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INTRODUCTION

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I. Scope of the Book

1. In general

The subject matter of this book, asset management, is a distinctive sector of the financial services industry through which firms and individuals with professed expertise recommend and in many instances determine the assets that will comprise the investment portfolios held by their clients. An asset manager may hold discretionary authority to make investment decisions unilaterally on a client's behalf; whether the manager possesses such authority determines how the manager–client relationship is categorized in some (but not all) regulatory systems. In other systems, the definitional linchpin for regulation is not whether an actor manages a client's investment assets but whether the actor serves as an 'investment adviser' as defined by the regulation. The book's scope is limited to asset management relationships that pertain to individual portfolios of investment securities, as opposed to management of collective investment schemes such as mutual funds and UCITs. However, the same manager may handle both collective schemes and individual accounts, and units in collective schemes often constitute some portion of the assets held in individual portfolios. **1.01**

Asset management relationships differ in many respects, in particular in the characteristics of clients served by managers and in the firms and individuals that populate this industry. Asset managers serve clienteles that vary widely in salient characteristics, including investment acumen and sophistication, investment objectives, bargaining power, and tolerance for investment risk. In various ways, the regulation of asset managers differentiates among types of clients. Investment managers differ as well in their expertise, the value and types of assets they manage, their geographic range of operation, and the clientele of investors they serve. The composition of the investment management industry includes stand-alone independent firms, as well as managers situated within or associated with financial services firms that provide other types of services, such as banking, insurance, and brokerage. In any event, and however classified by specialized regulation or by a jurisdiction's generally applicable law, at the heart of the legal relationship between a client and an asset manager are the duties each owes the other and the consequences the law assigns to breach of these duties. **1.02**

The book's geographic scope encompasses several European jurisdictions plus Canada and the United States. Among the European jurisdictions, all but one (Switzerland) are member **1.03**

states of the European Union and, as such, subject to EU-level directives on financial services.¹ These EU jurisdictions—England and Wales, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Poland, Scotland, and Spain—have all implemented the 2004 Markets in Financial Instruments Directive (MiFID) and its provisions applicable to asset management. Chapter 2 details MiFID’s history, definitions, and requirements. Although MiFID unquestionably increased the extent of harmonization in the regulation of EU financial markets, this book demonstrates that significant differences remain among MiFID jurisdictions. This is so for many reasons. In each jurisdiction history and economic circumstances combine with general or ‘background’ law to produce a distinctive legal and regulatory context for the provision of asset management services. These differences are prominent for issues that determine asset managers’ liability towards their clients and remedies available to the client.

- 1.04** Asset management is distinctive, if not unique, because the applicable law is in fact composed of a mix of legal doctrines that range from the general to the very specific and across boundaries between public (or administrative) law and private law. These bodies of law include the private law of contract, agency, tort, and trusts, grounded in civil and commercial code provisions in civil law jurisdictions; statutes and administrative regulations applicable to capital markets and the financial services industry, some but not all of which are specifically geared towards asset management relationships; provisions in contracts between asset managers and their clients; and, in many jurisdictions, self-regulatory rules and procedures developed by industry-based organizations that may carry the force of law. Absent the force of law, industry practices may shape the application of formal legal doctrine, for example, in assessments of whether a manager acted reasonably and with due care and through the development and use of standardized contract terms. Industry practices and legal requirements may also generate gatekeepers that impose additional constraints on asset managers; that is, other actors may furnish services that are essential to asset managers’ operation under terms that require monitoring the asset manager’s compliance with specific laws.² The institutions that enforce the law include specialist agencies and enforcement bodies situated within industry bodies, as well as general courts and other mechanisms for dispute resolution. Of course, clients themselves also enforce the law, subject to the doctrinal and institutional constraints elaborated in successive chapters of this book.
- 1.05** Adding to the complexity, in most jurisdictions covered by this book, law is made at more than one level. EU member states are subject to MiFID as implemented by or transposed into national law. Canada, like the United States, reflects a distinctive blend of national-level and provincial- or state-level law, administrative regulation, self-regulation, and governmental and non-governmental institutions.³ In Switzerland, a non-EU state and a major global financial centre,⁴ self-regulatory organizations play a prominent role and the asset management

¹ MiFID is also applicable to nations within the European Economic Area (EEA), which Switzerland is not.

² On gatekeeping functions generally, see John C. Coffee, Jr, *Gatekeepers* (2006). For further elaboration in the asset management context, see para 1.29.

³ The provinces of Ontario and Quebec are especially significant because they are the two most populous central provinces. See para 14.07.

⁴ Among other indicia of its prominence, Switzerland is the leader in cross-border banking with a 27 per cent market share. See para 10.02.

industry itself is highly professionalized but not subject to specific licensing or other regulatory requirements as a legal matter.

The book's structure reflects this complexity. Following the treatment of MiFID in Chapter 2, the chapters detail the law applicable to asset management in each of the jurisdictions included in the book. Each chapter begins with an introduction to features of that jurisdiction's asset management industry including available data about aggregate values of assets under management and salient characteristics of governmental structures and institutions. The chapters next examine the definition (or characterization) of asset management for regulatory purposes, followed by its characterization within private law. Each chapter then discusses the relevant regulatory institutions and their requirements, including, for MiFID jurisdictions, how MiFID's requirements have been implemented. These include requirements applicable to asset managers' organization, conduct of business, execution of orders affecting clients' portfolios, custody of clients' assets, and market abuse by asset managers. Each chapter also considers the impact of rules issued by self-regulatory organizations, ranging from formal legal recognition to more indirect forms of influence and authority. In each jurisdiction covered in the book, applicable regulation has long 'tentacles'⁵ (although arguably ones that differ in length, breadth, and texture) that structure the provision of asset management services.⁶ Nonetheless, due to the nature of asset management relationships, other non-regulatory sources of law remain salient. **1.06**

Against this extensive regulatory background, the chapters examine an asset manager's duties as specified by the jurisdiction's private law, taking into account the interrelationships between private law duties and regulation. In all jurisdictions, the starting point is the contract that stems from the relationship between a client and an asset manager,⁷ preceded by any applicable pre-contractual duties. The bases on which an asset manager may be subject to liability to a client as a consequence of its breach of duty follow, as do the bases on which an asset manager may be subject to liability as a consequence of another person's act or omission. Each chapter examines the remedies available to a client and the extent to which duties otherwise applicable to a manager may be varied or eliminated, or their consequences mitigated, through a contractual provision. The chapters conclude by examining the extent to which parties to an asset management relationship are free to choose the law to govern their relationship and the forum in which disputes will be resolved. **1.07**

The remainder of this Introduction does not attempt to summarize the book's content in comprehensive and detailed fashion. Instead, the Introduction next discusses the economic significance of asset management, followed by a general framework within which to assess some of the specifics of regulation applicable to asset management. A particular focus is the interplay between regulation and liability, as illustrated by specific regulatory techniques **1.08**

⁵ See para 15.03 (Scotland).

