[383]

In addition, courts may take the view in certain instances that applicable regulatory requirements are implied terms of the investment management agreement between the

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381 See Midland Bank Trust Ltd v Hett Stubbs & Kemp, [1979] Ch 384. This position has been upheld in the House of Lords in Henderson v Merrett Syndicates Ltd where Lord Goff stated: "[T]he common law is not antipathetic to concurrent liability, and there is no sound basis for a rule which automatically restricts the claimant to either a tortuous or a contractual remedy. The result may be untidy; but, given that the tortious duty is imposed by the general law, and the contractual duty is attributable to the will of the parties, I do not find it objectionable that the claimant may be entitled to take advantage of the remedy which is most advantageous to him, subject only to ascertaining whether the tortious duty is inconsistent with the applicable contract that, in accordance with ordinary principle, the parties must have agreed that the tortious remedy is to be limited or excluded." [1995] 2 AC 145, 193.

382 In the US, "gross negligence" is a well established concept similar in many respects to recklessness. See Retty Financing, Inc. v Morgan Stanley Dean Witter & Co., 293 AD2d 341 [2002].

383 See SNS Bank NV v Citibank NA, 7 AD 3d 352 (2004).

regulated fund manager and its client, the fund. Where an authorized firm was subject to detailed requirements on ‘best advice’, a court has held that relevant regulatory rules were incorporated by reference to the terms of business letter entered into with the client.[384] In the case of more abstract principles embodied in a regulatory regime, courts have been more reluctant to find implied contractual terms.[385]

Claims against the investment manager can be limited by the inclusion of exclusion clauses in the contract. However, such clauses must comply with public policy. As a result, liability for fraud cannot be excluded. Clear prior contractual disclosure may be effective where the rights and duties of the parties are clearly defined and can serve to fulfil the obligation to make full disclosure.[386] Exclusion clauses must be clear and unambiguous as they will generally be construed against those who see to rely on them.[387]

A recent English case, Springwell Navigation Corporation v. J.P. Morgan Chase Bank,[388] casts an interesting light on questions of contractual estoppel that can arise in the private investment funds context. In this case, the Court of Appeals held that a party could be barred, under the doctrine of contractual estoppel, from asserting that it had been induced to enter a transaction based on misrepresentations. The effect of this decision was to reinforce the concept of freedom of contract, which benefits larger financial institutions, as well as fund managers, in their dealings with sophisticated investors. To the extent that fund documentation includes terms which are based on premise that differ from the actual factual circumstances, but are included by the fund manager to secure additional commercial benefit, courts following Springwell would enforce such terms against the investors.

In light of the caution raised by Springwell, private monitoring solutions can be a useful means to redress potential overreaching by fund managers who seek to engage in such practices by improving the negotiation of fund documentation through facilitating the ongoing engagement of the fund participants with the monitoring of the legal duties that attach to the fund manager. In the absence of such negotiations, Springwell puts all potential fund investors on notice that courts will enforce fund documentation against them, where appropriate.

3.12 **Effectiveness of Private Litigation by Investors**

Until recently, private investment funds differed from other financial investments, such as the security of public listed companies, by the relative lack of lawsuits by disgruntled investors. In the United States particularly, the dictum “when investors lose money, they sue” has proved reliably constant for corporate shareholders, but surprisingly inapplicable to private fund participants.[389] Recent events following the global financial crisis are changing this anomaly.

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384 Investors Compensation Scheme Ltd v West Bromwich Building Society, [1999] 1 WLR 896.

385 Clarion Ltd v National Provident Institution, [2000] 1 WLR 1888, 1897.

386 See Kelly v Cooper, [1993] AC 205. However, for a discussion of limitations to the effectiveness of disclosure, see Section 6.7 below.

387 See Armitage v Nurse, [1997] 2 All ER 705. Although Armitage gives considerable latitude to an exclusions clause, a clear line is drawn at actual fraud. Such exclusions may, however, go so far as to exclude liability for gross negligence. See Midland Bank Trustee (Jersey) v Federated Pensions Services Ltd, [1996] PLR 179.

388 [2010] EWCA Civ. 1221. Springwell, an investment vehicle for a group of wealthy investors, sued J.P. Morgan for significant losses sustained based on the advice provided by J.P. Morgan to Springwell.

389 See, e.g., Rosenberg at 393-394 (“A possible explanation for the paucity of reported cases in this area is that, because reputation plays such an important role in the venture capital industry, investors are wary of being perceived as litigious, thereby jeopardizing their ability to invest in future funds.”).

With the exception of the recent Springwell case,[390] there has been a noticeable absence of private litigation by disgruntled investors against fund managers in the UK, especially in comparison to the US. In addition to being a larger market for private investment funds than all other countries (including the UK) combined, the US has been the source of the majority of litigation surrounding private investment funds.[391] These cases provide a valuable insight into both the manner in which the legal rights of fund participants can be enforced and remedies obtained, and the extent to which the governance challenge could be better addressed through structural approaches.

Civil lawsuits by investors and other creditors arising from hedge fund 'blow-ups'[392] have also been a frequent event in US courts over recent years. Similar to enforcement actions, civil cases have covered a range of claims against fund managers, including misrepresentation of performance, misleading disclosures, and improper valuations. Such cases have frequently included charges against the fund management firm, although in many cases such firms often lack the necessary assets to make investors and creditors whole for their losses. Alternatively, claims may be pursued against a fund's auditors or administrators, or in certain circumstances either the independent directors of the fund or the funds lawyers.[393]

However, even where a hedge fund collapses amid substantial allegations of fraud, the money available for recompensing investors will often not, in simple cases, be expanded by litigation. Where a US-based hedge fund manager has stepped over the line into criminality, the SEC can intervene and appoint a receiver to preserve remaining assets and oversee the orderly unwinding of the fund. The ultimate goal of the receivership is to locate and preserve as much of the estate as possible for investors. But if the fund manager and its principals are all insolvent themselves, as will often be the case in the wake of a fund's collapse, and there were no third parties involved in the fraud, litigation may ultimately prove unsatisfying for the aggrieved fund investors.

Litigation against private investment funds arises often out of the offering memorandum originally establishing the fund in question.[394] The claims in such cases are rooted in allegations of misrepresentations made by the fund, focussing particularly on any divergence between the representations made to induce the original investment in the fund and the manner in which the fund was actually run. Underlying claims may involve allegations that a fund misrepresented the risk that would be involved in pursuing its investment objective, departed from its investment strategy, failed adequately to diversify its investments or failed to

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[390] See Section 3.10 above.

[391] The observation, of course, could be made more generally about regulatory enforcement in the U.K. See MacNeil at 345-346 ("Perhaps the most prominent feature of regulatory enforcement in the UK capital markets is its low incidence. . . Moreover, from an international perspective, it is well known that the FSA is much less active than its US counterpart, the Securities and Exchange Commission (SEC), is taking enforcement action: even adjusting for different levels of market capitalization, the number of enforcement cases initiated by the SEC and the financial penalties imposed are much greater.").

[392] Lawsuits involving limited partners of a private equity funds have historically been much less common than is the case in the hedge fund arena. In part, this may be driven by the fact that such limited partners have tended to be institutional investors with the sophistication and experience to negotiate the levels of protection they require to address the risks related to the private equity funds within which they invest. However, litigation does occur with some regularity among limited partners and general partners, and the basis of these cases provide insight into how the governance challenge, left unaddressed, can give rise to the potential for abuse.

[393] See, e.g., the instance where investors in the Stanford Ponzi scheme sued former auditor BDO. www.bloomberg.com/news/2011-05-08/stanford-investors-sue-former-auditor-for-10-7-billion-1-.html.

[394] See Section 2.2 above.

invest with prudence. These causes of action may ultimately take the form of claims for fraud, fraudulent inducement, breach of fiduciary duty, negligent misrepresentation, or gross negligence.

For example, in San Diego County Employees Retirement Association v Maounis,[395] a pension fund that had invested in the collapsed Amaranth fund claimed that the fund manager misrepresented the fund as "multi-strategy" when it actually allegedly operated as a highly concentrated single strategy fund that lacked basic internal risk management controls. Ultimately, however, all claims against the defendants were dismissed, since the investors had been fully informed of the risks.

In Lincoln National Life Insurance Co. v Silver,[396] a limited partner brought claims of breach of fiduciary duty against a fund's general partner. The basis of the claims were alleged misrepresentations made to the fund's investors regarding the types of investments the funds would make and the use by the general partner of the fund's assets to support unrelated investments made by a prior fund. Lincoln National was successful at trial and received a judgment of $24 million, but shortly thereafter Ms. Silver filed bankruptcy.

Occasionally, where a fund that has lost a great deal of its value, a fund manager may direct money to favoured investors at the expense of less favoured investors. In Re Manhattan Inv Fund Ltd,[397] the court found that a payment made to Bear Stearns in its capacity as prime broker shortly before the collapse of the Manhattan Investment Fund was a fraudulent transfer recoverable by the bankruptcy trustee.[398]

In State v Forstmann Little & Co. Equity Partnership VI LP,[399] the State of Connecticut, a limited partner in a Forstmann Little private equity fund, claimed that the fund's general partner had deviated from its agreed investment objectives and restrictions resulting in significant losses to the fund and to the State of Connecticut. The legal claims were based on breach of contract and breach of fiduciary duty. At issue was language in both the limited partnership agreement and the offering memorandum establishing limits on the general partner's discretion, which the plaintiff alleged the defendant had violated by making impermissible investments to companies that eventually went bankrupt. In addition the plaintiff alleged that the defendant took various actions that protected and advanced the interests of other funds managed by the defendant, but were not beneficial to the fund in which the plaintiff had invested. Ultimately, however, the court found that the fund manager was not liable for damages to the plaintiff, despite finding that breaches of contract and of fiduciary did occur, on the grounds that the State of Connecticut knew about the wrongful conduct and acquiesced.

In Forsyth v GSC Fund Management Co. (US), Inc.,[400]limited partners in a "co-invest" fund established by Canadian Bank of Commerce alleged that the general partner had breached its

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[395] 07-CV2618 (S.D.N.Y. 29 March 2007).

[396] 966 F.Supp 587 (N.D. Ill 1995).

[397] 359 B.R. 510 (Bankr. SDNY 2007).

[398] Similar claims were made in Bayou against the redeeming investors themselves. Arguments can also be made that such redeeming investors did nothing illegal. Rather, they simply had adequate mechanisms in place, whether pursuant to side letters entered into with the fund and the fund manager or otherwise, to deduce that they should take their money out of the fund at a time of their own choosing rather than reacting to a crisis situation when misconduct is actually uncovered.

[399] No. 02-CV-519 (D.Conn 22 Mar 2002).

[400] 2007 WL 29822.

fiduciary duty in connection with a number of related party transactions at non-market prices. The court refused to dismiss the case on the basis that the allegations of wrongdoing made by the plaintiff were sufficient to serve as a basis for a claim that the general partners was grossly negligent in discharging its duties under the limited partnership agreement.

As can be seen, recourse remains available to fund investors in the courts by way of civil claims, exerting their rights under the private law, although the effectiveness of such remedies in practice depends on whether there are any assets left which can be used to satisfy the claims. Decades of expanding financial regulation have not eliminated these causes of actions as a means of obtaining remedy. However, fund documentation, and the particular relationships between fund manager, fund and fund investors, must effectively establish the legal and equitable grounds for establishing these causes of actions. Without implementing the private monitoring solutions, pro-fund manager agreements may prove to be a barrier to recover that is difficult to overcome. As one commentator has warned:

> [I]nvestors in a limited partnership who want to use the prospect of a lawsuit to intervene in the operation of the firm have to show extreme misconduct – a difficult task. Statutorily prescribed deference to management's decision making also separates investors in limited partnerships from managers of partnership funds. It means that investors cannot credibly use the threat of a lawsuit as a check against agent misconduct or a bargaining tool to engage management regarding its decision making.[401]

I will argue in the following chapters that the private monitoring solutions proposed herein will provide fund investors with the opportunity to create a clearer and firmer basis for potential legal action against miscreant managers.

3.13 **Conclusions**

The quality of investment advice, whether provided directly to a client or indirectly through a collective investment vehicle, is very important both to the financial markets generally as well as to each individual who benefits or suffers as a result. There is a necessary element of market risk here: every bad outcome suffered by a private investment fund is not necessarily proof of incompetence or malfeasance. Similarly, not every superlative return generated by such fund is proof of excellence or fair dealings. Nonetheless, as discussed above, investors should be able to protect themselves from certain types of "management risk", including the malfeasance and negligence of the fund managers themselves.

The historic status of private investment funds as unregulated arrangements is based on the explicit assumption that their participants have adequate knowledge and negotiating leverage to protect their interests. The regular occurrence of widespread investor protection failures raises the question of whether this assumption is correct in all cases.[402] The issue that then must be addressed is whether the governance challenge in private investment funds can be satisfactorily addressed by changes in the regulatory regime or by privately-negotiated structural approaches, which can be implemented at the level of fund documentation by agreement between the fund participant(s) and the fund manager.

The regulatory regime exists in parallel with the private law remedies that apply to the legal vehicles and relationships established by the fund documentation. The same series of acts

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401 Harris, "Critical Theory" at 16.

402 See Sections 3.7 and 3.12 above.

and omissions may have consequences under both systems. As a result, the recourse to legal and equitable remedies is natural and necessary to ensure that such quality, when promised, is delivered.

However, the private law rights and duties of fund participants and the fund manager can, and often are, modified in the documentation used to establish the fund.[403] Traditionally, the sponsors and promoters of a private investment fund have sought to limit, or eliminate, the liability of the fund manager and individual principals to the greatest extent possible. Subject to a certain core of prohibitions on such modifications, the private law in the UK and the US permits parties to extend or restrict legal and/or equitable duties and courts enforce these modifications when litigation occurs.

In addition, fund documentation typically provides broad indemnification rights to the fund manager and principals. Such provisions would customarily exclude wilful misconduct, recklessness and/or gross negligence. Together, exclusion and indemnification provisions such as these serve to limit the scope of recourse - technically and procedurally - that fund participants can expect when disputes arise.

As a result, the rights and duties of fund managers and principals can be eroded by the contracts themselves. Duties exist at "default" levels within any legal entity, such as a partnership. There is no fundamental limit on the ability of limited partners to decide to "raise the bar" in connection with the level of fiduciary and other duties owed to them by the general partner of their fund. Partnerships[404] are creatures of contract law, and the terms can be negotiated to meet the commercial needs of the parties. In the case of Company PIFs,[405] due to their creation under the laws of offshore jurisdictions, such as the Cayman Islands, where company law statutes have not been modernized, as has been the case in the UK with the Companies Act 2006, and the commercial tendency to mimic concepts and provisions from Partnership PIFs, there is also scope to adapt the constitutional documents where necessary to fit the requirements of the fund participants.

As discussed in the previous chapter, the ability of fund participants to engage in day-to-day management and monitoring is limited by the tax regime; as well as by practical matters such as the lack of time and specialist expertise. However, even given these legal and practical parameters, fund participants have not consistently exercised their negotiating effectively to protect their interests through the contractual arrangements establishing the fund and its relationship with its fund manager.

In financial services, one customary approach to supplementing and augmenting the private law rights and duties of potential parties has been through the construction and imposition of a regulatory regime to cover those unique aspects of financial transactions and relationships that the court cases have not addressed with the specificity and completeness that these parties require. In addition, private actors can demonstrate that they possess the regulatory capacity necessary to play a meaningful role in this regulatory regime, supplementing the top-down command-and-control authority of a financial regulator. In the case of private investment funds and their managers, the regulatory regime in both the US and the UK currently focuses on regulation and oversight of the fund manager as an authorized firm, and not on the structure and operation of the fund itself. A fund manager is liable to its regulator for violations of

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[403] See Section 2.2 above.

[404] See Section 2.3 above.

[405] See Section 2.4 above.

conduct rules as and when they occur, but both the SEC and the FSA have made clear that this is where their effective jurisdiction ends.[406]

In the following chapter, I will examine two recent regulatory reform packages that were adopted in the US and the EU as a reaction to the recent financial crisis to determine to what extent, if at all, they address the governance challenge, and supplant any need to consider and implement the private monitoring solutions.

[406] See Sections 3.5 and 3.6 above.

Chapter 4
Recent US and EU Regulatory Responses

4.1 Introduction

As has been frequently observed, after a financial crisis, legislators and regulators have an opportunity to adopt significant and potentially far reaching reforms, regardless of whether the reforms actually address the real causes of the immediate crisis.[407] Although the 2007-08 global financial meltdown was not a "hedge fund crisis" or a "private equity crisis",[408] in 2010 both the US and the EU adopted significant expansions of their regulatory regimes to address perceived short comings in how private investment funds and their managers are regulated.[409] The concerns underlying the new rules significantly pre-date the 2007-08 crisis and have been debated by industry members and commentators for some time.

The growth of private investment funds, and the debate over the appropriate response by financial regulators, had been a common feature of consultation papers and articles in the financial press for over a decade. However, the regulatory regime on both sides of the Atlantic remained largely static during these years, despite regular pronouncements from international organizations such as IOSCO and the Financial Stability Forum.[410]

Only in the aftermath of 2007-09 crisis was momentum permitted to build[411] in favour of new rules which would materially increase the ability of US and EU regulators to monitor and discipline private fund managers. Ultimately, persistent concern that private funds might comprise a "shadow banking system"[412] as well as the ramifications of the Madoff debacle, were sufficient to see the passage of Dodd-Frank in the US and AIFMD in the EU.[413] The desire to "rein in" private funds, however, sits somewhat awkwardly in the academic debate over corporate governance. As one commentator has argued:

> The irony of the hedge fund regulation movement is that financial economists have, for over seventy years, been decrying, first, the lack of independent shareholder involvement in the management of public firms and, second, the lack of swift capital reallocation in

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407 See Ellis Ferran, "The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis," Legal Studies Research Paper Series, University of Cambridge Faculty of Law, Paper No. 10/2011 (Feb. 2011).

408 See Awrey at 8 ("[A]lternative investment funds were not a proximate cause of the [global financial crisis], nor have the substantial number of fund failures which have followed in its wake triggered systemic instability.").

409 Ibid. at 9 ("The financial crisis that began in 2007 did not involve systematically important hedge fund collapses or private equity-backed corporate failures").

410 See, e.g., Jesse Westbrook, "SEC Didn't Act After Spotting Wall Street Risks Documents Show", Bloomberg.com (May 5, 2010) available at www.bloomberg.com/news/2010-05-05/sec-did-n-t-act-after-spotting-wall-street-risks-documents-show.html.

411 See Cristie Ford, "New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation," 2010 Wisconsin Law Review 101, 102 (2010) ("For students of financial market regulation, the global financial crisis of 2007-09 (GFC) has been a sobering illustration of human greed and short-sightedness, and regulatory failure.").

412 "Shadow banking" refers to those entities, firms and institutions that operate outside of the formally regulated banking sector, but engage in financial transactions to such a degree and extent that they can impact the stability of the overall financial industry.

413 See, e.g., Nouriel Roubini, "The Shadow Banking System is Unravelling", FT.com (Sept. 21, 2008), available at www.ft.com/cms/s/o/622 acc93-87f1-11dd-b11 4-0000779fo18c.html.

> American industry. Hedge funds do both, more effectively, than any financial institutions in American history perhaps, and we should not recoil in fear over the innovation.[414]

Despite these perceived advantages, hedge funds and private equity funds have been subject to a fairly comprehensive review by both the public media and lawmakers. In this Chapter, I will identify and examine the effectiveness of recent regulatory changes on both sides of the Atlantic to address concerns related to private investment funds. In connection with Dodd-Frank, I will discuss its impact on both US and non-US advisers, as well as assessing its future prospects. In connection with AIFMD, I will analyze its jurisdictional scope, as well as governance, marketing and disclosure issues.

4.2 **Dodd-Frank**

As Andrew J. Donohue, Director of the Division of Investment Management of the SEC observed in 2010:

> The U.S. securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles . . . Consequently, advisers to private funds can "opt out" of Commission oversight. This presents a significant regulatory gap in need of closing.[415]

According to Donohue, requiring the managers of these funds to be registered with the SEC[416] would provide the regulator with the tools necessary to oversee the industry and protect investors. This would be accomplished by the managers providing the SEC with reliable and complete data about the operations of private investment funds and their impact on U.S. securities markets, while allowing the funds to maintain flexibility with regard to their investment objectives and strategies.

Dodd-Frank can, therefore, be seen as simply the movement of the US towards the international consensus that private fund managers should be directly regulated by the national financial regulator. The historic American position that "private" investment advisors who had only a limited number of clients were best left outside the supervision of the SEC had become an anomaly, especially in light of the billions in assets under management that such "private" advisors were able to amass.

Many domestic and international fund managers previously exempt from registration under the Investment Advisers Act are now, as a result of passage of the Dodd-Frank, subject to registration with the SEC. Domestic investment advisers with assets under management of $100 million or more will need to register; however, if such advisers manage only "private funds"[417] that do not meet the definition of a "venture capital fund", the threshold is raised to $150 million or more of assets. Advisers which pass these thresholds are required to register under the Investment Advisers Act. The relatively low threshold of $150 million will ensnare

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414 Dale Osterle, "Regulating Hedge Funds," 1 Entrepreneurial Business Law Journal 1, 39 (2006).

415 Andrew J. Donohue, "Regulating Hedge Funds and Other Private Investment Pools", Speech to 3rd Annual Symposium on the Regulation of Investment Funds (February 19, 2010).

416 See Section 3.6 above.

417 "Private funds" are defined as entities that would be an "investment company" under the Investment Company Act of 1940, as amended (the "1940 Act"), but for the exceptions set forth in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.

many previously unregistered investment advisers to private equity and hedge funds which benefited from the 14-or-fewer clients exemption now eliminated by Dodd-Frank.

Domestic advisers having less than $100 million (or $150 million where solely advisers to Private Funds) of assets will have to register under State "blue sky laws" rather than being able to register with the SEC under the Investment Advisers Act, unless such an adviser would have to be registered in 15 or more states. An even lower threshold has been established "foreign private advisers" which will be required to register generally if they have $25 million or more of AUM and/or of investments in their sponsored funds attributable to US investors, or more than 15 clients domiciled in the United States.

4.3 **Domestic Advisers**

Dodd-Frank repeals in its entirety the so-called "private adviser exemption"[418] previously found in the Investment Advisers Act. Private equity, real estate opportunity and hedge funds have historically generally relied on this exemption to avoid registration under the Investment Advisers Act.[419] Going forward, many of these advisers will need to register with the SEC and adopt appropriate compliance programs.[420]

Dodd-Frank requires that the SEC provide an exemption from the registration requirements for domestic advisers to private funds, provided assets in the United States are less than $150 million and such adviser is solely an adviser to "private funds". Additionally, Dodd-Frank creates new exemptions from SEC registration, including advisers to "family offices" and advisers to "venture capital funds". As a result of Dodd-Frank, the number of potential SEC registrants is expected to increase significantly. The responsibility of the states for licensing, monitoring and overseeing all hedge funds and other alternative investment management firms has also been increased significantly from firms having less than $25 million in assets to firms having under $100 million in assets.

This represents a substantial increase in the responsibility (and jurisdiction) of state securities departments and law enforcement officials. But states will be taking on this increased responsibility at a time when many state coffers are empty and budgets are far from balanced. Where the extra monies for personnel and supervisory infrastructure will come from is unclear; if monies are not forthcoming, an inconsistent and largely nominal oversight of a large number of domestic advisers may result.[421]

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418 Any investment adviser that has had fewer than 15 clients during the preceding 12- month period and does not hold itself out to the public as an investment adviser.

419 See Section 2.5 above. Going forward, many of these advisers will need to register with the SEC and adopt appropriate compliance programs.

420 See Kenneth J. Berman and Gregory T. Larkin, "Dodd-Frank's Impact on Private Fund Managers," The Deal Magazine, 16 Nov 2010 (available at www.thedeal.com/newsweekly/community/dodd2.php) ("While not as onerous as other regulatory schemes, life under the Investment Advisers Act may bring significant change for currently unregistered advisers. It is not too soon for these advisers to begin their preparation for registration, including the preparation of compliance policies.").

421 Reports of the failure of Congress to adequately fund the SEC, leading to claims by critics of a "stealth repeal" of Dodd-Frank have been appearing regularly in the US financial press. See Section 4.6 below.

4.4 Non-US Advisers

Extraterritoriality remains a key feature of the U.S. approach to financial regulations, and Dodd-Frank is no exception.[422] Dodd-Frank exempts from registration any investment adviser that is a "foreign private adviser," which is defined in Dodd-Frank as any investment adviser that:

(a) has no place of business in the United States;

(b) has fewer than 15 clients[423] and investors domiciled in the United States in private funds advised by the investment adviser;

(c) has aggregate assets under management attributable to clients in the United States and investors in the United States in Private Funds advised by the investment adviser of less than $25 million, (or such higher amount as the SEC may set by rulemaking); and

(d) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company.

The SEC has previously permitted a "regulation-lite" approach that registered non-US advisers may observe with respect to their non-US clients (including, non-US funds in which US persons invest). Under the "regulation-lite" approach, a non-US adviser is permitted to treat each non-US fund as its "client" for many purposes of the Investment Advisers Act. As a result, most of the substantive provisions of the Investment Advisers Act would not apply to a non-US adviser's dealings with a non-US fund, even if the investors in the fund included US persons.[424] This has historically not been viewed as a significant loophole because non-US funds are not eligible for public distribution within the US to retail investors as a mutual fund. As a result, only non-retail accredited investors have access to these investments.

4.5 Other Compliance Requirements

Dodd-Frank modifies the reporting requirements for various types of advisers. First, the SEC can require any registered adviser to comply with certain additional record-keeping and reporting obligations to the SEC. Importantly, Dodd-Frank deems the reports of any "private fund" to which a registered adviser provides advice to be the records and reports of that adviser. Among other things reports will have to be filed with the SEC on:

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[422] Elizabeth Pfeuti, "Extraditions could soar with Dodd-Frank," Financial News (11 Oct 2011). ("New American financial regulations may result in more international financiers, including fund managers, numbering among those being surrendered to the U.S. justice system in the future. Fund managers have been prime targets as investors of U.S. based money").

[423] Traditionally, a 'person' is counted as a single client if it was a corporation, partnership, trust or other entity that receives investment advice based on its investment objective rather than the individual investment objectives of its own beneficial owners. In December 2004, the SEC adopted a new Rule 203(b)(3)-2 that requires hedge fund managers to register as investment advisers under the Advisers Act, despite open dissents from two of the five Commissioners. The broad exemption enjoyed by US hedge fund managers has always been anomalous. The overwhelming majority of developed international financial markets in which non-US managers are predominantly based have historically required formal registration.

[424] For example, a non-US adviser would not be required to comply with the following rules under the Advisers Act as to non-US clients: (a): Rule 206(4)-7 (the "compliance" rule), (b) rule 206(4)-2 (the "custody" rule) and (c) rule 206(4)-6 (the "proxy voting" rule).

(a) the amount of assets under management and the use of leverage;

(b) counterparty credit risk exposure;

(c) trading and investment positions;

(d) valuation policies and practices of the fund;

(e) types of assets held;

(f) any side arrangements whereby certain investors receive more favourable terms than other investors; and

(g) any other information the SEC determines "is necessary and appropriate in the public interest and for protection of investors, or for the assessment of systemic risk."

Also importantly, Dodd-Frank imposes new record-keeping and reporting obligations on advisers exempt from registration. In particular, the SEC is mandated to issue rules requiring unregistered advisers to maintain and provide to the SEC such reports as the SEC deems "necessary and appropriate in the public interest and for protection of investors," but does not otherwise define the requirements for these records and reports.

Dodd-Frank also authorizes the SEC to promulgate new rules that require a registered adviser to safeguard any client assets over which that adviser has custody. These steps could include verification of the assets by an independent public accountant. Section 206(4)-2 of the Investment Advisers Act and Rule 206(4)-2 already require examination of those assets by an independent public accountant unless an exemption applies to that adviser, so the Dodd-Frank requirement only provide incremental change.

Additionally, non-US advisers previously exempted from registration will need to become familiar with Rule 204-3 under the Investment Advisers Act, commonly referred to as the 'brochure rule'. The brochure rule generally requires every SEC-registered adviser to deliver to each prospective advisory client a written disclosure statement, or 'brochure', describing the adviser's business practices and educational and business background.[425]

In sum, the compliance requirements imposed on fund managers by Dodd-Frank are relatively limited and do not address the concerns discussed in early chapters about the governance challenge. The blanket exemption for fund managers with 14 or fewer clients was always recognized as an anomaly when compared with the approach taken by other industrialized countries.

4.6 **Future Outlook**

Although Dodd-Frank represents the most significant attempt to reform US financial services regulation in over 70 years, the laws' ultimate effectiveness remains unclear. The SEC remains central to the US approach, but its limitations and recent shortcomings are acknowledged.[426] Even before the 2007-09 financial crisis, questions concerning the

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[425] See Section 3.5 above.

[426] Edward F. Greene, "Dodd-Frank: A Lesson in Decision Avoidance," 6 Capital Markets Law Journal 29, 59 (2010) ("The Act evidences a love/hate relationship with the SEC. It assigns to the agency more rule makings and studies to be conducted than to any other agency, reflecting the Congress' reluctance to make hard

adequacy of the SEC's resources to perform its required functions were being called into question.[427] Since the financial crisis and the increase in its responsibilities under Dodd-Frank, the issues are even more noteworthy.

Perhaps most disappointing to many observers, Dodd-Frank does not attempt to rationalize or improve the US regulatory infrastructure. As one commentator has observed:

> Critically, the Act fails to reconfigure in any significant way the fragmented US regulatory structure, which currently encompasses 50 state-banking and securities regulators as well as multiple federal agencies.[428]

With the recent political change in the control of the US House of Representatives, rumors have circulated about possible attempts by the Republicans to repeal certain elements of Dodd-Frank.[429] Even if not repealed or significantly scaled back, its highly unlikely that further reform will be passed in the foreseeable future.[430]

Ultimately, the changes brought by Dodd-Frank leave the governance of private investment outside their scope. To the extent that definitive steps are to be taken to address deficiencies in the governance structure of such funds, they will need to be taken by the investors themselves. As one commentator has observed:

> There has been a growing consensus that there should be more regulation of hedge funds and private equity funds, although there is a substantial difference between the USA and the EU as to what the scope and content of that regulation should be. [Dodd-Frank] takes a minimalist approach.[431]

Europe, however, has decided on a more "maximalist" approach.

4.7 **AIFMD**

AIFMD attempts to harmonize regulatory requirements for sponsors and managers of alternative investment funds (AIFs) across the EU. AIFs are broadly defined to cover all CISs not authorized under the UCITS directive. As a result, hedge funds, private equity funds and a wide variety of other investment vehicles are AIFs and their management and administration fall within AIFMD.

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decisions. At the same time, the Act imposes structural changes and controls, which suggests the Congress' lack of trust in the agency partly inspired by the SEC's failure to detect the Madoff scandal.").

427 See Lybecker at 1087 ("The scandals of 2003-2004 are unique in the history of the SEC's administration of the Investment Company Act but appear to validate the concern that the Commission still has insufficient resources adequately to survive the securities industry and to catch wrongdoers among those that it is responsible for regulating before serious harm has been done.").

428 Ibid. at 75.

429 See, e.g., www.marketwatch.com/story/financial-group-official-sees-Dodd-Frank-rollback-2011-05-26. However, the Democrats retain control of the Senate and the White House, leaving several significant hurdles in the way of any attempted amendments.

430 See, e.g., Phil Mattingly, "Republicans Ask Geithner for Report on U.S. Rules Reductions", Bloomberg.com (Sept 8, 2011) (available at www.bloomberg/news/2011-09-08/republicans-ask-geithner-for-report-on-u-s-rules-reductions), and Pat Garofalo, "Three Years Later, GOP Keeps Fighting Financial Reform", US News and World Report (Sept 16, 2011) (available at www.usnews.com/opinion/articles/2011/09/16/three-years-later-gop-keeps-fighting-financial-reform).

431 See Greene at 64.

After over eighteen months of wrangling, AIFMD was finally passed in November 2010. AIFMD affects managers and promoters of AIFs and its reach extends to managers and advisers based outside as well as inside the EU (respectively EU managers and non-EU managers). The road to AIFMD was not a straight one. Instead it was filled with twists and turns due to the numerous power struggles that broke out along the way, both between the European Parliament and the European Commission, and between key member states. Criticisms of the legislative process that led to the final adopted test of AIFMD include (a) that the "one size fits all" approach failed to differentiate the different risks posed by different types of funds; (b) that the EU's reaction was disproportionate to the industries' actual significance; and (c) that protectionist preference were the primary motivation behind the directive.[432]

Importantly, the AIFMD continues with the traditional regulatory approach followed on both sides of the Atlantic by regulating the fund manager and not the fund itself.[433] In addition to the expansive definition of AIFs, the geographic scope of AIFMD is also particularly broad, with all fund managers based in the EU covered, as well as any non-EU managers who market their funds in the EU. The AIFs themselves may be based either within the EU or outside of the EU.

The primary focus of AIFMD is on establishing consistent standards for the authorization and ongoing oversight of fund managers, including requirements related to conflicts of interest, risk management and liquidity. As a result of such harmonization, a new pan-European passporting regime is now available, which serves as a "carrot" to complement the "stick" of further regulation.

