Fiduciary Contours: perspectives on mutual funds and private funds

By

Deborah A. DeMott

Forthcoming in Research Handbook on Mutual Funds (William A. Birdthistle & John D. Morley eds., forthcoming 2016 Edward Elgar Publishing)

1. INTRODUCTION

All fiduciaries owe obligations that include distinctive duties of loyalty, in addition to duties of care or performance. To say more requires knowing more about a particular fiduciary's circumstances; any further inquiry turns on the specific content of the fiduciary's duties and the consequences of breach.[1] Thus, the content of a fiduciary's duty necessarily underlies the legally significant determination of whether and when the fiduciary breached the duty.[2] The thesis of this chapter is that in the mutual-fund context, the specifics of fiduciary duty reflect the distinctive qualities of this form of investment in securities, conventionally understood to involve an

[1]SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943)("to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations? And what are the consequences of his deviation from duty?").

[2]Tibble v. Edison Int'l, 135 S. Ct. 1823, 1827 (2015)(whether beneficiaries of employee savings plan brought timely suit against plan fiduciaries under ERISA, 29 U.S.C. § 1113, requires consideration of "the nature of the fiduciary duty," which under trust-law standards incorporated by ERISA included an ongoing duty to monitor plan investments and remove imprudent investments).

investment company that issues shares sold to public investors.[3] The specific contours that shape fiduciary duties reflect many factors, including the highly prescriptive regulatory structure of the Investment Company Act of 1940 that is distinctly applicable to mutual funds. To sharpen its depiction of the fiduciary distinctiveness of mutual funds, the chapter draws contrasts with two other avenues or vehicles for investment through which an investor delegates investment choice: (1) "private" funds, that is, vehicles for pooled investment that are not subject to the full regulatory regime applicable to mutual (or "public" funds); and (2) non-fund investment-management relationships through which an investment adviser undertakes to manage an investor's individual securities account. In addition to their regulatory consequences,[4] management relationships geared to an individual account implicate the doctrines and concepts of common-law agency. The chapter's overarching thesis is that assessing the role and significance of fiduciary obligation as applied to investment funds, whether mutual funds or private funds, necessarily turns on their distinctive characteristics, including those prescribed by regulation. Moreover, these contrasts are timely. As I explain, the population of investment advisers now registered with the SEC includes many who advise at least one private fund. Newly-available information about private funds' practices calls into question whether they are always consistent with fund managers' fiduciary duties to investors, as do data concerning practices of hedge fund managers during the financial crisis.

---

[3]The regulatory structure for mutual funds requires registration with the SEC, as discussed *infra* n.11.

[4]Chief among them is whether the manager must register as an investment adviser under the Investment Advisers Act of 1940, discussed *infra* n.14.

In this chapter I also articulate a more general perspective on mutual funds. The distinctively hybrid quality of investment that mutual-fund vehicles enable can be viewed through three different lenses. First is an initial lens grounded in organizational or entity governance, stemming from the fact that mutual funds are generally organized in entity form.[5] A mutual fund's structure interposes the fund itself between investors and the fund's assets, liabilities, and managers. Prior scholarship examines governance features distinctive to entities, including boards of directors and voting rights conferred on fund investors, whether required by regulation or by contract, with some scholars investigating the function and efficacy of governance institutions in the mutual fund context. The second lens is grounded in the insight that shares in mutual funds are often characterized as products consisting of specified investment services that are packaged and sold by or on behalf of a fund to investors who may sell the shares, whether by exercising redemption rights against the fund itself or by selling into secondary markets for securities.[6] Understanding a mutual fund's investors as purchasers or consumers of a product carries implications for the duties owed by the fund's managers on an ongoing basis. It also highlights

---

[5]The specific forms of organization include business corporations, common-law trusts, and statutory business trusts, discussed *infra* nn.25-26. As discussed infra n.9, the operative definition for regulatory purposes is "investment company," which includes "an association" and "any organized group of persons whether incorporated or not." ICA § 2(a)(32); 15 U.S.C. § 80a-2(a)(32). If an investment adviser invests the assets held in individual-client accounts in an identical fashion, the SEC may determine that an investment company exists. See In re Clarke Lanzen Inv. Firm, Rel. IC 21140, 1995 WL 374552 (1995), discussed in Roiter at [ms. p. 11 & n. 36].

[6]For the "product" characterization, see Morley at 1233; Roiter at [ms. 13]. Mutual funds that issue redeemable shares are conventionally termed "open-ended" funds, in contrast to "closed-end" funds. For further discussion, see infra n.16.

the importance of disclosure furnished when shares are purchased, as well as the robustness of investors' redemption rights. The third lens—even if relevant only by way of contrast—views the ongoing tripartite relationship between a mutual fund's manager, the fund's assets, and the fund's investors through the lens of common-law agency. As the law defines agency relationships, the agent owes fiduciary duties to the principal throughout their relationship, and the principal has both an ongoing right of control over the agent plus the power to terminate the relationship. Seen this way, investors are clients and thus principals of the actors who advise them or manage their financial assets, not (or not only) consumers of a product or service. In the same vein, one might think that physicians have patients, not (or not just) customers for medical services.[7] As agents, managers owe duties that are distinctively fiduciary and that apply on an ongoing basis. From this vantage point the distinctiveness of the fiduciary issues associated with mutual funds is evident because what can seem relatively unproblematic from the perspective of entity governance or product sales may be troubling when viewed through an agency lens.

Let's begin by sketching the basic characteristics of mutual funds, private funds, and individual-account management relationships. Although the chapter in no way purports to exhaust the technical complexities, it notes salient aspects of applicable regulatory schemes for each investment vehicle or relationship, focusing on the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("ICA").[8] Following these sketches, the chapter

---

[7] And one might think that the conduct of investment bankers who refer to their clients as "muppets" is more likely to fall short of meeting fiduciary (and other) standards. Zingales at 1348.

[8] The chapter does not cover state-level regulation of investment advisers.

examines the contours of fiduciary duty applicable to each vehicle or relationship, whether stemming from regulation or generally applicable law, highlighting specific contrasts as between mutual funds and private funds. The next section identifies a few implications flowing from these contrasts, followed by a brief conclusion.

2. MUTUAL FUNDS, PRIVATE FUNDS, AND INDIVIDUALIZED INVESTMENT MANAGEMENT

Mutual Funds

Like much of the specialized terminology used in connection with asset management, “mutual fund” and “private fund” are widely-used labels that—like the notoriously undefinable “hedge fund”— are not legal or regulatory terms of art. Mutual funds are generally understood to offer retail investors the opportunity to invest in pooled investment vehicles. The starting point for regulatory purposes is the ICA’s opening definition of “investment company,” which is an issuer of securities that “is or holds itself out as being engaged primarily...in the business of investing, reinvesting, or trading in securities ....” or proposes to become such an issuer.[9] Alternatively, and often inadvertently, an issuer may become an investment company when 40% of the value of its total assets on an unconsolidated basis (but excluding Government securities and cash items) consists of investment securities.[10] An investment company must register with the SEC unless the ICA excepts its type of company from registration, or the SEC exempts the particular company

[9] ICA § 3(a)(1)(A); 15 U.S.C. § 80a-3(a)(1)(A).

[10] ICA § 3(a)(1)(c); 15 U.S.C. § 80a-3(a)(1)(c).

from registration.[11] Mutual funds are managed by "investment advisers," typically through a contract with the fund in which the adviser regularly furnishes advice concerning investing.[12] Managing an investment company generally requires that the investment adviser itself register with the SEC under the Advisers Act.[13] As discussed later, the Advisers Act itself defines "investment adviser" and may require registration by an investment manager that does not serve as an adviser to any mutual fund.[14]

The ICA classifies investment companies into two types, depending on whether the securities issued are redeemable,[15] a typology that conforms to the generally-used distinction between "open-end" and "closed-end" funds.[16] Investors in open-end mutual funds may sell their shares by exercising their rights of redemption; such shares, unlike those issued by closed-end mutual funds, are not listed for trading in secondary markets. Upon redemption the shareholder in an open-end fund receives a cash payment equal to the shareholder's proportionate interest in the

---

[11]ICA § 8(a).