⁶ Indeed, a specific regulatory environment may be so pervasive that it becomes unwise for a client negotiating an asset management agreement to insist on inclusion of a clause specifying that the contract will be governed by the law of the client's place of business, as opposed to the manager's: '[t]he investment manager is a regulated professional services provider whose operations will have been organized in accordance with the principles and regulatory framework of its place of business', although it is understandable that a non-local client may wish to 'seek the protection of its own courts in the event of a dispute with a foreign investment manager'. See para 11.116 (England and Wales).

⁷ In some cases within the scope of this book, the relevant legal relationship is established by a trust instrument. See para 13.09 (United States).

evident in the regulation of asset managers. In the concluding chapter we identify a few common themes that run through the treatment in individual chapters of asset managers' liabilities in relationship to a particular jurisdiction's regulatory framework.

2. Economic significance

- 1.09** Asset management has economic significance, both for clients and their managers and by aggregate measures. Whether or not a client's portfolio is successfully managed may determine, for a household, the ability to fund income needs in retirement or meet other life goals, consequences that if aggregated across similarly situated household portfolios may carry broader economic significance. For an institutional client (eg a foundation) or a municipality or other governmental unit, the results of portfolio management may affect the client's ability to carry out its activities or fulfil its responsibilities to its constituents. Although the global scale of asset management is difficult to measure,⁸ using any definition of asset management the value of assets under management is large. In 2011, one study reported \$121.8 trillion in assets under management on a worldwide basis, which represents an 8 per cent increase of \$20 trillion from 2010.⁹ The investment management business is not immune from the effects of general economic and financial cycles.¹⁰ During the 2008 financial crisis, many clients shifted assets into cash and redirected their assets back into equities thereafter.¹¹ Some of the cases detailed in various chapters illustrate investment management gone awry in the face of broader developments in financial markets.¹² Additionally, as the book's individual chapters illustrate, many investment managers operate beyond the national boundaries of the jurisdiction in which they were formed, placing asset management within the set of cross-border activities that affect capital markets. In many jurisdictions, not just those covered by this book, a foreign manager's ability to operate outside its home jurisdiction is subject to regulatory constraints that can limit the products it may provide or the clients it may serve, while shifts in regulatory practices more broadly may require adaptation away from historic practices.¹³

3. Regulation's goals and limitations in perspective

- 1.10** To an economist, asset management would represent a prototypical principal-agent relationship, in which a principal (a client or prospective client) obtains the services of a specialist agent (the manager) and delegates responsibility and pays a fee for the benefit of discretionary management services for which the client lacks expertise. Agency costs in this

⁸ Marcia L. MacHarg and Barton B. Clark, *International Survey of Investment Adviser Regulation* 1 (2d edn 1994).

⁹ Boston Consulting Group, *Global Wealth 2011: Shaping a New Tomorrow* (2011). This report defines assets under management to include 'cash deposits, money market funds, listed securities held directly or indirectly through managed investments, and onshore and offshore assets' and to exclude 'wealth attributed to investors' own businesses, residences, or luxury goods' (ibid at 1 fn 1).

¹⁰ Relatedly, indicia of the profitability of asset management businesses also fluctuate over time. For 2010, although the average pre-tax profit margin increased to 23 basis points, an increase of 4 basis points from 2009, revenue margins were lower in most geographic regions than prior to the 2008 financial crisis and cost-to-income ratios remained higher than pre-crisis levels (ibid 5).

¹¹ Ibid 7.

¹² See eg para 5.04 (Italy).

¹³ See para 10.105 (Switzerland); see also Boston Consulting Group, *Global Wealth 2011*, 5 (observing that '[o]ffshore wealth managers, particularly those based in Switzerland, faced the most significant challenges, as the push to increase tax and regulatory compliance as well as international reporting stemmed the flow of assets and imposed new costs').

context stem from risks that the manager will prefer, over a client's best interests, either its own interests or those of other clients, or that the manager will be insufficiently diligent, careful, or skilled in acting on behalf of its client. Agency costs also encompass costs incurred by the client in monitoring the manager to the extent feasible and otherwise self-protecting against potential lapses by the manager.¹⁴ Reducing such costs, which are endemic to asset management relationships, is a core objective of regulation, which aims to protect managers' clients as investors. As this book illustrates, this core objective situates the regulation of asset managers within the broad province of securities regulation; the specifics detailed in this book illustrate the repertoire of regulatory techniques available more generally. To be sure, jurisdictions differ in the specific techniques or strategies deployed towards this objective. Moreover, in some jurisdictions household clients are additionally protected by consumer protective legislation that ranges in applicability well beyond the bounds of investment services and products. MiFID itself differentiates between non-professional or 'retail' clients and other clients deemed to be more sophisticated.¹⁵ Furthermore, MiFID was geared to serve broad objectives; at the EU level, it was aimed at creating a single market for financial services and at harmonizing the protections available to investors, towards a general goal of increasing the competitiveness of financial markets in the European Union.¹⁶