AIFMD has not been without its critics. As one commentator has observed:

> The EU has failed to mount a persuasive case for why the Directive represents an improvement over existing national regulatory regimes or prevailing market practices in several key areas. Furthermore, by attempting to shoehorn an economically, strategically and operationally diverse population of financial institutions into a single, artificial class of regulated actors, the EU has established what is in many respects a conceptually muddled regulatory regime.[434]

Of possible relevance to the governance challenge is the inclusion of detailed disclosure requirements. Investors are now entitled to receive additional information from managers on a periodic basis.[435]

However, what AIFMD lacks is any attempt to address the manner in which private funds are governed. No attempt was made as part of the AIFMD adoption process to better empower fund investors to effectively intervene in the operation of the funds in which they invest, in order to address concerns which may have arisen or restrict the ability of the fund manager to act in a particular way under particular circumstances.

The effectiveness of AIFMD to address systemic risk concerns are outside the scope of this thesis. Clearly, such concerns are a valid basis on which to adopt the identification and containment of new regulation or adapt existing regulation. But systemic risk is fundamentally

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432 Ferran at 15.

433 See Sections 3.5 and 3.6 above.

434 Awrey at 11.

435 See Section 4.11 below.

separate from concerns relating to investor protection, and within those latter concerns, effective governance.

An additional layer of subordinate rules must be drafted and implemented before AIFMD becomes effective in 2013. As a result, a comprehensive assessment and appraisal of the directive is perhaps only possible then.[436] However, the lack of provisions addressing fund governance will not be remedied by any anticipated supplemental legislation.

4.8 Jurisdictional Scope

As a general rule, the management of an AIF which is marketed within the EU must be conducted by a manager authorised under AIFMD by the appropriate regulators in its home member state. Managers in the EU managing EU funds will have the "passport" to market those funds in the EU from early 2013. No such passport will be introduced for non-EU funds until early 2015 at the earliest. As a result, onshore EU funds will have a significant marketing advantage over offshore funds for at least two years.

When the "passport" becomes available, allowing EU and non-EU managers to market non-EU funds throughout the EU, jurisdictions that would satisfy the criteria set out in the AIFMD to allow the fund to qualify for the "passport" will have an advantage over those that do not. But to what extent this will result in a change in the domicile of funds from one overseas jurisdiction to another is difficult to say. The main offshore jurisdictions (Cayman, Bermuda, Channel Islands) appear confident that they are well placed to benefit from the introduction of the AIFMD. [437]

Non-EU managers, such as US alternative fund managers, for example, will not be able to obtain passports until 2015. Until then, they will need to market their funds in reliance on the private placement regimes that operate in individual EU member states. From 2013, once AIFMD is implemented by EU member states, US managers will be required to comply with certain "transparency" provisions of AIFMD relating to the production by the fund of an annual report, disclosure requirements to investors, and periodic reporting to the local regulator covering such matters as the liquidity of the fund, risk management and leverage. There will also need to be information-sharing arrangements in place between the SEC and the local EU regulator and (assuming the fund is not in the US) the supervisors of the fund, and the local EU regulator. In addition, the US and (if different) the country where the fund is located must not be on the FATF "blacklist" of states which give rise to money laundering and terrorist financing concerns. For example, a US manager marketing a Cayman fund to investors in the UK, all the requirements in the previous sentence are currently satisfied, so it will be up to the manager to ensure that the "transparency" provisions are satisfied also.

If the passport is made available to non-EU managers in 2015, a US manager who wishes to obtain it will need to comply with all the provisions of AIFMD (including those relating to

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436 See Awrey at 15 ("Perhaps not surprisingly given the broad nature of many of these requirements – to say nothing of the wide diversity of investment strategies, business models, conflicts of interest and other risks typically encountered in connection with different types of AIF – the Directive contemplates that the Commission will adopt level 2 implementing measures further specifying the precise substance of these requirements as they are intended to apply to each species of AIF. Accordingly, it is in many respects too early to evaluate the precise impact of these requirements in terms of the day-to-day conduct and practices of AIFMs.").

437 See, e.g., Joanne Harris, "European Parliament Spells Out Equivalency Requirements for AIFM", hedgefundsreview.com (Apr. 7, 2010), available at www.hedgefundreview.com/hedge-funds-review/news-15990002/european-parliament-spells-equivalency-requirements-aifm.

remuneration restrictions, capital requirements, depositaries and leverage). It will also need to apply to an EU member state — the manager's "member state of reference" for the purposes of AIFMD — and the regulator in that state will in effect become the US manager's supervisor for compliance with AIFMD. The US manager will also need to appoint a legal representative in the member state of reference" to act as its contact point with the local regulator. In addition:

(a) there must be cooperation arrangements in place between the regulator in the "member state of reference" and the SEC covering information sharing; and

(b) the country where the fund is located must not be on the FATF "blacklist" (for which see above); and

(c) the country where the fund is located must have signed an agreement with the "member state of reference" and any other EU Member State where the fund is proposed to be marketed relating to the exchange of tax information and in compliance with OECD requirements.[438]

For UK managers managing non-EU funds, such as Cayman funds, the marketing passport will also not be available until 2015. Until then, UK managers must continue to market their non-EU funds in the EU through national private placement regimes.[439]

AIFMD defines "marketing" as offering of funds at the initiative of or on behalf of the fund manager.[440] That means that if an investor takes the initiative by approaching the fund manager, the fund manager will not be marketing his funds for the purposes of AIFMD. As a result, a US fund manager, for example, will not be brought within the scope of AIFMD simply because he accepts investments from an EU pension fund manager. The fund manager would need actively to market the fund to those investors for that to occur.[441]

A US manager is likely to have a website that allows interested parties to access details of the funds. Although the manager will in one sense have "taken the initiative" by making the material on the website available, this should not be "marketing" for the purposes of AIFMD without some further act by the manager (for example, a separate e-mail directed at potential customers drawing attention to the existence of the site).

AIFMD provides that if an EU manager has assets under management below certain thresholds (in general, €100 million or, for unleveraged funds with no redemption rights for five years (typically smaller private equity funds), €500 million), AIFMD will not apply. In such cases, however, registration with the local regulator (along with disclosure of investment

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438 The Cayman Islands currently has such an agreement with the UK and several other EU Member States, including France, Germany and Ireland.

439 AIFMD requires that from 2013 the UK manager will have to comply with all the provisions of AIFMD, apart from those relating to depositaries; there will need to be cooperation agreements between the regulator of the fund and the FSA; and the jurisdiction where the fund is located must not be on the FATF "blacklist". Once the passport becomes available for non-EU funds, the UK manager will need to comply with AIFMD in full (i.e., the depositary requirements will now apply in respect of the fund), and the three bullets above will need to be satisfied.

440 See Section 2.5 above.

441 See Section 2.5 above for a comparison with the "evaluate in totality" of Dodd-Frank in the US, see Section 4.4 above.

strategies and trading information) will still be necessary, and AIFMD also allows the regulator to impose additional requirements.

4.9 **Governance and Disclosure Issues**

AIFMD establishes duties of care and loyalty that fund managers must fulfil, which includes duties to act honestly and fairly, in the best interest of the fund and its investors, and to ensure that all fund investors are treated fairly.[442] Further, the directive imposes specific requirements on identifying and containing conflicts of interest, as well as implementing adequate risk management systems.[443] However, AIFMD does not prevent a fund manager from delegating its functions to third parties, although it does impose some restrictions. In particular, the portfolio management and risk management function may be delegated only to entities that are authorized or registered to carry out such functions and subject to supervision (and where delegation is to an entity outside the EU, there must be cooperation between the third-country supervisors and the manager's EU regulator), and cannot be delegated to the depositary or the depositary's delegate. The fund manager remains liable to the fund and investors in the fund for any acts of the delegate.

Most of the information required by AIFMD will already have been provided in a well-drafted offering memorandum.[444] That said, AIFMD also requires certain disclosures that are unlikely to be made currently, such as:

(a) valuation procedure and methods used for valuing hard-to-value assets;

(b) the fund's liquidity risk management;

(c) the type of investors who have the right to receive (or do receive) preferential treatment, and what that preferential treatment consists of;

(d) what steps the manager is taking to cover potential professional liability risks; and

(e) how and when the manager will disclose various liquidity and leverage information required by AIFMD (such as the percentage of assets of the fund that are subject to special arrangements because of their illiquidity and the total amount of leverage employed by the fund).

A strong argument can be made that increasing the information provided by managers of private investment funds justifies bringing managers within the scope of regulation. However, the value of the information required by AIFMD is subject to question. As one commentator has observed:

> What is ultimately unclear, however, is the extent to which informational requirements embedded within the AIFM Directive will represent a marked improvement over existing national regulatory regimes or prevailing market practices.[445]

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442 Many of these concepts are elements also of the fiduciary duties that exist at equity. See Section 3.10 above.

443 For a discussion of these duties, see Awrey.

444 See Section 2.2 above.

445 Awrey at 17.

4.10 **Conclusion**

As a result of the 2007-09 financial crisis, widespread attention has been paid to the nature and scope of financial regulation. This is an exception to the general rule, as one commentator has noted:

> Regulation has been described as 'low politics' – the world of mundane technicalities far below the 'high' politics of international diplomacy or national party politics. Yet regulation has recently taken political center stage, not least as the credit crunch has exposed the contradictory demands of regulated firms and others for both less and more regulation, and the limits of governmental capacity to provide either, or at least not in the right places and in the right ways.[446]

Also at "centre stage" have been concerns over whether hedge funds and private equity funds are adequately supervised. When evaluating government regulation, it is important to bear in mind three potential disadvantages:

(a) whether such regulation will be counter-productive, or simply redundant because of actions taken by market participants in reaction thereto;

(b) whether defects in the processes of adoption, implementation and/or enforcement undermine its effectiveness; and

(c) whether such regulation unduly restricts the rights and freedoms of persons affected thereby.[447]

A comprehensive critique of Dodd-Frank and AIFMD, and their impact on private investment funds, is beyond the scope of this thesis. However, these three disadvantages remind us that no piece of legislation or regulation can realistically hope to provide a complete solution to a problem. There inevitably remains room for private actors who possess regulatory capacity[448] to evaluate and supplement the rules, with their own additional actions and precautions. As commentators have observed:

> Financial regulation is often reactive. New regulation seals up leaks in the financial system – usually following a crisis, a shift in markets or other change that threatens financial stability.[449]

In the US, for example, the modern financial regulatory system was created as a direct result of the Great Depression. The Dodd Frank reforms, like numerous reforms preceding it, was born from the 2007-09 financial meltdown,[450] the most serious recession in the US since the Great Depression.

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[446] Julia Black, "Forms and Paradoxes of Principles Based Regulation", Capital Markets Journal 3 (4) at 7 (2008).

[447] Cheffins at 163.

[448] See Section 1.9 above for a discussion of regulatory capacity of private actors.

[449] See Whitehead.

[450] Ibid. at 36 ("The current financial crisis highlighted gaps in financial regulation, principally arising from changes in the markets over the last thirty years").

Wide-ranging reforms were proposed and adopted in numerous countries to attempt, after the fact, to correct perceived shortcomings and omissions in their regulatory regimes.[451] Regardless of the financial regulatory model that a particular country follows,[452] there will always be a tension during a period of reform between making a fundamental change to country's regulatory model, and simply making incremental changes within the current financial model.[453]

Neither Dodd-Frank nor AIFMD attempt to directly address governance deficiencies in private investment funds or shift their regime away from the traditional "we regulate the managers, not the fund" approach. Although each regulatory reform package makes significant changes to the scope and detail of existing rules, the focus is on different regulatory priorities such as systemic risk. Even where concerns about investor protection are addressed, the new rules do so in a customary manner, in line with past approaches. The recent reforms have introduced some incremental improvements in the regulatory regime, although as noted in this chapter, the extent to which they provide for greater protection of fund investors beyond that which would be provided by good market practice remains limited.

Private funds carry with them inherently complex questions about jurisdictional reach and the effectiveness of regulation outside the country of origin.[454] Importantly, even with increased coordination and harmonization at the international level, government regulators will be subject to de jure or de facto jurisdictional limitations on their effectiveness. By contrast, private actors can pursue their interests across national boundaries as the need arises.[455]

In addition, the enforcement centralized, top-down rules would still reveal a systemic disadvantage that the SEC, the FSA and all financial regulators face – namely, hiring and retaining adequate talent. As one commentator has observed:

> [I]n order to enhance their professional expertise, government agencies have to hire the best available specialists in relevant areas and offer these experts compensation high enough to lure them away from potentially lucrative employment at investment banks and hedge funds. Competing with the private sector on

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451 See, e.g., Randall D. Gwynn, "The Global Financial Crisis and Proposed Regulatory Reform," 2010 BYU Law Review 421, 422 (2010) "(There is a widespread belief that the financial crisis was caused by the free markets being too free. If we had better government regulation and supervision, and more of it, according to this way of thinking, we could have avoided the financial crisis and would prevent future crises from ever happening again. These beliefs may or may not be correct, but governments are moving ahead as if they were.")

452 Generally speaking, the four global models are (a) institutional regulation, based on type of firm, (b) functional regulation, based on the function that is being performed by a firm, (c) "twin peaks" model, where one regulator is responsible for conduct of business supervision and another regulator for prudential supervision, and (d) an integrated model, where a single regulatory agency (like the UK's Financial Services Authority) is responsible for all sectors. Ibid. at 462.

453 Ibid. at 463. See, e.g., Renee M. Jones, "Back to Basics: Why Financial Regulatory Overhaul is Overrated," 4 Entrepreneurial Business Law Journal 391 (2010).

454 As one commentator has noted: The issue of jurisdiction is also complicated in the transactional context: such regulators do not fit neatly within existing legal and territorial jurisdictional boundaries. Black, "Constructing and Contesting" at 13-14.

455 See id. at 692 ("[P]rivate economic actors – financial institutions and investors – are not constrained by jurisdictional considerations and are able to oversee and manage their business affairs across national borders much more seamlessly than any government agency.").

> these terms is hardly a viable proposition for government agencies.[456]

As a result, regulators must be realistic and pragmatic about what they seek to accomplish with their finite resources. Despite much discussion and debate,[457] ultimately US and EU legislators and regulators decided to limit their reform efforts to a number of important changes involving the regulatory status of the fund manager and some potentially significant other claims in the applicable marketing instructions. In doing so, they ultimately favoured reforms in line with the traditional regulatory approach that they have historically followed in this area. However, by default, they have sent a clear message to all investors in private investment funds – responsibility for establishing appropriate governance mechanisms within the fund rests with the investors.

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456 Saule T. Omarova, "Rethinking the Future of Self-Regulation in the Financial Industry," 35 Brooklyn Journal Int'l Law 665, 687 (2010).

457 See Awrey at 19. ("Understanding the [AIFM] Directive as the product of not only a *policy* process – but also a *political* one – serves to shed considerable light on many of its apparent shortcomings.").

Chapter 5
Self-Regulation and Private Actors

5.1 Introduction

The first decade of the 21st Century witnessed a steady accretion of self-regulatory initiatives in the private investment funds industries. In the hedge fund arena, trade associations promulgated their own best practice standards. In the private equity industry, guidance was regularly issued on a variety of topics that included valuation, transparency and ethics. Critics contend that these developments were motivated primarily by a desire to avoid top-down regulation by national regulatory agencies.[458] However, given the narrow and incomplete regulatory changes embodied in Dodd-Frank and AIFMD, the ability to utilize market discipline and private actors to obtain identifiable regulatory goals[459] remains an important means to address those issues involving private investment funds which remain unaddressed, such as adequate governance mechanisms.

Private investment funds have evolved largely outside the financial regulatory regime,[460] although often in ways directly related to how and where the regime had chosen to draw various lines of demarcation. Such evolution continues to this day, spurred by the desire of fund managers and investors to innovate and pursue new opportunities in the financial markets.[461] As such innovations continue and alternative approaches are adopted by fund investors, unique legal concerns may arise as a result, giving rise to new questions about how the structure effectively addresses the governance challenge.

In practice, regulation extends beyond the mere issuance of rules and rulebooks, to include the entire risk-based framework used to determine the intensity of supervision to be provided to a particular sector within the financial services industry (e.g., private investment funds).[462] To the extent that financial regulators, such as the FSA and the SEC, continue to assess private fund managers as 'low impact' relative to the other supervised entities for which they are responsible, such managers will be the subject of only limited or thematic reviews.[463]

Industry guidelines and statements of best practice, promulgated either by specific trade association or by financial regulators (or groups of regulators) themselves, are increasingly being voluntarily adopted by private investment funds and their managers to demonstrate that their policies and procedures are in line with recognised standards. The promulgation of such guidelines both serves an educational effect on fund investors and counterparties and establishes a consistent baseline for analyzing the operational and structural elements of a fund manager and proposed fund.

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[458] See McVea at 83 ("Even before the recent financial market turmoil, regulators throughout the world were taking an increased interest in hedge fund activities. Fearful of such attention, the hedge fund sector on both sides of the Atlantic sought to head of further regulatory scrutiny by drafting self-regulatory codes of best practice.").

[459] See Section 1.9 above.

[460] See Sections 3.5 and 3.6 above.

[461] See DP06/6 at 18.

[462] See DP06/6 at 86.

[463] Ibid.

Due to the nature of private investment funds as historically unregulated financial arrangements between knowledgeable and sophisticated parties, [464] guidelines can be particularly effective in assisting the industry to continue to develop and respond to issues of common concern without the rigidity and delay associated with formal regulation. In the context of the governance challenge, such guidelines can be used as a means to focus investors on issues that should be addressed either prior to their investment in a fund or during their period of investment or both.[465]

As a result, there can exist a symbiotic relationship between the private monitoring solutions proposed herein and these guidelines and best practice statements. Without some additional legal step taken by the parties to fund documentation, these guidelines and statements do not operate to create legally enforceable conduct standards.[466] Their direct impact on a cause of action by a disgruntled investor is very limited. Similarly, the private monitoring solutions are a means, and not an end in themselves. They lack any particular normative content.[467]

What precisely the procedure should be for a fund in a particular set of circumstances is not dictated by the monitoring solutions, whether side letters, board of directors composition or exchange listings are used. Joining these two sets of concepts together could provide both the legal framework and the normative content necessary to address the governance challenge, while at the same time allowing adequate flexibility to permit private actors to react to changes in market practice.

In this Chapter, I describe the function of self-regulation in private investment funds and the role of private actors in addressing the governance challenge. In particular, I analyze and compare the President's Working Group's *Best Practices for Hedge Funds*, the Managed Funds Association's *Sound Practices for Hedge Funds*, the UK's Hedge Funds Standards and the Institutional Limited Partners Association's Guidelines.

5.2 **The Role of Financial Regulation**

As a result of the 2007-09 financial crisis, questions were again raised about the best approach to take in connection with financial regulation.[468] Often, this consists of a debate on the relative merits of "principles-based" regulation and "rules-based" regulation,[469] with the former attributed to the UK and the latter to the US[470] Both approaches have their advocates

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464 See Section 2.5 above.

465 For commonalities with the commercial practice of "due diligence", see Section 9.3 below.

466 See Section 3.9-3.11 above.

467 This is ultimately a criticism of the private monitoring solutions which will need to be addressed. See Section 9.2.3

468 See Omarova at 678 ("The recent global financial crisis brought the issues of long-term regulatory reform into the center of public debate in the U.S., as well as other countries. Not surprisingly, in the past two years, academics and policymakers advanced numerous proposals for reforming financial sector regulation. These proposals . . . address in a variety of ways the fundamental issue of translating the lessons of that last crisis into regulatory mechanisms designed to minimize the chances of similar crises in the future.").

469 For an interesting discussion of this debate, see John Walsh, "Institution-Based Financial Regulation: A Third Paradigm," 49 Harvard International Law Journal 381 (2008) ("In a principles-based system, the government establishes desired outcomes for regulated entities and then provides guidance on how the entities can achieve those goals. In a rules-based system, on the other hand, the government imposes bright-line requirements on regulated entities, and then uses the power of the state to enforce those requirements.").

470 Interestingly, the Advisers Act has been held up as an example of "principles-based" regulation in the US See, e.g., Barbash Massari, at 628 ("[T]he Act has been traditionally cited as a disclosure and record-keeping

and critics. Dodd-Frank and AIFMD demonstrate elements of each approach, although overall the majority approach used is rule-based. As one commentator has observed:

> The classic example of the difference between rules and principles or "standards" (to use another term) involves speed limits, a rule will say, "Do not drive faster than 55 mph"; whereas a principle will say, "Do not drive faster than is reasonable and prudent in all circumstances." Put another way, a rule generally entails an advance determination of what conduct is permissible, leaving only factual issues to be determined by the frontline regulator or decision maker. A principle may entail leaving both specification of what conduct is permissible and factual issues to the front line regulator.[471]

Each approach, however, describes solely the manner in which the centralized power of the state is exercised in financial markets. Neither approach necessarily provides for definitive answers about what private actors should do amongst themselves in areas not yet addressed by regulation.[472] The frontier surrounding a rule-based regime is perhaps more clearly demarcated than a principles-based regime, but neither approach can purport to be completely comprehensive. There will always be unanswered questions, especially concerning instruments or transactions that were either intentionally left outside the boundary line of regulations, or had sprung to life after the regulatory regime was last revised and updated.

Given the extensive responsibility that national financial regulators have, and the numerous priorities that have been set for them by their governments, it is unsurprising that attempts to regulate private investment funds have been largely limited to indirect regulation by way of their fund manager.[473] These fund managers are already within the orbit of the regulators, or (in the case of the US) will join a regulatory regime that has been in place for 70 years. Additional requirements addressing private fund concerns can be added, albeit indirectly and often incompletely, by existing requirements applicable to fund managers.

Even with the recent changes effected by the passage of Dodd-Frank and the adoption of AIFMD, which were discussed in the previous chapter, many important questions concerning the structure and governance remain unanswered by the top-down financial regulatory regime. Realistically, if the 2007-09 financial crisis was insufficient to compel governments to consider and address all concerns they had about private funds, then it is unlikely that any further extension of the regulation will be forthcoming in either the near or the medium-term.

Accordingly, our attention must necessarily turn to the private actors themselves.

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statute. Officials of the Securities and Exchange Commission have, from time to time, suggested that these characteristics make the Advisors Act a "principles-based" regulatory scheme rather than one based on rules.").

471 See Ford at 6-7. However, it is important to recognize that many scholars view rules and principles not as discrete concepts but more as points on a continuum. Ibid. at 8. No actual regulatory system is purely one or the other. See id. at 9 ("Rules still admit of considerable discretion and interpretation. Principles, in the fullness of context, may congeal around a particular meaning.").

472 See Section 1.9 above.

473 See Sections 3.5 and 3.6 above.

5.3 **The Limits of Financial Regulation**

All attempts to address an identifiable problem in the financial markets with new regulation immediately opens the debate on the net effect of that regulation on the market itself. On the one hand, additional regulation will often increase the cost of doing business for any affected firms. As a result, such firms may be placed at a material disadvantage either to other categories of firms in that jurisdiction that are unaffected by the new rules, or to similar firms in other jurisdictions that are less regulated. On the other hand, unresolved problems that exist in a regulatory gap can harm firms by making them less appealing to counterparties. In either case, however, the outside reach of regulation exists, and cannot be eliminated. Each new rule extends the scope of regulation incrementally, but does not eliminate the fact that certain parties, instruments and transactions inevitably remain beyond that outside reach. Every regulatory system necessarily has a frontier.[474]

Although financial regulation continues to evolve and adapt over time, significant extensions of regulation tend to occur in cycles, linked often to the rise of perceived abuses or shortcoming that are revealed as part of market crashes, whether large or small.[475] The changes to the frontier between private investment funds and the US and EU regulatory regimes embodied in Dodd-Frank and AIFMD in all likelihood represent the high water mark of significant change for some time to come. Other regulatory concerns, more directly related to the causes of, and continuing ramifications from, the recent global financial crisis, will take priority in the near term.

Debates about financial regulation often involve questions on how best to protect investors from new waves of financial innovation that lead to further complexities in the financial markets.[476] Expectations of what regulatory regimes, and the individual regulators who police them, must be based on a realistic assessment of what they can accomplish in the real world. As commentators have observed:

> If the crisis was a failure of regulation, and if regulators are lawyers, then it follows that lawyers in a complex world must have an awareness and basic knowledge of the nature of this complexity. Explicitly, it is difficult to see how a lawyer regulator, from the most senior to the most junior rank and file, can purport to regulate complex financial instruments without having a detailed understanding of those matters beyond legal definitions, qualitative intuitions, and half guesses.[477]

Since the trend towards ever-increasing complexity sees no signs of abating in the foreseeable future, financial market participants and commentators should acknowledge that there can often be a lag or gap between a new innovation in the market and the identification, deconstruction and categorization of that development by particular regulators with responsibility for that area.

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474 And along that frontier, both government oversight and self-regulation are necessary components of the overall regulatory regime. See Omarova at 685. ("It is important to emphasize from the outset that industry self-regulation cannot, and should not fully replace government regulation and supervision of the financial services sector. Government oversight is crucial to ensuring that private financial activity promotes, or at least is consistent with, the broader public interest."). See also Section 1.9 above.

475 See Section 4.10 above.

476 See Shadab.

477 Rhee at 102.

The report ultimately produced by the Inspector General of the SEC documenting the pattern of failure within the financial regulator in connection with the Madoff debacle makes for sobering reading, especially in light of the number of investigations conducted which failed to uncover the massive fraud.[478] Perhaps the most disconcerting aspect was not the SEC's failure to uncover the fraudulent activities of Madoff itself, by way of its reporting requirements and periodic on-site inspections, but rather the simple fact that when the SEC was provided detailed evidence of the crime that Madoff was committing, its personnel was unable to perceive and understand that a crime was even being committed.[479]

5.4 **A Role for Self-Regulation and Private Actors**

Fortunately, however, where state-based regulation ends, fund managers and participants have developed detailed and elaborate private rules that govern the organization, remunerating, risk management and reporting activities of these funds by means of voluntary, contractual arrangements.[480] As such, they can be productively analyzed and critiqued in the context of the theoretical literature regarding self-regulation. As commentators have observed:

> Industry self-regulators have two important potential advantages over both direct regulation of the financial services sector and pure market-based regulatory mechanisms. One such potential advantage is the industry's superior ability to access and assess, in a timely and efficient manner, the relevant market information . . . The other potential advantage of private industry actors over government regulators is their ability to monitor and regulate their own business operations on a truly global basis, without regard to national borders and jurisdictional limitations.[481]

Numerous legal scholars, under the banner of the "New Governance" paradigm, are focusing wider attention on the fundamental inadequacies of relying solely on top-down, centralized state regulations of complex systems, such as the financial markets.[482] Arguing that a state monopoly on the making and enforcing of rules is ultimately unsuccessful and inadequate, these commentators are exploring alternative approach that can overcome the challenges of informational asymmetry and expertise deficit, and which can complement and supplement command-and-control regulation. [483]

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[478] Office of Investigations, Securities and Exchange Commission, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (2009) (the "SEC Staff Report").

[479] See Rhee at 114. See the SEC Staff Report at 3659 ("[T]he Enforcement Staff's failure to appreciate the 'red flags' contained in Markopolos' 2005 submission was a lack of experience necessary for a fundamental understanding of equity and options trading").

[480] Eddy Wymeersch, "The Regulation of Private Equity, Hedge Funds and State Funds," Financial Law Institute Working Paper Series WP 2010-06 (April 2010) (available at ssrn.com/abstract-1685202) at 11.

[481] Omarova at 669-670. The private monitoring solutions proposed herein are based upon private actors exercising such abilities in order to overcome the governance challenge.

[482] See Ibid. at 672 for a useful summary. See also Janis Sarra, "New Governance , Old Norms and the Potential for Corporate Governance Reform," 33 Law & Policy 576 (2011).

[483] Omarova. at 673. ("[R]egulation is a multi-layered process that takes place on many different levels and in many different forms."). See also Jason M. Solomon, "New Governance, Pre-emptive Self-Regulation and the Blurring of Boundaries in Regulatory Theory and Practice," 2010 Wisconsin Law Review 591 (2010).

Self-regulation has been championed by its supporters as "responsive, flexible, informed, targeted" and criticized by sceptics as "self-serving, self-interested . . . and simply a sham."[484] Some critics have gone so far as to argue governments and financial regulators who seek to utilize self-regulation as a complement to other regulatory tools are abdicating their responsibility and creating a democratic gap in the exercise of their obligations to citizens.[485] In practice, however, there are a wide variety of arrangements and approaches that can be referred to as self-regulation,[486] and which undermine the traditional dichotomy between regulation on the one hand and self-regulation (in essence, deregulation) on the other.[487]

In the context of private investment funds, we can identify in several recent examples of industry guidelines and best practice statements the potential for effective means of flexible and targeted self-regulation, which address current issues facing these funds that remain outside the regulatory frontier. Below, I will discuss four such codes and describe certain key issues of each. Three focus on hedge funds and just one addresses private equity funds. Each code prioritizes slightly different elements, although similarities and overlapping necessarily exist.

5.5 **President's Working Group's <u>Best Practices</u>**

On 22 February 2007, the President's Working Group on Financial Markets (the PWG Committee) issued guidelines for the oversight of hedge funds, private equity funds and other private pools of capital, entitled '*Agreement Among PWG And US Agency Principals On Principles And Guidelines Regarding Private Pools Of Capital*'.[488] The guidelines were intended to guide US financial regulators as they address public policy issues associated with the rapid growth of private investment funds, and to serve as a framework for evaluating market developments, specifically concentrating on investor protection and systemic risk concerns. The PWG Committee designed the guidelines to provide a flexible principles-based approach to address the issues presented by the growth and dynamism of these investment funds.

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[484] Julia Black, "Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory World,'" 54 Current Legal Probs 103, 115 (2001).

[485] See Joanna Gray and Jenny Hamilton, <u>Implementing Financial Regulation: Theory and Practice</u> (John Wiley & Sons 2006) 262 ("Instead of society and government addressing the hard choices between differing values and goals enshrined in different regulatory regimes, which would be the most open and most democratic way, meta regulation shunts them onto the shoulders of firms and managers. 'Regulatory compliance cultures' within business are asked to make up for the shortfall in our wider democratic culture.").

[486] See Omarova at 675 ("Thus, self-regulation is often used interchangeable with terms, such as "self-governance," "collaborative governance," "negotiated governance," "co-regulation," "voluntarism," "private regulation," "soft law," "quasi-regulation," "enforced self-regulation, "communitarian regulation," and so on.").

[487] <u>Ibid</u>. at 677 ("[S]ocial scientists and legal academics tend to distinguish between systems of "voluntary" self-regulation, characterized by the absence of direct government intervention; "sanctioned" self-regulation, in which private actors formulate rules subject to government approval; and "mandated" self-regulation, in which private actors are required by the government to establish a self-regulatory framework."). The private monitoring solutions proposed herein would be best categorized as voluntary self-regulation. In addition, they represent a manner in which the regulatory capacity of private actors can be identified and harnessed for the pursuit of regulatory goals. See Section 1.9 above.

[488] The PWG Committee, consisting of representatives from the Treasury, the Federal Reserve, the SEC and the Commodities Futures Trading Commission, was originally formed in 1988 to further the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of financial markets and maintaining investor confidence.

In summary, the guidelines lay out certain responsibilities that various participants should bear in mind when addressing the issues that currently face private investment funds in the financial markets:

(a) funds should maintain and enhance information, valuation, and risk management systems to provide market participants with accurate, sufficient, and timely information;

(b) investors should consider the suitability of investments in a private pool in light of investment objectives, risk tolerances, and the principle of portfolio diversification;

(c) counterparties and creditors should commit sufficient resources to maintain and enhance risk management practices; and

(d) regulators and supervisors should work together to communicate and use authority to ensure that supervisory expectations regarding counterparty risk management practices and market integrity are met.

The guidelines stress the importance of market mechanisms in addressing the challenges presented by the rapid growth of hedge funds and private equity funds, both to market participants and policy makers. Importantly, the PWG Committee made no call for new laws or regulations to be adopted, on the basis that the current regulatory approach was sufficient to protect investors and the overall stability of the financial system. The focus instead was with the funds themselves, as well as their principal counterparties, such as prime brokers, to adhere to certain non-binding 'best practice' principles for leading hedge funds and experienced investors.

On 15 April 2008, the private sector committees of the PWG Committee released two separate reports that recommend best practices and assess the accountability of the hedge fund industry. The Investors' Committee and Asset Managers' Committee were created to determine best practices so that market participants may enhance investor protection and systematic safeguards consistent with the PWG Committee's principles and guidelines.[489] The best practices report for investors includes a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. The best practices report for the asset managers calls on hedge funds to adopt comprehensive best practices in all aspects of their business, including the critical areas of disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest.