[12]ICA § 2(a)(20).

[13]Advisers Act § 203(a); 15 U.S.C. § 80b-3(a). The Advisers Act contains several exemptions from its registration requirement, some of which are discussed infra nn. 40-41.

[14]Advisers Act § 202 (a)(11); 15 U.S.C. § 80b-2(11).

[15]ICA § 5(a)(defining "open-end company" as "a management company which is offering for sale or has outstanding any redeemable securities of which it is the issuer" and "closed-end company as "any management company that is not an open-end company.").

[16]Other types of investment vehicles may share functional characteristics with these basic forms. For example, publicly-traded private equity firms have been characterized as "essentially closed-end funds" although private-equity funds are a categorical example of private funds. *See* Phalippou at 124. Indices based on these funds' listed securities were launched in the last decade. *Id*.

fund, commonly known as the "NAV," or net asset value. Additionally—but less frequently—an investment company may be organized as a unit investment trust ("UIT"), which before making a public offering of its shares assembles an investment portfolio and designates a date for its dissolution and liquidation.[17] Issues specific to UITs are outside the scope of this chapter, as are issues specific to exchange traded funds. As open-end funds EFTs are generally structured as index funds based on various equity- and industry-based indices. Although ETF shares trade on securities exchanges, they are also redeemable by the fund but only in large blocks, known as "creation units."[18]

Central to the definition and operation of a mutual fund is whether the fund makes a public offering of its shares. The ICA's broad definition of "investment company," quoted above, is inapplicable to any issuer with no more than one hundred beneficial owners of its long-term securities and "which is not making and does not presently propose to make a public offering of its shares."[19] To meet ongoing obligations to redeem outstanding shares, mutual funds ordinarily conduct continual public offerings of their shares to generate the cash requisite to satisfy

---

[17]ICA § 4(2); 15 U.S.C. § 80a-4(2).

[18]ETF redemptions occur through an in-kind tender of a basket of specified securities. If an ETF invests in assets other than securities, it is not an investment company under the ICA. On ETFs generally, see Kirsch ch. 35. An attraction of ETF shares is that the price at which an investor may sell is determined at the time of sale into the market, while the NAV at which mutual-fund shares are redeemed is determined at the end of the trading day. When securities markets rapidly decline—as on August 24, 2015—sell-side pressures may be so overwhelming that ETF prices decline substantially more than the prices of the securities the fund owns. For more on ETFs, see Birdthistle ch. 12 and Roiter (in this volume).

[19]ICA § 3 (c)(1); 15 U.S.C. § 80a-3(c)(1).

redemption requests without contracting in size.[20] Mutual funds honor redemption requests on a daily basis and the fund may impose a redemption fee.[21]

A significant element in the hybridity of mutual funds consists of governance characteristics that partially mimic those of a generic business corporation. However organized under state law, the operations of a mutual fund are, as is evident above, managed by the fund's investment adviser.[22] Indeed, investors may perceive the fund's association with a particular adviser as a "brand" on which the investor can rely, much more so than on either the composition or the functions of the fund's board of directors. This perception is consistent with the finding that, performance aside, mutual funds suffer declines in investment flows following merger or acquisition events that change their investment advisers.[23] Nonetheless, compliance with the ICA requires that the fund have a board of directors, comprised of members no more than sixty per

[20]Roiter at [ms at 12].

[21]The investor may also have paid an up-front "sales load" to the distributor of the fund's shares, or the investor may be charged a "back-end" sales load at the point of redemption to be deducted from the proceeds.

[22]In contrast, in a generic corporation incorporated in Delaware, the corporation's "business and affairs" are by statute managed "by or under the direction of" the board of directors. Del. Code Ann., tit. 8, § 141 (a).

[23] Flows into mutual funds declined by 7% of fund assets during the year following an announced ownership in investment adviser due to a merger or acquisition event. See Kostovetsky. One might wonder how much this effect resembles ordinary business corporations that are closely identified with their CEOs, such that a change in CEO is a significant event. On Berkshire Hathaway Corp., an outlier on the spectrum of identification, see Lawrence A. Cunningham, *Berkshire's Blemishes: Lessons for Buffett's Successors, Peers, and Policy*, 2016 Colum. Bus. L. Rev. 1 (2016). More generally, scholars of CEO turnover find mixed results for stock prices. *See* Margarethe Wiersema, *Holes at the Top: Why CEO Firings Backfire*, Harv. Bus. Rev., Dec. 2002.

cent of whom may be interested persons of the fund. The ICA's long definition of "interested person" encompasses (among others) any interested person of the fund's investment adviser or securities underwriter.[24] Although a mutual fund's directors do not manage the fund's investment portfolio, the ICA specifies functions to be performed by directors, including most significantly an annual review of the fund's contract with its investment adviser. If organized as corporations, mutual funds incorporate in Maryland.[25] Trust-form funds mostly organize in Massachusetts as common-law trusts or in Delaware as statutory business trusts.[26]

Again, regardless of chosen state-law form, the federal ICA mandates that the fund have a board. As in generic corporations, fund shareholders have voting rights over the board's composition.[27] Additionally, the ICA requires that shareholders vote to approve the fund's initial contract with its investment adviser, as well as subsequent modifications to the contract, and requires that the fund's registration statement and prospectus state all investment policies that can be changed only by shareholder vote.[28] Although prior scholarship suggests that shareholder voting for mutual-fund directors lacks much functional significance,[29] ongoing litigation

[24]ICA § 2(a)(19)(iii); 15 U.S.C. § 80a-2(a)(19)(iii).

[25]Maryland's general corporation statute accommodates continual issuances of shares and permits the insulation of funds within the same fund family from liabilities incurred by their fund siblings. Roiter at [ms at 55], citing Md Code Ann, Corps and Assn's, § 2-208.1 and § 2-208.2.

[26]Roiter at [ms at 55].

[27]But in trust-form funds, shareholder voting rights are operative at the level of the trust, not the lower-level funds within the trust. Roiter at [ms at 51].

[28]ICA § 80a-8(b).

[29]Morley at 1250.

illustrates the potential peril to a fund's advisers and directors generated by unilateral deviations from fundamental investment objectives. In *Northstar Financial Advisors, Inc. v. Schwab Investments*, a class of mutual fund investors alleged that they were injured when the fund deviated from two fundamental investment objectives, which were to track a specific bond index and invest no more than 25% of the fund's assets in any one industry unless necessary to track the specific index.[30] The Ninth Circuit held that the investors stated claims against the fund for breach of contract, as well as against its adviser and directors, all claims grounded in a "structural relationship" between the investors and the fund comparable to a provision in a corporation's charter. The deviations injured fund shareholders directly when actions were taken unilaterally that required shareholder approval.[31] And the defendants conceded at oral argument that the investors' allegations stated a claim for breach of fiduciary duty.[32]

More generally, *Northstar* is not entirely consistent with viewing mutual-fund shares as products because it is difficult to visualize how a more typical product seller could effect post-sale modifications in the product itself that would be comparable to unilaterally-adopted alterations in investment policies. This weakens the plausibility of the product metaphor, unless one imagines a product that unilaterally morphs into something very different. More plausibly, *Northstar* is consistent with viewing a mutual fund as an instrumentality through which to effect an investment-management relationship in which share-ownership creates an agency relationship of

[30] 779 F.3d 1036 (9th Cir. 2015).

[31] 779 F.3d at 1059. This reasoning overcomes the obstacle that the fund's shareholders themselves were not parties to the fund's contract with its adviser.