In some respects, the regulation of asset managers differs from other components of securities regulation. Much of securities regulation focuses on the quality of information that pertains to investment assets, for example, by requiring accurate disclosure by issuers of securities in prospectuses and in periodic or current reports. This makes sense; investment securities differ from other assets because they lack intrinsic value and represent rights in something else.¹⁷ Likewise, securities are not consumable but rather are comparable to a currency that may be traded in secondary markets. Assuring the availability and accuracy of information about the 'something else' from which a security derives its value, and guarding the integrity of pricing in information-driven secondary markets, are the central regulatory objectives.¹⁸ Seen in this light, an asset manager or investment adviser intermediates between its client—the ultimate investor—and the issuer of a security. By filtering information generated by issuers of securities and through decisions to buy and sell securities at any given price, asset managers are a component force in market pricing more generally. Thus, systemic concerns for the informational integrity of securities markets extend to the regulation of asset managers and their conduct. To the extent a manager's judgment is biased by conflicts of interest, such as secret payments received from issuers or undisclosed own-account holdings in securities purchased for clients' accounts, the manager's decisions implicate systemic concerns about the flow of information to, and pricing within, securities markets, beyond the manager's duties in a relationship with any particular client.¹⁹ Furthermore, a jurisdiction's

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¹⁴ On agency costs and mechanisms to address them, see 'Agency Costs and Corporate Governance' in 1 New Palgrave Dictionary of Economics and the Law 26–30 (Peter Newman ed 1998).

¹⁵ In particular, retail investors are distinguished from professional investors and eligible counterparties. See paras 2.60–2.67 (MiFID). The EC is considering amending the relevant definitions to exclude municipalities from the category of 'eligible counterparty' because the financial crisis and episodes of alleged mis-selling suggest the present definition does not adequately reflect the ability of some non-retail clients 'to understand the risks to which they are exposed, especially in the case of very complex products' (ibid para 2.104).

¹⁶ See para 2.01 (MiFID).

¹⁷ Thomas L. Hazen, 1 Securities Regulation 13 (5th edn 2002).

¹⁸ Ibid 13–14.

¹⁹ See James D. Cox et al, Securities Regulation 1003–4 (5th edn 2009).

regulation of asset managers may reflect additional and broader regulatory commitments, such as assuring compliance with anti-money laundering,²⁰ anti-terrorist financing, and anti-tax evasion laws.

- 1.12** No system of regulation, however well designed or well enforced, is likely to ensure perfect compliance by investment managers with the duties they owe to investors, whether or not the duties originate in the regulation itself or in other bodies of law. Thus, regardless of jurisdiction, it is important to consider the circumstances under which an asset manager who breaches a duty owed to a client is subject to liability to the client, the potential means to enforce that liability, and the remedies that may be available to the client. Focusing on liability illustrates complex patterns of interrelationships among the sources of law applicable to the asset manager–client relationship. In particular, MiFID itself does not address questions of liability and remedies, which remain governed by the national law that is applicable to the asset management relationship in question. The book demonstrates that MiFID jurisdictions differ on many significant issues, including the most basic question of whether or how a manager’s breach of a duty articulated in MiFID (and the local jurisdiction’s implementation of MiFID) is itself a basis on which liability may be grounded. The concluding chapter examines this point more extensively.
- 1.13** The book also demonstrates that, MiFID aside, liability questions—and complex interactions among separate bodies of law—are inescapable even in jurisdictions with long-established and complex systems of specialized regulation. In Canada, as in the United States, elaborate structures of statutory and administrative regulation, which articulate bases for managers’ liability, are layered upon concepts and doctrines developed by cases (and, in Quebec, in a general Civil Code) outside this specialized context. Over time, those general bodies of private law shape developments in more specialized settings like the regulation of asset management and, in turn, themselves may reflect the influence on general law of applying the law in a more specialized context. To be sure, liability questions are significant even in the absence of specialized regulation. In Switzerland, in which asset management as such is not a regulated service, asset managers are subject to duties as their clients’ agents and through an elaborate web of law and self-regulation.²¹

II. Regulation and Liability in Context

1. General

- 1.14** Viewed within the context of regulatory design, the prospect that an actor may be subject to liability after-the-fact of a breach of a duty imposed by regulation might be seen as a failure in either the design or the enforcement of the regulation, or both. However, regulation is limited in scope for many reasons. Regulation imposes costs on the regulated constituency, ultimately borne in many cases by its clients or even more broadly, as when over-regulation stifles useful innovation. Sensitivity to such costs relative to regulation’s anticipated benefits

²⁰ In Switzerland, independent investment managers are subject to governmental audit only in connection with their proper performance of duties imposed by the Anti-Money Laundering Act of 1995, which applies to all financial intermediaries whether or not subject to licensing, regulation, or supervision for other purposes. See para 10.01.

²¹ See paras 10.09 to 10.19.

is both inevitable and desirable on the part of legislators and regulatory administrators.²² Thus, although conduct that leads to liability may evidence regulatory failure, it may also or alternatively reflect the limited nature of any regulatory system, itself the consequence of judgments and trade-offs made in the course of legislation and its implementation and enforcement.

A separate question is the extent to which regulation—in the sense of a public agency’s sustained and focused control exercised over activities that a community values²³—and liability are effective substitutes for each other. That is, by assigning rights to private parties and creating or tweaking liability rules, a state might consider using court-enforced liability rules as a substitute for regulation and its enforcement by public regulatory bodies. The theory is that the prospect of liability and the cost of compensating victims would deter conduct that violates rights. It is widely acknowledged that this approach is not an adequate response to some problems, such as environmental pollution. The difficulties of setting standards for manufacturers and other polluters through after-the-fact litigation, determining the damage caused by pollution, and facilitating access to the judicial system are overwhelmingly beyond the capacity of liability rules and private-party litigation.²⁴ In many areas, liability and regulation are better seen as complementary activities; for example, regulation may usefully set general standards with greater predictability than case-by-case litigation under liability rules, and the standards may be informed by regulators’ greater access to relevant knowledge. Moreover, as an instrumentality of the state, a regulator may have access to information not available to private parties and become informed of problematic conduct at an earlier time, enabling the regulator to take action prior to the occurrence of injury. In contrast, liability rules may address instances that lie beyond the scope of the regulation or that reflect non-compliance with the regulation or its lag in the face of ongoing developments. Liability may also be a better mechanism in some instances to provide compensation to injured parties because fact-specific litigation can be more sensitive to the circumstances of conduct that led to the injury and the specifics of the injury itself. Additionally, public enforcement confronts resource limits that may seem inevitable. Of course, the breadth or exclusivity with which a body of regulation should occupy a field, relative to litigation under liability rules, is often contested.