The PWG Committee recommendations are intended to complement each other by encouraging market participants to hold other participants more accountable. Given the global

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[489] The Committees were created in 2007 following the PWG Committee's release of principles-based guidelines to address the rapid growth of private pools of capital, including hedge funds. The Investors' Committee is comprised of representatives from labour organizations, endowments, foundations, corporate and public pension funds, investment consultants, and non-US investors. The Asset Managers' Committee includes representatives from a diverse group of hedge fund managers.

nature of the financial markets, the best practices were designed to be consistent with the recent work in the UK to improve hedge fund oversight.[490]

With the goal of disclosing material information so that investors can determine if they should invest or redeem an investment and to be in a position to monitor such investment,[491] the Best Practices suggest the following types of disclosure: private placement memorandum,[492] annual audited financial statements, periodic performance information, other investor communications, and other significant events.[493]

With the goal of consistent valuations of assets based upon documented policies and segregation of duties between those who choose the investments and those who value the investments,[494] funds are encouraged to establish a valuation committee to set the valuation policies and procedures and to oversee their use in the fund.[495] The valuation policies should include: the identity of the personnel involved in the process, the methodology for valuation of each type of investment, the supporting documentation required to be kept evidencing the valuations made, the pricing sources to be used in the valuation, guidelines for exceptions to the valuation policies, and controls over segregation of duties.[496]

With the goal of creating guidance for the fund managers on the topics of compliance, conflicts of interest, ethical issues and regulatory issues and to create a culture of compliance within its organization, funds are encouraged to:[497]

(a) prepare a code of ethics and a compliance manual;[498]

(b) appoint a conflicts committee to oversee treatment of conflicts that arise;[499] and

(c) inform its personnel of the foregoing procedures that are in place that include disciplinary measures and sanctions for failure to comply.[500]

In sum, given the PWG's focus on the immediate consequences of hedge fund failures on the broader financial markets, it is unsurprising that their focus here centred around general information flows and counterparty risks. It is notable, however, that governance itself was not a direct topic of consideration.

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490 See Section 5.7 below.

491 Best Practices, at v. For a discussion of limitations to the effectiveness of disclosure, see Section 6.7 below.

492 See Section 2.2 above.

493 Best Practices, at 1. For example, with respect to the private placement memorandum, the content should include: (a) the fund's operations and legal structure; (b) investment philosophy; (c) investment strategies; (d) investment products; (e) significant risks; (f) biographies of key investment management personnel; and (g) terms of the investment (fees, expense allocation, redemption rights, use of side pockets, disclosure framework, valuation framework, risks of investment, potential conflicts of interest and use of third party service providers). Best Practices, at 2-5.

494 Best Practices, at vi.

495 Best Practices, at 14.

496 Best Practices, at 17-20.

497 Best Practices, at 42-43.

498 Best Practices, at 43-50.

499 Best Practices, at 49.

500 Best Practices, at 51.

5.6 The Managed Fund Association's Sound Practices

The MFA, a trade group for hedge fund industry based in the United States with the goal of enhancing the understanding of the alternative investments industry, published its fourth edition of Sound Practices[501] in November 2007. The goals of Sound Practices range from improved market discipline and strengthening the US financial markets to enhancing investor protection. The goals of the PWG Committee, while aligned with the MFA, are broader to include a reduction of systemic risk and to foster investor protection.[502]

Importantly, there is no mandate that all of the Best Practices and all of the Sound Practices be adopted by each and every fund. The goal is that the publication of the Best Practices and the Sound Practices leads to voluntary adoption by hedge fund managers, even if only on a partial basis as applicable to the relevant hedge fund.[503] The Sound Practices are structured as recommendations to, or a set of voluntary guidelines for, hedge fund managers focusing on the hedge fund's operations as well as its primary constituents: the investors and clients of the hedge fund.[504]

Fund managers should acknowledge their duties and responsibilities to the investors in the hedge fund.[505] The MFA proposes practices intended to assist hedge fund managers in fulfilling these responsibilities, such as informative disclosure of objectives, investments, terms, risks, conflicts of interests, performance data, side letters, trade allocation policies, financial statements, valuation policies, code of ethics and soft dollar arrangements.[506] Policies should be established to safeguard its trading information.[507]

Since subscriptions and redemptions are usually based upon the current NAV, the hedge fund managers should establish policies for the determination of NAV that are fair, consistent and verifiable.[508] These policies should cover tracking of the assets and investments from their

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[501] The Sound Practices were originally published in 2000 and later revised most recently after the initial draft of the Best Practices were released for public comment.

[502] Best Practices, at i.

[503] A hedge fund is defined by the PWG Committee as "a pooled investment vehicle that generally meets most, if not all, of the following criteria: (i) it is not marketed to the general public (i.e., it is privately offered), (ii) its investors are limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (e.g., US Investment Company Act of 1940), (iv) its assets are managed by a professional investment management firm that is compensated in part based upon investment performance of the vehicle; (v) its primary investment objective is investing in a liquid portfolio of securities and other investment assets; and (vi) it has periodic but restricted or limited investor redemption rights." Best Practices at i n 3. Similarly, Sound Practices define hedge funds using the foregoing definition with the omission of clause (v). Sound Practices, at 7.

[504] Sound Practices, at 10-11. These recommendations and guidelines span seven topics as follows: (a) management, trading, and information technology controls; (b) responsibilities to investors; (c) determination of net asset value; (d) risk management; (e) regulatory controls; (f) trading relationship management, monitoring, and disclosure; and (g) business continuity, disaster recovery and crisis management. While there is overlap of topical information, the Best Practices differ from the Sound Practices by limiting its focus to the following five areas: (a) disclosure; (b) valuation of assets; (c) risk management; (d) trading and business operations; and (e) compliance, conflicts of interest and business practices. Best Practices, at iii-iv.

[505] Sound Practices, Section 2.1.

[506] Sound Practices, Section 2.2 - 2.13.

[507] Sound Practices, Section 2.11.

[508] Sound Practices, Section 3.1 and 3.6 - 3.9.

purchase and ongoing existence up to their sale and the validation and reconciliation of their valuation at fair value as compared to third parties' valuation of the same asset.[509] Inherent in this process is the need to keep supporting documentation to validate the amounts supporting the NAV.[510]

With the goal of creating a strong regulatory compliance infrastructure at a hedge fund, the Sound Practices encourage hedge fund managers to create a culture of compliance within its organization.[511] This involves monitoring compliance with all applicable laws in all jurisdictions in which the hedge fund operates, including all required regulatory filings[512] and having a document retention policy.[513] A written code of ethical conduct should be prepared and distributed to all of the hedge fund managers' employees as well as policies and procedures on anti-money laundering issues.[514] Employees should attest to their understanding of all of the foregoing compliance policies.[515]

Similar to the Best Practices, the focus of the Sound Practices on hedge funds was understandable and expected, given the MFA's constituency. Clearly, the two practice standards complement each other, differing unsurprisingly in the weight they give compliance in those areas where industry practitioners necessarily differ in their priorities from government regulators. Importantly, the Sound Practices also avoids prolonged considerations of governance in favor of specific tasks and rules.

5.7 **Sir Andrew Large's Consultation on "Hedge Fund Standards"**

In June 2007, Sir Andrew Large was appointed to lead a working group made up of hedge funds across Europe considering a voluntary code of practice for the sector.[516] The industry working group, independent of the FSA or any other EU regulator, focussed on risk management, valuation and disclosure requirements for funds. On 10 October 2007, Sir Andrew's Hedge Fund Working Group (HFWG) issued its report entitled *Hedge Fund Standards: Consultation Paper*.[517] The report recognized that potential conflicts of interests can rise between hedge fund managers, the hedge funds which they manage and investors in those hedge funds. Such conflicts can include manager remuneration and other related factors and the need to ensure fair treatment of multiple clients. The report proposes best practice standards that seek to mitigate these conflicts of interests by requiring adequate governance mechanisms and oversight.

The report recognized that there is a wide range of governance approaches within hedge funds. Some adopt informal approaches, where the managers themselves are significant investors and know the other, sophisticated investors. The report lists three particular drivers

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509 Sound Practices, Section 3.2 - 3.5.

510 Sound Practices, Section 3.5.

511 Sound Practices, Section 5.1.

512 See Sections 3.5 and 3.6 above.

513 Sound Practices, Section 5.2, 5.4, 5.5 and 5.8.

514 Sound Practices, Section 5.6, 5.7 and 5.9.

515 Sound Practices, Section 5.9.

516 For a discussion of Sir Andrew's work with hedge funds, see McVea.

517 http://www.hfwg.co.uk/sites/10085/files/hfwg_paper_part_1_pdf.

that potentially lead to governance issues in hedge funds, requiring a reinforcement of oversight processes:

(a) increasing remoteness between ultimate investors and hedge fund managers;

(b) increasing institutionalisation, with investors looking for a higher degree of comfort; and

(c) increasing 'retailisation' of the ultimate investor base due to the entry of retail investors and investment by insurance companies and pensions plans owing ultimate duties to retail investors.

Following this consultation paper, the HFWG, representing 14 leading hedge fund managers based mainly in the United Kingdom, published its final report on hedge fund standards on 22 January 2008. As a result of the feedback received,[518] the HFWG amended the proposed best practice standards (the Standards).[519] The HFWG was replaced by the Hedge Fund Standards Board (HFSB), consisting of 12 trustees, who have responsibility for maintaining the Standards and updating them in future.

Hedge fund managers wishing to become signatories to the Standards must apply to the HFSB and give an undertaking that, among other things, they will adopt the Standards on a "comply or explain" basis, and will contribute to the funding of the HFSB. In exchange, they are able to include, in their marketing material, and elsewhere, a statement to the effect that they are signatories to the Standards. The HFSB keeps a register of signatories and publishes an annual report on conformity with the Standards by the hedge fund industry.[520]

The 28 Standards are grouped in following categories

(a) disclosure to investors and counterparties (1-4) - these Standards cover disclosure to investors of the hedge fund's investment strategy and the risks associated with an investment in the fund; disclosure of the commercial terms on which the manager has agreed to manage the fund; performance measurement; and counterparty disclosures (such as to prime brokers);

(b) valuation (5-8) - these Standards cover separation of the valuation and portfolio management function; adoption of a valuation policy document covering all material aspects of the valuation process together with valuation procedures and controls; valuation of hard-to-value assets; and periodic disclosure of the percentage of the fund's portfolio that is invested in hard-to-value assets;

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518 The HFWG notes that it received 75 responses, and held 26 consultation events involving some 300 investors, hedge fund managers and prime brokers. There was broad agreement that the five areas of concern identified in the consultation paper - disclosure, valuation, risk management, fund governance and shareholder activism - had been correctly identified.

519 Given the UK focus of the members of the HFWG, and the fact that the UK is by far the largest centre for hedge fund managers in Europe, the Standards are unsurprisingly anchored in the FSA Principles for Businesses. As the HFWG itself notes, the FSA's Principles are "generally regarded as determinants of good business practice almost everywhere"; and that consequently "compliance with these Standards ought to be of comfort wherever the hedge fund manager is situated, regardless of whether a particular jurisdiction has a regulatory regime".

520 The report stresses that the HFSB will not act as a regulator, though it will have the power to remove a non-compliant firm from the register. Peer pressure, along with self-interest, will therefore be the spur to compliance.

(c) risk management (9-20) - these Standards are concerned with hedge fund managers establishing a risk framework and explaining their approach to managing risk, with specific Standards dealing with measuring the different sources of portfolio risk; establishing processes to ensure that the portfolio remains within its stated investment objectives, investment policy/strategy and other restrictions; and disclosure of the manager's investment and risk management approach in marketing materials, fund offering documents and annual reports;

(d) fund governance (21-22) - these Standards are designed to mitigate the potential conflicts of interest that can arise between hedge fund managers, the hedge funds which they manage, and investors in those funds, with specific Standards providing that a suitable and robust fund governance structure should be established, under which a fund governing body with suitable experience and integrity acts with the appropriate level of independence; and that details of the fund governance structure should be disclosed in the fund's offering documents; and

(e) shareholder conduct, including activism (23-28) - these Standards cover the prevention of market abuse through appropriate internal compliance arrangements; disclosure in the hedge fund manager's marketing materials that it has a policy to prevent market abuse; adoption and disclosure of a proxy voting policy; and a prohibition of the borrowing of stock in order to vote.

The Standards acknowledge that the hedge fund manager and the fund governing body are different entities, and that the former cannot ensure that the latter follow the Standards. Accordingly, in many Standards or parts of Standards the obligation is on the hedge fund manager to "do what it reasonably can to enable and encourage" the fund governing body to follow the Standard.[521]

The emphasis the Standards place on the ability to manage risk may further concentrate business in the hands of the larger firms, as being better able to devote the necessary resources to implementing appropriate systems and controls than smaller firms. However, since the responses to the consultation paper indicated that managers of all sizes were comfortable with the disclosure-based "comply or explain" regime, the flexibility in the Standards may be sufficient to cater for the position of smaller managers without the need for a separate tier of standards expressly for them. Furthermore, the fact that disclosure is at the root of all the HFWG's recommendations is likely both to counter general criticism of the secrecy with which hedge fund management is conducted, and result in investors obtaining more information relevant to their investments.

In many ways, the Sir Andrew and his Standards attempted a more intellectual integrated survey of hedge fund practices, and while still omitting other types of private funds, at least included a direct consideration of governance issues. Unfortunately, the Standards, being UK focussed, have not seen the level of wide-spread uptake and acceptance that the MFA's

[521] While this approach is an acceptance of the reality behind the respective positions of manager and fund governing body, it does leave unclear what in practice Standards of this type require the manager to actually do.

Sound Practices have. Perhaps it is notable that there was minimal input received from investors on the drafting of the Standards.[522]

5.8 ILPA Guidelines

Since their initial release in September 2009, the Private Equity Principles (ILPA Principles) promulgated by the Institutional Limited Partners Association (ILPA) have attracted significant attention and comment from the industry. Proponents of private equity funds frequently contend that every partnership agreement is bespoke, and the final result of heavy negotiations. This situation is possible because only a relatively small number of investors participate in such funds, and the expectation is that they will remain as investors in the fund for significant periods of time.

The ILPA Principles attempt to outline, in connection with certain key issues, the consensus views of a large number of active private equity fund investors. Some recommendations, however, are currently followed by only a handful of general partners.[523] As a result, the ILPA Principles can be seen as a statement of fund investors desired outcomes in these areas, even if not currently reflected by majority practice in the market.[524] Ultimately, the practical benefit of the ILPA Principles is its ability to serve as a reference point for investors and fund managers, by which their negotiations can be more efficiently conducted, as well as serving as a means by which to compare numerous funds and their compliance or non-compliance on a particular point.

Limited partnership agreements are typical based on the presumptions that there will be a very close relationship between the practices involved.[525] However, it is not possible to align the interests of general partners and limited partners in all circumstances. As a result, conflicts will arise and steps must be taken to address them. A general partner who has a clear duty to act in the best interest of his limited partners must be able to determine what those interests actually are, especially in light of any significant differences in opinion that certain limited partners might have.[526] Importantly, the ILPA Principles address governance issues as well as economic concerns. By laying the foundation for a meaningful dialogue between the general partner and the limited partners, those fund investors who are adequately prepared and motivated can influence the determination made by the general partner and monitor the implementation of such decisions.

In sum, the ILPA Principles address issues of particular relevance to private equity funds. Importantly, while the MFA's Sound Practices and Sir Andrews' Standards were prepared by fund managers and the PWG's Best Practices were agreed upon by regulators, only the ILPA Standards entirely originated with fund participants.

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522 See McVea at 80 ("The HFSB's project has also been criticized for having no or very little investor input (a position which can be contrasted with the PWG in the United States, where an Investors' Committee was established alongside an Asset Managers' Committee). This is liable to lend credence to the view that the HFSB is nothing more than a self serving mouthpiece for an industry, which has used self-regulation first and foremost as a cynical ploy to stave off more stringent FSA regulation, which, arguably, better serves the public interest.").

523 See Preqin Study, where only 4% of recent funds comply with the requirement that a general partner can be removed by a 2/3 vote of limited partners.

524 In January 2011, ILPA released an updated version of these recommendations, relaxing certain of its more controversial provisions to better reflect current market practice.

525 See Sections 2.2 and 2.3 above.

526 See Section 2.3 above.

5.9 Comparisons and Criticisms of Guidelines and Standards

The four codes of conduct discussed above were each prepared by different industry groups, each answerable to a different constituency. Regardless, there are many similarities between the codes. Of most importance, none of these codes are legally binding. As such, there is no formal sanction that can be applied to a particular fund manager who ceases to comply. Regulators, such as the SEC and FSA, were not directly involved in their formulation and these codes are not formally sanctioned under applicable rules and regulations.

However, the bodies that promulgated these codes retain the flexibility, outside of the traditional hindrances and delays due to lobbying and budget constraints that impact governmental rule-making, to continually revise and update their codes to ensure that they remain relevant to the rapidly evolving industry to which they relate. Finally, each code focuses a substantial amount of its attention on improving information flows from the fund managers to the fund participants. The private monitoring solutions, discussed in the following chapters, will take these themes and provide them with the mechanisms for legal enforceability which the codes, on their own, necessarily lack.

5.10 The Role of Investors in Investor Protection Failures

There will always be a frontier at which the mandate of top-down, centralized financial regulation ends.[527] It is not feasible in the real world for any financial regulatory system to anticipate all potential outcomes. Inevitably, top-down systems will apply more detailed prescription to products and transactions involving retail investors, and less detailed prescriptions to larger, more sophisticated institutions.[528] To attempt a one-size-fits-all approach could either expose retail investors to unacceptable risks or suffocate the wholesale markets in red tape and unnecessary paperwork.[529]

For that group of sophisticated investors who wish to participate in private investment funds,[530] they will require a framework in which to have their pre-investment and post-investment due diligence conducted.[531] In the absence of public disclosure requirements imposed by the national regulator, it is ultimately left to the private actors themselves (fund investors and fund managers) to establish such framework.

Industry codes and best practice standards can be seen as an attempt to populate this gap for the benefit of the private actors who will remain active in these types of transactions. Ultimately, however, their lack of legal enforcement limits their effectiveness. Investors, therefore, are left to fend for themselves, supported by whatever rights private law affords them.[532] The central question that arises in connection with recent private investment fund enforcement actions[533] and legal cases[534] is to what extent did investors have access to

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527 See Section 1.9 and 5.2 above.

528 See Sections 2.2 and 2.5 above.

529 See Section 9.2.2 below.

530 See, e.g., Harris, "Critical Theory" at 31 ("Investors in limited partnerships are not frequently individuals managing their own money. Instead, the largest investors in private equity limited partnerships are pension funds and other institutional investors that operate for the benefit of fund contributors..."). See also Section 2.5 above.

531 See Section 9.4 below.

532 See Sections 3.9-3.11 above.

533 See Section 3.8 above.

adequate information, both initially and on an ongoing basis, to monitor the actions of the fund manager and its key personnel, in order to detect and/or prevent the occurrence of fraudulent misconduct.

Frauds and other malfeasances involving private investment funds, whether structured as Partnership PIFs[535] or Company PIFs[536], may occur because a fund was originally established with the intention of defrauding investors or, more likely, where the fund was initially launched with the intention of being a successful venture, but due to unexpected poor performance, engages in fraud to preserve an illusion of success. In either case, underlying these incidents is the question of whether more effective governance mechanisms within the fund would have served to better protect investors, whether limited partners in a Partnership PIF or shareholders in a Company PIF, over time.

There are clearly limits to the extent which investors can protect themselves from outright fraud simply through reviewing documentation. If the documentation is invalid, and those who are purporting to be independently verifying its accuracy are in on the fraud themselves, there may be little hope for an investors. However, at the very least, investors need information which they could have independently reviewed and verified in order to make an initial investment decision and to review investment performance over the course of the relationship. The best approach to following when considering a prospective investment, or when monitoring a current fund investment, is a multidisciplinary issue outside the scope of this thesis. For these purposes, the focus will be not on particular data points that should be obtained or how to process such data points to generate a conclusion or recommendation. Instead, this thesis focuses on how to put in place a framework, at the level of the legal entities which comprise the fund, outside the black-letter regulatory requirements that may be applicable to such fund, to obtain such information[537] at a time and in a manner that allows one or more fund investors to act upon it, in order to effectively protect their interests. Obviously, there is no guarantee that investors will use such information.

In the case of the Madoff scheme,[538] it appears unfortunately clear that many investors conducted little or no due diligence prior to handing over significant sums of money.[539] Importantly, several prospective investors who conducted due diligence on Madoff ultimately decided not to invest.[540] This strengthens the argument that sophisticated investors who choose not to perform due diligence, but still invest in a private fund, should be left to suffer the consequence of their actions or inactions.[541]

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534 See Section 3.12 above.

535 See Section 2.3 above.

536 See Section 2.4 above.

537 See Smith at 266 ("[I]n the absence of an issuer's obligation to make public disclosure, the investor's ability to obtain material information on his investment with some regularity (whether quarterly, annually or both), or upon specified events, becomes more critical.").

538 See Section 3.2 above.

539 See Smith at 255 ("Investors or their professional money managers may not have adequately scrutinized Madoff's investment program for any number of reasons. Madoff's prominence on Wall Street may have obviated the need to conduct customary diligence. Years of steady "investment returns" may have pulled investor into disregarding potentially troubling signs.").

540 See, for example, letter from Harry Markopolos to the SEC (Nov. 7, 2005) available at http://online.wsj.com/documents/Madoff_SECdocs_20081217.pdf. See also Section 9.5.4 below.

541 See Smith at 277.

The question of what constitutes sufficient due diligence, whether pre-investment or ongoing, is an important one, and involves financial analysis, risk measurement and old-fashion detective work.[542] Such due diligence will often necessarily involve a review by lawyers of the constitutional documents and material legal agreements entered into by the fund, and a review by accountants of financial statements and trading records. Nonetheless, due diligence prior to an investment typically includes a legal review of the fund's constituent documents and offering documents and key service provider agreements (e.g., investment management agreement, administration agreement),[543] as well as a commercial analysis of the fund's financial statements and trading records. Often, key personnel within the fund manager will be interviewed, including the portfolio managers and the chief compliance officer, as well as those persons within the fund's administrator who are responsible for the valuation of the fund's assets. Current and former investors may also be approached in order to see if any concerns exist. On an ongoing basis, investors should have access (directly or indirectly) to sufficient information to determine whether or not the factors that led them to invest initially in the fund are still correct. Due to the unregulated nature of private investment funds, such information would typically only be made available when the fund is compelled to provide it, either due to a contractual obligation to a particular investor (e.g., a side letter), or an obligation assumed by the fund to a third party (e.g., stock exchange listing), or due to the oversight obligation of its governance body (e.g., independent board of directors).

For so long as the financial regulators maintain the position that the structure and operation of private investment funds, and consequently issues related to the governance challenge, will not be directly addressed by their regulatory regimes, the private monitoring solutions are three alternative approaches which informed and motivated private actors could consider.

5.11 **Private Actors and Private Law**

Once we begin to turn our attention towards private actors and the options available to them to address the governance challenge, the importance of the private law duties rises significantly. Although the wider interaction between financial regulatory regimes and the older, more generally applicable legal and equitable systems remains an area of some contention and debate[544], where a particular product or service falls outside of financial regulation, it is natural that financial market participants begin to consider in detail their rights and obligations at law and equity.

Necessarily, questions regarding such rights and obligations, as well as claims for any breaches thereof, will be resolved in the civil courts. In the context of private funds, the marketing restrictions excluding retail investors act to limit participation to those investors for whom civil litigation is not an outright impossibility. The private monitoring solutions are underpinned by the private law, and it is to the private law that fund participants might look to enforce their rights under their side letters or to seek recourse against fund directors or securities exchanges who failed to fulfil their duties to them under contract or tort, or at equity.

Just as the private monitoring solutions are complemented by the normative content provided by industry best practices and guidelines, they are also made effective by the ability of fund participants to go to court and seek particular remedies. As such, they are more than simply another means by which commercial parties can conduct initial or ongoing due diligence in

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542 See Section 9.4 below.

543 See Section 2.2 above.

544 See, e.g., the Law Commission's <u>Fiduciary Duties and Regulatory Rules</u>, Report No. 236 (December 1995).

connection with an agreed transaction. Instead, they are a means to actually change the constellation of potential liability that surrounds the fund manager and would provide the participant with legal or equitable relief.

5.12 **Using Privately-Negotiated Structural Approaches to Address the Governance Challenge**

The privately negotiated structural approaches proposed herein to address the governance challenge in private investment funds focus on improvements that can be made at the level of the fund documentation by agreement between the fund participant(s) and the fund manager. These improvements can be implemented with different breadth of coverage, either as regards:

(a) a single participant in a private investment fund (i.e., a "one-dimensional" solution);[545]

(b) all participants in a single private investment fund (i.e., a "two-dimensional" solution);[546] or

(c) a collection of private investment funds who have voluntarily agreed to adhere to a legally binding set of requirements (i.e., a "three-dimensional" solution).[547]

This thesis will propose and analyze the potential private monitoring solutions at each level.

By monitoring, I mean the ability of a party, whether a governmental entity or a private actor[548], to obtain relevant and timely information about a financial product or transaction - in this case, a private investment fund - in order to take such steps as the party may deem necessary to protect its interests. Notably, onshore regulators have repeatedly taken the decision <u>not</u> to perform a monitoring role with regards to these funds. As a result, fund participants must look to private monitoring solutions in order to address any concerns that they have.

Of course, the mere receipt of information is not sufficient in itself to eliminate fraud, malfeasance, negligence or error. Much more is necessary in order for a fund participant to exercise its rights effectively. Monitoring, therefore, also requires the ability to access the adequacy of the information received and to process it in such a manner that appropriate conclusions can be drawn. Where a fund participant lacks such abilities, an agent could be selected who can accomplish these tasks. Certain private actors will have these abilities, together with the time and resources required, while others will not.[549] For the former, the private monitoring solutions provide a framework for conducting these exercises themselves. For the latter, the solutions although provide an approach for appointing agents who can supplement the vigilance of the fund participant.

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[545] See Chapter 6.

[546] See Chapter 7.

[547] See Chapter 8.

[548] In the case of a private actor, the private monitoring solutions will look to their regulatory capacity in order to determine how their actions could potential assist in the attainment of regulatory goals. See Section 1.9 above.

[549] Such private actors, therefore, will not possess the regulatory capacity required to be part of, and make a meaningful contribution towards, a decentralised regulatory regime.

A client will expect that an investment manager who has undertaken to act for him in connection with the pursuit of delineated investment objectives is in a relationship of trust with him, [550] whether that undertaking is directly made in a bilateral relationship or indirectly made through a variety of limited partnerships[551] and offshore companies[552], as is commonly seen in private investment funds. In the latter case, the client will rely on the governance structure of these vehicles to enforce the obligations of loyalty to which he is entitled.

Investors appoint fund managers as their agents[553] to make investments on their behalf indirectly, through a private investment fund, rather than directly. As noted above, there is an informational asymmetry between the active fund manager and the passive investors which drives the governance challenge. The separation of ownership and control that is a recurring feature in the traditional corporate governance analysis is magnified in the case of private investment funds by their use of non-corporate and offshore vehicles, structured primarily for tax reasons.[554]

Historically, the structures implemented and contractual documentation adopted for private investment funds have operated to limit the availability and effectiveness of legal, equitable and regulatory remedies for fund participants.[555] By altering this practice, incrementally increasing the potential for such remedies, potential investors can take constructive steps towards addressing the governance challenge. Investors in private investment funds with adequate knowledge about the potential risks associated with such funds and the variety of prior investor protection failures that have occurred can negotiate amendments or supplements to the fund documentation to better protect them against such outcomes, provided that they have adequate negotiating leverage with the fund manager and its principals. Absent such leverage, fund investors face only the options of either participating in a fund structure without necessary amendments and improvements or declining the opportunity to invest.

Three potential solutions are discussed below which would enable fund investors to better address the problems arising from the governance challenge:

(a) side letters, which provide a particular investor with further information and/or legal standards with regard to the operation of the fund;[556]

(b) improving the operation of the board of directors in either corporate-based funds or the general partner vehicle of limited partnership structures[557]; and

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550 See Bristol & West Building Society v Mothew, [1998] Ch p.18.

551 See Section 2.3 above.

552 See Section 2.4 above.

553 See Section 1.6 above.

554 See Sections 1.3 and 1.4 above.

555 See Section 3.8 above. See also Rosenberg at 367. ("Given the amount of money at stake and the uncertainty involved in the investments, one would assume that limited partners in venture capital funds would avail themselves of substantial legal protections to ensure that those managing their investments act in the investors' best interests. Yet a close examination of the nature of venture capital limited partnerships reveals that few such protections exist. The managers of venture capital funds have virtually no general *legal* obligation to behave in the best interest of their investors.").

556 See Chapter 6.

557 See Chapter 7.

(c) listings of private investment funds on securities exchanges as a means of adopting ongoing compliance oversight from an independent third party.[558]

As noted above, each approach addresses the governance challenge redressing informational asymmetries and providing for legally enforceable conduct standards.

Further, each approach recognizes the commercial contexts in which private investment funds operate by emphasizing voluntary steps that fund managers and investors can take incrementally. In addition, they each operate with a distinct scope of application — side letters as a "one-dimensional" solution involving only a single participant, board composition and operation as a "two-dimensional" solution involving all participants in a single fund and listings as a "three-dimensional" solution involving all participants in a number of different funds — although they build in part on the key elements of the simpler approaches. However, as we move up levels, reliance on other parties increases, as does the distance from the fund participant to the prospective monitor, thereby potentially decreasing effectiveness. Accordingly, I will evaluate the agency issues that arise in the context of each monitoring solution.

5.13 Conclusions

Any claims that further rules and regulations can in themselves serve as an adequate deterrent to the repeat of such incidents must be thoroughly reflected upon in light of the systemic failure of SEC personnel to take heed of any one of early indicators it received of Madoff's pyramid scheme.[559]

To the extent that sophisticated and experienced investors fail to conduct initial due diligence and ongoing monitoring of their participations in private investment funds — as appears to be the case for numerous individuals, charities and financial institutions that became ensnared in the Madoff scheme — their ability to obtain adequate compensation for the subsequent losses through private law remedies and/or regulatory actions is uncertain, at best.

Investors who instead effectively negotiate private monitoring solutions to address the governance challenge, by providing themselves with adequate information and legally enforceable conduct standards, can in effect operate as "deputised regulators"[560] for their own benefit by seeking to better ensure that the fund manager is complying with its various obligations. Assuming that actual regulatory and criminal enforcement personnel are not unlimited in number, time or attention[561], then there will always be a counter-argument to regulatory expansion that unsophisticated and inexperienced investors should be the primary (but not necessarily exclusive) focus of such resources.

The various self-regulatory approaches that have developed around private investment funds in recent years have provided prospective fund investors with highly relevant parameters with which to analyze and judge the operational and legal risk of a fund and its manager. By performing this role, private actors can make a meaningful contribution to the wider regulatory regime, by supplementing the top-down command-and-control authority of the financial regulator. Disclosure is at the foundation of these best practice concerns. A long-standing

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558 See Chapter 8.

559 See Section 3.2 above.

560 See Sections 1.9 and 5.2 above.

561 See Section 5.3 above.

criticism of private investment funds has been their proclivity for secrecy. However, what these approaches specifically, and intentionally, lack is direct legal enforceability. Therefore, investors looking to use these tools to address the governance challenge must consider ways in which to create an enforceable legal obligation upon the fund manager to fulfil all, or part, of these practice standards.

Although the “victims list” of the Madoff affairs makes for solemn reading, the individuals and institutions disclosed to date repeatedly fall into the category of prospective investors who financial regulators have consistently expected to be able to understand the risks they face and make the appropriate (and simple) decision of whether or not to invest in a particular fund.[562] The approach of both the SEC and the FSA has been, and remains, that their resources are focused on those elements of the financial system that pose the most risk to the most people. Many would argue that wealthy citizens should not receive a greater allocation of scarce police personnel and assets to protect their belongings, and that if they believed they needed increased protection, then they should consider hiring their own private security personnel as needed. And some could contend that the same analysis should apply to the regulation of private investment funds.

Recognising that the negotiation position of such investors may differ from fund to fund, the following chapters lay out three different private monitoring solutions which operate at the level of the underlying legal documentation of the fund in order to address the concerns raised by the governance challenge.

[562] See Section 2.5 above.

Chapter 6
Side Letters as a Means of Mitigating the Governance Challenge

6.1 Introduction

The first means by which the governance challenge can be addressed is by an investor entering a side letter agreement with the fund and/or the fund manager whereby it is agreed that particular amendments are made to the fund documentation to address specific concerns. The law of contract[563] is central to the structuring and operation of private investment funds. As noted above, any successful attempt to address the governance challenge will need to take into account, directly or indirectly, the underlying contractual basis of these structures. Side letters are an example of a direct amendment to those legal arrangements.

It has become increasingly common for investors in private investment funds to seek special terms and conditions to govern their investments through such 'side letter agreements'. Side letters operate to amend or supplement particular terms within the fund documentation[564] in order to accommodate the particular commercial, legal and regulatory needs of the investors. Side letters can be used to overcome provisions in the constitutional documents of a Partnership PIF[565] or a Company PIF[566] that have been identified as problematic generally, as in circumstances, for example, where distribution or compensation provisions of a limited partnership agreement are believed to give rise to agency costs for fund investors.[567]

Side letters have been used in connection with private equity funds for many years and are a more recent development with hedge funds. Institutional investors (such as funds of funds, pension plans, and government plans) frequently obtain side letters in connection with their participation in private investment funds. This can be driven both by their internal investment guidelines, which establish numerous requirements that they must fulfil in connection with their participation in a given fund (including, for example, tax related issues), and by the relative bargaining power that arises as a result of their ability and willingness to invest large sums of money.