[32] 779 F.3d at 1056.

sorts between fund investors and the fund's adviser. On this view, unilateral deviations from fundamental investment policies are comparable to actions for which an agent lacks authority. Lacking actual authority to bind the principal, the agent is subject to liability to the principal for injury stemming from third-party reliance on the agent's appearance of authority.[33] And, when the agent's unauthorized actions are self-interested, they are garden-variety breaches of an agent's duty of loyalty to the principal.

Private Funds

In one sense, the ICA defines the universe of private funds as a negative space, one occupied by funds encompassed within the broad ICA definition of "investment company" but nonetheless excepted from the definition. This chapter focuses on private funds for which the rationale for exclusion from the ICA is that the funds "seem to be sufficiently controlled by their investors."[34] However, the history recounted in this chapter calls into question whether all such funds were in fact "sufficiently controlled." Most prominently private funds encompass hedge funds as well as private equity and venture capital funds. In general, hedge funds require a substantial initial investment, to be invested by the fund's manager in a portfolio of assets of a type as specified in the fund's prospectus or offering memorandum, which typically contemplates that the advisor will have substantial discretion in making investment decisions. To generate above-market returns, hedge fund managers may expose their investors to complex forms of risk, augmented in complexity from the investor's standpoint by the relatively non-transparent style of

---

[33]Restatement (Third) of Agency § 8.09.

[34]Frankel (2011) at 127. Other bases for exclusion are not recounted here.

hedge-fund investing.[35] Private equity funds differ in significant ways from venture capital funds. In investment strategy, venture capital funds invest in relatively new companies, while private equity funds, also known as buy-out funds, focus on acquiring and holding controlling stakes in established companies. Both structures contemplate that the fund will liquidate after a stated period, typically after all the firms in the fund's portfolio have themselves enjoyed a liquidation event, such as through an IPO or a strategic acquisition.[36] Managers of private equity funds market themselves to two distinct constituencies: to prospective investors in the fund, but also to incumbent owners of companies into which the fund may invest. Private funds with advisers registered with the SEC as of September 2014 had around $7.4 trillion in regulatory assets under management ($5.4 trillion for advisers to hedge funds and $2 trillion for advisers to at least one private equity fund).[37] Although this number represented a fraction of overall assets under management ("AUM") in the United States (roughly $50 trillion),[38] the private fund segment of the asset management industry is significant in many ways, not least among them its capacity for

[35]In addition to potential returns higher than mutual-fund investing, hedge funds "also offer more complex risk exposures that vary according to style and market circumstances," including illiquidity and lack of transparency stemming from the proprietary nature of hedge-fund trading strategies. Getmansky *et al*. at 484.

[36]Morley at 1235-36.

[37]Champ at 1. The term "regulatory assets" means that the adviser may have under management other assets that are outside the regulatory scheme. These are the latest full-year data available. As of third quarter 2015, the comparable statistic for hedge funds was around $6.2 billion. *See* Private Funds Statistics, available at http://www.sec.gov/divisions/investment/private-funds-statistics-2015-q3-accessible.pdf.

[38]In 2014, the global fund industry reportedly controlled $120 trillion in investor assets, with managers in the United States accounting for $50 trillion in AUM. Healy and Greer at 302.

developing innovative and complex vehicles for investment, and, in some cases, generating systemic risk.[39]

Private funds rely on two ICA provisions that exclude certain issuers from the broad definition of "issuer": (1) an issuer that has no more than one hundred beneficial owners of its outstanding securities and that does not make or propose to make any public offering of its securities;[40] and (2) an issuer that does not make or propose to make any public offering of its securities if all of its outstanding securities are owned by persons—of any number—who at the time of purchase were "qualified purchasers."[41] To be a qualified purchaser requires meeting statutorily prescribed financial tests; for example, a natural person is a qualified person if the individual owns no less than $5 million in investments.[42] Wealth, like income, is not a complete proxy for investment acumen, whether the focus is an individual or an entity or other institution.[43] Although wealth should enable an investor's access to expert advice and capacity to absorb

[39]A memorable instance is the late 90's collapse of Long Term Capital Portfolio, L.P., which prompted a recapitalization involving 16 financial institutions conducted under the supervision of the Federal Reserve Bank.

[40]ICA § 3(c)(1); 15 U.S.C. § 80a-3(c)(1).

[41]ICA § 3(c)(7); 15 U.S.C. § 80a-3(c)(7). The National Securities Markets Improvement Act of 1996 added this additional exclusion, which enabled a new type of private fund that may have an unlimited number of investors so long as each meets the "qualified purchaser" criterion. For the history, see Frankel (2012) at 146-51.

[42]ICA § 2(51)(A); 15 U.S.C. § 80a-2(51)(A).

[43] Whether the focus on wealth as a proxy for investor sophistication is entirely adequate when an investor is an institution that itself owes fiduciary duties to its own beneficiaries is beyond the scope of this chapter. For recent assessments of possible ways to specify investor sophistication, see Securities and Exchange Commission (2015) and United States Government Accountability Office (2013).

financial losses, it does not necessarily assure that the advice will be sound, that the investor will follow it, or that either the investor or the adviser will discern all that's material when an investment vehicle is opaque in material respects. But wealth is more readily measurable than are these propensities and probabilities. Moreover, some of the limitations inherent in quantitative definitions of investor sophistication in an opaque environment became evident when large public pension funds acknowledged their failure to ask or disclose how much private equity funds kept in fees when reported investment returns seemed high enough to allay any curiosity or concerns about the toll imposed by fees.[44]

Although the ICA may exclude a private fund itself from its general registration requirement—and thus from the substantive constraints imposed by the ICA discussed later in this chapter—it's a separate question whether the private fund's adviser must register with the SEC as an investment adviser. The Advisers Act long contained an exemption from registration known as the "private adviser exemption" available to advisers with fewer than fifteen clients over the prior twelve months that did not advise a mutual fund (or other registered investment company) and did not hold out as an investment adviser to the public. Many advisers to hedge funds and private equity funds relied on this exemption, which permitted each fund to be treated as a single "client." The Dodd-Frank Act eliminated the exemption, effective July 2011, for advisers in the United States with $100 million or more assets under management. If an adviser advises *only* funds excluded the from the ICA definition of investment company—i.e, only private funds—the

---

[44] Gretchen Morgenson, *Challenging Fees Tucked in Footnotes*, N.Y. Times, Oct. 18, 2015; Timothy W. Martin, *Pension Funds Tackle Fee Mystery*, Wall St. J., Nov. 23, 2015, at C1.

adviser is exempt from required registration under the Advisers Act so long as it has less than $150 million in assets under management.[45] To register, an adviser must complete and file a disclosure document—Form ADV—with the SEC, along with a brochure to be given to clients; the brochure requires narrative answers concerning specified items for disclosure.[46] Since 2011 the SEC also requires most registered advisers to file Form PF to report such matters as counterparty risk and leverage. Information reported on Form PF is not publicly available.[47]

A separate question is how a prospective investor in a private fund investor obtains sufficient information to choose among available private funds. For prospective investors in hedge funds, comparative information about hedge fund performance comes from a cottage industry of private data vendors.[48] Although the regulatory bar against general advertising by hedge funds[49] that necessitated their services was lifted in 2013, only with reluctance have hedge

---

[45] Advisers Act § 203(m); 15 U.S.C. § 80b-3(m). Dodd-Frank created a narrowly-defined exception (to the general registration requirement) for "foreign private advisers" who must satisfy several criteria geared to determine that they have no significant presence in the United States or significant following among US investors. See Advisers Act § 202 (a)(30)(defining 'foreign private adviser') and § 203 (a)(3)(registration requirement inapplicable to foreign private advisers). For discussion, see Greene & Adams at 362-63. Nonetheless, for large advisers, the perception of adverse reputational consequences, combined with the less-than-onerous registration process, may not justify the expenditure of much energy to avoid registration.