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In any event, it is helpful to consider interactions between liability and regulatory choices. The next section begins with a selective survey of regulatory techniques used in connection with asset managers. The following section identifies and examines a few salient examples of interactions between liability and regulation based on the survey.

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2. Techniques of regulation and asset managers

A. General

The distinctiveness of asset management explains the variety of regulatory techniques used in the jurisdictions covered in this book. This section discusses four such techniques: (1) mandated

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²² See Robert Baldwin, *Understanding Regulation* 94 (1999). Even given scepticism about purely economic appraisals of regulation’s efficiency, ‘there is a role for the appraisal of costs and benefits in regulation but it is a constrained one. . . . What can be done is to use economic appraisals not to impede regulation (as an end in itself), or in order to give business a say in regulatory policy-making, but as a supplement to the policy-making process’ (ibid).

²³ P. Selznick, ‘Focusing Organizational Research on Regulation’ in *Regulatory Policy and the Social Sciences* 363 (R. Noll ed 1985), noted in Baldwin, *Understanding Regulation*, 2.

²⁴ See Stephen Breyer, *Regulation and Its Reform* 177 (1982).

disclosures by the manager; (2) registration and licensing requirements; (3) conduct of business requirements, in particular arrangements for custody of clients' portfolio assets; and (4) self-regulation grounded in industry organizations, perhaps best seen as an aspect of the 'style' of a jurisdiction's regulation more generally. There are differences among jurisdictions, including the extent to which a particular regulatory approach dominates a jurisdiction's overall regulatory approach. Of course, the available repertoire includes other regulatory techniques not highlighted here in the interests of space and the reader's time.

B. Mandated disclosure of information

- 1.18** As a regulatory technique, mandating the disclosure of information has been characterized as 'augmenting the preconditions of a competitive marketplace'.²⁵ That is, a disclosure regime does not mandate conduct by those subject to the regulation, nor does it necessarily restrict the choices available to consumers of the regulated service. The objective is enabling better informed choices, in this context enabling clients and prospective clients to draw comparisons among managers across criteria informed by their disclosure of specific types of information. An advantage of disclosure as a regulatory technique is that less fine-tuning of standards is required of the regulator itself, with lower risks of error.²⁶ To be sure, some disclosure requirements have the likely effect of reshaping conduct because by mandating disclosure the regulator creates an incentive to avoid conduct that, if known, would be detrimental to an actor's reputation. More generally, mandated disclosure may prompt useful discussion within a regulated firm and productive interactions with its legal counsel, such that, although the relevant disclosure requirements are imposed by state authority, they are implemented through decisions internal to regulated firms themselves, arguably resituating them as participants within the regulatory process and enhancing compliance with regulatory objectives by enrolling actors within regulated firms in 'the regulator's way of thinking about the market'.²⁷ To be sure, disclosure is not the sole regulatory technique that may carry this consequence.
- 1.19** Unsurprisingly, mandated disclosure by asset managers is a widely used regulatory technique in jurisdictions covered by this book. An underlying principle of MiFID is that investors should be adequately informed when they make investment decisions, including decisions concerning asset managers.²⁸ MiFID's Implementing Directive details the specifics of adequacy, which vary depending on whether the client is a retail or a professional client; professional clients are assumed to be better able to identify for themselves the information needed to make informed decisions. In general and with the degree of detail varying with the category of client, information must be furnished about the investment manager itself, the nature and risks of financial instruments, the safeguarding of client funds and other assets, and fees and costs. On some issues, MiFID left discretion in implementation; in Italy, for example, in which the law permits a third party to hold in an omnibus account financial assets belonging to an asset manager's retail (or potential retail) client, the management firm has a duty to inform its client of this fact, as well as a duty to provide a prominent warning of the risks.²⁹ The prevalence of mandated disclosure as a regulatory technique does not mean

²⁵ Ibid 161.

²⁶ Ibid 163.

²⁷ For full development of this point, see Annelise Riles, *Collateral Knowledge* 234–6 (2011).

²⁸ See para 2.79 (MiFID).

²⁹ See para 5.25 (Italy).

that the technique is beyond criticism on varying grounds, including the basic observation of diminishing returns when disclosure becomes ‘top heavy’³⁰ and lesser details obscure more important information, overloading and dulling the discriminatory powers of the disclosure’s intended user. Additionally, the regulatory duty to disclose specified information is not equivalent to a manager’s affirmative duty to warn a client about financial risks associated with a particular transaction³¹ or other possible implications of the duty of care that the manager, as an agent, owes its client as principal.

In the United States, the mandated disclosure of specified information has long been central to the regulatory system applicable to investment advisers under the Investment Advisers Act of 1940 (the Advisers Act).³² Indeed, such disclosure is an adviser’s primary duty; advisers are subject to specific disclosure requirements, including an obligation to furnish clients and prospective clients with information as specified by the Securities and Exchange Commission (SEC). By specifying what must be disclosed, and mandating a format, disclosure regulation of this style might facilitate a prospective or present client’s ability to draw comparisons among advisers. **1.20**

More noteworthy, and more distinctive, is the dominance of mandated disclosure as a regulatory technique in the United States compared with some of the other jurisdictions covered by this book, including Canada.³³ As becomes evident in subsequent paragraphs, on some issues the United States regulates more through mandated disclosure in preference to other potential regulatory techniques. **1.21**

C. Registration and licensing requirements

With the exception of Switzerland, all jurisdictions covered by this book require that an asset manager comply with a licensing or registration requirement administered by a public regulator, unless the manager is exempt from the requirement. The specifics of these requirements vary. In MiFID jurisdictions, prior authorization is required to perform investment services (including asset management) as a regular occupation or business on a professional basis.³⁴ Among MiFID’s requirements for authorization are membership in an authorized investor compensation scheme and compliance with prescribed minimum capital requirements. Minimum capital requirements are greater when a manager holds clients’ assets or engages in particular activities associated with higher risk.³⁵ In Ireland, authorization requires an in-person meeting with the Central Bank, followed by submission of extensive information.³⁶ Before granting authorization, the Central Bank must be satisfied as to the probity and competence of each of an applicant’s directors and senior managers, among other criteria. The Bank may impose additional requirements on an applicant.³⁷ In Canada, regulation for this purpose is conducted on a provincial level. Registration and licensing in Ontario require meeting requirements for proficiency; individuals falling within the regulatory **1.22**

³⁰ Lachlan Burn, *Disclosure in the EEA Securities Market—Making Sense of the Puzzle* 3(2) Capital Markets Law Journal 139 at 145 (2008).