As a side letter operates to effect an amendment to the arrangements between the fund, the fund manager, and the particular investor, any provisions in the side letter that operate to agree between the parties a different set of rights and obligations between the parties will be directly relevant to determining the contractual and fiduciary duties owed. Courts routinely have regard to the terms of any contracts establishing the relationship between an advisor and his client in determining both the fiduciary nature of the relationship and the scope of such duties.[568] Investors with sufficient negotiating leverage are able to ensure that they benefit from fuller recourse against the fund manager for any breaches that may occur.

As discussed in Chapter 3, courts have in certain instances found that, based on the business relationship between an adviser and the recipient of advice, a duty of care was owed where the business relationships were structured in a manner that sought to remove such a

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563 See Section 3.11 above.

564 See Section 2.2 above.

565 See Section 2.3 above.

566 See Section 2.4 above.

567 For a discussion of such shortcomings, in the context of private equity funds, see Harris, "Critical Theory" at 17-30.

568 See Section 3.10 above.

relationship. However, a fund investor can, in a side letter, make explicit whether affiliates of the fund manager, or companies directly or indirectly related to one or more principals of the fund manager, clearly undertake all agreed duties of care to the fund and/or the investor. This can be important in situations where an investor may be entitled to damages upon a successful claim, but the legal entity against which they have direct legal recourse has insufficient assets to fulfil the judgement, as noted in Chapter 2. If the current approach to modifying private law duties[569] has focused primarily on the fund manager's perceived need to provide certainty and minimize litigation exposure, then side letters that contain particularly negotiated amendments which swing the pendulum back to the default private law positions (or further) are worth examining in detail.

In this chapter, I will discuss general issues related to the negotiation and use of side letters in private investment funds, as well as key specific terms. Next, I will analyze the role that side letters can play in addressing the governance challenge. Finally, I will examine practical issues that arise in their use, including the impact of directors duties and possible limitations on their effectiveness.

6.2 **General Issues**

Private fund documentation[570], as traditionally drafted by fund manager's counsel, is not beyond criticism. As one commentator has observed in the case of private equity funds specifically:

> [I]n the private equity fund, the importance of many contract design features has been vastly overstated. Although the design features of these agreements may appear on their face to provide some protection to investors, there is still significant reason for investors to worry about a fund manager's abuse of discretion. The implication is that contract design is an unsatisfactory solution to the agency costs in private equity.[571]

However, this commentator goes on to acknowledge that different private enforcement mechanism might provide a solution that provides for "increased, ongoing monitoring of fund manager conduct." [572]

A side letter is a written agreement between a fund and an investor, or between a fund manager and an investor, which supplements the fund's offering documents, subscription documents and constitutional documents.[573] The purpose of a side letter is to give one particular investor more preferential terms than those offered to other investors. The effect of entering into a side letter, therefore, is to customize in some manner the legal and commercial relationships in one case, without effecting those relationships with other fund participants.

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569 See Sections 3.8-3.12 above.

570 See Section 2.2 above.

571 Harris, "Critical Theory" at 7.

572 Ibid.

573 These constitutional documents could be either the memorandum and articles of association for an offshore company or the partnership agreement of a limited partnership. See Sections 2.3 and 2.4 above.

As a general rule, the documentation will clearly provide for side letters to be entered into with fund investors,[574]although in many instances other fund investors may not be aware of what variations have been so agreed. The terms contained in a side letter can vary greatly from investor to investor, based on the particular needs that they have in the context of participating in a certain fund. Some investors may have template side letters that they will use in each fund investment they undertake, thereby providing a measure of consistency and uniformity across potentially disparate sets of relationships with fund managers. In other circumstances, particular impediments identified by a prospective investor will be addressed by way of a specific provision in a side letter, rather than revisions to be underlying documentation.

Which parties should enter into the side letter depends on the particular issue which is covered by the side letter. Some issues will require the fund's directors to sign (e.g., capacity undertakings or more favourable redemption terms) and others may be signed only by the fund manager (e.g., fee rebates and additional portfolio information). In particular, when looking at extending the scope of legal duties owed to the fund and its investors, as well as the parties against whom recourse may be sought, it will often be necessary to consider joining as parties to the side letter entitles beneficially owned or controlled by the principals of the fund manager, which may not otherwise have a legal relationship to the fund, but were established for tax planning or other reasons.

6.3 **Side Letter Terms**

Additional information requests are a common side letter term.[575] Such request could cover details about the investments underlying the fund, the decision-making process with regards to the investment process and bespoke reporting requirements. In addition, investors may request special notices of significant events that arise, such as threatened legal or regulatory action, a drop in the fund's NAV above a certain threshold, or the departure of key individuals within the fund manager.[576]

The value of increased information in the hands of fund investors underpins all three monitoring solutions discussed herein, together with the belief that sophisticated investors can have an advantage over government officials in what they can with such information. As one commentator has observed:

> With respect to access to market information, private actors have a significant potential advantage over government regulators in terms of their ability to identify, analyze and evaluate potential systemic implications of the underlying trends in global financial markets, particularly with respect to complex financial products and transactions. As a general matter, private investors and financial institutions are better equipped to access the key market data in real time and to process that information intelligently and efficiently.[577]

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[574] For example, any 'entire agreement' clauses will need to make clear that they do not act to make a side letter unenforceable. Also, any offering document disclosures as to fees charged or redemption notices should include a reference to the possibility that certain investors may be participating on more favourable terms.

[575] For a discussion of disclosure issues involving hedge funds and side letters, see McVea.

[576] However, the ability of investors to benefit from such information by redeeming out of a fund ahead of other investors is currently being challenged in the US courts. See Section 3.7 above.

[577] Omarova at 686. In such cases, the private actors will have the potential to exercise regulatory capacity in a decentralised regulatory regime. See Section 1.9 above.

Liquidity-driven terms are also common. These may take the form of relaxing or eliminating lock-up periods or redemption limits that would otherwise apply. Liquidity provisions are intended to ensure that the fund manager has the ability to effectively manage the underlying portfolio without the threat of a potential 'run on the bank', which could occur if the fund is forced to sell increasingly illiquid and/or undervalued positions in order to provide money to redeeming investors. Waivers of such limits for a single investor, or small group of investors, could potentially impede the ability of other investors to protect themselves in times of crisis.[578] Importantly, increased redemption rights may be directly exercised as a result of additional information received as described above.[579]

Economic terms are frequently varied by side letters as well. This may be accomplished either by way of management fee rebates or performance fee waivers from the fund manager or the waiving of sales charges and redemption fees by the fund. Historically, this has been one of the primary driver for side letters, and have been justified commercially by the acknowledgement that the role of the fund vehicle is primarily to administer the collectivized relationships between investment manager and clients in an efficient manner. Differences in fees that would be justifiable in a bilateral context have been accommodated in fund documentation.

The issuance of side letters may present administrative burdens to the fund manager in relation to complying fully with the terms during the life of the fund. Also, they raise concerns by the other fund investors about any special deals that may have been struck by one or more of their fellow investors. As a result, so-called 'most favoured nations' (MFN) provisions are frequently included in side letters so as to ensure that an investor is given the right to receive the benefit of any terms contained in side letters entered into with any subsequent investors. Unfortunately, one consequence of using such clauses is that they can serve to multiply significantly the obligations of a fund manager beyond the original scope negotiated, increasing the possibility of inadvertent breach.

6.4 **Addressing the Governance Challenge**

Side letters provide the opportunity for a single investor in a private investment fund to implement bilaterally with the fund and/or the manager contractual mechanisms that can mitigate the impact of the governance challenge. This can be accomplished by:

(a) providing an investor access to further information on an ongoing basis to better monitor the fund manager's compliance with its legal and regulatory obligations; and

(b) agreeing different legal standards to which the fund manager will be subject in connection with his activities with regards to the fund.

To the extent that the underlying documentation[580] of one private investment fund possess unique aspects not previously encountered by the investor, the required side letter provisions could be revised to respond to these particularities. Also, as an investors negotiating leverage

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[578] In the Bayou litigation, fund investors who were unable to redeem out of a fund have made claims against other investors who were able to redeem. See Section 3.7 above.

[579] The FSA has recently focussed on the detrimental effect of such terms on other investors in a fund. See Financial Services Authority, Discussion Paper DP05/3: Wider Range Retail Investment Products (23 June 2005).

[580] See Section 2.2 above.

will potentially differ materially in relation to different funds, the scope and effectiveness of side letters will vary from one fund to another, as a result of the level of success in negotiations with the fund manager. Consequently, there is necessarily a wide scope of variance in the level of protection any one fund investor will obtain across all of the fund investments in its portfolio, as well as in the level of protection that the fund investors in any one fund will enjoy.

6.4.1 ***Information***

Where an investor has the time and resources to make adequate use of further information on the day-to-day operation of a private investment fund, a side letter can include terms that give such investor a wider flow of information from the fund manager than is provided to the other fund investors. Such information can be provided to the investor on a confidential basis to be analyzed either on its own or by comparison to other funds in which there are similar investments.

Bespoke reporting arrangements can be put in place where an investor receives information on the change in value in all, or certain, investments, as well as insight into the internal decision-making process of the fund manager with regards to the underlying investment portfolio. As a result of such information, questions may be raised with the fund manager regarding actions or omissions that may be symptomatic of, or precursors to, improper valuations or misrepresented portfolio performance, for example.

Provisions can also be included in side letters whereby the fund manager is contractually bound to notify the investor of certain non-investment related events with regards to the fund or the fund manager, such as a threatened lawsuit, a pending regulatory action, or the departure of one or more senior professionals within the fund manager. Information such as this could provide a fund investor with a sufficient factual foundation to detect, at an earlier stage than otherwise might be possible, an underlying breach by the fund manager of legal and/or regulatory duties owed either to the fund or the investor directly.

Certain significant investors in a private investment fund may also be in a position to negotiate in their side letter a term that would entitle them to provide a member, or an observer, to either a board of directors or the advisory committee of the fund. Such participation can provide an investor with further access to relevant information about the extent to which the fund manager is fulfilling its duties to the fund. Frequently seen in private equity funds (and potentially of use in a wider variety of private investment funds), an advisory committee is composed of senior personnel from the fund manager as well as investor representatives.[581] The committee can function as an approval mechanism for potential investments that would otherwise be outside the scope of the fund or resolving potential conflicts of interest. In the case of Partnership PIFs, adequate steps should be taken to ensure that any involvement in an advisory committee does not lead to a loss of limited liability for such investor.

6.4.2 ***Legal Duties***

In a side letter, a fund manager can agree with an investor that it will be subject to higher or lower levels of duty to such investor in particular circumstances. In this manner, the applicable legal obligations owed by the fund manager can be expanded, restricted or clarified to further protect the investor.[582] The terms of any contracts between a fund manager, the fund, and an investor in the fund will play a crucial role in defining the boundaries of any fiduciary

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[581] See DP06/6 at 30.

[582] See Sections 3.9-3.11 above.

relationship with the fund manager. In order to establish whether and to what extent the fund manager is in a position of trust with regard to the fund (and, therefore, the investor), courts will look at what the fund manager was retained to do and on what terms.[583]

Courts have regard to the terms of any contracts establishing the relationship between an advisor and his client in determining both the fiduciary nature of the relationship and the scope of such duties.[584] Courts have in certain instances found that, based on the business relationship between an adviser and the recipient of advice, a duty of care was owed where the business relationships were structured in a manner that sought to remove such a relationship.[585] A fund investor can, however, make explicit whether affiliates of the fund manager, or companies directly or indirectly related to one or more principals of the fund manager, clearly undertake all agreed duty of care to the fund and/or the investor.

As discussed earlier, the default private law rights and duties of fund participants and the fund manager can, and often are, modified in the documentation used to establish the fund. Traditionally, the sponsors and promoters of a private investment fund have sought to limit, or eliminate, the liability of the fund manager and individual principals to the greatest extent possible. Subject to a certain core of prohibitions on such modifications, the private law in the UK and the US permits parties to extend or restrict legal and/or equitable duties and courts enforce these modifications when litigation occurs.

6.5 **Practical Issues**

In assessing the potential effectiveness of side letters as a private monitoring solution to the governance challenge, it is necessary to identify and evaluate the practical issues that arise in connection with negotiating and implementing them. Although side letters are a convenient means to amend the standard terms already in place in the fund documentation, and where necessary address the problems resulting from the governance challenge, they also present potential practical and legal problems that must be recognized and addressed by prospective investors. Failure to adequately address these issues may materially limit the effectiveness in addressing the governance challenge.

6.5.1 ***The Fund's Prospectus and Constitutional Documents***

The first consideration when a side letter is requested by an investor is whether the fund's prospectus and constitutional documents[586] permits the fund to enter into a side letter in respect of the relevant special terms and conditions. In order to treat one partner or shareholder materially different from the others, it will often be necessary to have clear provisions in the partnership agreement, in the case of a Partnership PIF[587], or the articles of association, in the case of a Company PIF[588], stating that this is permissible. Without such language, there may be a risk that such disparate treatment would be illegal and voidable under either partnership law or company law, as applicable. In addition, other fund participants may claim that the offering memorandum used to market the fund interests contained a

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583 See Section 3.10 above.

584 See Section 3.9 above.

585 See Section 3.8 above.

586 See Section 2.2 above.

587 See Section 2.3 above.

588 See Section 2.4 above.

material misstatement or omission if the different treatment provided to certain participants was not adequately disclosed.

Therefore, the fund manager must ensure that existing investors have received adequate disclosure that other investors in the same class of shares or interests may be permitted to invest on more favourable terms in order for the directors to fulfil their directors' duties and the fund manager to fulfil its common law fiduciary duties. If, for example, the fund is listed on the Irish Stock Exchange (ISE)[589], the applicable listing rule will require the fund to ensure equality of treatment for all shareholders who are in the same position. Side letters can, therefore, cause difficulties for a listed fund in terms of complying with its listing obligations.

In light of these general concerns over the impact of side letters on the other fund investors, the UK Alternative Investment Management Association (AIMA) issued a guidance note on hedge fund side letters (the Guidance),[590] which was reviewed by the FSA prior to its issuance.[591] Pursuant to the Guidance, UK hedge fund managers should disclose the existence of any side letters containing 'material terms' entered into with investors in their funds. A material term would be:

> Any term the effect of which might reasonably be expected to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investors ability either:
>
> (i) to redeem shares or interests of that class; or
>
> (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position, at a material disadvantage in connection with the exercise of their redemption rights.[592]

The Guidance states that keyman provisions, redemption limit waivers, and portfolio transparency rights as 'material terms'. Although no similar guidance has been issued by US trade associations,[593] similar concerns can arise in funds subject to US law. In the absence of such guidance, the AIMA Guidance has become an international point of reference for dealing with side letter disclosures and related issues.

In addition, there are unanswered questions involving the content of some side letters. Arguments have been made that where a side letter term purports to alter the terms of the partnership agreement, in the case of a Partnership PIF, then such side letter term might not be enforceable, if instead a formal amendment, including a note of the other partners, would be required.[594] Although the answer to this question may vary from one jurisdiction to another, side letter terms which are limited to either simply clarifying the language of the limited partnership agreement, or extracting a contractual commitment from the fund manager that

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589 For a more extensive discussion of listing rules as a private monitoring solution, see Chapter 8 below.

590 'AIMA's Industry Guidance Note on Side Letters', 28 September 2006.

591 The Guidance makes clear that it is not itself 'FSA Guidance' and the FSA Handbook would prevail in the event of any conflict. Ibid.

592 Ibid.

593 See Sections 5.5 and 5.6 above.

594 See Section 2.3 above.

any discretion granted to them will be exercised in a particular way under certain circumstances, should be safe from most challenges. However, more aggressive side letter terms that attempt to go so far as to materially alter a contractual term that applies as between limited partners, in addition to between a limited partner and the general partner, such as, for example, the contribution provisions which support an indemnity provision, may be open to challenge.

6.6 Directors' Duties

Side letters are used to make different legal arrangements with individual fund participants outside the constitutional or contractual arrangements of a private investment fund that apply to other investors. As discussed above, the terms contained in the fund documentation are generally intended to apply equally to investors who participate in the fund. However, as these vehicles operate as a means to collectivise bilateral investment management relationships, funds often reserve the right for the board of directors, in the case of Company PIFs[595], to enter into a side letter, on request by an investor, changing certain terms and conditions, such as those relating to subscriptions and redemptions.[596]

As directors owe their duties to the fund as a whole, and not the fund manager of any particular group of shareholders[597], when entering into a side letter the directors will need to determine that, in doing so, the interests of existing investors are not being compromised. The problems posed by side letters, which are given on a case by case basis in reference to particular factual situations, are multiplied when investors are giving special contractual terms in side letters that waive such terms and conditions in advance.

The legal position with regard to the use of side letters by funds domiciled in the Cayman Islands funds and the implication in terms of their corporate governance are particularly relevant in the current environment.[598] Under Cayman Islands law, if a director, acting within his authority, is not negligent or fraudulent and complies with his fiduciary duties, the fact that a decision to enter a side letter with a prospective shareholder turns out to cause loss to the company and the other shareholders is unlikely to result in personal liability for the director. To the extent that terms of the fund documentation are to be varied, directors need to analyze and understand the reasoning for the proposed changes and its impact on the other investors in the fund prior to agreeing the amendments.[599]

A Cayman Islands private investment fund would fall within a lightly regulated category of funds of the Mutual Fund Law (MFL). As a result, the regulatory authority generally does not perform any form of oversight or compliance review of such funds. Directors will therefore be in the position of having to balance commercial considerations for private investment funds, with a duty to act in the best interests of the fund's shareholders, without the reference to imposed regulatory parameters. The Companies Law contains provisions which to protect third parties entering into transactions with the company from such transactions being deemed

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595 See Section 2.4 above.

596 Many questions have arisen in 2008, as a result of the redemption pressures put on hedge funds due to the "credit crunch" and the resulting market dislocations, relating to the efficacy of such waivers and liability exposures to the directors.

597 See Section 2.4.3 above.

598 See Section 2.4 above for a discussion of Cayman law issues.

599 In the case of fee rebates, this may involve only the fund manager and not the fund itself.

invalid or by reason of the company's lack of capacity or lack of corporate benefit.[600] In negotiating a side letter, it is important to understand any limitations that such terms will impose on the fund's future actions. Under the MFL,[601] directors of hedge funds regulated by the Cayman Islands Monetary Authority (CIMA) must prepare offering documents in respect of equity interests which

(a) describe the equity interests in all material respects; and

(b) contain such other information as is necessary to enable a prospective investor in the fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests.

The issue of whether the fiduciary duties of a director require the disclosure of side letters as 'necessary to enable a prospective investor in the fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests' is therefore also relevant to the process of entering into side letters. Funds that use side letters can include clear and unambiguous disclosure of the fund's intention to use such arrangements in the offering documents and specific enumerated powers in the constitutional documents enabling the directors to enter side letters on behalf of the company.[602]

Many larger investors, who are often themselves fiduciaries, seek to use side letters as risk reduction tools for their own investments. However, their risk reduction exercise can have a corresponding risk enhancement on the part of other investors in the fund. Further, by establishing different economic and commercial interests among a fund's investors, the governance challenge is increased as such investors may find that their ability to establish and maintain common positions vis à vis the fund manager is limited.

The directors must also consider their fiduciary duties as directors, which include a duty to act in what they consider to be the best interests of the fund.[603] This duty is owed to the fund itself, and as a result, the directors are not entitled to consider solely the interests of a specific shareholder or the fund manager in determining whether or not to enter into a side letter.

The effect of providing a special term to one investor can act to put the other investors at a significant disadvantage. For example, where greater portfolio transparency rights are requested by an investor, the directors should consider whether this would confer a material advantage over other investors, should such information better prepare them to redeem out of a fund at an earlier stage during times of market turbulence. In certain instances, directors may decide that their duties require that the same transparency should be provided or offered to all investors.

Directors concerned over their potential liabilities will also want to ensure that the use of side letters is monitored on a regular basis for any actions that are needed. MFN clauses, which seek to obtain for an investor the best terms that the fund or fund manager has granted to any other investor in the fund, often require close oversight to ensure inadvertent breaches to not

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[600] See Section 28 of the Companies Law (2010 Revision).

[601] See Section 4(6) of the Mutual Funds Law (2009 Revision).

[602] See Section 3.10 above.

[603] See Section 2.4 above.

occur. A mistake made in connection with a side letter could also mean that the fund manager or the fund could be liable to an investor for breach of contract.[604]

6.7 **Limitations on Effectiveness**

A side letter between a fund investor and a fund manager is an example of private rule-making by industry actors, which exists in addition to the financial regulatory regime in which the parties are operating.[605] However, to be effective the provisions of the side letter must be complied with, and information provided pursuant to it must be analyzed and acted upon. As one commentator has noted:

> [I]nformation disclosure regimes can be seen as augmenting the pre-conditions of a competitive marketplace and enhancing consumer sovereignty, in turn promoting competitive and market efficiency. Similarly, such regimes don't restrict or impede consumer choice, or impede producer/supplier flexibility and are therefore consistent with notions of market freedom and the superior ability of the markets to distribute the greatest good to society through product competition.[606]

Underlying this argument is a belief that investors make poor investment decisions because they do not possess adequate information about the investment in question and its risks.[607] While a centrally mandated information disclosure regime imposed by a financial regulator can implement disclosure requirements in connection with particular investment products or transactions,[608] in their absence, investors must seek to obtain that information on their own, or elect to forgo the investment opportunity in its entirety.[609] As one commentator has observed:

> There is a temptation in the modern "information society" to view information as communication. Disseminating information becomes equaled with creating knowledge and understanding. But effective communication is a two-way process and requires the reflexive monitoring of each recipient's response. Information dissemination on the other hand is a contextual, nonreflexive and impersonal, it requires interpretation to give meaning.[610]

No matter how extensive and detailed the information disclosure requirements are in a side letter, the investor (or his agent) must analyze the information provided in a critical and

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604 See Section 3.11 above.

605 See Sections 1.9 and 5.2 above.

606 Gray and Hamilton, Implementing Financial Regulation at 198-9.

607 Ibid.

608 See Sections 3.5 and 3.6 above.

609 See, e.g., Steven L. Schwarcz , "Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown," 93 Minnesota Law Review 373, 385 (2008) ("There do not appear to be any perfect solutions to the problem of investor ignorance of complex transactions. Government already takes a somewhat paternalistic stance to mitigate disclosure inadequacy by mandating minimum investor sophistication for investing in complex securities; yet sophisticated investors and qualified institutional buyers (QIBs) are the very investors who lost the most money in the subprime financial crisis. And any attempt by government to restrict firms from engaging in complex transactions would be highly risky because of the potential of inadvertently banning beneficial transactions."). For a discussion of possible limitations on the effectiveness of information disclosure, see Gray and Hamilton at 205-215.

610 Gray and Hamilton, Implementing Financial Regulation at 223.

comprehensive way in order to draw the appropriate conclusion. If an investor is unable[611] or unwilling to do this, the value of the side letter is limited.[612] Such an investor, or investors, will need to look to others in order to process this information. In the case of Company PIFs,[613] or where companies are used as general parties for Partnership PIFs,[614] the fund investors may look to the independent directors to perform this role.

Although many observers have argued that disclosure can be a very effective regulatory tool,[615] there are those who criticise its real utility.[616] As discussed above, behavioural finance argues that cognitive biases cause individuals to process disclosures incompletely or ineffectively.[617] While acknowledging the real contribution that this growing literature has made, it is important to recognize that in the context of private investment funds the prospective investors will be non-retail. As a result, even if they are unable to process the disclosures efficiently and effectively, they will have the means to retain an agent who will be able to provide that service. In the case of a retail investor who cannot afford such expense, the issues about the limitations of disclosure, and the risks of distraction and processing, are more credible.[618]

It is also important at this juncture to acknowledge that there are circumstances where certain side letter terms can actually operate to exacerbate the governance challenge within private funds, rather than address it. For example, where some investors are given preferential rights over other investors to withdraw their assets from an open-end fund, such as a hedge fund, the governance of the fund is improved, if at all, in the favour of the former only at the potential expense of the latter.

Importantly, however, preferential redemption terms are not proposed in this thesis as one of the terms that would be included in the side letters be used as private monitoring solutions. Instead, such side letters would focus on heightening the information flow between the fund manager and the particular investor, or increasing the standard for the legal and equitable duties owed by the fund manager to the particular investor. As a private monitoring solution, a side letter would not be used to alter or undermine the relative rights and obligations among

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611 Critics would argue that there is some information so complex, that even a sophisticated, non-retail investor would not be able to effectively analyze it. See Schwarcz at 405 ("Complexity can deprive investors and other market participants of the information needed for markets to operate effectively. It was responsible for the failure of disclosure in the subprime crisis. Even beyond disclosure, complexity is increasingly a metaphor for the modern financial system and its potential for failure.").

612 See Sections 9.2.2 below.

613 See Section 2.4 above.

614 See Section 2.3 above.

615 See, e.g., Edward Rock, "Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure," 23 Cardozo Law Review 675 (2002); Frank H. Easterbrook and Daniel R Fischel, "Mandatory Disclosure and the Protection of Investors," 70 Virginia Law Review 669 (1984).

616 See, e.g., Susanna Kim Ripken, "The Dangers and Drawbacks of the Disclosure Antidote: Towards a more Substantive Approach to Securities Regulation," 58 Baylor Law Review 139, 146 (2006) ("The emphasis in securities law on providing information to the public is premised on the belief that individuals are rational, self-governing actors who are willing and able to process the information wisely."). See also Troy A. Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation," 81 Washington University Law Quarterly 417 (2003); Alan R. Palmiter, "Towards Disclosure Choice in Securities Offerings," 1999 Columbia Business Law Review 1 (1999).

617 See Section 2.5 above.

618 See, e.g., Robert A Robertson, "In Search of the Perfect Mutual Fund Prospectus," 54 Business Lawyer 461 (1999).

the various fund participants. In this regard, the extensive use of side letters in private equity funds, which by their very structure have no need for preferential liquidity terms, is perhaps a better point of reference than hedge fund side letters.

Invariably, different investors in a private fund will have varying levels of expertise and experience in relation to participating in funds of a particular type or asset class. As a result, such investors will react to any particular information flow in potentially different ways. Solutions to the governance challenge in private funds, therefore, cannot be measured against the same standards of homogeneity and fungibility that apply to retail investors participating in a mutual fund. In a private fund, by contrast, each sophisticated non-retail investor knows that, in the absence of uniform product-level regulations and mandatory disclosure regimes, each fund participant must make certain important decisions independently and to the best of their abilities.

Further, there may be jurisdictional issues involving choice of law that need to be resolved in order to evaluate the effectiveness. As noted above, it is not uncommon to fund vehicles to be established in various different domiciles (e.g., Delaware, England, Cayman Islands) and relevant fund manager entities to be located elsewhere (e.g., London, New York). Therefore, questions will be raised as to which law should govern the side letter in order to maximize its chances of being enforceable when needed. In the case of side letter provisions to be enforced against the fund manager directly, the law of the jurisdiction where it is located would be advantageous, although selecting the law of the jurisdiction where the relevant fund vehicle is located would provide synergies with the interpretation of the constitutional documents of such vehicle.[619]

In addition, side letters operate to increase the potential inequalities between fund participants by limiting the circumstances in which their rights and interests in the fund vehicle are pari passu. Given that the alternative to investing in a fund with a manager is giving it a sum of money directly to invest on a separate, segregated basis, the concern over disparate rights and obligations can be acknowledged but recognized as similar to other commercial difference that may exist between investors, such as different fees or being excused from certain types of investments (e.g., gambling, armaments). Ultimately, the purpose of the fund vehicle is to provide access to the fund manager’s talent and abilities in circumstances where a directly-negotiated, bilateral contract is not available. A fund is not an end in itself.

Finally, there may be legal limitations that impact the effectiveness of side letters based on the type of legal vehicle used for the fund. In the case of a Partnership PIF, the use of side letters may raise concerns about individual parties actually engaging in management activities, and thereby putting their limited liability at risk. As one commentator has observed:

> [T]he legal default rule of limited liability for investors also reinforces the separation of ownership and management and, again, creates the potential for agent misconduct. The implications of the liability rules reaffirm the notion that the general partner controls the operation of the business and is personally liable for partnership debts. The limited partners protection from liability has been traditionally tied to the idea that they avoid excessive intervention in managerial decision making. When private equity investors participate in management, they create a small chance that they too may be exposed

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619 See Section 2.2 above.

to potential liability under the control rule and other legal principles that tie liability to conduct.[620]

Side letters, therefore, can be subject to certain practical limits on their effectiveness due to issues that are in their negotiation and implementation. Further, not all fund investors will find that they are able to obtain the levels of protection that they require in all the funds with which they would like to invest. Finally, entering a side letter is often the first step of an ongoing process of monitoring and oversight that rests fundamentally with the investors who requested the side letter.[621]

Regardless of these limitations, however, where a side letter can be entered into effectively, such investors could materially improve the governance of the fund, at least to the extents of its own participation in the fund. In the absence of any other means to address the governance challenge in that particular fund, something is clearly better than nothing, especially if the only other alternatives available to the prospective investor is to participate in the fund without attempting to address the governance issues, or to simply not invest at all.

6.8 **Conclusion**

Side letters provide a meaningful means for a fund participant, acting bilaterally with the fund manager, to take steps to address the governance challenge, in whole or in part. However, the ultimate weakness of side letters, that they undermine the equal treatment of fund investors who would otherwise presume would be on a *pari passu* basis with each other, are at the source of the FSA's and ISE's concern over them.[622]

Although they may be a potential solution to the governance challenge for one or more fund investors, they run the risk of setting the interests of different investors against each other and thereby amplifying the governance challenge facing the remaining investors. As a result, the ultimate effectiveness of the unilateral use of side letter is potentially less appealing than alternative approaches which could address the governance challenge for all investors in a particular fund. Such an approach would necessarily need to focus on the central governance mechanisms within the fund vehicle itself. In the next chapter, therefore, I will look at the manner in which the operation of a board of directors can be improved to better address the governance challenge.

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620 Harris, "Critical Theory" at 14-18.

621 See Section 9.4 below.

622 See Section 6.5.1 above.

Chapter 7
Board of Directors Composition as a Means to Mitigating the Governance Challenge

7.1 Introduction

The second means by which the governance challenge can be addressed is by having independent directors on the boards of fund vehicles — either in connection with a Company PIF or the general partner vehicle of a Partnership PIF — with the necessary skills and experience to act credibly and independently in making decisions for the fund. Much value in many private investment funds has been destroyed since the commencement of the recent global financial crisis. Legitimate questions are being asked about the adequacy of directors in fulfilling their obligation to "direct" their companies, rather than merely "observing" the fund manager. As one commentator has observed:

> Boards must play two roles: advisors and supervisors to their CEO and their corporation. These two roles are usually combined and draw on each other. Boards do not, however, have the tools necessary to perform either function well. To advise well, one must know what is going on in the corporation. To supervise well, one must know what is going on in the corporation and take some advisory action as well . . . Thus, in both roles Boards must receive sufficient and adequate information . . .[623]

A private investment fund's dependence on the fund manager for information is a key driver underlying the governance challenge.[624] Directors of the fund vehicle must ensure that their fiduciary duties are adequately fulfilled, especially in circumstances that find them in direct conflict with the fund manager.[625] The inclusion of directors who are independent of the fund manager can serve to better address the governance challenge for all participants in a particular investment fund.

As discussed above, recent scandals involving hedge funds have shown a lack of effective oversight of corporate accounting and financial reporting and failures in managing conflicts of interest by those involved.[626] A common theme raised in discussions of these scandals, and the accompanying proposals for new reforms to prevent their recurrence, is the substantial enhancement of the independence and oversight responsibilities of boards of directors.

In particular, questions have arisen about increasing the roles and responsibilities of independent directors in the context of fund governance. Independent directors have the potential to act as watchdogs for investors over the fund manager and other service providers to the fund, by bringing impartiality and experience to a fund's board and its oversight of the fund's affairs and activities. In light of the governance challenge faced by private investment funds, independence has become an essential element of a fund's board, not only from a listing rule compliance perspective[627] but also from an investor expectation perspective.

Notably, independent directors in US-regulated public investment companies play a critical role in protecting the interest of fund shareholders, by their oversight of fund operations and their monitoring of conflicts of interest with the fund manager. They seek to ensure that fund

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623 See Frankel, "Corporate Boards" at 516 (2009).

624 See Section 1.6 above.

625 See Section 2.4.1 above.

626 See Sections 3.7 and 3.12 above.

627 See Chapter 8.

shareholders receive the benefits to which they are entitled, pursuant to the fund's documentation and at law and equity. Explicit regulatory obligations imposed by the SEC on independent directors supplement and extend the fiduciary and other duties that they owe under the state law where the fund was established. Adopting voluntarily a similar approach for private investment funds would provide an additional means for addressing the governance challenge.

Investment funds are different from operating companies in a number of important ways. As a result, the question of the manner in which a board of directors can operate to address governance issues is potentially different. As one critic has noted:

> The transliteration of traditional corporate governance norms to the mutual fund context is simplistic – and misplaced. Unlike their counterparts in operating companies, fund directors are not subject to the threat of shareholder insurgencies or takeover pressures; they lack the realistic power to replace fund management, and they generally rely on the management firm for information, direction and compensation.[628]

Consequently, any analysis of the role of independent directors in the particular case of private investment funds must recognize the commercial realities of the manner in which such funds are operated, in order to ensure that the anticipated benefits are ultimately delivered to the fund investors.