[46]For more about Form ADV, see DeMott and Laby at 418-19.

[47]The SEC adopted Form PF jointly with the Commodities Futures Trading Commission. Although Form PF information is primarily intended to assist the Financial Stability Oversight Council in monitoring systematic risk, the SEC has also used the information in regulatory and examination programs and to facilitate its understanding of risks posed to investors. Champ at 2.

[48]Getmansky *et al*. at 491.

[49]Securities Act Rule 502(c).

funds embraced the resultant opportunities for advertising.[50] Many (but not all) hedge funds self-report information about their returns to private vendors, who sell their data to potential investors.[51] Much research identifies the vulnerability of such self-reported return data to various biases, including an observed propensity for funds to commence reporting following a period of out-performance and to choose to "delist" from the database when the fund lacks capacity to absorb new investment or has suffered poor performance.[52] Additionally, standard commercial databases do not provide other information relevant to investors' choices, such as whether the fund's manager used its discretionary authority to restrict withdrawals from the fund,[53] as discussed below. For prospective investors in private equity funds, data on the performance of funds associated with a particular sponsor or investment adviser may prove elusive. Private equity sponsors prepare private placement memoranda in a process geared to attract new investors and exercise discretion about the information to be shared with prospective investors. Many private equity sponsors use private placement agents to market new funds.[54]

---

[50] Section 201 of the 2012 JOBS Act directed the SEC to lift the general prohibition, which required it to revise Advisers Act Rule 506. Under revised Rule 506(c), a hedge fund may advertise so long as all investors are accredited, but it must verify their accreditation. Associated uncertainties make robust advertising unlikely. For a full account, see Kaal [ms at 32-33].

[51] Getmansky *et al*. at 491.

[52] Getmansky *et al*. at 492.. Additionally, the fact that some data bases do not include funds that are "extinct" generates a survivorship bias because poorly-performing funds choose to shut down and thus are no longer represented in the data. This affects the estimated mean and volatility of hedge-fund returns overall. *Id*. at 493.

[53] Aiken *et al*. at 200.

[54] On private placement agents, see Cain *et al*.

From 2011 to present, much changed for private-fund advisers and their clients, triggered by the Dodd-Frank registration mandate and its aftermath.[55] The Advisers Act subjects registered advisers to constraints relevant to fiduciary-duty issues, as I discuss below. Just as significantly, registration as an adviser exposes the registrant to the SEC's examination process.[56] In its initial round of examinations of newly registered fund advisers, the SEC identified numerous deficiencies in policies, procedures, and disclosure practices. For example, reportedly between 40-60% of newly-registered private equity advisers had deficiencies, most prominently insufficient disclosure of fees and allocation of fees and expenses as well as problematic conduct concerning portfolio companies.[57] As drafted, many limited partnership agreements created "an enormous grey area" that allowed advisers to "charge fees and pass along expenses that are not reasonably contemplated by investors."[58] In one egregious instance, the SEC alleged in an enforcement action that an adviser, without adequate disclosure to its investors, allocated to the funds it manages millions of dollars attributable to its own expenses, including its CEO's salary and bonus, as well as causing the funds to borrow money from the adviser at unfavorable rates in order to pay the adviser's expenses.[59] And "zombie" advisers, unable to raise additional funds, by

---

[55]As the then-director of the SEC's Division of Investment Management characterized matters in 2014, "[i]t is difficult to overstate how much the regulatory landscape for hedge fund managers has changed over the past four years." *See* Champ at 1. Much changed as well for managers of private equity funds. *See* Wyatt.

[56]These consequences are detailed in DeMott and Laby at 419-20.

[57]Rendón et al. at 1351.

[58]Bowden at 4.

[59]In re Clean Energy Capital LLC, SEC Rel. No. 3955, 2014 WL 7662742 (Oct. 17,

continuing to manage legacy funds may disserve investors' best interests in various ways and without proper disclosure.[60]

More generally, the initiation of the SEC examination process and subsequent enforcement proceedings elicited media engagement with issues that previously had been "relatively opaque," given the confidentiality of private equity documentation.[61] Less opacity led to new due diligence procedures for private equity investors, as well as changes in advisers' fee and allocation practices.[62] The SEC's scrutiny of the hedge fund industry was significantly shaped by its Aberrational Performance Inquiry designed first to identify funds that consistently outperformed standard market indices and then to focus more closely on those funds. The SEC's inquiry led to enforcement actions against fund managers who had overvalued their funds' returns.[63] For advisers to private funds now registered under the Advisers Act, additional regulatory scrutiny now figures largely in the environment, as do reactions from investors to revelations about problematic conduct.

Private funds are not subject to the mandatory governance structures that the ICA imposes

---

2014).

[60]Bowden at 4.

[61]Rendón et al. at 1352. In particular, the Wall Street Journal reported on the relationship between private-equity firm Kohlberg Kravis Roberts & Co. and its related entity, Capstone, having obtained portions of a limited partnership agreement. The Journal opined that KKR may have breached terms in the agreement by not sharing fees earned by Capstone. *See KKR Error Raises a Question: What Cash Should Go to Investors?,* Wall St. J., May 21, 2014.

[62]*See* Wyatt at 4.

[63]Healy and Greer at 303.

on mutual funds. Hedge funds—many organized as limited partnerships or limited liability companies (LLCs)—generally do not have boards of directors.[64] However, the organizational structures for hedge funds may provide for committees chosen by investors with the assigned function of approving or disapproving transactions in which the adviser has a conflict, as explored in Section III. Even when hedge funds do have boards of directors—typically because a fund is organized in the Cayman Islands, which requires a board—the functional substance of the board is open to question. Directors of Caymans-based hedge funds, at least as of 2012, often served on the boards of dozens of unrelated funds.[65] In contrast, the governance of private equity funds incorporates more investor input, but not control. Private equity funds—often structured as limited partnerships—often have investor-chosen advisory committees empowered to veto certain types of transactions, such as conflict transactions, and to trigger votes by investors on designated matters.[66]

Private funds do not confer redemption rights comparable to those of an open-end mutual fund.[67] Private equity funds, as noted above, liquidate periodically (typically every five or ten

---

[64]Morley at 1243.

[65]Research made possible by hedge fund registrations under the Advisers Act revealed patterns of board staffing in the Caymans. Unlike directors of mutual funds who may serve on multiple funds with the same adviser within the same family of funds, many directors of Caymans-based funds each populated numerous boards of funds under unrelated management. Azan Ahmed, *In the Caymans, It's Simple to Fill a Hedge Fund Board*, N.Y. Times, July 1, 2012. Many directors also served their funds as lawyers or otherwise worked for the fund, distinct from board service. *Id*.

[66]Morley at 1255. The long lock-in period for investors' capital may explain why these rights are present.

[67]Although investors lack the ability to sell private-fund shares into secondary markets

years) and are not structured to create interim redemption rights.[68] A limited partner in a private equity fund may always request an early withdrawal, but whether to grant the request is within the general partner's discretion.[69] Private equity structures, although seeming severe in this way, are nonetheless relatively straightforward. In contrast, redemption rights in hedge funds can share the same complexity associated with other aspects of hedge fund vehicles. For example, new investors in a fund are often subject to a one-year "lockup" period that prohibits any withdrawal of funds.[70] Any redemption requires advance notice, typically thirty days up to as long as a year and limited to quarterly or annual periods for redemption.[71] More significantly for purposes of this chapter, hedge funds may incorporate mechanisms that confer discretion on fund managers to restrict redemptions, which if exercised can stymie an investor's desire to achieve liquidity. Most hedge fund agreements permit the manager to impose temporary "gates" on redemption during periods of high investor demand for exit by restricting how much an investor (or all investors)

---

comparable to those for ETFs or closed-end mutual funds, a secondary market exists for interests in private equity funds. *See* William Alden, *A Boom in Private Equity's Secondary Market*, N.Y. Times, Feb. 18, 2015.