³¹ See paras 7.93 and 7.114 (the Netherlands).

³² On distinctions between investment advisers under the Advisers Act and MiFID’s definition of asset manager, see paras 13.06–13.10 (United States).

³³ See para 14.02 (Canada).

³⁴ See para 2.24 (MiFID).

³⁵ See para 11.18 (England and Wales).

³⁶ See para 12.23.

³⁷ See para 12.24.

definition of portfolio manager must have worked for a minimum amount of time in the industry and hold the CFA (Chartered Financial Analyst) designation³⁸ unless the regulator grants an individual exemption on the basis of comparable qualifications or experience.³⁹

- 1.23** In contrast, although investment advisers in the United States who are not exempt are required to register with the SEC, adviser registration does not require compliance with capital adequacy or other financial requirements, nor does it require that prospective advisers have specific credentials or experience,⁴⁰ be members of an investor compensation scheme,⁴¹ or meet in-person with SEC personnel. Instead, the regulatory technique that underlies adviser registration is disclosure, both to the SEC, via the completion of a form, and to prospective advisory clients. For clients, registrants must prepare a brochure that covers 18 items prescribed by the SEC and furnish the brochure either before or at the time a client enters into an advisory relationship.⁴² Supplementary brochures must be prepared for each individual supervised by an advisory firm who has contact with clients or who makes discretionary investment decisions.⁴³ And, once an adviser registers, it becomes subject to examination by the SEC.⁴⁴

D. Conduct of business requirements: Custody arrangements

- 1.24** Jurisdictions that subject asset managers to specific regulation use regulatory techniques in addition to mandated disclosure and licensing/registration requirements. As noted in paragraph 1.06 for MiFID, asset manager regulation imposes requirements that go to the manager's conduct of its business. Despite the dominance of mandated disclosure as a regulatory technique in the United States, aspects of investment advisers' conduct are subject to substantive regulation.⁴⁵ This section comments in particular on regulations that affect a manager's custody (or safeguarding) of clients' financial assets.
- 1.25** A client is subject to evident risks when a manager has physical custody of, or otherwise exercises control over, assets belonging to the client. These include exposure to claims of the manager's creditors in the event of its insolvency; confusion concerning ownership when the

³⁸ Although the CFA Institute, the licensing body for the CFA designation, is not designated as a self-regulatory organization for purposes of securities regulation and lacks power to impose statutory or regulatory requirements, its Code of Ethics and Standards of Professional Conduct stipulate duties CFAs owe to clients, which overlap with and duplicate obligations directly imposed by securities regulation and the general law, as well as the duties imposed and enforced by the IIROC, the national self-regulatory organization for the securities industry in Canada (see para 14.76). This places the CFA Institute within the ambit of the overall regulatory context applicable to Canadian asset managers (see para 14.77).

³⁹ See para 14.50. Indeed, Toronto is second only to New York City in the number of residents who hold the CFA designation (see para 14.214).

⁴⁰ See para 13.29.

⁴¹ Investment advisory clients of Bernard Madoff's notorious Ponzi scheme were able to receive compensation from the Securities Investor Protection Corporation (SIPC) because as a registered broker-dealer Madoff's firm was a member of SIPC, which insures customer accounts up to certain limits and provides mechanisms to liquidate failed firms. Madoff did not establish a separate business unit for his bogus advisory business and used letterhead stationery in communicating with advisory clients that displayed a logo proclaiming SIPC membership. See Diana B. Henriquez, *The Wizard of Lies* 222 (2011).

⁴² See para 13.30.

⁴³ *Ibid.*

⁴⁴ See paras 13.33–13.37.

⁴⁵ A prominent example is the structure of fees that a registered adviser may charge its clients. Subject to exceptions, registered advisers may not charge performance fees, ie fees calculated as a percentage of the capital appreciation in an account (as opposed to a fee based on a percentage of the assets in the account) (see para 13.62).

manager's record-keeping is inadequate; conversion and other forms of misappropriation; and facilitating fraudulent schemes that require the creation of fictitious statements concerning assets in clients' portfolios. Risks are also present when clients' assets are deposited with a third party. Thus, although it is unsurprising that regulations applicable to asset managers address custody, the jurisdictions covered by this book differ in how custody arrangements are regulated. To some extent these differences reflect whether custody is perceived to be a function that should fall within the regulated province of banks and credit institutions. Thus, categorizing a function may determine its regulatory treatment.

MiFID permits asset managers to hold financial instruments and funds belonging to clients so long as the manager makes 'adequate arrangements' to safeguard clients' assets and rights in the event of its insolvency and to prevent usage of such assets on the firm's own account without the client's express consent.⁴⁶ If the manager deposits clients' assets with a third party, the manager must select the depository with due care, skill, and diligence.⁴⁷ Custody regulation in the Netherlands implements this general pattern through a detailed set of rules.⁴⁸ **1.26**

In contrast, in Italy the regulation implementing MiFID does not contain comparable rules because custody of clients' investment assets falls within the regulatory powers of the Bank of Italy and is governed by a Bank regulation.⁴⁹ German regulation restricts the provision of custody services to licensed banks; when an asset manager is itself a bank, it is customary for custody to be governed by a separate agreement.⁵⁰ Likewise, in Switzerland, independent asset managers may not maintain cash or securities accounts for their customers.⁵¹ In Canada, asset managers do not provide custodial services; although institutional clients typically have their own custodian, managers serving retail clients may have access to their brokerage accounts.⁵² In the United States, a complicated SEC rule defines 'custody' broadly and requires that investment advisers deemed to have custody must maintain client accounts with a qualified custodian, as defined by the rule.⁵³ Such an adviser must also have a reasonable basis to believe that quarterly account statements are sent to clients.⁵⁴ Finally, formal regulation aside, practice in a particular market may shape custody arrangements. In Poland, firms that provide only asset management services typically do not act as custodians of clients' assets; the practice is to enter into a separate custody agreement with a full service brokerage firm or a bank.⁵⁵ **1.27**

E. The 'style' of regulation and self-regulation

Observers of regulation note that regulatory systems differ in what might broadly be termed 'style'. Some regulators are more responsive than others to inquiries from and concerns articulated by the regulated constituency; regulators vary in the relative flexibility or rigidity with which they enforce rules and in whether enforcement has more of an administrative than a **1.28**

⁴⁶ See para 2.40 (MiFID).