In this Chapter, I will discuss the role of an independent director, both generally and in the context of investment funds, either public or private. Next, I will analyze the duties of independent directors and the effectiveness of boards. Then, I will describe the role of directors in general partner vehicles, and the intersection between limited company law and partnership law. Finally, I will critique the effectiveness of independent directors and evaluate their role as a private monitoring solution.

7.2 **Role of an Independent Director**

The term 'independent director', in the case of a traditional operating company, refers to a director who is independent of the company's internal management. In the case of a fund, the term refers to the director's independence from the company's external fund manager, rather than from its executive management, which are rarely seen in most fund structures.

Directors of investment funds can be categorised as either 'interested' or 'independent'. An 'independent' director can be defined as one who is independent of management and free from any business or other relationships which could significantly interfere with the director's ability to act with a view to the best interests of the company. Interested directors are employees of the fund's investment manager. Independent directors in contrast will not have any significant relationship with the fund's manager.

Independent directors can perform two complementary functions: (a) providing specialized advice and expertise to the executive directors and (b) monitoring executive decision making.[629] Financial incentives are traditionally not a primary factor in motivating individuals to

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628 Alan R. Palmiter, "The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing," 1 Brooklyn Journal of Corporate, Financial and Commercial Law 165, 189 (2006).

629 See Cheffins at 96 ("This will involve reviewing the performance of management to ensure that those in charge are running the company in the shareholders' interests and are complying with the legal duties, regulatory requirements, and ethical imperatives associated with the operation of a public company."). A similar function can be served in connection with close companies.

serve in such capacity.[630] The return he or she receives for services rendered will be relatively modest compared to, for example, the portfolio manager in charge of the fund. However, the risks that independent directors face are significant and growing, whether from legal actions or reputational risk.[631]

The effectiveness of independent directors has many critics.[632] Limitations on their ability to influence the affairs of their companies include: (a) the desire not to antagonize management, (b) time constraints, (c) lack of adequate information and (d) inability to coordinate their actions with other independent directors.[633] However, they also have their champions.[634] For example, independent directors of registered mutual funds in the US are felt by many commentators to serve a vital role in the process of securing the regulatory goals of the SEC. Of particular importance is the continued confidence of mutual fund investors in the vehicles in which they entrust their savings, as well as the benefit to the financial markets generally of the liquidity provided by this money being directed to, and utilized by, other market participants.[635]

The US Investment Company Act of 1940 establishes a detailed regime for independent directors of retail mutual funds, providing a central role for them in resolving potential conflicts of interests and serving as a means for "checks and balances" within the governance structure. Individuals who are "interested persons"[636] are not eligible to serve as independent directors. A director will be "interested" under the Investment Company Act - and therefore not independent - if the person is affiliated with the investment company or its fund manager, or is

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630 Ibid. at 101 ("Non-executives say they are keen to serve and carry out their duties because board appointments are prestigious, offer an intellectual challenge, and can yield potentially valuable business connections.").

631 Ibid. at 103-104.

632 See Gilson and Kraakman at 873 ("The justification for relying on outside directors as a monitoring mechanism is straight forward. Because such directors are 'independent' - that is, they do not have a personal financial stake in retaining management - they can act as shareholder surrogates to assure that the company is run in the long term best interests of its owners.").

633 Cheffin at 105. See Section 7.3 below.

634 See, e.g., Victor Brudney, "The Independent Director - Heavenly City or Potemkin Village," 95 Harvard Law Review 597 (1982).

635 See Larry D. Barnett, "The Regulation of Mutual Fund Board of Directors: Financial Protection or Social Productivity?" 16 J.L. & Policy 489, 480 (2007-2008) ("Given the current importance of mutual funds, instances of exploitation of fund shareholders may damage the economic welfare of individuals and reduce investments in securities by the public."). Similar concerns could be raised in support of private investment funds as well.

636 Section 2(a)(19) of the Act outlines those individuals who should be deemed "interested persons" and including the following:

> (A) When used with respect to an investment company— (i) any affiliated person of such company; (ii) any member of the immediate family of any natural person who is an affiliated person of such company; (iii) any interested person of any investment adviser of or principal underwriter for such company; (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company...
>
> (B) When used with respect to an investment adviser of or principal underwriter for any investment company— (i) any affiliated person of such investment adviser or principal underwriter; (ii) any member of the immediate family of any natural persons who is an affiliated person of such investment adviser or principal underwriter; (iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter; (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter...

a family member of such a person.[637] The Investment Company Act was unique at the time of its adoption in its attempt to construct a financial regulation regime directly on top of the pre-existing board of directors role in corporations,[638] rather than simply rely on further disclosure requirements.

The two principal functions of a mutual fund's board of directors are negotiating the investment management agreement with the fund manager and supervising the compliance of the fund, the fund manager and other service providers with the legal and regulatory requirements to which they are subject.[639] In the US, numerous provisions of the Investment Company Act promote the use of independent directors in retail mutual funds. This is accomplished by making a number of exemptive rules available only if sufficient directors are independent.[640] The SEC views fund director independence as an important tool to limit conflicts of interest and improve governance at the fund level.[641] The independent directors are anticipated to perform a "watch-dog" role [642] and the SEC has increased their reliance on these individuals over the years.

Similar to private investment funds, and unlike most other operating business, a mutual fund will not employ its own internal management and staff. Instead, they will appoint third-party, such as investment management firms, to provide the services that they require. As a result, the ability of the board to effectively oversee the actions of the external fund manager is imperative. In certain instances, the independent directors may be required to vote separately to approve certain actions. [643]

According to the US Supreme Court:

> [T]he structure and purpose of the Investment Company Act indicate[s] that Congress entrusted to the independent directors of investment companies ... the primary responsibility of looking after the interest of the fund's shareholders.[644]

Independent directors, therefore, must take adequate steps to ensure that they are fulfilling this important responsibility. However, questions still remained about how boards, and the independent directors serving on them, could operate most effectively. In 1999, the US-based Investment Company Institute (ICI) issued its best practices recommendations for boards of

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637 See Investment Company Act, Section 2(a)(19).

638 See Palmiter at 169 ("In 1940 when Congress got around to regulating investment companies, it grafted its regulatory scheme onto the existing corporate structure and placed its faith in the fund board as a substitute for investor self-reliance.") Perhaps, it is more fair to say that the fund board's role is as a "supplement to" investor self-reliance, rather than a "substitute for."

639 Ibid. at 172.

640 See, e.g. Rule 12b-1 (regarding distributing expenses) and Rule 17a-7 (regarding transactions between clients of the same investment manager).

641 See 'Mutual Fund Regulation' A Time for Healing and Reform" (4 Dec 2003), available at http://sec.gov/news/speech/spch 120403hjg.htm.

642 See Moses v Burgin, 445 F.2d 369 (1st Cir. 1971).

643 See, for example, Rule 12b -1.

644 Burks v Lasker, 441 US 471, 486 (1979). See also SEC Division of Investment Management, Protecting Investors : A Half Century of Investment Company Regulation (May 1992).

directors of retail mutual funds,[645] many of which have the potential for direct application in the context of private investment funds. The recommendations included the following:

(a) at least two-thirds (2/3) of a fund's directors should be independent;

(b) former officers or directors of the fund manager should not qualify as independent directors;

(c) independent directors should nominate and select any new independent directors;

(d) the compensation of directors should be determined by the independent directors, not the fund manager;

(e) fund directors should have investments in their funds;

(f) independent directors have access to independent legal advice; and

(g) independent directors should meet separately when considering issues directly related to the fund manager (e.g. advisory contracts).

Each of these recommendations can work towards maintaining a fuller and more comprehensive oversight function in connection with the fund managers ongoing compliance with its legal and regulatory obligations to fund participants.

Importantly, the requirements imposed by the independent directors rules sit on top of the corporation law which governs the establishment and operations of the legal entities.[646] In the US, such entities are creatures of state law, and the jurisprudence and case law which applies to them varies from state to state. This, however, is complemented and expanded by independent director requirements in a "top-down" manner by federal law.

The fundamental requirement, in most instances, is that at least 40% of the members of a board of a registered investment company not be "interested persons",[647] in addition, a series of so-called "exemptive rules" will only be available to registered investment companies if a majority of the directors are independent.[648] Over the last decade, the SEC has sought to reinvigorate the composition of fund boards and the role of independent directors.[649] Central to

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[645] Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999) available at www.ici.org/pdf/rpt_best_practices.pdf.

[646] See Section 2.4 above.

[647] Section 10(a) of the Investment Company Act.

[648] These include Rule 10f-3 (permitting funds to purchase securities in an offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rue 12b-1 (permitting the use of fund assets to pay for distributions); Rule 15a-4(b)(2) (permitting approval of an interim advisory contract without shareholder approval following a change in control of the adviser); Rule 17a-7 (permitting cross-transactions with affiliates); Rule 17a-8 (permitting mergers between affiliated funds); Rule 17d-1(d)(7) (permitting funds and affiliates to participate in joint liability insurance policies); Rule 17e-1 (permitting payment of commissions to affiliated brokers); Rule 17g-1(j) (permitting funds and affiliates to maintain a joint fidelity bond); Rule 18f-3 (permitting funds to issue multiple classes of shares); and Rule 23c-3 (permitting the operation of closed-end funds that periodically repurchase shares from investors).

[649] See, e.g., "Role of Independent Directors of Investment Companies", Investment Company Act Release No. IC-24816 (Jan. 16, 2001).

the reasoning behind using independent directors to fulfil a regulatory or public policy goal is the belief that interested directors, despite the fiduciary duties that they owe to a company, will not be consistently fair to fund investors in their decision making.

This lack of confidence in interested directors has been a recurrent theme of SEC regulation since its initial adoption in 1940. These concerns centre around the risk that on the occurrence of a potential conflict of interest, such individuals will be unable (or be seen to be unable) to take a decision on the merits in light of the best interest of the fund participants.[650] The SEC has stated plainly:

> The role of independent fund directors in policing conflicts of interest is central to the Investment Company Act.[651]

The definition of "interested" covers a wide variety of people who might be subject to influence and conflicts of interest which would impede their ability to make decisions in the best interest of mutual fund shareholders. Importantly, the status of a director as "interested" or "independent" does not in itself impact his or her liability to exposure.

Interestingly, an independent directors' regime also exists in the UK in the context of listed investment trusts. In the UK, directors of closed-end and listed investment companies are subject to the requirements and recommendations of the UK Code on Corporate Governance. The Association of Investment Companies' (AIC) Code of Corporate Governance (AIC Code) and the UKLA Listing Rules. Because of their unique structure, not all of the provisions of the UK Code on Corporate Governance are appropriate.[652]

Under these principles, a majority of the board of the investment company (including the chairman) should be independent of the fund manager. In addition, detailed requirements are established for addressing full disclosure of information to the board and its role in overseeing overall strategy and investment performance.

Determining the full extent to which mutual fund investors and investment trust shareholders have economically benefited from independent directors is an open question.[653] It is worth noting that in the mutual fund context, academic support for independent directors is more common.[654] However, the presence or absence of additional incremental gains in financial

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650 See Barnett at 499. See also Stephen P. Ferris and Xuemin Yan, "Do Independent Directors and Chairman Matter? The Role of Boards of Directors in Mutual Fund Governance," 13 Journal of Corporate Finance 392 (2007).

651 "Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and their Investment Advisers and Principal Underwriters", Investment Company Release No. IC-21341 (Sept. 14, 1995).

652 Because of these various sources of governance guidance, the AIC has issued a "Corporate Governance Guide for Investment Companies" (AIC Guide), which integrates these requirements in a systematic fashion. The current version (March 2009) is the fourth version of the AIC Code.

653 See Donald C. Clarke, "Three Concepts of the Independent Director", 32 Delaware Journal of Corporate Law 73, 75 (2007). ("The overall weight of the findings is that there is no solid evidence suggesting that independent directors improve performance."); Jeffrey N Gordon, "The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices," 59 Stanford Law Review 1465, 1468 (2007) ("One of the apparent puzzles in the empirical corporate governance literature is the lack of correlation between the presence of independent directors and the firm's economic performance."). It is worth noting, however, that each of these studies focused on publicly traded companies and their share price.

654 See, e.g., Donald C. Langevoort, "Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty", 83 Washington University Law Quarterly 1017, 1019 (2005) ("To be clear, I believe (and research shows) that disinterested directors do add

performance is only one measure of the benefit of independent directors. Further, a meaningful distinction can and should be made between the impact of independent directors in publicly listed companies and their impact in private companies and private investment funds. In the latter, for example, the role that the independent director would play in overcoming informational asymmetry would be much greater.

The absence of perceived conflicts or inconsistent goals and motivations in an independent director would seem to strengthen the case for fuller and favour consideration of particularly troublesome topics, such as a potential dispute with the fund manager. As a result, independent directors have been a common solution to potential corporate governances problems in many countries (and in many different contexts),[655] even while the underlying rationale for their use remains under-theorized.[656]

7.3 Duties of Independent Directors

In legal terms, the distinction between 'interested' and the term 'independent' directors can be a potentially misleading one. All directors must act independently of any other outside interests they may have.[657] A director, regardless of who appoints him, has a duty to act honestly and in good faith in the best interests of the fund, owing his duties to the fund as a whole and not to any individual shareholder or service provider, as well as having a duty to act with the care, diligence and skill which would be displayed by a reasonable man with his knowledge and experience in the circumstances.[658]

When the interests of the fund and the fund manager conflict, a director appointed by the manager will be in a position where he has a conflict of interests.[659] Any director will have a duty, arising from his position as a fiduciary, not to put himself in a position where he has a conflict of interest between the business of the fund and his other business interests.

Contracts in which a director is interested (e.g., the fund's investment management agreement) are typically voidable at the option of the company. The director may also be liable to account for any profits made unless permitted by the constitutional documents, typical by means of disclosure.[660] Even upon disclosing a potential conflict of interests, however, a

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value as a form of shareholder protection. . ."). However, the amount of such support is not extensive or beyond rebuttal. See Barnett at 504 ("Unfortunately, there is a dearth of rigorous social science research on whether, and the extent to which, fund shareholders benefit from independent directors, from any particular number or percentage of independent directors, or from a requirement that independent directors be chosen by independent directors."). See also Lyman Johnson, "A Fresh Look at Director 'Independence': Mutual Fund Fee Litigation and Gartenberg at Twenty-Five," 61 Vanderbilt Law Review 497 (2008).

655 See Clarke at 73.

656 Ibid. at 77.

657 See Cadbury Report at para 4.12: 'An essential quality which non-executive directors should bring to the board's deliberations is that of independence of judgement'.

658 See Section 2.4 above.

659 Conflicts can arise both at the launch of the fund, when the contracts with the fund manager and administrator are being negotiated, and during the ongoing operation of the fund, over performance issues such as the valuation of assets, changes to investment strategies and in the monitoring of the performance of the fund manager. These are the same areas which have given rise to recent lawsuits and regulatory enforcement actions by investors against their fund managers. See Sections 3.7 and 3.12 above.

660 The articles may be drafted to permit a director to give a general notice of his interest in a particular company which can eliminate the need to disclose the interest each time it becomes relevant to a matter being discussed.

director is still required to consider only what is in the best interests of the fund in making a decision.[661] However, a director may represent the interests of a particular party (e.g., the fund manager) at board meetings as long as he does not contract to vote in a particular way on a particular issue and, as his primary duty, he acts in the interests of the fund in all respects. Therefore, although in theory the duties of directors should be uniform and consistent across all of a fund's directors, whether manager appointed or independent, in practice the objectivity of an independent director can operate to impact the actual functioning of a board.

A robust and experienced board of directors can provide effective checks and balances on a fund manager. However, independent directors can adequately address the governance challenge only if the fund, and its fund manager, provide them with appropriate, useful, and timely information.[662]

Fund participants concerned about the governance challenge can take steps to monitor and confirm that the independent directors have access to, and make effective use of, such information. Importantly, US courts have held that management (non-independent) directors have a special duty to provide the independent directors with "sufficient information so as to enable [the independent directors] to participate effectively in the management of the investment company." [663] Accordingly, each of the independent directors should be provided, upon the launch of the fund, with a full set of the fund's constitutional documents including its offering memorandum, its constitutional documentation, and all agreements with service providers.[664] On an ongoing basis, the independent director should receive regular reports, from the fund manager, the custodian and the administrator about the activities of the fund.[665] The fund manager can then advise as to why the breach occurred and how and when the breach will be rectified.

The independent directors should have direct access to senior staff of the fund manager, the custodian and the administrator. They should query any aspects of the valuations that cause them concern, such as specific investment transactions and unusual expense items, and on any items in the reports to investors which conflict with the detailed valuation reports or the fund's investment policies and guidelines.

7.4 **Effectiveness of Directors**

In order to address the governance challenge, directors must have the background and resources necessary to perform their monitoring function. Otherwise, they will be unable to operate as an effective check on the fund manager. Further, the operation of the board of directors must be conducted in a manner conducive to its effectiveness.

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661 In the case of a direct conflict of interests between a director and a fund (e.g., where both will be contractual counter-parties to the other), such impartiality may be difficult. It could at times be appropriate for the director to excuse himself from the discussion altogether, notwithstanding that his interest is disclosed.

662 These informational needs actually begin prior to a director's appointment to the board. A potential independent director should conduct a thorough preliminary investigation of its proposed investment objectives and strategy, target investors, the intended composition of its board, the fund manager and its principals and other significant operational matters.

663 Fogel v. Chestnutt, 553 F2d 731, 743 (1975).

664 See Section 2.2 above.

665 Investors with sufficient negotiating leverage may seek to obtain such a right to notification directly pursuant to a side letter. See Chapter 6 above.

The literature on what constitutes an effective director, whether popular[666] or academic[667], is extensive.[668] Accordingly, only a few observations are included below in the context of private investment funds. Without effective directors, any attempt to base a private monitoring solution on them would be undermined. The directors of a private investment fund must have the necessary collective expertise to understand the fund's trading and the risk profile and liquidity of the underlying investments. They will need to have the ability and experience to evaluate the fund's performance and the performance of key service providers.[669] A director should also be able to devote sufficient time to carry out those duties, which should be reflected in his remuneration. When the primary driver of directorships is simply to secure the offshore taxation treatment of a fund vehicle, then it is unsurprising that the customary remuneration of such directors has been low. However, in light of the increasing demands being placed on independent directors, the requisite remuneration has begun trending upwards.[670] Individuals with the necessary experience are not plentiful and such individuals will often have other professional options available to them.

Fund investors seeking to rely on board composition and oversight to address the governance challenge should consider not only the experience and expertise of a potential independent director, but also the number of other directorships and commitments which the candidate has, and assess whether he will have the time available to perform his duties with regard to this particular fund properly.[671] Trophy directors who are too busy to contribute effectively should be avoided as this undermines the overall effectiveness of the board of directors.

Another problem faced by directors in private investment funds arises from the same individual sitting on multiple boards for different funds, either managed by the same fund manager or different fund managers.[672] A director who sits on the boards of multiple funds with similar investment strategies has a duty to ensure that confidential information obtained in his capacity as a director of one fund manager is not disclosed to the directors or investment manager of the other fund unless such information is already in the public domain.

Although each of the above can be limiting factors on the ability of directors to perform their monitoring function, steps could be taken prior to their appointment to assess each candidate's experience and available time commitment to determine their suitability prior to their appointment. In order to preserve their independence, the position of independent directors can be strengthened by enabling the directors themselves to:

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666 See, e.g., Harvey L. Pitt, "How To Be An Effective Director as Standards Change," Compliance Week (October 26, 2004) (available at www.complianceweek.com/pages/how-to-be-an-effective-director-as-standards-change/article/183008).

667 See, e.g., Ron Duchin, John G. Matsusaka and Oguzhan Ozbas, "When are Outside Directors Effective," 96:2 Journal of Financial Economics 195 (May 2010).

668 See, e.g., Gilson and Kraakman at 874 ("Good character and financial independence from management may be necessary conditions for effective monitoring but they are hardly sufficient.").

669 See Cadbury Report at para 4.11: 'Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. We recommend that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions.'

670 See Section 2.6 above.

671 See, e.g., "Oceanic Hedge Fund - Change in Directors Fees," Reuters (3 March 2008) (available at www.reuters.com/articles/2008/03/03/idUS118961+03-Mar-2008+RNS20080303).

672 See, e.g., Charles Gubert, "Hedge Fund Directors: The Corporate Governance Conundrum Facing Managers," CCO Connect (Feb. 15, 2011) (available at ccoconnect.com/features/details/2011/2/15/hedge-fund-directors-the-corporate-conundrum-facing-managers/zz).

(a) set their own compensation,[673] to avoid potential conflicts in having it set by the fund manager they oversee; and

(b) have the power, in appropriate circumstances, to hire their own lawyer to advise them, which should be paid out of the fund's assets.[674]

The board is ultimately responsible to the investors in the fund for ensuring that the fund conducts its business effectively. Generally, the directors acting on a collective basis at a properly constituted board meeting is the preferred method for exercising the board's authority.

Boards must, however, decide how its oversight and authority is to be exercised in between board meetings, as it is unrealistic to expect all governance decisions to be made only at quarterly board meetings. Directors can delegate decision making to sub-committees or individual directors, but they cannot avoid responsibility for such decisions. The directors should define in advance those more routine items of business that can be delegated to a sub-committee or a service provider.

Where a board generally consists of both independent and non-independent directors, the composition of a sub-committee can be set in such a way as to enable the independent directors to be in the majority. All sub-committees should be formally created with written terms of reference ratified by the board in order to provide effective oversight, all proceedings and decisions of sub-committees should be formally reported to the board and fully ratified by resolution. Without directors of adequate calibre and commitment, or without effective operation of the board, either at formal meetings or during the interim period, the benefits sought as a private monitoring solution cannot be obtained.

7.5 The Role of Directors in General Partner Vehicles

Given the limitations on the involvement of limited partners in the management of a partnership, as discussed above,[675] the mutual duties of partners to each other play an important role in the governance arrangements of Partnership PIFs. The scope and extent of these duties can operate to protect participants from over-reaching and self-dealing by the general partner.

General partners often have a wide range of commercial relationships with the limited partnership. A general partner will receive fees directly from the partnership, may earn compensation from the partnership or third parties in transactions by the partnership, and may engage in transactions directly with the partnership. 'Interested transactions' between the

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[673] Factors to be taken into account in setting compensation include the demands on a director's time, the nature of the role and responsibilities and the director's skill and experience. Typical requirements of fund directors could include:

(a) attendance at quarterly board meetings, with agenda and written papers circulated ahead;

(b) additional conference telephone meetings to review and approve annual audited accounts and associated documentation and to review and approve semi-annual accounts; and

(c) specially convened meetings for discussion of 'one-off' matters — such as, nominations of additional or replacement directors or changes to service providers' contracts or to the prospectus.

[674] Similar practices have been adopted by directors of US mutual funds. See Section 7.2 above.

[675] See Section 2.3 above.

partnership and the general partner, or entities affiliated with the general partner, are fertile ground for disputes. As a result, partnership agreements[676] typically attempt to define very precisely the scope of the general partner's fiduciary duty[677] to the partnership.

When there is conflict between the limited partners and a corporate general partner,[678] the limited partners may look to the directors and officers of the corporate general partner as being responsible for the actions of the general partner. However, these directors and officers will seek to remove themselves from the conflict by insisting that their duties of care and of loyalty are to their corporation,[679] and not to the partnership of which they are general partner.

This tension is illustrative of the impact of multiple vehicles within a fund structure on potential claims that can be made at law and equity by aggrieved fund participants. I will start by analyzing a particular concern that was raised under Delaware law, discuss how it was addressed ultimately, and conclude with an observation of how the question would have been addressed under English law.

7.5.1 ***Fiduciary Duty in Delaware Partnerships***

As partners are agents of the partnership for purposes of the partnership's business, a fiduciary relationship is established among the partners.[680] As a result, a partner cannot use the partnership assets for his own benefit, cannot take a secret profit for himself or carry on a business in competition with the partnership, cannot secure for himself that which is duty to secure for the partnership, and cannot avail himself of knowledge or information which is properly regarded as property of the partnership.[681]

For limited partnerships formed under Delaware law, there is a statutory framework imposing various duties and allowing for those duties to be shaped and adjusted by agreement. Such duties, if unmodified by agreement, may be inconsistent with the goals of private investment fund sponsors and investors. Section 17-1101(d) of DRULPA explicitly provides that the fiduciary duties of a partner may be expanded or limited in a limited partnership agreement. The Delaware courts have consistently upheld the right of partners to modify themselves traditional aspects of fiduciary duty, thereby promoting predictability in the enforcement of limited partnership agreements in Delaware.

The nature of the fiduciary obligations among partners, in the absence of agreement to the contrary, is rigid and absolute.[682] The Delaware Court of Chancery, in Boxer v Husky Oil Company,[683] held that:

> the duty of the general partner in a limited partnership to exercise the utmost good faith, fairness, and loyalty is required both by statute and common law. This fiduciary

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676 See Section 2.2 above.

677 See Section 3.10 above.

678 For a thorough discussion of the economic theory of limited partnerships generally and limited partnerships with incorporated general partners, see Ribstein, "Applied Theory".

679 See Section 2.4 above.

680 See Sections 2.3 and 3.10 above.

681 See Latta v Kilbourn,150 US 524 (1893).

682 See Meinhard v Salmon, 164 NE 545 (NY 1928).

683 429 A2d 995 (Del Ch 1981) ('Boxer').

duty of partners is often compared to that of corporate directors. . . . 'The form of the enterprise does not diminish the duty of fair dealing by those in control of the investments'.[684]

While DRULPA does not mandate the absolute standard of undivided loyalty, the laws assume, in the absence of agreement by the parties to the contrary, a high degree of duty. The parties must make clear their intention to contractually limit a general partner's fiduciary duties, and the burden is on them to demonstrate that the default fiduciary duty rules that would otherwise govern as pre-empted.[685]

A sponsor of a private investment fund structured as a Partnership PIF will often seek to insulate itself from personal liability to third parties by using a structure which has a newly incorporated, wholly-owned special purpose vehicle limited partnership as the general partner of a limited partnership. One advantage of this structure is that if there were to be a breach of fiduciary duty by the general partner, the party directly liable for breach would be the special purpose entity, whose net worth is relatively small, and not its shareholder, the sponsoring fund manager.

A Delaware court has demonstrated a willingness to go beyond the general partner itself and impose, in favour of the limited partners, a fiduciary duty on the directors of the corporate general partner, even though those directors were not in privity with the limited partners. In USA Cafes, LP litigation[686] (USA Cafes) discussed below, the court held that the directors had a fiduciary duty to the corporation and used the double fiduciary duty as a basis for imposing liability on the directors to the limited partners.

7.5.2 ***The USA Cafes Decision***

Historically, a director of a corporate general partner[687] owed no fiduciary duties to a limited partner. Rather, the director instead owed his or her duties to the corporation itself, while the corporation, as general partner, owed fiduciary duties to the limited partners. In USA Cafes, however, the court held that the directors of the general partner owed a fiduciary duty to the partnership and the limited partners.[688] The court relied on a line of cases in the trust area,[689] noting that in instances in which the directors or officers of a corporate trustee have been personally at fault and have violated a duty owed to a beneficiary,[690] some courts have held that trustee directors or officers are in a fiduciary relation not merely to the corporation but to the beneficiaries of the trust administered by the corporation and have imposed personal liability on such individuals. The court concluded that imposing a fiduciary duty on a director of a corporate general partner of a limited partnership was only a recognition of the fiduciary

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684 Ibid at 997, quoting Miller v Schweickart, 405 F Supp 366 (SDNY 1975).

685 See Weaver v Miller Technology Management, LP, CA No. 19721 (Del. Ch. 13 Feb 2005).

686 600 A.2d 43 (Del Ch 1991).

687 It is worth noting that use of corporation as general partners, rather than individuals subject to unlimited liability, has attracted scholarly attention over the years. See Ribstein, "Applied Theory" at 873 ("The personal liability of the general partners has, in fact, been singled out as the most important distinction between limited partnerships and corporations.").

688 USA Cafes at 47. See Andrew Levy and Daniel Bamdas, "Fiduciary Duty and Limited Partnership/Limited Liability Company Laws," New York Law Journal (August 22, 2003).

689 See Tobias v First City Nat'l Bank & Trust Co, 709 F Supp 1266 (SDNY 1989); Remenchik v Whittington, 757 SW2d 836 (Tex App 1988).

690 See Fine Iron Works v Louisiana World Expo Inc, 472 So 2d 20 (La App 1985).

obligations inherent in the role of a director who sits on the board of an entity that is itself a fiduciary.[691] Given that the duty had been recognized in directors of trustees, the court held that it was appropriate to extend the general partner directors' duty in an analogous manner.[692]

Under traditional analysis, a director's fiduciary duty is one of undivided loyalty to the company on whose board he or she sits, which includes all of the elements of loyalty, care, and fair dealing implicit in a fiduciary relationship.[693] To the extent that the corporate general partner must operate in accordance with certain restrictions, such as its fiduciary obligations to the limited partnership, the directors must make their decisions in light of such restrictions. Under a pre-USA Cafes analysis, this cause of action against the directors belonged to the general partner, not to a third party harmed by the general partner. Under the USA Cafes analysis, however, the limited partners also were brought within the zone of persons to whom the directors owe a duty and potentially possess a cause of action.

7.5.3 ***Developments Following USA Cafes***

In 1994, the DRULPA was amended to confirm that the duties and liabilities of persons other than partners, such as agents or employees of a limited partnership or general partner, may also be set forth in the partnership agreement, and that such persons are not liable to the limited partnership or the partners if such persons rely in good faith on the provisions of a partnership agreement.[694] The amendment was significant for expressly permitting the partners in a limited partnership to define the scope of the duties owed by officers and directors of a corporate general partner.

On 20 August 2001, the Delaware Chancery Court in Brickell Partners v Wise[695] enforced a partnership provision that limited the fiduciary duties of directors of corporate general partners. In Brickell the court stated that 'by definition, [directors of corporate general partners] find themselves in a position of on-going conflict because they owe fiduciary duties to the corporate general partner (on whose board they serve) and fiduciary duties to the limited partnership governed by the corporate general partner'.[696] In dismissing the action brought by the limited partners, the court emphasized the amendments of DRULPA.

The USA Cafes decision significantly altered the traditional fiduciary relationships of directors of corporate general partners to limited partners of a limited partnership. It recognized that the directors of corporate general partners are obliged to cause the general partner to satisfy its

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691 USA Cafes at 48 ('[T]he central aspect of the [fiduciary] relationship is, undoubtedly, fidelity in the control of property for the benefit of another.)

692 Ibid at 49.

693 See Section 2.4 above.

694 DRULPA provides:

> To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner or to another person that is a party to or otherwise bound by a partnership agreement, (1) any such partner or other person acting under the partnership agreement shall not be liable to the limited partnership or to any such other partner or to any such other person for the partner's or other person's good faith reliance on the provisions of the partnership agreement, and (2) the partner's or other person's duties may be expanded or restricted by provisions in the partnership agreement.

Section 17-1101(d).

695 794 A2d 1 (2001).

696 Ibid at 115.

duty to the limited partners[697] and that limited partners should have remedies against them if they fail to do so. The Brickell, court has made clear, however, that well-drafted partnership agreements can limit the fiduciary duties of the officers and directors of corporate general partners, and can provide their own standards for the balancing of the interests of the general partner and the partnership.

Corporate general partners, therefore, can negotiate to include in partnership agreements mechanisms that address conflicts between the general partner and the partnership in compliance with Section 17-1101(d) of DRULPA. Conversely, however, limited partners could require that such liability carve out not be included and, as a result, the USA Cafes rule would govern. Allowing the fiduciary duty to extend to limited partners would promote the private monitoring solutions advocated herein by placing the limited partners within the category of persons to which the general partner directors owe their duties.

7.5.4 *English Law*

There has been no similar case to USA Cafes under English law. As a result, the position of English courts should be similar to the position in Delaware prior to that decision, namely that a director of a corporate general partner owed no duties to the limited partners, although this proposition has not yet been tested in court. As with Delaware post-Brickell, a partnership agreement could be prepared that clearly state that the limited partners are owed a fiduciary duty by the directors of the corporate general partner.

As discussed in Chapter 2, the primary argument in favour of using limited partnerships a fund vehicles has primarily been the benefits of tax transparency, not cutting off fiduciary duties. As a result, limited partners in either Delaware or English partnerships could argue strongly in favour of a clear statement that directors of corporate general partners owe limited partners such fiduciaries, without compromising the desired tax treatment, thereby supporting the enrolment of private monitoring solutions to address the governance challenge.

7.6 Limitation on the Effectiveness of Independent Directors

As one commentator has remarked:

> [T]he whole purpose of having independent directors is surprisingly under-theorized, leading to inconsistent rules, in particular regarding the effect of director shareholdings both across countries and within the United States.[698]

Academic critiques of independent directors in the public company context should not be overextended reflexively to the realm of privately held vehicles, such as private funds. Two non-economic effects of independent directors which are of particular importance in the private vehicle context are that they enhance the fidelity of management to the objectives of the shareholders, while also increasing the reliability of information provided to shareholders.[699]

With the full weight of rigorous ongoing disclosure requirements and the bright light of stock analysts and business media bearing down on a public company, the marginal impact of

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697 See USA Cafes at 149.