[68]Morley at 1254.

[69]When such requests are granted, other partners may object to the valuation that underlies the pro rata share of a hypothetical liquidation of the fund that the exiting limited partner receives. Typically limited partners who wish to exit propose to transfer their interest to a new limited partner; the general partner is more likely to consent to a transfer than a withdrawal, and a transfer holds less potential stigma for the exiting limited partner contemplating whether it will be permitted to invest in other sponsors' funds in the future.

[70]Getmansky *et al*. at 489.

[71]Getmansky *et al*. at 489.

may redeem within a period of time.[72] Additionally, some hedge funds incorporate "side pockets" that enable the fund's manager to segregate relatively illiquid assets from the principal fund, to be distributed to investors as payments in kind, typically through the distribution of interests in a newly created special purpose vehicle.[73] Once placed in a side pocket, an asset may remain there for a long time, which can distort how investors understand the returns reported by the fund.[74]

A manager's discretionary power to restrict redemptions can create a conflict between investors' interests and those of the manager. Wishing to prolong the fund's life and protect its fees (and not just guard the fund's investors against fire sales of relatively illiquid assets) the manager may impose the gate and side-pocket assets to serve its own interests and sacrifice those of the fund's investors, who may strongly prefer the certainty of liquidity in times of market turmoil. Indeed, the SEC brought post-crisis enforcement proceedings against a hedge fund manager who side-pocketed assets for his own use.[75] More generally, the long duration and relative illiquidity of an investment in a hedge fund—or for that matter in any private fund—underscores the importance of disclosure at the point of sale, as well as subsequent compliance by fund managers with ongoing disclosure protocols governing matters such as valuation of fund

---

[72]Aiken *et al*. at 198.

[73]Aiken *et al*. at 199.

[74]Additionally, the side pocket can enable a manager to insulate a difficult-to-value asset from a market in which it would perform poorly, later to triumph when the asset achieves superlative returns. See Aiken et al. at 199, discussing incident recounted by Michael Lewis in *The Big Short* 189-99 (2010).

[75]In re Lawrence Goldfarb, SEC News Digest 2011-85, 2011 WL 1662366 (May 3, 2011).

assets.[76]

Nonetheless, looking forward, hedge-fund investors who are surprised by how a manager used its discretion may sanction funds in fund families that restricted withdrawals. Investors may decline altogether to invest or invest only if the manager lowers its fees. Recent research confirms that investors, not having anticipated the widespread use of discretion to limit redemptions during the financial crisis, responded post-crisis in a manner that sanctioned funds within fund families that deployed discretionary restrictions on redemptions. Funds within families with tainted reputations experienced difficulties raising capital and were more likely to have cut their fees than funds in a control group that did not impose discretionary restrictions on redemptions.[77] Additionally, funds that imposed discretionary restrictions on redemption were no more likely to have sold illiquid assets than funds in a control group that did not impose such restrictions, which "casts doubt on the proposition that [such restrictions] served investor interests by preventing costly fire sales."[78] Thus, it's plausible that prospective investors would understand a fund family in which fund managers imposed discretionary restrictions on redemption as one in which the overall ethos may depart from loyalty to investors' interests, as made evident at the most acute point of conflict between the investors' interests and the manger's self-interest. Thus, just as private fund registration under the Advisers Act and its aftermath made less opaque the environment for private funds and their investors, how fund managers deployed their

[76] John Cannon and Kathleen Marcus, *Disciplined Compliance with Investor Disclosures Protects Funds from SEC Enforcement*, 47 Sec. Reg. & L. Rep. 2361 (2015).

[77] Aiken et al. at 198.

[78] Aiken et al. at 209.

discretionary power to restrict withdrawals during the 2008 financial crisis revealed information relevant to managers' loyalties that proved to be salient to investors' decisions.

Individualized Investment Management

Investing in a fund managed by an investment adviser is, of course, not the sole route through which an investor may delegate investment decisions. An investor may establish an individual management account. Typically in the United States individual-account management services are offered by "retail" firms that otherwise manage mutual funds and pension funds, but not by "institutional" asset management firms, which manage private funds.[79] For regulatory purposes, individual-account managers have long been defined as investment advisers and as such may be required to register with the SEC or a state securities authority.[80]

The key point for purposes of this chapter is that an individual-account investment manager is a common law agent who is also subject to duties defined by the Advisers Act (or its state-law counterpart), when applicable. As a common law agent, an investment manager owes fiduciary duties to its client. Moreover, as the principal in a relationship of common law agency, the client holds rights and powers that do not typify investors in funds as delineated above. It is constitutive of agency—integral to the definition—that the principal holds a power and right of interim control over the agent.[81] Even if the principal's exercise of control contravenes a contract

---

[79]Healy and Greer at 303.

[80]For the details, see DeMott and Laby at 416-18.

[81]Restatement (Third) of Agency § 1.01 & cmt. f ("[a]n essential element of agency is the principal's right to control the agent's actions), quoted in Hollingsworth v. Perry, 133 S. Ct. 2652, 2666 (2013).

with the agent, the principal retains a power of control albeit its exercise constitutes a breach of contract.[82] Investing instead through a fund vehicle interposes the fund itself as the principal; a fund investor may have governance rights but those are different from a principal's more direct powers and rights of control. Additionally, as a principal in a relationship of agency with an investment manager, an individual-account investor has the power to terminate the relationship notwithstanding any agreement to the contrary.[83] To be sure, some individual-account advisers may impose termination fees on clients but most do not, and a prospective management client presented with an agreement that charges for exit may decide to seek management services elsewhere.[84]

The vantage point of the principal-agency relationship created by individual-account management helps illuminate the distinctiveness of mutual funds. As just seen, investors in mutual funds, unlike principals, lack powers of interim control over the fund's managers. Indeed, interim control seems inimical to the advantages of investing through a pooled-investment vehicle, especially when the vehicle serves a large number of investors. This feature of mutual-fund investing is congenial to viewing shares in a mutual fund as products or as comparable in some respects to equity investment in a publicly-held corporation, especially when the investor in

---

[82]*Id*. cmt. f.

[83]*Id*. § 3.10.

[84]Jason Zweig, *Should You Have to Pay a Fee to Fire an Adviser?*, Wall St. J., July 26-27 (2014). The SEC has not addressed the question of termination fees by rule but in general is believed to disfavor termination fees that exceed a reasonable estimate of the costs of setting up and maintaining the client's account. If an adviser does not charge a termination fee, it's likely that the client may owe a portion of the annual account-management fee for the pre-departure tenure of the client's funds with the manager.

question does not hold a controlling position. On the other hand, investors in open-end mutual funds have ongoing rights to exit from their relationship with the fund manager by redeeming their shares, subject to any applicable charges such as back-end sales loads.[85] The right to redeem thus functions as an equivalent to a client-principal's power to terminate the agency relationship with an individual-account manager.[86]

These contrasts and similarities also serve to illuminate the distinctiveness of private funds. As detailed above, like investors in retail mutual funds private-fund investors lack the powers and rights of direct control that are constitutive of a relationship of common-law agency, as well as lacking the smidgens of mandatory governance rights held by investors in mutual funds. Investment in a private fund is also "stickier" than mutual-fund investment because exit can be a long-term prospect. Additionally, for hedge-fund investors exit is both complex and subject to the vagaries of a fund manager's discretion to restrict redemptions. Developments in the private-fund environment that followed Advisers Act registration for many fund managers imply that the relative opacity that previously characterized many private funds came with drawbacks, including obstacles to pricing the potential impact of managerial discretion, amplified by an opaque informational environment. And market developments for hedge funds illustrate

---

[85]Roiter at [ms. pp. 15-16]. Professor Roiter notes that such charges appear not to impose "major obstacles" to redemption because "[w]hether overall market performance in a given year is strong or not, gross redemptions remain relatively close to gross new sales." *Id*. at [ms 16]. To be sure, redeeming early may trigger unpleasant tax consequences, and re-investing in the context of a 401(k) plan confronts whatever limits on investment choice the plan imposes.