⁴⁷ See para 2.42 (MiFID).

⁴⁸ See paras 7.33–7.36.

⁴⁹ See para 5.34.

⁵⁰ See para 4.59.

⁵¹ See para 10.08.

⁵² See para 14.84.

⁵³ See paras 13.64–13.65.

⁵⁴ See para 13.50.

⁵⁵ See para 8.28.

prosecutorial cast.⁵⁶ The overall effectiveness of a jurisdiction's regulation of asset managers may stem from managers' responsiveness to the bodies that supervise them, in turn likely a function of the ongoing relationship between the regulator and asset managers. Thus, in France, in which asset managers' liability rarely features in judicial proceedings, managers are supervised by an authority with disciplinary powers;⁵⁷ relative to the number of inspections conducted by the supervisor in 2009 (80), very few cases came to the enforcement committee for breaches of asset management rules that resulted in injuries to investors.⁵⁸ In Poland, twenty years on since the establishment of a free market, there are virtually no high-profile cases involving breach of duties owed to clients by Polish investment advisers and managers, an outcome attributed to a robust regulatory body, the Financial Supervision Commission.⁵⁹

- 1.29** Overall regulatory effectiveness is also a function, at least in complex fields like asset management, of the degree to which formally separate bodies of regulation complement and reinforce each other. One example of complementarity is the gatekeeping function served by clearing firms in the United States. Typically, clearing firms—large broker/dealers—do not have client contact for the accounts with respect to which they furnish clearing services such as trading, settlement, and delivery of securities.⁶⁰ A clearing firm has a duty to be alert to illegal conduct on the part of the investment managers it serves, including violations of trading and anti-money laundering rules. Its failure to discover such conduct makes it subject to discipline. Another example of complementarity is the dual operation of know-your-customer rules in some jurisdictions. In Canada, an investment adviser's duty to ascertain a client's identity and investment profile obliges the adviser to take reasonable steps to determine whether the client is an insider of an issuer of publicly traded shares. The adviser's duty to know its client thus functions, not only as a means to protect the client against unsuitable investments, but as a gatekeeping mechanism to safeguard market integrity.⁶¹
- 1.30** Regulatory effectiveness over time may require shifts in authority among separate regulatory bodies, their consolidation, or the complete displacement of one body by a new one. For example, following the 2008 financial crisis, in Ireland the Central Bank came to play an increasingly prominent role in supervising financial services firms and enforcing its rules against non-compliant firms.⁶² The regulatory landscape in the United Kingdom is shifting to replace a single regulator for financial services with, *inter alia*, a new specialist regulator with responsibility for conduct issues across the spectrum of financial services.⁶³ Coordination among separate regulators is also a significant element of overall effectiveness. Thus, although securities regulation in Canada is a provincial function, coordination occurs through mechanisms that compensate for formal jurisdictional diffusion, in particular through a self-styled 'informal' association of securities regulators that develops model regulations to be adopted by provinces (designated as 'National Instruments'), including regulations applicable to asset managers.⁶⁴

⁵⁶ Baldwin, *Understanding Regulation*, 56.

⁵⁷ See para 3.05.

⁵⁸ See para 3.161.

⁵⁹ See para 8.87.

⁶⁰ See para 13.79.

⁶¹ See para 14.63.

⁶² See para 12.145.

⁶³ See para 11.11.

⁶⁴ See paras 14.40–14.42.

In securities regulation generally, regulation that seeks to determine the merits of securities offered for investment is often denounced as ineffective to prevent fraud⁶⁵ and inefficient as a regulatory technique even from the perspective of honest issuers and the professionals who serve them in securities-related matters.⁶⁶ In the realm of asset management, the closest analogy to ‘merits regulation’ (distinct from the licensing and registration requirements discussed in paras 1.22–1.23) is regulation of the contents of the management contract. Such regulation also has obvious implications for the relationship between public and private law because when the relevant regulation specifies the contractual terms that are permissible, it forecloses the application of contract-law principles to terms to which the manager and the client themselves have agreed or would have agreed absent the state-mandated terms. Among the jurisdictions covered in this book, the experience in Spain up through 2010 is unique. As authorized by the relevant ministry, the Spanish regulator drafted and circulated a ‘normalized model contract’ as a stated minimum for portfolio management contracts; in time the model became the standard, perhaps because management firms were required to submit their standard contracts in advance to the regulator for its review and comments. From 2010 onward, this framework applies only to contracts with retail investors, and firms need no longer seek advance regulatory authorization for their standard contracts. Spanish regulation continues to require submission to the regulator of a brochure stating the fees—including the maximum fee—charged by the firm for all services rendered on a regular basis.⁶⁷ **1.31**

Another determinant of overall regulatory style is the extent to which regulatory functions are devolved to self-regulation based in the relevant industry. Observers of regulation sometimes characterize the development of self-regulatory regimes as defensive responses by an industry to hold governmental regulation at bay.⁶⁸ On the other hand, and less cynically, actors within an industry may have a stronger commitment to rules and enforcement bodies they view as ‘their own’⁶⁹ than they would to the same rules and enforcement mechanisms if promulgated by a governmental body, and the rules may be better informed, more readily adjusted in light of changed circumstances, and closer to standards that are realistically attainable by regulated firms. Enforcement within a self-regulatory regime may be more effective.⁷⁰ **1.32**

No position in this debate will be ventured here. However, it is noteworthy that the jurisdictions covered by this book vary in the extent and status of self-regulation. These variations appear not to be a function of the existence and range of industry associations themselves. For example, in Luxembourg, there is no organization characterized as self-regulatory and no self-regulatory rules applicable to individual asset management, but the Luxembourg Bankers’ Association (the ABBL) includes in its membership most banks and financial institutions, as well as professionals in the financial sector. ABBL represents their interests but does not play a self-regulatory function.⁷¹ Separately, an industry’s interests may prompt investment in industry-wide initiatives towards standardization in contract terms that, although not typically viewed as self-regulatory, may structure how industry members **1.33**

⁶⁵ Hazen, *Securities Regulation*, 27.