698 Clarke at 77. Clarke proceeds to categorize and analyze three categories of non-management directors: the independent director, the outside director, and the disinterested director.

699 Gordon at 1469. See also Robert F. Radin and William B. Stevenson, "Comparing Mutual Fund Governance and Corporate Governance," 14 Corporate Governance 367 (2006).

independent directors on economic returns in a mature stock market may be explained by the presence of only incremental benefits which fail to rise above the "noise" of share price volatility and fluctuations. However, in the private vehicle context, these contributions would have a larger impact. Unfortunately, to date, rigorous social science research on the impact of independent directors in private companies has not been published.

US courts, following the lead of the SEC, have repeatedly relied on the presence of independent directors on mutual fund boards to lower the judicial scrutiny applied to cases involving claims related to breach of fiduciary duty.[700] However, it is important to bear in mind the important differences between investment funds and other types of business corporations, and address governance issues accordingly. Unlike a traditional business, the product being sold by an investment fund is its own security. As a result, the market for its product and the market for its capital are one and the same.[701] Also, external management is typical in the case of investment funds, with a broad delegation of authority to the fund manager who acts as "sponsor" and "promoter" of the fund.[702]

Accordingly, the critique can be made that analogizing investment funds to business corporations is an incorrect, or at least incomplete, analogy.[703] For example, there is no external market for corporate control in the case of investment funds,[704] due to lack of a meaningful secondary market in most fund interests. However, the counter-argument can be made that the negotiation, involvement and liquidity of fund investors in various types of funds can provide more discipline than in the case of business corporations, rather than less.[705]

The choice of individual directors is a subjective one, as is the manner in which each of them may define their particular role. As opposed to mutual funds and other public investment funds, which give their participants the opportunity to vote with their feet by redeeming out when they disagree with a manager,[706] illiquid private investment funds will need directors more willing to act aggressively on behalf of fund investors.

Importantly, even the recognition that independent directors have some positive impact on the governance of private investment funds demonstrates that they can fulfil a useful, and pragmatic, strategy as part of a wider solution to the governance challenge.[707] Although at the

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700 See Langevoort, "Private Litigation".

701 Langevoort at 1019. As a result of viewing the fund interests as "product," the temptation to envision a "buyer beware" approach typical of day-to-day purchases arises. However, the fiduciary nature of the underlying relationship between the investment manager and its indirect client (the fund investor) remains.

702 See Section 1.8 above.

703 See William A. Birdthistle, "Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence," 2010. U of Ill Law Rev. 61, 69 (2010) ("Any attempt to understand and assess the investment industry must begin with an appreciation for the substantial structural differences that exist between mutual funds and typical corporations. These dissimilarities produce material differences between the governance regimes of mutual funds and those of the more widely studied and understood corporations.").

704 Langevoort at 1032.

705 Ibid. at 1032 ("[C]ompetition gives the fund ample incentive to use corporate governance as a bonding mechanism to find new investor money and keep the money it has under management, so that residual regulation need not be heavy-handed.).

706 It should be noted that shareholder exit as a means of effecting corporate governance is a limited and fragile tool. See Birdthistle at 72 ("The device of shareholder exit . . . does not allow unsophisticated investors to benefit indirectly from the actions of sophisticated institutional players unless both sophisticated and unsophisticated investors inhabit the same market segment.").

707 Langevoort at 1040.

time of the formation of the fund, the directors will be those identified and appointed by the fund manager, [708] an initial review and ongoing monitoring of the composition of the board and the calibre of individual directors can be undertaken by fund investors as a prerequisite to their investment.[709]

Critics have argued that, in the case of public investment funds, referring to a fund investor as a "shareholder" and attributing to him or her to the rights and influence typically associated therewith is inappropriate.[710] However, private investment funds can be distinguished on this point by the sophisticated nature of their investors and the negotiations that occur as part of the investment process.[711]

In the past, the primary consideration in appointing independent directors to fund vehicles has been to maintain the offshore tax status of the fund or to assist in the tax planning of the fund manager.[712] The calibre and experience of the director could be a secondary concern. As the fund manager typically arranges for the appointment of the fund's initial directors, an independent director will often be personally or professionally acquainted with the principals of the fund manager prior to their involvement with the fund. However, recent litigation has resulted in increased scrutiny of private investment funds.[713] Investors are increasingly expecting a higher level of sophistication and expertise from the independent director. Investors, through their due diligence exercise prior to their investment[714] and their preliminary negotiations with the fund manager, can make clear that prospective directors must have the skills necessary to adequately oversee the fund.

The view of the mutual fund industry on the use independent directors has been positive and supportive. As the Advisory Group on Best Practices for Fund Directors, established by the Investment Company Institute, observed in 1999:

> The regulatory requirements governing investment company boards of directors are unique in the world of American business. Independent directors of investment companies in particular play a critical role in overseeing fund operation and policy conflicts of interest between the fund and its investment adviser or other service providers. In fulfilling this role, independent directors act as "watchdogs", protecting the interests of fund shareholders. There is broad consensus that this governance system has worked well for investment companies and their shareholders.[715]

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[708] See Birdthistle at 70.

[709] See Section 7.4 above.

[710] Birdthistle at 73. ("Categorizing mutual fund investors as shareholders imbues them with all the rights, privileges, and rich theory appertaining thereto. But when we observe that mutual fund shareholders are, in fact, protected almost solely by their ability to buy and sell mutual fund shares, they begin to take on the appearance of mere participants in the comparatively unprotected arena of product markets.")

[711] See Section 2.5 above.

[712] See Section 2.6 above.

[713] See Section 3.7 and 3.12 above.

[714] See Section 9.4 below.

[715] Advisory Group on Best Practices for Fund Directors, Investment Company Institute, Enhancing A Culture of Independence and Effectiveness (June 24, 1999). But see Thomas R. Hurst, "The Unfinished Business of Mutual Fund Reform," 26 Pace Law Review 133 (2005).

However, as Cheffins has stated:

> To the extent that the board is acting as a 'watch dog', logically the directors need to be able to evaluate management's performance in an impartial and detached manner. Directors who are also full-time executives are not well-suited to do this since they will in essence be reviewing their own conduct. Non-executive directors are much more likely to have the required objectivity since they do not have managerial duties. They should be even better positioned to act in a dispassionate fashion if they are independent in the sense that they never had any connection with the company other than their seats on the board.[716]

Failures at the level of the board of directors[717] have been linked to two categories of failures at the corporate level:

(a) directors who have failed to detect and/or remedy imprudent behavior by managers,[718] and

(b) directors who have failed to act as adequate limits on managers who have "lost their way" and lend their companies into dramatic financial collapse.[719]

Fund directors do not function like directors of more typical operating companies. They do not participate in decisions concerning the strategy or investment activities of the fund, nor do they have direct supervision over the separate firms that provide them vital services, such as the fund manager or any distributors.[720]

A critique of the effectiveness of independent directors would include the observation that even if accurate, current information were to be provided to them, many would not be able to spend sufficient time analyzing it in order to take necessary actions. As Cheffins further observed:

> A typical outside director will not have the time to become fully conversant with what is going on since he will only devote between one and two days a month to company business and a considerable portion of this will be spent in the boardroom or at committee meetings.[721]

However, the role of independent directors is not to conduct forensic audits on the data and information they are provided. Their role, properly conceived, is to monitor the performance of

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716 Cheffins at 605.

717 See, e.g., John A. Haslem, "Why Have Mutual Fund Independent Directors Failed as 'Shareholder Watchdogs'?," 19 Journal of Investing 7 (2010).

718 Cheffins at 611.

719 Ibid. at 612.

720 Roberta S. Karmel, "Mutual Funds, Pension Funds, Hedge funds and Stock Market Volatility – What Regulation by the Securities and Exchange Commission is Appropriate," 80 Notre Dame Law Review 909, 915 (2005).

721 Cheffins at 611.

the management function which has been delegated to third parties and act as an "early warning system" to identify and resolve potential problems at an early stage.[722]

Importantly, the "curious institution"[723] of the mutual fund board has not been without critics. As one commentator has argued:

> Fund boards have been weak and even reckless protectors of fund investors, their deficiencies exacerbated as mutual funds have grown into the leading investment vehicle for private retirement savings in the United States.[724]

Critics have accused the SEC of over-relying on independent directors as a regulatory solution,[725] and have focused particular attention on the metric of management fees and fund expense ratios, which have continued to grow significantly in recent decades.[726]

Rather than see the independent directors as "watch dogs", these critics instead focus on the "empty ritual" of part-time directors who lack independent sources of information and real negotiating leverage.[727] The capabilities and calibre of independent directors has also been challenged,[728] noting that there are no qualification standards for such directors and that these individuals are typically securities industry professionals who may be affiliated, or have been affiliates, with businesses which currently, or may in the future, provide services to either the fund or its manager.[729]

Interestingly, since the adoption of the Investment Company Act over seven decades ago, no mutual fund directors have ever been proposed by fund investors to oppose the manager-selected slate.[730] As a result, critics question whether they can ever be more than mere rubber stamps. However, it is unfair to claim, as some critics have,[731] that the independent director approach insulates the fund manager from oversight and liability, and that the SEC lacks, therefore, the means to supervise fund managers directly. In fact, the SEC has direct regulatory responsibility for every mutual fund manager pursuant to the Investment Advisers Act, and oversees a detailed product regulatory regime pursuant to the Investment Company Act.

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722 Ibid. at 605.

723 See Palmiter at 165 (2006) ("Mutual fund boards are a curious institution.").

724 Ibid. at 166.

725 See Markham at 154 ("The SEC's fixation on the use of outside directors to guard against conflicts of interest on the part of investment advisers to mutual funds has proved to be ineffective.").

726 See Palmiter at 166.

727 Ibid. at 167. ("The fund board is composed of part-timers who rely on the fund's management firm for information, direction and compensation. Even if they wanted to, the fund directors cannot realistically threaten to take the fund's business elsewhere. Negotiations on behalf of fund investors is understandably an empty ritual.").

728 Ibid. ("Director professionalism, part of a relatively recent 'best practices' movement in the mutual fund industry, offers some promise – but at most can only be aspirational . . . Although fund directors have become more aware of their functions and responsibilities, they continue to be difficult, highly-paid actors in the face of a fund management culture that focuses on building market share, asset size and profits. Against these odds, director professionalism has little chance.").

729 Ibid. at 171.

730 Ibid.

731 Ibid. at 173.

The role of the board, and the independent directors, supplements these approaches by establishing a role for individuals associated with the oversight of the fund vehicle (e.g., corporate directors) to also serve in a regulatory capacity. Further, to become overly fixated on management fees and expense ratios as the sole measure for determining the effectiveness of independent directors is to deny the larger role, and wider responsibilities, that these directors have in connection with regulatory compliance generally.

Although some have argued that the compliance role played by the board is largely ministerial,[732] the directors still perform a role in reviewing the operation of the fund and its adherence to SEC requirements that the SEC itself couldn't accomplish, given any reasonably foreseeable staffing and funding levels. The directors perform their role at no cost to the U.S. government, or ultimately U.S. taxpayers. Their costs are borne by the fund and its investors, who ultimately benefit from the services that they provide.

It is important to recognize that the mere involvement of the board of directors in the regulatory process on a polycentric basis[733] is not, in itself, a complete and final solution to the underlying problems and risks that original drove the need to regulate in this area.[734] The enrolment of directors provides an addition nexus of oversight which can complement the efforts of other parts of the regulatory apparatus.

Finally, it is unclear what, if anything, is gained from reducing the roles and responsibilities of the board of directors. Perhaps the only meaningful result of such action would be to more explicit demarcate that the responsibility for the governance of the fund lies exclusively with the national financial regulator.[735] In such case, only public monitoring solutions (e.g., product regulation) are available to address the governance challenge. Where, however, the government has decided not to implement product level regulation, as is the case with private funds, or where regulatory resources are inadequate to internalize the formerly "outsourced" oversight functions, undermining or excluding directors from the regulatory process achieves little.

Critics will correctly point out that independent directors, in and of themselves, do not function as an absolute bar on fraud or malfeasance. During the recent global financial crisis, there were frequent incidents of governance failures in firms that possessed one or more independent directors. However, since no regulation or enforcement mechanism or structural solution would pass such demanding scrutiny, it would be unproductive to dismiss independent directors out of hand simply because they do not offer a perfect solution.

Instead, their limitations must be recognized and addressed as part of implementing this private monitoring solution. If there is a concern about the time constraints on independent directors, then steps must be taken to insure that compensation for serving in that role is sufficient to cover the anticipated duties expected. If there is concern over lack of adequate information being provided, then independent directors with sufficient credentials and experience should be selected in order to ensure that proper and timely requests are being made of the fund manager and other service providers. One particularly effective way to

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[732] Ibid. at 176.

[733] See Section 1.9 and 5.2 above.

[734] See Clarke 75 ("Board independence does not, of course, guarantee corporate success").

[735] See Ibid. at 208 ("The 'product' structure, compared to the 'board' structure, of mutual fund regulation makes clear that investors are purchasing services from an investment management firm. The buck stops with the government regulator . . . ").

coordinate and reinforce the actions of independent directors is to have them select and retain their own independent counsel, who could provide them with legal advice independently of the law firm advising the fund and the fund manager.[736] Having addressed these shortcomings, tasks that could otherwise prove too challenging, such as valuing "hard to value" assets, would be easier for boards to oversee.

7.7 Conclusion

The fundamental responsibility of fund directors, whether in a Company PIF or as the board of directors of a corporate general partner of a Partnership PIF, is to ensure that fund participants receive the benefits that they are entitled to as investors. The fund documentation creates binding obligations on the fund manager,[737] and reasonable expectations that the fund will be operated in a particular way. The ongoing performance of the fund, as well as any proposals put forward by the fund manager to change or alter some aspect of the fund's policies or procedures, must be evaluated by fund directors in light of these benefits to which the investors are entitled.

An independent and responsive board of directors can be an effective means of addressing the governance challenge by ensuring that the fund manager is subject to regular monitoring and oversight. Unlike a side letter, which serves to protect only the investor who was able to obtain those contractual concessions,[738] the benefits of an effective board are enjoyed by all fund participants.

Independent directors can provide specialized advice and expertise to the manager-appointed directors, while also monitoring the decisions made by the manager. Although the role of independent directors has not been without its critics, the absence of conflicts in an independent director can facilitate a fuller consideration of complex or troublesome critics. Further, the extent of the criticism is notably only that perhaps independent directors do not provide quite all of the benefits that their most committed supporters claim. No critic has argued that, in fact, their presence actually undermines corporate governance.

Importantly, in order to accomplish and enhance the governance process, independent directors need their fund's managers to provide them with full and adequate information about the state of the fund and the presence of potential conflicts. By serving effectively in their "watch dog" role, independent directors can, in turn, provide fund managers with a more responsible alternative than detailed, prescriptive regulations.

In addition, the proper operation of a board of directors can have equal relevance to Partnership PIF, with a corporation established to serve as the general partner.[739] Section 17-1101(0) of DRUPLA permits the provisions of a limited partnership agreement to expand or restrict a partner's, or other person's, duties (including fiduciary duties). As a result, parties to a limited partnership can agree to modify the default rules concerning fiduciary duties that would otherwise apply.

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[736] US mutual funds have benefited significantly in recent years from the use of independent counsel by independent directors. See, e.g., Geoffrey Hazard and Edward Rock, "A New Player in the Boardroom: The emergence of the Independent Directors' Counsel," Scholarship at Penn Law, Paper 6 (2004) available at lsr.nellco.org/upenn_uws/6; and James D Cox, "Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel," 48 Villanova Law Review 1077 (2003).

[737] See Section 2.2 above.

[738] See Chapter 6 above.

[739] See Section 2.7.2 above.

For example, a partnership agreement could instead contain a specific acknowledgement by the limited partners that the officers and directors of the corporate general partner owe duties both to the partnership and to the general partner, together with an agreement that those individuals will not be liable to the partnership for actions that they took in the good faith belief that the corporate general partner was acting in a manner consistent with its duties to the partnership. As discussed above, a similar approach should also work in the case of English limited partnerships.

Unfortunately, the most that strengthening the role of independent directors on a fund's board can accomplish is an attempt to address the governance challenge in that particular fund. Fund investors will still need to consider the unresolved governance issues of each prospective fund separately, to determine whether there is adequate independence at board level or, alternatively, that a side letter can be negotiated to provide sufficient protection. Accordingly, in the next chapter I will examine the manner in which the admission to listing of private investment funds on a recognized exchange can provide a means to address the governance challenge in a similar way across a significant number of funds.

Chapter 8
Listings of Private Investment Funds as Means of Mitigating the Governance Challenge

8.1 Introduction

The third means by which the governance challenge can be addressed is by the listing of one or more fund vehicles on a regulated exchange. This can allow fund participants to harness the regulatory power of a private securities exchange, and indirectly the state-based regulator that oversees it, for the purpose of enforcing certain rules that would be applicable to the fund upon listing. Although such oversight and monitoring can still be subject to the practical limitations of motivation, expertise and resources noted in earlier chapters, regulating a fund's corporate governance through adherence to listing rules (rather than through further bespoke legislation such as AIFMD, as discussed earlier[740]) can be an effective means by which to overcome the governance challenge, subjecting the fund to a detailed initial and ongoing compliance obligations.

At first sight, it might appear that this solution is limited to those funds that require the liquidity provided by secondary trading. The central function of a stock exchange is to serve as a means by which securities can be converted into cash.[741] However, liquidity is not its only function. Appraising the value of a security necessarily requires a flow of adequate and current information about the security and its issuer. As a result, exchanges have developed requirements that certain information is made public at the initial listing of the security, as well as ongoing disclosure by the issuer for the duration of the period that it is listed. Academic research has demonstrated that issuers gain valuation premium from listing in markets and on exchanges with superior regulatory functions.[742]

Private investment funds have recognized for many years the advantages that listings can provide investors beyond liquidity. Many funds which do not require secondary liquidity, either because the funds are open-ended or because the investors view the funds as part of a long term investment strategy whereby their proceeds will be distributed to them when the underlying portfolio companies are realised, still obtain listings on exchanges in order to voluntarily submit themselves to limited oversight by a third party. As a result of certain legal or regulatory limitations, some investors may be prohibited from investing in a private investment fund if those securities (e.g., shares) are not listed on regulated and recognized exchange. Even if not subject to formal restrictions, some investors value the oversight provided by the regulated stock exchange and the access to more regular announcements and information from listed funds.

As Berle and Means originally pointed out several decades ago:

> [T]he ideal situation – that of constant running disclosure of all information bearing on value being of course necessarily unattainable. It can, however, be approximated . . .[743]

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740 See Chapter 4 above.

741 Berle and Means at 255.

742 See, e.g., John C. Coffee, Jr., "Law and the Market: The Impact of Enforcement," 156 University of Pennsylvania Law Review 229, 305 (2007).

743 Ibid. at 259. For further discussions on the value and limitations of disclosure, see Section 6.7 above.

The disclosure requirements imposed by an exchange on the issuer relate to information which it has in its possession that would not otherwise be readily uncovered by current or prospective investors.[744] Such disclosures cannot be presumed to provide all of the information necessary for any decisions which need to be made. However, the information adds to the mix of fact and opinion already available and can function as a means to "level the playing field" between different parties with different levels of access to such information.

By creating a "market in information," stock exchanges can serve as informational intermediaries, and facilitate the creation of a more substantive relationship between issuer and security holder.[745] The role of any informational intermediary cannot be a total solution, as they cannot serve as a guarantor of the completeness of the information that they receive and circulate. However, they can increase the amount of accurate information in investors' hands over time.[746]

Upon listing, both the fund itself and the fund's directors will be responsible for ensuring that the fund complies with the continuing obligations imposed by the rules of that stock exchange. In essence, such funds "opt in" voluntarily to a regulatory and oversight regime that subjects them to a higher standard of behaviour that they would subject to operating on their own. Importantly, the benefit of such higher standard is shared pari passu among the fund's investors, unlike the case of side letters, which primarily benefit only the investor who obtains such letter agreement. Also, the listing requirements can provide for a consistent basis of comparison across a number of private investment funds, rather than requiring a fund participant to analyze, for example, status and operation of each particular fund separately. Breaches of the listing rules can lead to the exchange imposing sanctions on the fund or the fund's directors, such as financial penalties, or a public statement censuring the fund, such as a temporary or even a permanent de-listing of the fund's shares. Fund investors may take comfort from the increased information flow that results from such oversight.

In this Chapter, I will analyze the role that exchanges could play in addressing the governance challenge. I will describe several key aspects of the listing regime for funds on the Irish Stock Exchange (ISE), the leading exchange for hedge fund listings, including general obligations of disclosure and communications with fund participants. Finally, I will examine other exchanges and the approach they have taken towards private investment funds.

8.2 **Regulatory Functions of Exchanges**

The regulatory function of securities exchanges, in addition to their ability to set prices and provide liquidity, has long been recognized.[747] The scope of such regulation can include disclosure requirements and standards of conduct. In recent decades, we have increasingly witnessed the regulatory function of exchange shift towards government regulators, whether in the name of harmonization or increased effectiveness.[748]

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744 Ibid. at 278.

745 See Easterbrook and Fischel at 96 ("Markets in information are one way to induce people to act as if they are in a relation with repeat transactions, even when they are not.").

746 Ibid. at 292-293.

747 See, Paul G. Mahoney, "The Exchange as Regulator," 83 Virginia Law Review 1453 (1997): Stavros Gadinis and Howell E. Jackson, "Markets as Regulators: A Survey", 80 Southern California Law Review 1239 (2007).

748 Mahoney at 1457 ("[F]or most exchanges, comprehensive governmental regulation of rules and procedures is a twentieth-century phenomenon. For most of their history, then, exchanges have been the primary regulators of securities markets.").

Importantly, in the absence of uniform, top-down regulations, independent exchanges, developing and implementing their own rules, can potentially respond more efficiently to new development and update their rules accordingly. As one commentator noted:

> Given the difficulty of determining optimal rules, a system of competing markets should do a better job of furthering investor welfare than a system in which a regulator creates and enforces uniform rules.[749]

And where a regulator has not adopted any rules, such as with the case of private investment funds, securities exchanges would be the only institutional alternative for attempting to determine optimal rules. In adopting the rules for the exchange, the exchange's members will look to promulgate and enforce rules that are most attractive to investors. Without investors willing to support the issuers listed on an exchange, the exchange would find itself with few issuers wishing to be listed.[750] As a result, listing rules promulgated by exchanges historically included provisions that provided protection against fraud, manipulation and other similar risks.[751]

Ultimately, state regulation, such as the Securities Act of 1933 in the US and the Prospectus Directive in the EU, supplanted exchange listing rules as the primary basis for the oversight of listed companies and replaced them with top-down, centrally mandated listing rules. But the ISE's listing rules on investment funds provides a unique alternative to state regulation, which is largely absent for private investment funds. But can an exchange's rules be effective without the overt involvement of the state? As one commentator observed:

> Exchanges have strong incentives to provide rules of market structure that their investors want and to compel adherence by their members to contractual and fiduciary obligations.[752]

When an exchange admits a security, it signals to prospective investors that such security is worthy of investment. This was supported by placing initial and ongoing disclosure requirements on issuers in order to assure investors that there would be a regular flow of information to term regarding each issuer and their securities.[753]

Historically, enforcement of these rules and regulations was primarily through contract, and termination of the listing was the strongest sanction.[754] Over recent decades this private, contractual sanction has been supplemented by detailed financial regulation. An exchange, therefore, could establish a reputation among investors and issuers for particularly high

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749 Ibid. at 1456.

750 See Ibid. at 1459 ("Self-interested stock exchange members will produce rules that investors want for the same reasons that self-interested bakers produce the kind of bread that consumers want.").

751 Ibid. at 1462.

752 Ibid. at 1500.

753 See Gadinis and Jackson at 1247 ("To maintain a high-quality marketplace, exchanges also focused on establishing criteria to determine which stocks they were going to admit and ensuring that investors received appropriate information as to the characteristics of each stock. Thus, exchanges put in place a signalling function: a stock admission to listing indicates to investors that the stock is worth its investment. To enhance this perception beyond the initial listing stage, exchanges gradually required listed companies to offer ongoing disclosures on their business activities, their investments, their obligations, and their future plans.").

754 Ibid. at 1248.

standards for its listings of certain securities or certain types of companies,[755] as, for example, the ISE has done over the past two decades in the area of hedge funds.

Since private investment funds sit outside most state-based financial services regime (e.g., the Prospectus Directive), to the extent that an exchange, such as the ISE, decides to establish its own regime for admission to listing, that private regime will be analogous in many important respects to the historic self-regulatory position that many exchanges had previously enjoyed.[756]

Clearly, over the years a number of examples have arisen where self-regulatory organizations (SROs), such as exchanges, have failed in their supervisory mission.[757] However, as discussed above,[758] not all self-regulation is equal, and there are different approaches to the enrolment of private actors into a regulatory function that can be considered.[759] In light of the highly technical nature of many private investment funds' investment objectives, and their non-retail investor basis, exchanges could have an increased role[760] in providing oversight for such funds, in the absence of direct state-based regulation.

Importantly, when private investment funds are admitted to an exchange such as the ISE, there is no trading of fund shares, units or interests on the exchange. As such, one of the largest concerns that can arise about the regulation of exchanges, whether by the state or by a SRO, does not arise in this context. Since the exchange does not provide for secondary trading, and therefore provide for liquidity and price-setting for the issuer and the market, concerns over insider trading,[761] for example, do not exist. To date, the ISE has played a largely unique role in providing "no trading" listings for hedge funds and certain other similar investment vehicles. There is a proven market-based desire for the regulatory services that it provides. As a result, it is worth examining in more detail, the nature and scope of the ISE's approach to private investments before analyzing how that role might be expanded and updated to better address the governance challenge.

8.3 **Irish Stock Exchange**

The ISE has become a leading platform for listing investment funds structured as offshore companies.[762] The popularity of the ISE as a listing venue for private investment funds,

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[755] Ibid. at 1248. ("These rulemaking, monitoring, and enforcement efforts allowed stock exchanges to develop a brand; listing on the NYSE, for example, confirmed that an issuer was able to meet some of the highest corporate standards on a global scale.").

[756] Ibid. at 1250 ("Stock exchanges had strong incentives to provide a regulatory framework for the operation of an organized market, and government authorities similarly had strong interests in sound regulation for the securities industry.").

[757] For a short discussion, see Ibid. at 1256.

[758] See Section 1.9 above.

[759] See Sections 1.9 and 5.2 above.

[760] Ibid. at 1298 ("Self-regulation has significant benefits for the oversight of securities markets. In comparison to government agencies, stock exchanges have superior technical expertise regarding marketing operation, provide a consensual process for disciplining their members and listed companies, and transfer the cost of regulation from the tax payer to the industry.").

[761] See, e.g., Utpal Bhattacharya and Hazem Daouk, "The World Price of Insider Trading; The Journal of Finance, Vol LVII, No. 1, p75 (2002); and Laura Beny, "A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading", Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series, Page 264, http://isr.nellco.org/harvard_olin/264.

[762] See, e.g., Ellen Kelleher, "Dublin Finds Hedge Fund Favor", Financial Times (January 16, 2011) (available at www.ft.com/intl/cms/s/0/931390fa-2012-11eo-a6fb-01144feab49a.html). It is estimated that as many as 680

especially considering that such listings do not provide for a liquid secondary trading market for a fund's shares or units, can be seen in part as a means by which investors and fund managers have found a regulatory 'half-way house' between the full breadth of freedoms inherent in forming fund vehicles in lightly regulated offshore jurisdictions and the demanding rigours of being registered as a public mutual fund in most onshore jurisdictions.[763] The fact that fund managers and fund participants have engaged, on their own initiative, the ISE to play a quasi-regulatory role means that the underlying viability of this private monitoring solution has been validated and it is worth exploring in greater detail.

An ISE listing provides private investment funds with a predetermined scope of regulatory oversight that can satisfy the desires of fund investors for increased procedural safeguards. As noted above, what is unique about an ISE listing for a hedge fund is that no trading will typically occur through the exchange for the fund's units. Such transactions would remain off exchange, primarily through the mechanism of subscription and redemption with the fund itself. By contrast, the current listing rules on many established exchanges, such as the LSE and the NYSE for primary listed investment entities have historically contained numerous provisions which act as barriers to the listing of certain private investment (e.g. private equity funds), such as the prohibition on exercising control over portfolio companies and requiring the board of directors of listed vehicles to be independent of the fund manager.[764]

Obtaining a listing for a private investment fund on the ISE delivers two key benefits to the sponsors of such funds:

(a) increasing a fund's potential investor base, where legal or regulatory constraints applicable to certain institutional investors can mean that they are prohibited from investing in "unlisted securities"; or

(b) providing publicly available information for investors, as announcements made by listed funds are reported through the ISE information service.

In 1998, the ISE codified its rules for listing investment funds and published 'Investment Funds: Listing Requirements and Procedures' (the 'ISE Listing Rules'). The ISE Listing Rules provide for a number of fund structures to be listed, such as hedge funds, funds of funds, feeder funds, property funds, and venture capital funds. The most common legal structure for listed funds is a limited company, although unit trusts and limited partnerships may also be listed.

An over-arching theme of the ISE Listing Rules, which particularly resonates when considering the governance challenge in private investment funds, is the equal treatment of investors. Accordingly, the general requirements[765] which must be addressed in order to be listed on the ISE include:

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hedge funds are listed in Dublin, representing about 7% of all funds, but representing assets under management of over $1.2 trillion, a substantial proportion of global hedge fund assets. Ibid.

763 Jonathan R. Macey and Maureen O'Hara, "Regulating Exchange and Alternative Trading Systems: A Law and Economics Perspective", 28 Journal Legal Studies 17, 22 (1999) ("[B]y listing on a stock exchange, a firm can reduce transaction costs by opting into a panoply of rules that govern the activities of stock exchange members.").

764 See DP06/6 at 85.

765 As a general rule, a fund which has been authorized by the Financial Regulator in Ireland will be deemed to have fulfilled the ISE's requirements in relation to eligibility. For other funds, there are a number of issues to be considered in assessing the suitability of a fund for listing on the ISE.

(a) all shareholders within the same listed share class must be treated equally (e.g., be charged the same fees and have the same voting rights and entitlement to dividends);

(b) shares of a listed fund must be freely transferable and may not be subject to compulsory redemption provisions except where the holding of the shares may result in regulatory, legal, taxation, or other material disadvantage to the fund or its shareholders as a whole; and

(c) a listed fund is required to have at least two directors who are independent of the investment manager and the directors must collectively have appropriate and relevant experience and must take responsibility for the information contained in the listing particulars/prospectus.

Importantly, these requirements build upon, and expand the scope of benefit of, the previous structural approaches to addressing the governance challenge discussed above.

As the ISE has historically been the exchange of choice for listing hedge funds, an examination of its rules can provide an introduction to the types of obligations that can be readily imposed on private investment funds. Observance of the continuing obligations ensure that holders of listed units (unitholders) have simultaneous access to the same information and are kept informed of developments in the nature and conduct of the activities of the listed fund. The continuing obligations requirements cover a number of subjects relevant to the governance challenge faced by private investment funds:

(a) general obligations of disclosure;

(b) notification of interests and key developments; and

(c) communications with unitholders.

Each will be discussed separately below.

8.4 General Obligation of Disclosure

The ISE Listing Rules contain a series of rules that provide for a broad obligation on the part of a listed fund to provide information to the ISE and to fund participants. These rules apply to any fund listed on the ISE and are in addition to both the law governing the legal vehicle constituting the fund (e.g., Cayman company law)[766] and the law and regulations applicable to the fund manager (e.g., for a manager located in London, the FSA's enforcement of European directives such as MiFID and AIFMD).[767]

Generally, a listed fund must promptly notify the ISE of any information which is necessary for the unitholders and the public to appraise its financial position. No information provided to the ISE may be passed on to a third party until the ISE has been notified, except in limited circumstances.[768] A listed fund must notify the ISE of any major new developments in its activities which are not public knowledge and which may lead to a substantial movement in the

766 See Section 2.4 above.

767 See Section 3.5 above.

768 'Investment Funds — Listing Requirements and Procedures of the Irish Stock Exchange', August 1998 (the 'ISE Listing Rules'), Section 8.1.

price or net asset of its units.[769] Any change of which the directors are aware in the financial position, performance, or the expected performance of the listed fund where knowledge of the change would lead to a substantial movement in the price or net asset of the units must similarly be notified to the ISE.[770] Since a listed fund must ensure equality of treatment for all unitholders who are in the same position,[771] a listed fund must notify the ISE of any proposal to, or development which may, vary the class rights of unitholders.[772]

Certain narrow exceptions to these strict disclosure rules are permitted in limited circumstances. Where the directors of a listed fund consider that notification of such information required might prejudice a listed fund's legitimate commercial interests, the ISE may, upon application, grant a dispensation from the relevant requirement.[773] A listed fund may give information, without notifying the ISE, in strict confidence to the advisers to a listed fund, to parties with whom a listed fund is dealing, to persons with whom it is negotiating any commercial, financial, or investment transaction, or to any regulatory or statutory body.[774] A regular flow of information from the fund and the fund manager to all fund investors on a predetermined basis (rather than ad hoc under a collection of disparate side letters)[775] can serve to better ensure that investors have the relevant basis to make any necessary decisions concerning their participation in the fund.