[86]Roiter at [ms. 14] ("Just as an investor can terminate the services of a personal investment manager, so too a mutual fund investor, by redeeming her shares, can terminate reliance on the fund's adviser.").

that investors, having failed fully to anticipate how hedge-fund managers might use their discretion in times of crisis, sanction funds in families associated with discretionary limits on redemptions.

3. CONTOURS OF FIDUCIARY DUTY

Fundamental distinctions and institutions

For mutual funds, as for private funds, the significance of fiduciary duties necessarily turns on many factors, including the structural and market characteristics sketched above, as well as on regulatory prescriptions. This section begins with a few foundational distinctions and commonalities, followed by selected specifics. In general, a central objective of regulating asset managers (regardless of how categorized) is reducing agency costs.[87] Toward this end, regulation in the United States is structured around the segmentation of investors through qualifications that establish barriers to investor eligibility. However, as the history recounted above illustrates, even investors who for regulatory purposes are deemed sophisticated may be vulnerable to risks of self-interested managerial behavior. Informational vacuums aggravate these risks.

On questions specifically relevant to fiduciary duties, overall the Advisers Act is a principles-based regime: beyond specific restrictions and requirements imposed by the statute itself, much turns on the interpretation and application of general fiduciary principles.[88] The Supreme Court established the foundational significance of general fiduciary principles for

---

[87]DeMott at 424.

[88]For the "principles-based" characterization, see Champ at 3, 6.

investment advisers in *SEC v. Capital Gains Research Bureau*, holding that an adviser who published a subscription newsletter breached its fiduciary duty through a practice of "scalping" its clients.[89] The adviser recommended securities for purchase in anticipation of selling its own recently acquired holdings once the clients acted on the recommendation and the market price rose. A majority of the Court agreed with the SEC that the scalping practice constituted a fraud or deceit on the adviser's clients that violated Advisers Act section 206 (1)-(2). Although the adviser may have given honest advice it believed sound, its fiduciary duty as an adviser required that it disclose to clients the material fact of the scalping strategy.[90]

A legacy of *Capital Gains* is the general recognition that an investment adviser's fiduciary position requires that the adviser avoid conflicts of interest or, at a minimum, disclose them to clients and obtain the client's informed consent, apart from specific requirements imposed by the Advisers Act itself, discussed below.[91] In contrast, although the ICA regime incorporates general fiduciary principles, it also prescribes much through substantive restrictions.[92] The differences between the two regimes—in overall orientations of managers subject to them as well as specifics—may tend to segment advisers, perhaps making it challenging for a private-fund adviser to transition smoothly into the ICA environment with new registered funds.[93]

---

[89]375 U.S. 180 (1963).

[90]375 U.S. at 197

[91]DeMott and Laby at 422-23.

[92]Champ at 6.

[93]Champ at 6. Mr. Champ, then the Director of the SEC's Division of Investment Management, cautioned hedge-fund advisers "to proceed carefully and thoughtfully before

Related to fiduciary-duty issues but reaching more broadly, the two regimes also differ in their frameworks for internal compliance. For example, it is mandatory for an ICA-registered fund that the fund's chief compliance officer (CCO) report directly to the fund's board, which has sole power to appoint and remove the CCO (but not the adviser).[94] A direct relationship with the fund's board can further the CCO's capacity to act independently by formally insulating the CCO from the adviser's senior management.[95] Internal compliance processes and personnel are highly significant to fiduciary duties when an actor is a complex organization. In part this is because official or formal enforcement of the law and regulation is necessarily subject to limits. As is well known, governmental institutions like the SEC with assigned enforcement functions are constrained by limited resources. Client-initiated enforcement is also subject to constraints; for

---

becoming advisers to registered funds," detailing major differences between the relevant regulatory regimes. *Id*. "Consider carefully your reasons for taking on a registered fund client, and the potential conflicts with your existing business...Merely "tacking on" new [compliance] policies and procedures to the adviser's existing program, without considering the overall impact on the adviser's business model, may increase the risk of compliance weaknesses, deficiencies or violations." *Id*. at 6-7.

[94]The ICA compliance rule, Rule 38a-1, was adopted at the same time as Advisers Act Rule 206(4)-7. Rule 38a-1 requires that the fund's board approve the fund compliance program and those of its adviser and service providers. Under the rule, a fund must have its own chief compliance officer (CCO), whom only the board may appoint and remove. The CCO must report directly to the board. In contrast, Rule 206(4)-7 makes fewer specific demands. Rule 206(4)-7 requires the designation of a CCO, plus the adoption and implementation of policies and procedures reasonably designed to prevent violations of the Advisers Act by advisers and the persons they supervise. One basis for the difference is relatively greater heterogeneity among private-fund advisers.

[95]On the other hand, a CCO's position is weakened when the CCO is an employee at will who may be fired by the adviser's CEO. *See* Sullivan v. Harnisch, 969 N.E.2d 758 (N.Y. 2012)(CCO fired by CEO after CCO alleged CEO's personal transactions constituted front-running of clients' transactions; as employee at will under New York law, CCO had no tort claim for wrongful discharge in violation of public policy).

example, there is no private right of action based on the antifraud provisions of the Advisers Act.[96] Additionally, in opaque environments, a client who may have a viable claim (such as a state law claim for breach of fiduciary obligation) may lack sufficient awareness of the adviser's practices to assert the claim. Finally, as I detail more fully below, the extent to which fiduciary duties may be modified or eliminated through investment management agreements or otherwise is a significant and overarching question.

Principal transactions

Prohibitions on self-dealing are at the core of the fiduciary duty of loyalty. For example, it is well established that as a fiduciary "[a]n agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship."[97] Consent given by the principal to a self-dealing transaction is ineffective unless the agent acts in good faith in obtaining the principal's consent and discloses all material facts to the principal, and the consent concerns either a specific act or transaction or transactions of a specified type that reasonably would be expected to occur within the agency relationship's ordinary course.[98] Against this common law backdrop, it is noteworthy that both the ICA and the Advisers Act—and despite the latter's "principles based" style—deal explicitly with principal transactions, that is, transactions through which a fund's investment adviser for its own account buys securities from

---

[96]Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 18-19 (1979)(limiting private suits to actions under Advisers Act section 215, which makes void contracts in contravention of Act and contracts performance of which would contravene Act).

[97]Restatement (Third) of Agency § 8.03.

[98]*Id.* § 8.06 (1).

or sells securities to a fund.

Their divergent regulatory styles are manifest in differences between the ICA and the Advisers Act. The ICA's stance on principal transactions, articulated in ICA section 17(a), is generally prohibitory.[99] Any such transactions with the adviser itself are prohibited, as are transactions with any affiliate of the adviser, any affiliate of the fund, and any affiliate of an affiliate of the fund. Additionally, under ICA section 17(d) and SEC Rule 17d-1, an adviser to a registered fund may not participate in any "joint enterprise or other joint arrangement or profit-sharing plan" in which the fund is a participant without first obtaining an exemptive order from the SEC. These broadly-drawn prohibitions apply to advisers who manage funds registered under the ICA in addition to private funds.[100] The ICA's prohibitory treatment of principal transactions, unlike the common law of agency, does not contemplate consent to such transactions, even if effected through a vote by fund investors approving the transaction. Viewing a share in a mutual fund as akin to a product that an investor purchases, the ICA's prohibition on principal transactions resembles a form of product-safety regulation effected by specifying acceptable (and unacceptable) characteristics in product design. But the product metaphor, as explained above, does not capture the hybrid complexity of mutual-fund investment, which represents as well an ongoing relationship akin to common law agency that warrants the imposition of fiduciary norms.