⁶⁶ Cox et al, *Securities Regulation*, 16.

⁶⁷ See paras 9.18–9.22.

⁶⁸ Baldwin, *Understanding Regulation*, 39.

⁶⁹ *Ibid* 30.

⁷⁰ *Ibid*.

⁷¹ See paras 6.06 and 6.60.

conduct business with clients. Thus, the UK-based Asset Management Association and its predecessors have developed model forms for use with institutional clients in response to the potential of 'protracted negotiation of contracts that seek to document the same scope of services'.⁷²

- 1.34** In contrast, in Switzerland, self-regulatory organizations (SROs), in particular the Swiss Bankers' Association, are a substantial component of regulation. In ways that have evolved over time, the Swiss financial regulator has set standards for asset managers via reliance on the Bankers' Association.⁷³ Most recently the regulator defined, as investors qualified to invest in the likes of hedge funds and private equity, only clients of licensed financial intermediaries (such as banks and securities dealers) or of asset managers affiliated with an SRO with a code of conduct conforming to the regulator's guidelines.⁷⁴ In Italy, three associations for asset managers draft and issue guidelines but these have no formal effect; their motivation is to obtain the regulator's approval and recognition of compliance with the MiFID framework and aid their members' compliance.⁷⁵ In the United States, current debate focuses on SROs as vehicles for enforcing regulatory rules, in particular via the examination of member firms. Although securities broker-dealers have long been subject by statute to an SRO, investment advisers have not been.⁷⁶ The SEC has recommended, in response to a legislative mandate, that Congress consider whether one or more SROs should examine advisers and whether the SRO for broker-dealers should examine advisers who are dually registered as broker-dealers for their compliance with the Investment Advisers Act.⁷⁷
- 1.35** A related but separate debate is whether the substantive content of regulation itself is best formulated as general principles or as more specific rules. Generally-formulated principles appear to leave more discretion to individual firms, effectively devolving a regulatory function to the firm level, distinct from devolution to an industry-based SRO. MiFID itself, although often said to be principles-based, represents a mix of detailed rules and more general principles.⁷⁸ In a background note to the first draft of the MiFID implementation directive, optimism is expressed concerning the effects of principles-based formulations, which are said to 'create . . . strong incentives for the firm to monitor its own activities and determine whether its activities comply with the principles'.⁷⁹ Whether such incentives are realized is, of course, a separate question. On the other hand, generally stated regulatory requirements may create uncertainty and lack of predictability, a worrisome prospect to firms and their legal counsel if a generally drafted regulation constitutes a basis for retroactive action by the regulator, including the imposition of penalties for non-compliance.⁸⁰ Effectiveness in a principles-based regulatory regime may require high levels of mutual trust among its participants, in part because effective compliance is a consequence of polyvalent or networked

⁷² See para 11.63.

⁷³ See para 10.15.

⁷⁴ See para 10.17.

⁷⁵ See para 5.41.

⁷⁶ See para 13.03.

⁷⁷ See para 13.37.

⁷⁸ See paras 2.18 and 2.19 (MiFID).

⁷⁹ MiFID First Implementation Directive, Background Note at 6.

⁸⁰ See Julia Black, *The Forms and Paradoxes of Principles-Based Regulation* 3(3) Capital Markets Law Journal 425, 426 (2008).

effects, that is, the interactions of many actors, including industry-based groups structured and operating with varying degrees of formality.⁸¹

Finally, in at least some of the jurisdictions covered in this book, private sector actors in practice may adopt, as their own through contract, the content of regulatory rules. That is, asset management agreements in some MiFID jurisdictions may reproduce some or all of the MiFID rules of conduct,⁸² implying a ‘peculiar interplay’⁸³ as between regulatory provisions and the contractually-imposed obligations that result from contracts formed between private sector actors. Although this practice differs formally from the development of standardized contract terms at the industry level, as discussed in paragraph 1.33, the end result is some measure of standardization in contract terms. Moreover, the practice of adopting by contract the content of regulatory rules represents neither self-regulation as traditionally understood nor is it comparable to the mandatory management contract discussed in paragraph 1.31. Nonetheless, the practice may represent the depth of regulation’s reach into private parties’ conduct and uncoerced choices. **1.36**

3. Regulatory choices and liability

As discussed in paragraph 1.15, regulation and liability might be understood as substitutes for each other, at least in a theoretical sense. However, this book illustrates a more complex picture; for one thing, the systemic issues associated with asset management imply that relying simply on after-the-fact applications of liability rules would be grossly inadequate. Some measure of before-the-fact regulation thus seems so inevitable that only its relationship to after-the-fact liability is salient, in particular how ex ante regulation and ex post liability determinations might best complement each other. Also complicating the account is the fact that in some jurisdictions, regulators themselves are significant enforcers of liability rules with the objective of seeking compensation on behalf of clients from investment managers whose breaches of regulatory rules have injured clients or resulted in unjust enrichment to the manager.⁸⁴ Thus, liability rules imply choices about mechanisms for enforcement, the relationship between public institutions and private parties as enforcers through litigation processes, and the use of procedures within the administrative process in contrast to litigation in general courts as forums for enforcement by regulatory bodies. Even within a system of broad-reaching regulation, it is unsurprising that managers’ clients turn to litigation when the manager overreaches its authority under the management contract or acts inconsistently with instructions received from the client.⁸⁵ Whether the manager has complied with an agent’s most basic obligation—to act within (and only within) the scope of authority—is of utmost importance to the client but perhaps not so pressing from the perspective of the more systemic concerns that justify regulation. **1.37**

⁸¹ Ibid 444–5. See also Riles, *Collateral Knowledge*, 227 (‘new architectures historically have never worked at the level of design. Where regulatory reforms have succeeded, it has been because, in one way or another, they enroll the targets or clients of regulation in the regulatory mission and encourage them to take responsibility for the regulatory problem’).