8.5 Notification of Interests and Key Developments

A fund participant's ability to monitor the actions and decision-making process of the fund manager is an important element of effectively addressing the governance challenge. The ISE Listing Rules establish several requirements which support and foster this flow of information. The extent to which either the fund manager or directors of the fund or any related parties thereto owns shares of fund will often be relevant to investors' views on the fund and its prospects. Accordingly, a listed fund must notify the ISE of certain information relating to interests in listed units, of which the listed fund, its directors, or fund manager are aware, including:

(a) any interest of any director of a listed fund, including any connected person in the units of a listed fund; and

(b) any interest of the investment manager in the units of a listed fund.[776]

Fund investors will also frequently desire notification of key operational developments of the fund, in order to better understand the full extent of and changes to the fund's investment

[769] ISE Listing Rules, Section 8.2.

[770] ISE Listing Rules, Section 8.3.

[771] ISE Listing Rules, Section 8.11. This rule can raise particular difficulties when negotiating side letters with an investor in a listed fund.

[772] ISE Listing Rules, Section 8.13.

[773] ISE Listing Rules, Section 8.4.

[774] The directors of a listed fund must be satisfied that any recipients of such information are aware that they may not deal in the units before the relevant information has been made available to the public. ISE Listing Rules, Section 8.5.

[775] See Chapter 6 above.

[776] ISE Listing Rules, Section 8.10.

activities. As a result, the ISE Listing Rules require that a listed fund notify the ISE of the following information relating to the operation of a listed fund:

(a) any proposed or actual material change in the general character or nature of the operation of the listed fund, including changes to the investment policy or investment, borrowing and leverage restrictions;

(b) any material change in tax status;

(c) any general suspension of redemptions, transfers, or calculations of net asset value;

(d) any change in fund manager, custodian, administrator, registrar, or transfer agent;

(e) in the case of a company, any change in directors or material change in any director's function;

(f) any change in the minimum subscription;

(g) any change in the valuation policy;

(h) any material change in the listed fund's constitutive documents;

(i) any proposal to change the open or closed ended status of the listed fund;

(j) notice of any annual general meeting or extraordinary general meeting; and

(k) any change in the financial year end of the listed fund.[777]

The information supplied to the ISE above covers numerous topics that would be of interest to an investor concerned about addressing the governance challenge. Such notifications are similar in many respects to the information provisions often obtained by significant institutional investors in their side letters,[778] and could serve as an early warning of investor protections concerns in development. Although many of these notification events can be requested in individual client side letters, the benefit of having them in listing rules would be that notification is made to all fund investors simultaneously, thereby decreasing the likelihood that certain investors may be disadvantaged against other investors. Certain of the above matters must be referred to the ISE for prior approval.[779] In addition, in exceptional circumstances, where any action proposed by or for a listed fund may lead to a substantial change in the nature and substance of a listed fund, the ISE may require that the proposal be approved by unitholders in advance.[780]

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777 ISE Listing Rules, Section 8.14.

778 See Chapter 6 above.

779 ISE Listing Rules, Section 8.15.

780 ISE Listing Rules, Section 8.19.

8.6 Communication with Unitholders

For the governance rights of a fund participant to be effectively exercised, he or she needs to receive adequate information about the choices he or she is expected to make. Accordingly, the manner in which his or her consent is solicited and obtained is the final step in exercising oversight in connection with addressing the governance challenge, and the ISE Listing Rules establish a detailed procedure for such communications. In order to obtain the approval of unitholders, the ISE Listing Rules mandate that a listed fund must send a circular to unitholders in a prescribed form. [781] Any circular must be sent to the unitholders at least 15 business days before the date upon which it is proposed or scheduled that unitholders will vote or otherwise take action in respect of the proposals outlined in that circular.[782] A listed fund must ensure that all the necessary information are available to enable unitholders to exercise their rights. In particular, the fund must:

(a) inform unitholders of meetings which they are entitled to attend;

(b) enable them to exercise their right to vote, where applicable; and

(c) notify the ISE or distribute circulars to unit holders providing information on key issues of concern to them, such as the allocation and payment of dividends, or the issue of new units.[783]

A proxy form must be sent with the notice convening a meeting of unitholders to each unitholder entitled to vote at the meeting, and such proxy must provide for two-way voting on all resolutions intended to be proposed at the meeting.[784] A listed fund must forward to the ISE a copy of all circulars and reports to unitholders, as well as all resolutions passed by unitholders other than resolutions concerning ordinary business at an annual general meeting, without delay after the relevant general meeting.[785]

8.7 Addressing the Governance Challenge

By operating on a non-compulsory, "opt-in" basis, an ISE listing provides a potential market oriented solution to the governance challenge by giving prospective investors and fund managers the ability to obtain more effectively a complete package of disclosure and notification requirements. Exchange listing rules can utilize a "comply or explain" model[786] that would enable listed companies greater flexibility that traditional, mandatory regimes, which encourage a "box-ticking" mentality that can undermine the ultimate effectiveness of the rules. Further, "comply or explain" acknowledges and accepts that one size does not fit all.

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[781] If the proposal is to be voted on at an annual general meeting of a listed fund, the contents of the circular may be incorporated in the directors' report circulated to unitholders in advance of such a meeting. ISE Listing Rules, Section 8.20.

[782] ISE Listing Rules, Section 8.23.

[783] ISE Listing Rules, Section 8.25.

[784] ISE Listing Rules, Section 8.28.

[785] ISE Listing Rules, Section 8.32.

[786] See Section 1.4 above.

A key role of the ISE is to provide all fund investors with relevant information about the fund, its performance, and its service providers.[787] Such information can empower some or all of the fund investors to monitor the fund manager's ongoing performance, notably in terms of whether or not the investment strategy being pursued is successful, but also for early warning signals that the fund manager may be in breach of duties owed to the fund. Where indications arise that raise questions over the full compliance of the fund manager with such duties, steps can be taken to ensure that the board of directors of the fund, or the general partner of the fund where the fund is organized as a limited partnership,[788] are adequately informed of, and focused on, the developments in light of the fiduciary and other duties that they owe as directors.

Obtaining a regulated listing on an exchange such as the ISE can be seen as a more efficient means of obtaining a type of 'multilateral side letter',[789] whereby additional requirements are brought to bear on the fund and the fund manager outside of the fund's constituent documents for the benefit of all investors. In addition, as they ultimately benefit all investors in the fund equally, the continuing obligations of the fund can be used as a basis for providing the independent directors with adequate information on which to act when needed to protect the rights of shareholders.

By voluntarily including a neutral third party — such as a securities exchange — in the overall fund structure and tasking that person to perform a pre-identified set of regulator-like functions, adequate monitoring of the fund manager by the fund investors is supported and weakness in the governance structure of the underlying fund vehicles can be addressed. Although the ISE has demonstrated the most success to date in fulfilling this adopted role, there is no reason that other securities exchanges could not implement one or more competing regimes and, in the process, address some of the ISE's current shortcomings (e.g. no effective regime governing private equity funds).

However, listing on a regulated exchange such as the ISE, in addition to addressing the governance challenge, will impose procedural burdens on the fund and the fund manager. Traditionally, though, one advantage that private investment funds have benefited from has been the ability to take actions quickly in response to recent developments. A listing of the funds units significantly limits that ability. Under the rules of many regulated stock exchanges, including the ISE, certain issues must be voted on by the shareholders before a fund may take any action. If the approval of shareholders is required on any matter, a fund must send a circular to shareholders. Both fund managers and fund investors will need to have adequate comfort that the gains made with respect to addressing the governance challenge by way of an optional listing do not result in restrictions being imposed on the fund that impede its ability to be commercially successful.

8.8 Developments with the London Stock Exchange

Although the ISE has maintained a leading position in the listing of hedge funds over the past two decades, other exchanges can and have taken steps to better address the needs of fund participants and fund managers in connection with obtaining listing for private investment

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787 The overriding obligation imposed is that the information necessary to enable the unitholders to evaluate the financial position of the fund and to avoid the creation of a false market in the fund's shares must be made public knowledge as soon as possible. If the fund is listed on more than one stock exchange, the fund must usually ensure that the same information is provided to each stock exchange.

788 See Chapter 7 above.

789 See Chapter 6 above.

funds. In 2007, the LSE launched a dedicated new market for both UK and non-UK domiciled specialized investment funds known as the Specialist Fund Market (SFM).[790] A 'Specialized Investment Fund' (SIF) is defined by the LSE to include single strategy funds, feeder funds, specialist sector funds, limited partnership structures, specialist geographic funds, and funds with specialist corporate governance structures. The SFM is, however, only be available to issuers of SIFs targeted at institutional, professional, and highly knowledgeable investors. Investment entities considering a transfer from the Main Market will generally be required to comply with any delisting requirements applicable in respect of the relevant market.[791] Issuers that wish to market such funds to a wider audience, including retail investors, continue to have access to the LSE's Main Market, and to the Alternative Investment Market (AIM), which has been successful in attracting investment entities, primarily property funds or other conventional investment funds. [792]

In order to be eligible for listing on the SFM an applicant must follow the initial and ongoing obligations as laid down in the LSE's Admission and Disclosure Standards and the FSA Conduct of Business Rules, which require that any applicant to the SFM:

(a) be categorized as a SIF targeted at institutional, professional, and highly knowledgeable investors;

(b) have its prospectus approved by the applicant's EEA Competent Authority, which will be the FSA (through the UKLA) for applicants whose home Member State is in the UK;

(c) apply to the LSE[793] for admission to trading on the SFM, which application must:

    (i) include a demonstration that the securities to be listed will be freely transferable and negotiable; and

    (ii) highlight relevant risk factors in any prospectus.

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790 The London Stock Exchange's Specialist Fund Market Guidance for Admission to Trading for New Applicants, (July 2007).

791 The development of the SFM can be seen as an attempt by the LSE to position London as the premier European listing venue for private equity and hedge funds in the light of the recent success of Euronext in attracting the listings of global private equity and hedge fund alternative investment fund powerhouses such as Kohlberg Kravis Roberts, Apollo Management, Boussard & Gavaudan, and Marshall Wace utilizing the more flexible European Union listing regime, which includes significantly more flexibility with respect to disclosure requirements as well as legal and corporate governance structures. See James MacKintosh, "Exchange joins fight to host alternative funds," The Financial Times (12 July 2007).

792 Prior to the launch of the SFM, funds seeking a London listing had three main options:

(a) a primary listing on the official list under Chapter 15 of the Listing Rules,

(b) an AIM listing, or

(c) a secondary listing on the Official List under Chapter 14 of the Listing Rules.

793 Investment entities that wish to transfer from AIM to the SFM are required to produce a prospectus in line with the rules governing the publication of prospectuses as in the jurisdiction of the relevant home EEA Competent Authority and following approval by such body passported into the UK prior to the application to the LSE for admission to trading on the SFM. In addition such investment entities may also be required to produce a prospectus in connection with admission to the SFM in line with the rules governing the publication of prospectuses as in the jurisdiction of their relevant home EEA Competent Authority, unless an exception applies as set forth in the EU Prospectus Directive and relevant implementing legislation.

The SFM provides a potential competitor to the ISE in terms of its appeal to investors and managers of private investment funds. The SFM can accept a variety of sophisticated legal structures including limited partnership interests and non-voting share structures, allowing the flexibility to create structures that can comply with home country tax or securities laws while also allowing access to permanent capital.

Some institutional investors seeking to satisfy their concerns about the governance challenge may require issuers to apply additional elements of governance and regulation. Where this is the case, funds are able to provide additional tailored disclosures in their prospectuses. As with the ISE listing rules, the SFM rules foster a flow of information which concerned investors may use to better address the governance challenge, by detecting investor protection concerns at an earlier stage of development than otherwise might be possible. To date, however, there has only been a limited number of funds who have listed on SFM.[794] Its future, as a result, remains unclear.

8.9 Limitations on Effectiveness

A key element to any evaluation on the effectiveness of exchange listings as a possible solution to the governance challenge must include analysis of whether the exchange can enforce its rules and sanctions those parties who fail to comply. A review of the publicly available information from each of the ISE and the Central Bank of Ireland suggests that no enforcement actions or disciplinary proceedings were taken by either the exchange or the financial regulator during the period 2007-2010. Further, some critics have asserted that lax corporate governance in Ireland was a contributing factor to its recent economic unravelling.[795]

We must therefore consider whether such lack of internal limits on most proceedings reflects a monitoring failure on behalf of the ISE of such a degree as to deny them the credibility required to fulfil the role laid out for it in this chapter.

As noted earlier, however, the 2007-2009 financial crisis was not, at its core, a crisis emanating out of private investment funds, but rather other elements of the global financial system. Accordingly, it not necessary that there be any particular number of enforcement actions as involving ISE listed funds as a result of the crisis itself. Another potential criticism is that as the investors distance from a monitor (in this case, the exchange) increases, the power of the monitor increases as a result of the agency issues involved. In the case of independent board directors,[796] the independent director performs that role for that particular fund. Once we arrive at an exchange, we have a large organization performing a regulatory function for a large number of funds, and a very large number of investors. The governance of any one particular fund is necessarily going to be a smaller portion of an individuals' concern than in the case of either the fund participant with a side letter or the independent director.

However, we should consider the effects of regulatory competition between exchanges as a means to limit these concerns. Regulatory competition has occasionally been cast as providing either a "race to the bottom" or a "race to the top." Importantly, investors can, and

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[794] See list of funds admitted to SFM available at www.londonstockexchange.com/companies-and-advisors/stm/home/list-of-smf-securities.xls.

[795] See, e.g., Irene Lynch Fannon, "Corporate Governance and Ireland: The Birth and Death of the Celtic Tiger" (2009) (available at ssrn.com/abstract=1905593), although, notably, the focus excluded investment funds.

[796] See Chapter 7 above.

do, identify the added value that good governance and effective oversight provides to an issuer of security, and adjust their investment decisions accordingly.[797]

An exchange will benefit from having a reputation for a strong regulation, and other exchanges who are competing for listings will necessarily need to consider whether they should increase their standards in order to give prospective fund investors the level of protection they require. A useful place for such exchanges to look when considering possible changes to their listings rules would be the best practices statements and industry guidelines discussed earlier in Chapter 5. Notably, in the case of private fund listings, the exchanges compete solely by reference to the regulatory function, since the listing is not intended to create a trading market. As a result, effective oversight is centre stage in the decision-making process.

Also, it is worth noting that enforcement actions are just a single option, among many, that a regulator has. As one commentator noted when contrasting the low level of UK enforcement actions to the significantly higher level of US actions.

> [T]he FSA would no doubt counter that formal enforcement action is only one of the regulatory tools available to the FSA to deal with contraventions. Alternatives, which focus more on ex ante rather than an ex post approach to dealing with contraventions include supervisory action, team work and the policy consultation process. . . It would be rash to conclude, for example, that the low level of enforcement in the UK results in a lower level of compliance.[798]

No doubt the ISE would make a similar argument in its favour.

Importantly, the key factor that has lead to the prevelance of partnerships and offshore companies among private fund structures is their tax treatment. They have been selected for their use in spite of, not because of, their governance inadequacies. The ability to design a fund in order to best suit the commercial needs of fund managers and investors does not require as a prerequisite poor or inadequate governance mechanisms.

The tremendous success of the ISE as a listing venue for hedge funds demonstrates a proven desire among many market participants for heightened third party oversight that is not constrained by a one-size-fits-all, top-down regulatory mandate. The reputational capital of other exchanges could also be put to use performing this private monitoring role if demand were to sufficiently build. In the meantime, the ISE provides such services to the market.

8.10 **Conclusion**

Rather than requiring a prospective investor to "start from scratch" when examining a particular private investment fund to identify sources of governance risk and, thereafter, to adequately bespoke solutions to address that risk, the listing of such fund on an exchange can provide a consistent basis of comparison across funds of similar structures on domiciles or investment objectives. To the extent that the listings rules of such an exchange promote the equal treatment of investors and fosters the dissemination of accurate and timely information about

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[797] See, e.g., Daines.

[798] See MacNeil at 346.

the fund, fund investors will be better able to exercise their rights as equity-holders to protect their interests.

By voluntarily including a securities exchange in the overall fund structure and tasking that exchange to perform regulator-like functions, adequate monitoring of the fund manager by the fund investors is supported. Historically, however, many exchanges (e.g., NYSE) have not anticipated the listing of legal entities other than corporations, such as limited partnerships. As a result, governance standards drafted with corporate shareholders of operating businesses in mind will be inadequate to address the needs of investors in private investment funds. Such shortcomings will need to be addressed as, and when, more exchanges provide meaningful competition to the ISE.

Chapter 9
Evaluating and Implementing Private Monitoring Solutions

9.1 Introduction

The recent financial crisis has acted as an important catalyst for recognizing and prioritizing concerns about adequate governance structures in private investment funds. These concerns over the manner in which these funds are directed and controlled warrant a vibrant debate by academics and practitioners. This thesis establishes a conceptual framework with which to address such concerns to the extent that, and for so long as, they remain outside the scope of current financial regulatory regimes.

Raising new funds has become more difficult, and fund managers face more demanding investors,[799] with vivid memories of how many fund managers made free use of their broad powers into fund documentation to restrict investors options to either suspend investment activities or redeem/withdraw from the fund. Investors are increasingly willing to use whatever contractual and other rights are available to them in order to protect their interests.[800] Threatening and pursuing litigation against fund managers is now a ready tool for the disgruntled investor.[801]

Investors in private investment funds, and their agents serving either as directors on the boards of various fund vehicles or as the securities exchange on which the fund's shares or units have been admitted to listing, can address the governance challenge when adequately empowered with the information necessary to monitor the ongoing compliance of the fund manager with its duties and obligations to the fund and the effective means through the governance mechanisms of the fund to ensure that any breaches that may occur are remedied. In light of the current commercial realities of the industry, however, any success proposals made to address the governance challenge must be both pragmatic to adopt and practical to implement.

Prospective fund participants must overcome any remaining inertia or apathy, and acknowledge their obligation to themselves and their ultimate beneficiaries to fully negotiate their investments in these funds. Accepting terms offered on a "take-it-or-leave-it" basis will leave these problems unsolved.[802] Fund participants must also realize that the traditional mechanism for voicing displeasure towards a fund manager - refusal to participate in the next fund - is often an inadequate solution.

In sum, the three potential solutions identified herein would enable fund investors to better address the problems arising from the governance challenge by facilitating a better flow of information from the fund manager to the investors and their agents, while at the same time reinforcing the legally enforceable conduct standards applicable to the fund manager. Importantly, each private monitoring solution could be used either independently or cumulatively. An investor can agree side letter terms that are effective until such time as the fund is listed on an agreed exchange. Alternatively, an exchange could include a requirement in its listing rules that all listed funds must have a certain number of independent directors. Interwoven throughout each of these solutions is the ability to make reference to, or integrate

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799 See Preqin Study at 22.

800 Ibid.

801 See Sections 3.7 and 3.12 above.

802 See Section 9.5.4 below.

key features of, the industry guidelines and best practice documents that continue to evolve and develop in the marketplace.

Each private monitoring solution recognizes the commercial contexts in which private investment funds operate by emphasizing voluntary steps that fund managers and investors can take incrementally. They operate on an open-ended basis that facilitates learning and adaptation. Further, each focuses on the provision of accurate and timely information as the means to overcome the investment protection concerns that arise due to the collectivized nature of the private investment fund. Finally, each co-exists with the regime of direct government regulation within which private funds, their managers and their investors currently reside.[803]

Receipt of material new information provided through the private monitoring solutions discussed above must be acted upon by way of the rights embedded in the constituent documents of the fund, which may include special redemption rights, rights to suspend investments by the fund or other mechanisms to induce a full or partial "stand-still" on the fund manager. The reputational risk that some fund investors fear that will result from them being seen as "troublesome" must be measured against the obligations they have to their own beneficiaries to monitor and oversee the investments that they make.

Finally, it is important not only that the governance challenge be addressed, but also that good governance in private investment funds be visible and demonstrable. Such visibility is vital not only to the fund manager and its principals and agents, who may need to be able to demonstrated when called upon that they have fulfilled the legal and regulatory duties owed to the fund, but also to the investors in private investment funds and the financial markets as a whole. However, the private monitoring solutions are open to the criticisms that in order to be successful, these self-regulatory solutions must actually be adopted and implemented by the potential beneficiaries, which is not assured given that some fund participants have been disengaged from the monitoring role.[804]

In this chapter, I will provide critiques of the private monitoring solutions discussed above, as well as a critique of the recent regulatory reform's failure to address the governance challenge. Next, I will discuss the role that private actors, such as fund participants, can play in conducting pre-investment and post-investment due diligence on the fund and the fund manager to better establish a foundation for ongoing monitoring.[805] Finally, I conclude with an analysis of how the private monitoring solutions can be implemented in order to address potential criticisms.

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803 See Omarova at 698 ("Contrary to a common misperception, self-regulation is not identical to 'de-regulation'. The concept of self-regulation advocated here is a significantly more complex and flexible regime combing private rule-making by industry actors with direct government regulation."). See also Sections 1.9 and 5.2 above.

804 See, e.g., "Dumb Money and Dull Diligence," The Economist (December 18, 2008) (available at www.economist.com/node/12817637?story-id=12817637); Jason Zweig, "How Bernie Madoff Made Smart Folks Look Dumb," The Wall Street Journal (December 13, 2008) (available at online.wsj.com/article/SB122912266389002855.html).

805 By performing this role, private actors can demonstrate that they possess the regulatory capacity necessary to play a meaningful role in a regulatory regime, supplementing the top-down command-and-control authority of a financial regulator. See Section 1.9 above.

9.2 **A Critique of Private Monitoring Solutions**

In addition to the particular criticisms that might be made against each of the private monitoring solutions individually, which are discussed above in each chapter, more general critiques may also be made, which are discussed below. These criticisms will argue that private actors lack the ability or the means to protect their own interests, and as a result government regulation is the only feasible alternative if these issues are to be adequately addressed.

9.2.1 ***Regulation is More Effective than Private Action***

A potential criticism of the private monitoring approaches will be that top-down regulatory changes are best positioned to remedy the principal by-products of the governance challenge directly, thereby making the ability for investors to resolve these concerns themselves redundant. The renewed momentum for increasing the level and scope of regulation applicable to private investment funds and their managers would appear difficult to rebut. For example, after the G20 issued their joint communiqué at their April 2009 meeting, calling for greater oversight of large hedge funds, various legislatures and regulators duly followed on with white papers and detailed proposals.[806]

Critics will claim that the private monitoring solutions proposed herein do not guarantee a successful outcome in all circumstance. For example, the effectiveness of independent directors and direct oversight by shareholders have been challenged.[807] Further, it may be claimed that fund participants are insufficiently motivated or incentivized to negotiate adequate protections for themselves.[808] As one commentator has observed:

> The financial crisis is partly a story about the fallibility of industry actors in safeguarding their own enlightened self-interest, behaving rationally, and responding to (or perhaps even grasping) the systemic risk their conduct was generating. Considerable human experience in fact suggests that in the face of uncertainty, bounded human rationality has considerable presence.[809]

However, as national and international financial regulators debate comprehensive and far reaching changes to the global financial architecture, the adequacy of governance structures of private investment funds is not consistently prioritized as agenda item.

As discussed above, we are witnessing a renewed drive for comprehensive regulatory reform in the financial services industry,[810] while at the same time industry trade associations and other interested parties are continuing to develop anthologies of "best practices" which can be

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806 See Chapter 4 above.

807 See, e.g., Easterbrook and Fischel at 104-105. ("Neither independent directors nor a shareholder vote necessarily *ensures* that a particular transaction will increase shareholder wealth. Independent directors may be too uninformed to make intelligent decisions. Or maybe friendship in conjunction with directors' fees and a belief that the market won't notice "just this one time" lead them to play dead. Similarly, collective action problems may cause rational shareholders to vote in favor of a particular transaction even if it is wealth-reducing . . .") (emph. orig.). See Section 7.6 above.

808 Ibid. at 251-252. ("If the gains from private bargaining are small – perhaps because the legal rule is only slightly inferior to some alternative, perhaps it is sufficiently unlikely that events will bring a given legal rule into play, perhaps because the parties cannot appropriate all benefits of a new and better solution – people will not incur the costs of striking a bargain.").

809 Ford, "New Governance" at 136.

810 See Chapter 4 above.

promoted among fund managers and other informed parties as a form of non-compulsory self-regulation.[811] Unfortunately, neither Dodd-Frank nor AIFMD, nor any other pending regulatory reforms on either side of the Atlantic, has attempted to directly address governance issues.[812]

In the absence of legislative or regulatory actions, we must look to private actors, private law and the private monitoring solutions proposed herein.[813] The private law endeavours to provide aggrieved fund participants with causes of action which may be pursued through legal proceedings after such fraud or malfeasance comes to light.[814] By implementing one or more of the private monitoring solutions discussed in the prior chapters, investors can seek to solidify both (i) their potential causes of action against a fund manager should the need arise and (ii) their ability to better detect any "red flags"[815] at a stage early enough to effectively react and intervene to protect their financial interest.

The recent US and EU regulatory reforms clearly sought to close perceived gaps in the manner in which private investment funds and their managers are regulated.[816] However, private monitoring solutions, which can be implemented by agreement between the fund participants and the fund manager, will remain a practical and effecting means of addressing these concerns to the extent that further regulation is not introduced to directly resolve governance issues. Even if addressing governance issue in private investment funds were to become a priority policy goal of regulators, there are still practical issues that would potentially impede their implementation. Any policy decision to increase the amount or scope of regulation applicable to private investment funds contains within it an implicit, but equally important, practical decision to re-allocate staff and expertise away from other parts of the financial landscape (e.g. retail funds, mortgage lending) to private investment funds. Just as doubling the "cops on the beat" in Mayfair and Belgravia, at the expense of Bermondsey or Brixton, would prove highly controversial, so should similarly motivated decisions in the financial services industry.

Finally, this analysis of private monitoring solutions occurs in the context of a wider social and political debate about the appropriateness of shifting responsibility for longer-term financial security from the government to individual citizens.[817] In this light, a financial regulator can elect to focus its attention on regulating products or regulating processes. While the former can potentially limit the ability of firms to innovate and compete in a rapidly changing market,

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811 See Chapter 5 above.

812 See Section 4.12 above.

813 See Section 5.11 above.

814 See Sections 3.9, 3.10 and 3.11 above.

815 When fraud or malfeasance is uncovered in a private investments funds, it is common to focus on so-called "red flags" which are incidents or indicators from which it is clear in retrospect that there should have been cause for concern. Common "red flags" include:

(a) a manager's insistence on secrecy;

(b) incomplete information; and

(c) unanswered queries about fund operation or performance.

The Madoff affair is in many ways simply the largest and most notorious example of bad practices and inefficient governance structures which have been a feature of private investment funds from their inception. See Section 9.4 below.

816 See Chapter 4 above.

817 Gray and Hamilton, Implementing Financial Regulation at 187.

the latter would allow for a framework of rules that would co-exist with, rather than replace, market forces, leaving flexibility for product providers and consumers to make choices based on their evaluation of their needs and risks.[818] As a result, there will continue to be a space in the current legal and regulatory framework for private actors to use the private monitoring solutions to bolster and reinforce their private law rights.

9.2.2 ***Non-Retail Investors Cannot Protect Their Own Interests***

Another criticism of the private monitoring solutions would be that many so-called "sophisticated" investors, who may satisfy certain objective or subjective requirements necessary to be distinguished from retail investors,[819] still lack the ability to negotiate adequate protections and utilize effectively the information provided to them.[820] As a result, the private monitoring solutions may not be consistently effective in all circumstances.

Notably, however, this is in fact a larger critique of the basis upon which certain financial market participants are exempted from regulation. Of course, the alternative would be to have a single standard (i.e., retail) applicable to everyone in the financial markets at all times, regardless of their size or sophistication, and regardless of the nature of the product or service being transacted. And in such a regulatory scheme, the financial regulator would be less capable of prioritizing its limited resources to address the needs of the most vulnerable because all investors would rightly assume that, given their categorization as "retail" investors, the regulator would be policing their transactions and/or counterparties.

The decision to exempt certain individuals and institutions precedes the question of how such exempt persons should address the lack of regulatory oversight. Once that decision has been made, as it has in the US, the UK, across Europe and in industrialized countries around the world, the merits of the private monitoring solution can then be assessed.

9.2.3 ***Private Monitoring Solutions Lack Normative Content***

Another potential criticism of the private monitoring solutions is that they lack of normative content - in other words, they are a means and not an end. The private monitoring solutions provide alternate mechanisms for addressing the concerns that arise from disparate ownership of fund vehicles structured to resolve other, more pecuniary, issues, but do not themselves provide direction as to how best to exercise the grievance powers regained.

The same concerns that underline the governance challenges have led to appearances in recent years of sets of "best practices" or similar standards adopted by trade associations or ad hoc working groups rather than financial regulators, as discussed in Chapter 5. In part, the goal of these drafting committees has been to forestall more intrusive regulation on the private investment fund industry.

Importantly, the establishment and promotion of "best practices" standards can support and promote these private monitoring solutions by providing the private actors associated with these funds with more commonly understood "frames of reference", enabling the process of

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818 Ibid.

819 See Section 2.5 above.

820 However, experience is often a very good teacher, as some observers have noted. See Erik F. Gerding, "Law Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation," 2007 Wisconsin Law Review 977, 1023 (2007) ("The ultimate form of investor education, and the one most effective in preventing bubbles, appears to be the experience of participating in the rise and crash of a bubble.").

implementing the private monitoring solutions to be accomplished more efficiently. Of course, the mere publication of a document purporting to be industry best practice has only limited legal effect. Some further steps must be taken to give fund participants the necessary legal and equitable rights.

Unless these standards are adopted by fund managers in a binding manner, and fund participants have rights, directly or indirectly, against them for failure to comply,[821] where appropriate, these exercises will remain theoretical and abstract. Since by design these standards remain outside the formal, compulsory aspects of the financial services regulatory regime,[822] the most effective way to provide these standards legal effect is by way of changes to the underlying fund documentation[823] voluntarily agreed by the fund participants and the fund manager.

As discussed above, the MFA expressly states that the recommendations in the Sound Practices go beyond the requirements of laws and regulations[824] and further that they do not cover all of the legal requirements with which a hedge fund manager must comply.[825] Moreover, the PWG Committee and the MFA have each recognized the lack of specific modularity of their recommendations, and therefore acknowledge in their respective reports that some recommendations may not even be applicable to certain hedge fund managers and other recommendations may even have to be tailored to suit certain hedge fund managers.[826]

Since the recommendations are not legally binding on fund managers, there is no person or entity that is overseeing compliance therewith by fund managers and that has standing to enforce hedge fund managers to comply with any of such recommendations. In essence then, the Best Practices and the Sound Practices are self-elected programs for fund managers for which the hedge fund managers themselves are responsible to self-regulate.

It may be that some will be motivated to 'go beyond' compliance with their legal requirements and adopt some or all of the guidelines and standards. By their title alone, "best practices" and "sound practices" imply a sense of "doing the right thing". Thus, even the title is, on an implicit level, a way to encourage fund managers to adopt one or more of these recommendations simply by implying that it should agree to do what is 'right'. However, neither the Best Practices nor the Sound Practices nor the HFWG Standards nor the ILPA Guidelines have the binding force of law. They are simply recommendations and guidelines for the fund managers.[827]

Private monitoring solutions - whether one-dimensional (i.e., side letters),[828] two-dimensional (i.e., board composition and operation)[829] or three-dimensional (listing)[830] - can often be more

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[821] For example, pursuant to a claim for breach of contract. See Section 3.11 above.

[822] See Sections 3.5 and 3.6 above.

[823] See Section 2.2 above.

[824] Best Practices at 5.

[825] Best Practices at 12.

[826] See Sections 5.5 and 5.6 above.

[827] This is apparent on an initial reading, as the verb tense used is "should" or "should endeavour to " rather the mandatory "shall" or "must", as well as in each introduction to the Best Practices and the Sound Practices, where the MFA and the PWG Committee "strongly encourage" and "recommend" hedge fund managers to implement their proposals.

[828] See Chapter 6 above.

[829] See Chapter 7 above.

effectively implemented by reference to such standards, either in whole or in part. As a result, these "soft" standards can be given "hard" edges by incorporating them into the legal structure of the fund. By way of example, a side letter can include an undertaking that the fund is, and will remain, in compliance with particular sections of a set of "best practice". Alternatively, a board of directors could adopt an annual "comply or explain" statement to investors where the fund's fulfilment of the standards will be measured and explained. Finally, listing rules could be regularly updated to reflect, either explicitly or implicitly, changes in such "best practices" as they evolve over time.

By providing a legal foundation for industry practice standards, therefore, the private monitoring solutions analyzed in the preceding chapters can provide a legally enforceable basis for implementing such standards. In addition, potential investors can ask each fund manager seeking its investment for such fund manager's level of compliance with a particular set of standards as part of such potential investor's due diligence process. Investors can then evaluate the level of compliance and the areas of non-compliance of a fund manager and determine whether it is satisfied with the results and the reasons behind such decisions. In the event investors request reasons for non-compliance, fund managers should be prepared to explain the deviations.