In contrast, section 206(3) of the Advisers Act permits principal transactions when the

[99]ICA § 17(a); 15 U.S.C. § 80a-17(a).

[100]The SEC has pursued enforcement actions against advisers who, without a prior exemptive order, caused hedge funds they managed to sell illiquid bonds to a registered fund to reduce the hedge funds' liquidity problems. *See* In re Ruffle, SEC Rel. No. IC-31066, 2014 WL 2447729 (June 2, 2014), discussed in Champ at 6.

client approves them in advance and in writing, having received disclosure of the proposed transaction and the capacity in which the adviser will act.[101] Advance consent can be difficult to obtain when markets are dynamic, with the consequence that many advisers refrain from principal transactions with their clients.[102] Some hedge fund advisers address the statutory requirement of consent through "conflict committees" charged with reviewing and determining whether to approve conflicted transactions on behalf of the fund. To be effective, it is important that the committee's members themselves not be conflicted. In *In re Paradigm Capital Management, Inc.*, the conflicts committee consisted of the adviser's CFO and CCO, and the adviser's CFO served in the same role at an affiliated broker-dealer. The SEC found that this structure did not provide effective written consent, as section 206(3) requires, to transactions conducted by the adviser's owner on behalf of a hedge-fund client through a broker-dealer also controlled by the adviser's owner.[103] *Paradigm* is better known for the SEC's subsequent award of $600,000 through its whistleblower reward program to the broker-dealer's head trader who reported the trading activity.[104]

---

[101]Advisers Act § 206(3); 15 U.S.C. § 80b-6(3). This provision is expressly inapplicable to transactions with a customer of a broker-dealer if the broker-dealer does not act as an investment adviser in connection with the transaction. *Id*.

[102]DeMott and Laby at 422.

[103]In re Paradigm Cap. Mgmt., Advisers Act Rel. No. 3657, 2014 WL 2700783 (June 16, 2014). In at least 83 principal transactions, the adviser's owner caused it to sell securities with unrealized losses from the hedge fund to the affiliated broker-dealer, with the objective of realizing losses to offset the fund's realized gains.

[104] The firm retaliated against its head trader after he reported problematic principal transactions to the SEC. The firm and its owner settled the SEC's anti-retaliation enforcement

Fees

Concerns focused on fees surround investment management relationships, whether regulated under the Advisers Act or the ICA, but differ in focus and specifics. Section 205 (a)(1) of the Advisers Act prohibits fee structures calculated "on the basis of a share of capital gains...or capital appreciation" achieved for all or any portion of the client's funds. This prohibition expressly does not apply contracts with registered investment companies or investments of assets in excess of $1 million when the contract incorporates a "fulcrum" fee, which both increases and decreases in amount over time as performance is measured against an appropriate index.[105] Otherwise, the regulatory strategy of the Advisers Act relies on an adviser's duty to make full and fair disclosure of fees to its clients. An adviser would breach its fiduciary duty by charging one client more than another for substantially the same service without disclosing the discrepancy.[106]

The ICA addresses mutual fund fees explicitly in section 36 (b), which deems an investment adviser to have a fiduciary duty to fund investors "with respect to the receipt of compensation for services, or payments of a material nature," paid by the fund or its investors to the adviser or any affiliate. This duty situates a mutual fund's investment adviser in an agency relationship of sorts with the fund's investors. So situated, one might wonder how—consistent with well-established agency-law doctrine—a mutual fund's adviser could justify taxing the fund

---

action for $2.2 million.

[105]Advisers Act § 205(b)(2). On fulcrum fees generally, see Bieber and Price.

[106]DeMott and Laby at 427.

itself, and thus its present investors, with the costs of distributing new shares.[107] After all, the fund's adviser, paid a management fee typically calculated as a percentage of the fund's assets, has an interest in enticing new investors to augment the fee.[108] The SEC resolved the obstacle posed by ICA section 12(b)—which prohibits a fund from paying for its own costs of distribution absent exemptive action by the SEC—in 1980 through Rule 12b-1, which lifts the statutory prohibition by permitting fund directors wider latitude in allocating distribution costs.[109] The results were mixed: fund directors seemed willing to approve fee requests, regardless of circumstances.[110]

Private funds, in contrast, are not subject to the prohibition on performance-geared fees stated in Advisers Act section 205(a)(1).[111] Simplifying greatly, a commonly-used structure for hedge funds consists of an annual management fee of 1-2% plus an annual performance fee calculated as 20-50% of net trading gains.[112] For private equity funds, an annual management fee

---

[107]Frankel (2007) at 377-86.

[108]Roiter at [ms. 31].

[109]Roiter at [ms. 37].

[110]Roiter at [ms. 37-38]. In the aggregate, Rule 12b-1 fees benefited advisers through growth in fund size, while benefits for fund shareholders did not follow through decreased expenditures via economies of scale or lower fund flow volatility. Lori Walsh, The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flow, Expenses and Returns (2004), *available at* https://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.

[111]Advisers Act § 205 (a)(4)(prohibition on performance fees inapplicable to investment advisory contract with investment company excepted from ICA registration by ICA § 3(c)(7).

[112]In this structure, the performance fee typically is subject to a "high water mark," which means that losses must be made up before the performance fee becomes applicable to gains. Some fund managers were known for especially high fees: SAC Capital charged a 3 percent

of 1-2% of committed capital is typical,[113] plus an 80%-20% division of profits as between the fund's limited partner investors and the fund's general partner. As discussed above, post-crisis developments confound the pre-crisis view that these proportionate allocations and their amounts (along the lines of "two and twenty"), akin to facts of nature, were immutable. Additionally, by 2015, the sharp increase in institutional investing in hedge funds pressured traditional fee structures, led by investors with greater bargaining power.[114] Distinct from fees explicitly paid to an investment adviser, the adviser's fiduciary duty also applies to how it allocates expenses it incurs, for example as between the funds it manages and investors who co-invest with the fund. In June 2015, the SEC charged a prominent private equity firm, Kohlberg Kravis Roberts & Co., under Advisers Act section 206(2) alleging the misallocation of over $17 million in expenses attributable to buy-out opportunities that failed. The firm had allocated all of these expenses to funds it managed but none to co-investors with the funds, a cohort that included KKR's own executives.[115] The firm settled for $30 million, inclusive of a $10 million penalty, as widely noted in news media.[116]

---

management fee and a performance fee of up to 50 percent. Peter Lattman and Ben Protess, *$1.2 Billion Fine for Hedge Fund SAC Capital in Insider Case*, N.Y. Times, Nov. 4, 2013.

[113]The fund "calls" or requires the payment of committed capital only when it has identified investments to make.

[114] Kaal at [ms. 24]. In Professor Kaal's assessment, the 2/20 structure no longer typifies private funds.

[115]In re Kohlberg Kravis Roberts & Co., Rel. No. Ia-4131, June 29, 2015, 2015 WL 4123730.

[116]*E.g.*, Alexandra Stevenson, *KKR Settles Over "Broken Deal" Expenses*, N.Y. Times,

Exculpatory provisions

A general question about duties is whether or to what extent parties may modify or eliminate duties that the law imposes or mitigate the otherwise-applicable consequences of breach of duty. Once again, the contrast between the ICA and the Advisors Act is informative. ICA section 17(i) explicitly prohibits the use in investment advisory agreements of provisions that protect a person against otherwise-applicable liability "by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his duties" under the agreement.[117] An implication is that exculpatory provisions—termed in this context "hedge" clauses—may protect against liability for lesser breaches of duty, including ordinary negligence.

The principles-based Advisers Act does not explicitly address hedge clauses. In interpreting the Act's general prohibitions on fraud, the SEC long disapproved of hedge clauses in investment-advisory contracts, distinct from the ICA context, reasoning that such clauses were likely to mislead investors into believing that they had waived all rights against the adviser. To be sure, early hedge clauses that the SEC condemned were problematic on many grounds, one clause stating that "'no liability is assumed'" by the adviser for the accuracy of information given to its clients.[118] More recently, the SEC's staff indicated that by using a hedge clause an adviser does not necessarily violate the Adviser Act's antifraud provisions. The hedge clause in question,

---

June 29, 2015.

[117]ICA § 17(i); 15 U.S.C. § 80a-17(i).

[118]DeMott and Laby at 449.

which came to the staff's attention during a routine examination, purported to exculpate the adviser from liability stemming from conduct that was not "grossly negligent, reckless, willfully improper, or illegal" and that did not constitute a material breach of the advisory contract or action beyond the scope of the adviser's authority.[119] Like provisions permitted by ICA section 17 (i) this language would exculpate the adviser from liability stemming from ordinary negligence. The SEC's staff stated that although using the language would not constitute a per se violation of the Advisers Act, only by considering the full facts and circumstances, focused on the particulars of each client, could the adviser's proposed deployment of hedge clause be assessed.

4. IMPLICATIONS

Four implications emerge from the material recounted in this chapter. First, the amount and quality of information available to investors matters. Just how and how much information can matter is evident in the post-crisis history of private funds. Second, it is an open question how long memories will retain lessons learned from the crisis and its aftermath. Memories may endure longer, though, when they concern epoch-defining events, especially ones that came as a bad surprise and that are shared by many who lived through the epoch. Tellingly, even general news media have not forgotten which hedge funds imposed discretionary restrictions on redemptions.[120]

---

[119] Heitman Cap. Mgmt., 2007 WL 789073 (Feb. 12, 2007).

[120] For a recent example, see Rob Copeland, *Citadel's Ken Griffin Leaves 2008 Tumble Far Behind*, Wall St. J., Aug. 3, 2015 (characterizing funds' gating in 2008 as "still grating" to some observers). And Claren Road's more recent delay in paying out withdrawal requests, characterized as "unusual since the financial crisis ended," nonetheless "rankled some investors." Juliet Chung, *More Withdrawals for Carlyle Group's Claren Road*, Wall St. J., Dec. 22, 2015 at C4.

Third, much of the regulatory architecture applicable to investment funds turns on carefully segmenting investors into groups that can be readily typified. One might wonder whether by segmenting investors the regulatory architecture also segments advisers, who may find it challenging to transition from a principles-based regime to the prescriptive ICA regime. Fourth, scholars who focus on mutual funds place considerable weight on the power held by mutual-fund investors to redeem their shares. This emphasis may suggest the vulnerability to critique of the discretionary power over redemption held by many hedge-fund managers. To be sure, memories of crisis-era conduct may endure and continue to inform choices made by investors in private funds. Even granting that assumption, investors' choices are always made on the basis of information, and the private-fund context can prove opaque.

5. CONCLUSION

As the incoming President of the American Finance Association, Professor Luigi Zingales addressed a broad question that may not have been equally welcome to all in the audience for his presidential address: "Does Finance Benefit Society?" To be sure, Professor Zingales did not much engage with the asset management industry.[121] Tellingly, though, he emphasized the importance of scholarly identification of the "rent-seeking components of finance,"[122] the importance of acknowledging that poor general repute has a role in shaping regulation and

[121]He did point out that for business-school case studies critical of venture capital, "one has to read marketing cases, not finance ones." Zingales at 1359.

[122]Zingales at 1343.

governmental intervention,[123] and the widespread consequences that follow problematic conduct in the finance sector. This chapter does not question the proposition that investment funds, however structured, can be and often are widely beneficial. But the chapter does identify reasons to wonder whether, at any particular time, all is optimal.

[123]Zingales at 1328.

REFERENCES

Aiken, Adam L., Clifford, Christopher P., and Ellis, Jesse A., Hedge Funds and Discretionary Liquidity Restrictions, 116 J. Fin. Econ. 197-218 (2015).

Bieber, Sander M. and Price, Lisa R., Fulcrum Fees: Registered Funds' Alternative Fee Structure, 21 Inv. Lawyer, no. 9 (Sept. 2014).

BIRDTHISTLE, WILLIAM A., EMPIRE OF THE FUND (forthcoming 2016).

Bowden, Andrew J., Spreading Sunshine in Private Equity, May 6, 2014, available at http://www.sec.gov/news/speech/2014–spch05062014ab.html

Cain, Matthew D., McKeon, Stephen B., and Davidoff Solomon, Steven, Intermediation in Private Equity (May 2015), *available at* http://ssrn.com/abstract=2586273

Champ, Norm, Remarks to the Practicing Law Institute, Hedge Fund Management Seminar 2014, Sept. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542916156

DeMott, Deborah A., Regulatory techniques and liability regimes for asset managers, 7 Cap. Mkts L. J. 423-31 (2012).

DeMott, Deborah A. and Laby, Arthur B., The United States of America, in LIABILITY OF ASSET MANAGERS 411-55 (Busch, D. & DeMott, D. eds 2012).

FRANKEL, TAMAR, INVESTMENT MANAGEMENT REGULATION (4th ed. 2011).

Frankel, Tamar, United States Mutual Fund Investors, Their Managers and Distributors in CONFLICTS OF INTEREST (Thévenoz, Luc and Bahar, Rashid eds. 2007) 363-94.

Getmansky, Mila, Lee, Peter A. and Lo, Andrew W., Hedge Funds: A Dynamic Industry In Transition, 7 Ann. Rev. Fin. Econ. 483-577 (2015).

Greene, Nathan and Adams, John, US regulation of investment advisers and private investment funds—a concise overview, in RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS (Athanassiou, Phoebus ed.) 355-78.

Healy, Robert and Greer, Amy, In the Crosshairs: The Asset Management Industry, 46 Sec. Reg. & L. Rep. 302-06 (2014).

Kaal, Wulf A., The Post Dodd-Frank-Act Evolution of the Private Fund Industry: Comparative Evidence from 2012 and 2015, __ Bus. Law. __ (forthcoming).

KIRSCH, CLIFFORD, MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION (3rd ed. 2015).

Kostovetsky, Leonard, "Whom Do You Trust?" Investment-Advisor Relationships and Mutual Fund Flows, 29 Rev. Fin. Studies 898-936 (2016).

Morley, John, The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation, 123 Yale L.J. 1228-87 (2014).

Phalippou, Ludovic, Private equity funds' performance, risk and selection, in RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS (Ahtanassiou, Phoebus, ed. 2012) 113-37.

Rendón, Veronica E., Fleishhacker, Ellen Kaye, Lavin, Kevin J., Esser, Meredith B. and Kurzman, Jennifer S., Private Equity Management of Fees and Expenses: A Cautionary Tale, 46 Sec. Reg. & L. Rep. 1351-53 (2014).

Roiter, Eric D., Disentangling Mutual Fund Governance from Corporate Governance, 5 Harv. Bus. L. Rev. (forthcoming Fall 2015).

Securities and Exchange Commission, Staff Report on the Review of the Definition of "Accredited Investor," Dec. 18, 2015, *available at* https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf

Wyatt, Marc, Private Equity: A Look Back and a Glimpse Ahead, May 13, 2015, available at http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

United States Government Accountability Office, Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered, July 2013, *available at* http://www.gao.gov/assets/660/655963.pdf

Zingales, Luigi, Presidential Address: Does Finance Benefit Society, 70 J. Fin. 1327-63 (2015).