Alternatively, the investment in a given fund could be conditioned on a fund managers' covenant to comply with identified practice statements and such covenant, depending upon where placed, could be a contractual obligation[831] enforceable by the investor counterparty. Therefore, abstinence or forbearance of investment is a tool that may used to "enforce" compliance with the recommendations. This would lead to all or a portion of the recommendations being incorporated by reference into contracts to which the fund manager is a party. This act by a fund manager would be tantamount to its voluntary obligation to comply with those recommendations so incorporated. Similarly, the threat of redemption after investment can be another tool used by investors to "enforce" compliance with the recommendations.

Proactively, each of the Best Practices,[832] the Sound Practices,[833] the HFWG Standards[834] and the ILPA Guidelines[835] create an avenue for the fund manager to identify itself (and perhaps single itself out from others) as noble and worthy of attention for having voluntarily adopted one or more of these practice statements. In agreeing to be accountable, the fund manager could incorporate the applicable provisions into the fund's organizational documents and offering documents. This step not only puts investors on notice of the fund manager's desire to comply, but would also create a contractual obligation of the fund manager which could be enforced by an investor in the fund.

By providing a legal foundation for industry practice standards, therefore, the private monitoring solutions analyzed in the preceding chapters can provide a legally enforceable basis for implementing such standards, and thereby contribute a normative basis that can

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[830] See Chapter 8 above.

[831] See Section 3.11 above.

[832] See Section 5.5 above.

[833] See Section 5.6 above.

[834] See Section 5.7 above.

[835] See Section 5.8 above.

evolve over time as industry participants address new concerns that arise in the financial markets.

9.2.4 *Substituting One Set of Agency Problems for Another*

As noted in Chapter 1, there are two means by which agency cost can be reduced: better alignment of interest of the agent and the principal (which is discussed below) and appointing a monitor to oversee and discipline the agent.[836] In this context, such responsibility has traditionally been given to the financial regulator.[837] A further critique, therefore, could be made that if there are agency problems related to government regulation of private fund governance, then similar breakdowns could occur in the context of the private monitoring solutions.

In the case of side letters,[838] the fund investor may not have the technical background or trained personnel to act upon the information it receives. Just as a regulator may not have the current, state-of-the-art expertise to "keep on top of" fund managers operating in new or particularly complex parts of the market, a fund investor who has obtained detailed side letter terms may not be able to effectively use the information it receives. A similar gap may also exist in the knowledge and background of an independent director.

In the case of both independent directors[839] and securities exchanges,[840] both involve a significant move away from the investor-as-monitor and towards increased reliance on parties further and further away from the investor. The paradox is then that an attempt to access expertise that the investor lacks by involving third-parties actually increases by some degree the risk of failures like have been identified above for state-based regulators because of the involvement of third parties who may not be as sufficiently incentivized as the investor to perform the monitoring. Ultimately, however, in the absence of regulatory action addressing governance concerns identified herein, the benefits of partial or incomplete actions outweighs the risks that arise from doing nothing.

9.2.5 *Economic Incentives are Sufficient to Ensure Adequate Governance*

For completeness, it is worthwhile to identify and address a countervailing line of argument that, in fact, nothing need be done to reinforce the position of investors in private investment funds. Investment funds succeed in their pursuit of their investment objectives in part by aligning their interest of the fund manager with the interests of the fund participants. As one commentator has observed:

> If either party fails to live up to the implicit bargain, the theory is that there is a reputational penalty. That is, investors who fail to satisfactorily reinvest in successful funds are quietly excluded from future funds. Meanwhile, fund managers who do not live up to norms of good conduct find that they cannot raise capital for the next fund.[841]

A good reputation is a valuable economic interest for both managers and investors.

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836 See Section 1.6 above.

837 See Sections 1.9 and 5.2 above.

838 See Chapter 6 above.

839 See Chapter 7 above.

840 See Chapter 8 above.

841 Harris, "Critical Theory" at 7-8.

Some could argue, therefore, that the simple reliance on economic incentives to deliver adequate investment returns can also provide an adequate solution to governance concerns by aligning the interests of the parties.[842] The presence of significant carried interest or performance fees distinguishes many private investment funds from their retail fund cousins.[843] As a result, critics could claim that the agency problem could be effectively addressed solely by aligning the interests of the fund manager with the fund participants by creating a collection of performance fee thresholds, high watermarks and hurdles that would sufficiently incentivize the fund manager to adequately protect and grow the value of the fund.

However, such incentive allocation can also encourage levels of risk disproportionate to the best interest of fund participants.[844] Effective governance mechanisms in such circumstances are a means to mitigate the effects of such a divergence of interest between the parties. Although the effects of the "one way bet" aspect of incentive allocations can be counter-balanced by requiring the fund manager to have significant sums of money at risk in the fund alongside of investors (thereby translating the fund managers participation into a "two way bet"), fund participants must still look to monitoring enrolments in order to construct a complete solution to the governance challenge.

Importantly, it should be noted that the hedge fund industry and the private equity industry have already established economic incentives such as described above as market standard terms. Observers would, in fact, be hard pressed to find any funds in either asset class that does not already have such alignments of interests already in place. Accordingly, based on the various governance failures discussed earlier in this thesis, such alignment is not in itself a complete solution to our concerns about the governance challenge. As a result, there is clearly more that can be done to supplement the benefits derived from the remuneration practices of private funds, The private monitoring solutions can perform that role.

9.3 **Recognizing the Limits of Regulators**

Just as no regulatory regime is complete and final,[845] no regulatory reform can be expected to totally eliminate the prior shortcomings or gaps. As one commentator has observed:

> [F]inancial regulation reform in an era of rapid technology–driven innovation is an inherently dynamic phenomenon. Conceptually, it should be viewed as an ongoing intellectual enterprise, a process of continuous collective deliberation and exchange of ideas, rather than a static set of rules enacted into law at any particular point.[846]

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842 See, e.g., Seth Chertok and Addison D. Braendel, "Closed-End Private Equity Funds: A Detailed Overview of Fund Business Terms, Part I," 13:2 The Journal of Private Equity 33 (2010); Robert C. Illig, "Hedge Funds: The Missing Link in Executive Pay Reform," 28:9 Banking & Financial Services Policy Report 10 (Sept 2009).

843 See, e.g., Peter R. Orszag, "The Taxation of Carried Interest," Congressional Budget Office Testimony before the US Senate Committee on Finance (July 1, 2007).

844 Ibid. at 10.

845 See, e.g., Katharina Pistor and Chenggong Xu, "The Challenge of Incomplete Law and How Different Legal Systems Respond to It" (January 2004) (available at www.sefhku.hk/zcqxu/publication/PX_Regulatory%Regimes_2-04.pdf).

846 Omarova at 678.

Although private investment funds have opted out of many aspects of the financial regulatory regime,[847] their managers, promoters and counterparties are frequently within the regulated sphere.[848] Most of the instances of fraud and governance failures that have been discussed herein have occurred in the context of a fund manager who is registered with the SEC or authorized by the FSA.[849] These entities were known to their regulators and subject to supervision and periodic review. Importantly, as noted above in the case of Madoff,[850] accusations and allegation had been repeated filed with the SEC and the SEC failed to take meaningful steps to investigate this registered investment adviser.

Ultimately, there will always necessarily be a gap between (a) the number of professionals in a financial regulator with the requisite level of skills, experience and sophistication and (b) the number of private investment funds active in the markets and soliciting prospective investors. Absent an attempt to prohibit such vehicles outright, this inability to have sufficient "police on the beat", especially in light of other investment protection failures involving mortgage lenders, banks and mutual funds which potential impact a vastly greater number of citizens, we must recognize that individuals contemplating investing in these funds are both best place and most motivated to ensure that the vehicles comply with desired standards of governance and investor protections.

The risk of "regulation for regulation's sake" is ultimately that it will lure investors into a belief that it is the regulator, rather than the investor himself or herself, who has ultimate responsibility for the initial and ongoing oversight of a fund and its manager. Rules without adequate staffing and continuous policing will be inadequate to ensure that investors' rights are adequately protected.[851] For example, as previously noted the information required to be provided as part of the Form ADV used to register investment advisers in the US is rudimentary and subject to material gaps. Investors who conduct even a basic due diligence exercise on the fund manager will often obtain much more relevant information than the Form ADV provides.

So what should be the appropriate role for "investor protection" in the context of private investment funds in light of other competing regulatory priorities? As one commentator has noted:

> Investor protection has traditionally been concerned with the defensive protection of the vulnerable investor against unscrupulous market participants.[852]

Despite the manner in which investor protection dominates the overt regulatory agendas of financial regulators across the globe, there are numerous different grounds on which regulatory action can be justified.[853] As one commentator has observed:

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847 See Section 2.5 above.

848 See Sections 3.5 and 3.6 above.

849 See Sections 3.8 and 3.10 above.

850 See Section 3.2 above.

851 See, e.g., Norman S. Poser, "Why the SEC Failed: Regulators Against Regulation," Brooklyn Law School Legal Studies Paper No. 132 (2009) (available at http://ssrn.com/abstract=1348612).

852 See Moloney, How to Protect Investors at 46 .

853 See, e.g., Ibid. at 45-92.

> 'Investor protection' has considerable intuitive appeal and dominates as a regulatory objective internationally. But it remains a controversial justification for intervention. Sharp distinctions arise between characterizations of investor protection as, for example, a threat to entrepreneurialism and efficient capital raising, as an expression of social virtues and as a moral imperative.[854]

Traditionally, investor protection focused on the vulnerable investor at risk of being defrauded by more sophisticated, and potentially less scrupulous, market professionals.[855] As discussed above, prospective investors who are permitted by marketing regulation to participate in private investment funds must demonstrate certain objective or subjective characteristics sufficient to distinguish them from the wider class of retail investors.[856] This is not to say, however, that those non-retail investors will necessarily always have negotiating parity with each fund manager. To require such parity as a condition of being exempted would leave few perfectly balanced counterparties to actually do business.

Therefore, it is important to acknowledge that informed investors who can effectively use the governance mechanisms built into the private investment fund vehicles themselves - as reinforced by the private monitoring solutions described above - can be better positioned in many instances to operate as an effective limitation on fund managers, than financial regulators who may lack the specialist expertise to correctly identify problems and shortcomings, and who must allocate their limited resources and headcount among numerous competing priorities.

9.4 Due Diligence as the Commercial Foundation for Private Monitoring Solutions

The approaches discussed above to resolving the governance challenge can be seen to sit alongside a longer-established and more widely recognized process that most investors in private funds purport to undertake prior to any investment - due diligence. As a result, many current and prospective fund investors will already have a commercial, non-legal foundation on which to implement the private monitoring solutions.[857]

The practice of due diligence (i.e., the commercial and legal review of a prospective private investment fund and its managers prior to investment) varies greatly in scope and depth from one investor to another.[858] Efforts have been made over the years to standardize the approaches among investors and across asset classes. Recent events, such as the Madoff debacle,[859] as well as the earlier meltdowns of Amaranth Advisors (2006) and Long Term Capital Management (1998), have highlighted the shortcomings of a limited due diligence based on untested presumptions and excessive confidence in the earlier efforts of other investors.

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854 Ibid.

855 Ibid.

856 See Section 2.5 above.

857 For an example of due diligence reviews in the context of hedge funds, see, e.g., "AIMA Launches New Due Diligence Questionnaires," Alternative Investment Management Association (12 April 2007) (available at www.aima.org/en/media-centre/press-releases.cfm/id/51A9EFBE-EISD-4CEC-83A88A2376C6F333).

858 See Schwarcz at 398 ("Under a market-discipline approach, the regulator's job is to ensure that the private sector exercises the type of diligence that enables markets to work efficiently").

859 See Section 3.2 above.

Importantly, the limitation on the type and number of prospective investors who may participate in a private investment fund discussed above is based in part on the belief that such persons can and will ask for and review relevant information about a fund's track record, compliance, controls and risk assessments.[860] Failure by a prospective investor to conduct such a review undermines the basis upon which such exemptions were originally conceived.

A due diligence exercise should be viewed as both a pre-investment and post-investment activity.[861] In addition to the ongoing monitoring of performance and its attributions, post-investment due diligence will be linked, whether implicitly or explicitly, to the governance structure of the particular fund. Of course, due diligence involves expenditures of time and/or money, and cannot be guaranteed in all circumstances to reveal all flaws or shortcomings in a prospective investment.

Each of the private monitoring solutions discussed above can also be seen as a means to ensure effective, post-investment due diligence continues over the duration of the fund investments. The approaches differ in the breadth of fund participants who benefit from the diligence efforts. Historically, due diligence has been seen as a separate process conducted by each investor for its own benefit, although there has been a growing trend in recent years towards standardizing and sharing the results of due diligence.[862] The process of entering into a side letter with a fund manager to provide information or other rights would be an effective means to secure the basis for ongoing oversight of the investment. It can also serve as a means to promote more effective governance. Broadening the scope of application out to include enhanced governance procedures at the level of a fund's board of directors, or for all funds admitted to a particular exchange, can similarly perform such a dual service.

Although it must be acknowledged that anticipated fund performance will always be the primary factor in selecting a private fund for investment,[863] the due diligence function can be expanded to analyse and address fund governance concerns as well. A well-governed fund with poor performance will appeal to few discerning investors. However, the risks to retaining a high return after a significant governance failure are substantial enough to warrant a reasonable allocation of time and attention to ensuring the appropriate private monitoring solutions are in place.

9.5 Implementing Structural Approaches

As Easterbrook and Fischel have noted:

> Investors in any venture are concerned about the possibility that the actions of others will reduce their return. Those who attempt to attract other people's money have incentives to adopt governance mechanism that respond to potential investors' concerns. . .[864]

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[860] See Section 2.5 above.

[861] See, e.g., Stephen J. Brown, Thomas L. Fraser and Bing Liang, Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy" (2008) (available at ssrn.com/abstract=1016904).

[862] See, e.g., Gökhan Afyonoğlu, "Due Diligence on Alternative Investments: An Institutional Investor's Perspective" (May 7, 2010) (available at ssrn.com/abstract=1631305).

[863] See, e.g., Robert C. Pozen, Betsy Palmer and Natalie Shapiro, "Asset Allocation by Institutional Investors after the Recent Financial Crisis," MFS White Paper Series (December 2010) (available at www.pa-papers.org/documents/Spring2011-MFSpaperforlibrary.pdf).

[864] Easterbrook and Fischel at 232.

As discussed in Chapter 1, corporate governance is the means by which transparency and accountability are effectuated within the management of a legal vehicle, such as a partnership or company. Both Partnership PIFs and Company PIFs provide scope for participants to negotiate and create bespoke solutions for governance issues, as they assess their importance in their particular circumstances.[865]

As more litigation arises as a result of the recent global financial crisis, the law relating to limited partnerships in Delaware and offshore companies in the Cayman Islands will continue to evolve. In the absence of comprehensive product-level regulation, these bodies of law are the principal source of law governing the relationship between fund managers and fund participants.

Any analysis of the effectiveness of the private monitoring solutions to address the governance challenge must be conducted with the understanding that in many cases some or most of the fund investors may be unable to obtain the terms they desire, due to, for example, the small size of their proposed investments or the popularity of a particular fund or fund manager. As a result, different investors in the same fund or the same investor in different funds will need to potentially rely on different methods for acquiring some or all of their desired terms. Importantly, all three private monitoring solutions currently exist in commercial practice today. They are not being considered or hypothesized in a vacuum. Their viability being therefore established, at least in certain quarters for certain purposes, we can turn our attention now to how to best support their wider adoption and implementation.

9.5.1 *Legal Duties and Obligations*

As discussed in Chapter 2, as a result of complex structures adopted by many fund managers involving the use of multiple management vehicles, including entities established in various onshore and offshore jurisdictions, investors in a private investment fund may face significant difficulties in ensuring adequate oversight and accountability. As the vehicle(s) in which the investors have entrusted their money are legally and commercially distinct, the interests of the investors and the fund manager can and will diverge with respect to many issues.

Each private investment fund that is individually negotiated and established contains within it agreements reached about the level of fiduciary protection and other duties that will be provided to investors. Delaware law, in particular, allows parties to set by contract the terms of their relationship with great flexibility and very little paternalism. However, one party's "freedom of contract" is another party's caveat emptor.

If the current approach in fund documentation to modifying private law duties has focused too much on providing certainty and minimizing litigation exposure for the fund manager, rather than inherent flaws or shortcomings in the decided cases themselves, then potential solutions to the governance challenge which seek to swing the pendulum back to the default private law positively (or further) are worth examining in detail.[866] Investors in private investment funds, therefore, need to be vigilant with respect to their ongoing participation in such funds in order to detect any structural or operational conflicts that may arise. Simply relying indefinitely on the original pre-investment due diligence exercise will be insufficient.[867]

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[865] Ibid. at 251 ("Participants in business ventures are free to reflect their wishes explicitly in a written contract. Both partnership and corporate law enforce private decisions.").

[866] See Section 5.11 above.

[867] See Section 9.4 above.

The underlying documentation of a private investment fund can be negotiated to address adequately the governance challenge present in private investment funds. However, any discussion of appropriate steps to take must take place in light of the current commercial realities in this industry. The perception has been recently that fund managers who are able to deliver consistently strong investment returns are able to raise any further required capital from their existing investors.[868] As discussed earlier, any proposals made to address the governance challenge must be both pragmatic to adopt and practical to implement.

Therefore, any implementation of private monitoring solutions to address the governance challenge will focus on the legal and equitable duties that a fund manager owes to its client, the private investment fund. The key fund documents will affect the scope and applicability of the duty of care and fiduciary duties which will form the basis for claims against the fund manager.

As discussed in Chapter 3, fiduciary duties can be an effective means of recourse for clients to ensure that the investment manager providing them with professional services does so in fulfilment of certain recognized standards. Unfortunately, in the case of a private investment fund, the fund vehicle itself intermediates the relationship between the investment manager and the ultimate participants. The fund itself, whether a limited partnership[869] or an offshore company,[870] must take the steps required to enforce any such claims. The participants in the fund must necessarily rely on the governance mechanisms of such vehicles in order for such actions to be commenced.

Historically, lawyers preparing the constitutional documents of a private investment fund on behalf of the fund manager have included clearly and broadly drafted exclusion clauses, which operate to protect the manager from investor claims. The clauses and related provisions are required in order to shift the balance from the outcomes that would otherwise result if the basic legal and equitable rules and principles to be applied by a court.

Whether a fund is a Company PIF or a Partnership PIF, the default position of the underlying law would be one in which partners and/or shareholders would directly benefit from duties and obligations imposed on their general partners and/or boards of directors, respectively. Further, the bilateral agreements entered into with advisory entities, in addition to the partnership agreements and articles of associations that form these vehicles, also include extensively drafted exclusion clauses, which seek, to the extent possible under the general law and applicable financial services regulation, to circumscribe the recourse that a disgruntled client would have to his or her investment manager. From this perspective, the private monitoring solutions to the governance challenge can be seen as an attempt to allow fund investors, on an informed basis, to enjoy the fuller benefit of the legal protections to which they are otherwise entitled.

9.5.2 *Effective Implementation*

If a fund participant waits until significant investment losses have occurred or allegations of fraud have been made to closely review and analyze the constitutional documents of their fund, then it will be too late at that time to negotiate adequate and acceptable amendments to address the concerns that have been raised. The time for such negotiations was prior to the

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868 See DP06/6 at 22.

869 See Section 2.3 above.

870 See Section 2.4 above.

investor's participation in the fund. As unnegotiated fund documents will continue to reflect the primacy of the managers' concerns for certainty and limitation, prospective investors must take affirmative steps to use the private monitoring solutions to return the balance back to one more appropriate in light of their underlying concerns.

The private fund model can undergo refinement and improvement in response to the changing priorities of fund participants. In the face of sustained public criticism, and a hostile media environment, and in the absence of any credible or sustained effort by regulators to address the governance challenge, fund managers and investors still retain the flexibility to address governance concerns themselves.

As private investment funds are ultimately commercial arrangements negotiated by informed and motivated parties, the enthusiasm of prospective fund managers for well-defined limitation on liability from lawsuits, which has been effectively implemented to date in fund documents, can be counter-balanced by investors who would prefer the fuller protections they would otherwise be entitled to under the private law as it currently stands. For example, as the scope of fiduciary duties[871] are defined by the contract(s) that establish that relationship, steps may be taken by the prospective investors to ensure that the scope of that duty is not reduced past the point which they would find commercially acceptable. But such a decision can only be contemplated if the full measure of the legal impact of the fund documentation is assessed as part of an effective pre-investment diligence review. Once such an assessment has been done, the extent to which the manager has attempted to shift the balance from the default positions that would otherwise apply can be determined.

Informed investors may then seek to implement one or more private monitoring solutions to seek to redress any commercially unacceptable imbalances. As a result, these private monitoring solutions can serve as common points of reference which may provide the alternative investment industry with an effective mechanism for attempting to resolve these issues across a variety of jurisdictions and numerous different funds themselves. Improved governance mechanisms also hold out the possibility of greater appeal among prospective investors for private investment funds. With the implementation of private monitoring solutions for the governance challenge, funds providing adequate independent oversight and increased transparency could lead the increased allocation by investors to these fund managers.

The increasing remoteness of fund investors from the managers and promoters of private investment funds has occurred at a time where the institutional participation in private investment funds has remained high. Such sophisticated and knowledge participants can identify and prioritize the concerns they have about conflicts of interest, accurate valuation practices and adequate disclosure. When aided by reference to industry practice standards, such as the MFA's Sound Practices,[872] or the PWC Committee's Best Practices,[873] the HFWG Standards[874] or the ILPA Guidelines,[875] the duties and obligations of the fund manager in contract and in tort, and at equity, can be identified and established to the parties mutual satisfaction.

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[871] See Section 3.10 above.

[872] See Section 5.6 above.

[873] See Section 5.5 above.

[874] See Section 5.7 above.

[875] See Section 5.8 above.

9.5.3 ***Non-State Market Driven Governance Systems***

Although not in the area of financial services firms, there have been developments in other areas of regulation to which parallels could be drawn to the private monitoring solutions proposed herein, and the manner in which private actors can operate in a way that is synergistic with, and supplementary to, established governmental regulation.

Cashore has described non-state market-driven (NSMD) governance systems which operate outside traditional top-down state authority in order to privatize governance.[876] Although his focus was on environmental regulation generally, and forest certification specifically, he identified a trend towards domestic and transactional private governance systems that deserve their legitimacy and effectiveness from the private actors that comprise the market for those goods and services. His paper focused on establishing an analytical framework for NSMD governance systems which centred on whether a system could achieve legitimacy to operate in domestic and international spheres.[877] In the NSMD governance systems Cashore describes, "no one can be incarcerated or fined for failing to comply."[878] However, he recognizes that state apparatus can be used in ways that are consistent with, and support, NSMD, even where state power is not used to force compliance. In the context of the private monitoring solutions described herein, the private actors will need to potentially make use of a state's court system, in order, for example, to enforce a contractual provision or a duty owned by a fiduciary to a company or a partnership. However, they will do so as private litigants and not require relevant state agencies to undertake investigations or enforcement actions of their own.

As a result, fund participants making use of a private monitoring solution (e.g., side letter) have direct legal rights against a fund manager that a participant in a NSMD forest certification program might lack, although the issues of legitimacy that support NSMD could contribute to extra-judicial stability and authority for the private monitoring solutions, if they become widely adopted.

Importantly, private monitoring solutions can supplement and reinforce other approaches to addressing the governance challenge. For example, effective boards of directors within funds can assist financial regulators in their oversight and enforcement rules. As SEC General Counsel Brian Cartwright has stated in the context of independent mutual fund directors:

> In many ways, we at the SEC have the same task you do: Investor protection. So it's no surprise that, just like you, we at the SEC also need to be committed, vigilant and independent. Like you, America's investors have entrusted us with a tough, challenging job. Because we share the same goal, your effective oversight complements our work at the SEC. We at the SEC benefit directly from the good work you perform as independent fund directors. When you succeed in your role as effective independent directors, America's investors benefit. I therefore pledge my continued support and thank you from the bottom of my heart for your critical contribution to the protection of America's investors.[879]

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[876] Benjamin Cashore, "Legitimacy and the Privitization of Environmental Governance: How Non-State Market-Drive (NSMD) Governance Systems Gain Rule-Making Authority; Governance: An International Journal of Policy, Administration and Institutions, Vol:15, No. 4, pp 503-529 (October 2002).

[877] Ibid. at 505.

[878] Ibid. at 510.

[879] www.sec.gov/news/speech/2006/spch111506bgc.htm.

Similar sentiments could be expressed in connection with fund investors who take on monitoring responsibilities through side letters, or exchanges which agree to provide such monitoring services to the funds listed thereon. As noted in Chapter 1, the choice between top-down state regulation and bottom-up self-regulation is not “either/or.”

The private investment funds industry is a clear example of a part of the financial market, and the financial regulatory system, where knowledge and power is fragmented. Fund participants can and should contribute to a hybrid regulatory process to achieve the regulatory goal of good governance in private funds.

9.5.4 *The Last Line of Defense*

The ability of prospective investors to potentially negotiate with fund managers about the terms of the fund documentation, including whether and in what manner to adopt private monitoring solution, does not guarantee that in every case, or in any particular case, the investor will be able to agree to adequate terms. Such commercial negotiations will result in terms that reflect primarily the relative negotiating leverage of each party and the cut-and-thrust of the wider financial markets at the time of such negotiations.

The clear assumption underlying the line of demarcation drawn around private investment funds by both the SEC and the FSA, excluding retail investors and enabling only a small sub-set of prospective investors to participate in these vehicles, is that such sophisticated, non-retail investors will have the ability to evaluate the risks inherent in unsatisfactory legal documentation and decide not to invest. For retail investors who lack this ability, detailed product-level regulation is required.[880]

Investors who are unable to get adequate enrolment of private monitoring solutions to address the concerns that they have identified must be willing to invoke the last line of defence that they have available to them: to “just say no” to an investment in that fund. Surveys of private equity fund investors, for example, have revealed that this is not an idle threat, with over half (53%) of investors interviewed indicating that had in the past determined not to invest in a fund due to the terms and conditions, and approximately 20% stating they reach such decisions frequently.[881]

9.6 **“Our Reach Exceeds Our Grasp”**

The question of whether private investment funds are useful additions to the financial markets of the 21st Century is beyond the scope of this thesis. Similarly, I have not addressed herein whether such funds are proper investments, either for individual savers or institutional investors, nor have I discoursed upon the particular size or sophistication threshold at which such individual or institutional investor should be permitted to participate in these funds. Instead, I focus on the narrow, yet highly important, question of how private actors can best address the governance challenge present in private funds, given the decision of financial regulators not to regulate in this area. As such, I have necessarily taken the law and regulation in this area as I have found them. As a result the private monitoring solutions I propose herein are able to moderate governance concerns as they arise today.

Some critics might suggest that the private monitoring solutions are too modest in their design and in their impact to warrant serious consideration. The limit of each of the solutions have

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880 See Section 3.4 above.

881 Preqin Study at 16.

been listed and evaluated above. However, in view of both the status quo and the acknowledged need to address the various shortcomings identified in the aftermath of the global financial crisis, the private monitoring solutions can operate as the thin edge of a wedge that could ultimately lead to significant improvements in the way that private funds are governed.

Once recognition of the utility of these mechanisms is widened from their current users in the market, they can continue over tom eto be the means vy which further improvements are made. Importantly, the private monitoring solutions are not an end in themselves. As market practices continue to evolve, each of these mechanisms can be adapted or expanded to address such new development. As a result, their initial modesty underlies their latent potential to have a broad and lasting impact on private fund governance over time.

Further regulatory initiatives in the area of private investment funds are possible in the future, and should such developments occur, the implementation of the private monitoring solutions will need to be re-evaluated. However, in the absence of the outright criminalization of private funds or the creation of an exclusively regulated vehicle for such investment activities, there must always be a gap between the “reach” of our investment activities and the “grasp” of our regulatory system. This gap creates the need for private actors to address their concerns themselves and, accordingly, the private monitoring solutions will have a purpose to serve.

9.7 **Conclusions**

Timothy F. Geithner, when he was President of the Federal Reserve Bank of New York, once observed that “[h]edge funds, private equity and other kinds of investment vehicles help to dispose risk and add liquidity.”[882] Private investment funds serve an essential role in the global financial markets. They should, and will, remain a feature of these markets for years to come. Accordingly, issues surrounding their operation and governance must be addressed, either by the government or by the private actors who participate in them.

The very aspect of private investment funds that raises so many concerns with certain commentators and regulators - their “private” nature - can provide adequate scope for the parties concerned to construct through negotiations mechanisms to address the governance challenge that they face. These vehicles are “private” precisely because neither party desires to conduct their business through public, regulated vehicles. This is a choice which both parties elect as optimal to them and their long term commercial interests.

Despite the prevalence of well established ‘market forms’ for many types of private investment funds, each private investment fund is structured to address the unique requirements it faces, such as the tax treatment of the participants and/or the underlying investments, the regulatory status of the fund manager and the types of underlying investments being made.

By their collective nature, all investment funds (public and private) face potential investor inertia, ignorance and apathy. As a result, a governance challenge that sits at the heart of all collective investment funds must be addressed: how can the integrity of a professional relationship (i.e., the investment manager) be maintained where the ultimate clients (i.e., the participants in the fund) are distant and dispersed?

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[882] Timothy F. Geithner, Remarks at the Institute of International Bankers (October 18, 2005), available at www.ny.frb.org/newsevents/speeches/2005/gei051018.html.

In this thesis, three related monitoring enrolment mechanisms have been identified and analyzed as alternate solutions to the governance challenge. The three approaches - side letters, board operation and exchange listings - focus particularly on the methods by which information can be received and, therefore, influence can be exercised.

The power of the monitoring solutions discussed herein is that they lay out processes by which private actors can resolve issues related to the governance challenge over time and in different contexts. As noted above, the monitoring solutions are not an end result, in and of themselves, but instead are potential tools which can be used either individually or cumulatively, in layers one upon another. For example, an exchange may have in its listing rules that a certain proportion of directors be independent. Similarly, such a provision may be contained in an investor's side letter. Alternatively, a side letter may contain certain provisions that attempt to address investors concerns, while also containing a further provision that these specific requirements fall away should the fund manager eventual decide to have the fund listed on an agreed exchange.

The private monitoring solution can thereby assist in establishing recognized practice standards for private investment funds that can provide a more responsive, real-time scheme for establishing minimum levels of investor protection.[883] Whether they simply reflect current majority views or seek to "raise the bar" in terms of what fund managers should be doing, the flexibility that such standards provide foster the ability of such funds to continue to evolve and innovate. Taken together, a practical and effective solution to the governance challenge is, therefore, available to private fund investors, which can supplement and extend the reach of financial regulations in the pursuit of their wider regulatory goals.

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883 See, e.g., Steven L. Schwarcz, "Keynote Address: Understanding the Subprime Financial Crisis," 60 South Carolina Law Review 550, 560 (2009) ("It is impossible to know how future financial crises will arise. Ultimately, the key to protecting against future crises is to remain open, flexible and aware of changing circumstances.").

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Securities Act of 1933

Securities Exchange Act of 1934

Codes, Rules and Regulations

Internal Revenue Code

Investment Advisers Act of 1940 Rules

Securities Act of 1933 Rules

Securities Exchange Act of 1934 Rules

LIST OF ABBREVIATIONS

AIMA	Alternative Investment Management Association
BIPRU	Prudential Sourcebook for banks, building societies, and investment firms
BVCA	British Venture Capital Association
CAD	Capital Adequacy Directive
CFC	controlled foreign corporation
CIS	collective investment scheme
CIS Order	Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062)
COBs Rules	Conduct of Business rules
DP	Discussion Paper
DRUPLA	Delaware Revised Uniform Limited Partnership Act
DRUPA	Delaware Revised Uniform Partnership Act
ECI	Income effectively connected with a US trade or business
FINRA	the Financial Regulatory Authority (US)
FPO	Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 11529)
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSMA	Financial Services and Markets Act 2000
HMRC	HM Revenue and Customs
IME	investment manager exemption
Investment Advisers Act	Investment Advisers Act of 1940 (US)
Investment Company Act	Investment Company Act 1940 (US)
IOSCO	International Organisation of Securities Commission
ISD	Investment Services Directive
ISE	Irish Stock Exchange
Joint Report	2003 Joint Report of the Law Commission of England

	and Wales and the Scottish Law Commission
LLC	limited liability company
LLP	limited liability partnership
LSE	London Stock Exchange
MFL	Mutual Funds Law of the Cayman Islands
MFN	most favoured nation
MiFID	Markets in Financial Instruments Directive
NASD	National Association of Securities Dealers
NAV	net asset value
OCIE	Office of Compliance Inspections and Examinations
OEIC Regulations	Open-ended Investment Company Regulations 2001 (SI 2001/1228)
OEIC	open-ended investment company
PFIC	passive foreign investment company
PRIN	Principles for Business Sourcebook
QEF	qualified electing fund
QIS	qualified investor scheme
RAO	Regulated Activities Order
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933 (US)
Securities Exchange Act	Securities Exchange Act of 1934 (US)
SFM	Specialist Fund Market
SIF	Specialised Investment Fund
SP	Statement of Practice
SRO	self-regulatory organisation
SYSC Sourcebook	Senior Management Arrangements, Systems and Controls
TCGA	Taxation of Chargeable Gains Act
UBTI	unrelated business taxable income

UCITS	Undertakings for Collective Investment in Transferable Securities
UKEP	UK Equivalent Profits
UKLA	UK Listing Authority