⁸² See paras 12.68–12.74, 12.79 (Ireland); para 7.58 (the Netherlands); para 5.42 (Italy).

⁸³ See para 5.43 (Italy).

⁸⁴ eg England and Wales (see paras 11.21–11.22). In the United States, in which a private party’s remedies for violations of the Advisers Act are limited to rescission of the advisory contract, proceedings brought by the SEC (or in criminal matters the federal Department of Justice) and by state regulators are a significant source of monetary relief for clients (see para 13.112).

⁸⁵ See para 9.68 (Spain).

- 1.38** One measure of the effectiveness of a particular regulation is whether the regulation, if complied with, forecloses or reduces conduct by an asset manager that would, to some degree of probability, result in liability. Consider in this light three examples of specific regulations discussed above, beginning with licensing requirements as implemented in Ireland and Canada. In Ireland, as noted in paragraph 1.22, obtaining a licence as an asset manager requires affirmative vetting by the Central Bank of the manager's senior personnel and directors towards the objective of assuring competence and probity. If effective, this vetting requirement creates an ex ante roadblock that denies admission to the profession of actors who are likely to indulge in liability-generating conduct. Effectiveness turns on the Central Bank's ability to predict future conduct based on the information then available to it, so that it may make an informed decision whether or not to grant a licence or impose particular restrictions on a manager. This might, of course, be backstopped by the Bank's subsequent ability to revoke or restrict a licence because of new information. Canadian licensing requirements, which share the same general objectives, are noteworthy because they use a proxy to determine competence, which is whether an individual portfolio manager (unless individually exempted) holds the CFA designation and has a stated number of years of experience. Although the CFA requirement functions as a barrier to entry to the asset management profession (and arguably may raise fees) and does not represent a proxy for assessing an individual's probity,⁸⁶ it strengthens the ethos of the industry as a whole and should at least help foreclose liability stemming from a manager's lack of competence. Its effectiveness may thus be a function to some degree of increased professionalism within the industry, distinct from the accuracy of the requirement as a proxy measure for competence. Additionally, designation as a CFA brings an investment manager within the ambit of the CFA Institute, thereby reinforcing professional identity and compliance with the Institute's rules, which significantly overlap with and reinforce regulatory and self-regulatory requirements, as well as requirements imposed by the general law.⁸⁷
- 1.39** The regulation of custody arrangements (see paras 1.24–1.27) responds to more specific risks than do requirements for licensing. That is, physical custody of or control over a client's portfolio assets presents a focused occasion or opportunity for the occurrence of specific adverse events; the regulatory concern that asset managers be competent persons of suitable probity ranges more broadly against a wide landscape potentially blighted by breaches of many sorts of duties. As individual chapters detail, the jurisdictions covered by this book vary in how custody arrangements are regulated or, alternatively, governed by an industry practice that is not explicitly required by applicable regulation. Categorical requirements that segregate custodial from management functions, such as the requirement that only a licensed bank may serve as custodian of a client's portfolio assets, may foreclose the occurrence of conduct that would result in liability on the part of an asset manager more effectively than do regulations, cast in more general terms, that impose duties on the manager itself. To the extent that such a categorical requirement increases the overall costs of management ultimately borne by the client, the costs may be justified by the regulatory efficacy generated by a tailored response to specific serious risks of injury to clients. Custody arrangements are not the sole context in which a regulator might consider a shift towards more categorical requirements. In its October 2011 Proposal for a MiFID II Directive,

⁸⁶ See para 14.214.

⁸⁷ See n 38.

the European Commission proposed a ban on the receipt of inducements from third parties or persons acting on their behalf in relation to the provision of service to clients, which would apply both to portfolio managers and to investment advisers who inform clients that they provide advice on an independent basis.⁸⁸ The ban would replace the present MiFID regime, in which (for example) an inducement may be accepted under an exemption that turns on whether it is ‘value adding’, enhancing the value of the service to the client.⁸⁹

Mandated disclosure of information, discussed in paragraphs 1.18–1.21, a universally used technique within the repertoire of contemporary securities regulation, also has implications for asset managers’ liability. For starters, misstatements by the manager in response to disclosure requirements could be a basis for liability to a client, subject to the requisites detailed in the individual chapters that follow. Distinct from the consequences of the manager’s breach of a regulatory rule (which vary across jurisdictions), the misstatement may be actionable within the law of tort. Separately, compliance with disclosure requirements may operate to protect a manager against liability to a client. As detailed in the individual chapters, information available to the client, whether or not prompted by disclosure requirements, may undercut the reasonableness of the client’s reliance on assertions allegedly made by the manager. More generally, scholarly treatments of the history and role of disclosure within securities regulation often begin with a quotation from Louis Brandeis: ‘Sunlight is said to be the best of disinfectants: electric light the most efficient policeman.’⁹⁰ In the context of asset management, mandated disclosure of information about the asset manager and its personnel may foreclose liability because, accurately disclosed, the information enlightens investors to avoid dealing with that manager!

1.40

This book’s concluding chapter discusses four themes that are central to the impact of a regulatory scheme on a manager’s private law duties and liability for the jurisdictions covered by this book. These are: (1) whether the manager’s breach of a regulatory duty affects the manager’s private law liability; (2) whether (and to what extent) contractual derogations from regulatory duties are effective; (3) the impact of a breach of regulatory duty on the validity of the asset management contract; and (4) whether a manager’s duties under private law may be stricter or more demanding than the applicable regulatory duties. Significant variations are evident on these points among the jurisdictions covered by the book. Of course, the jurisdictions included in this book differ on other issues as well.⁹¹ Although we venture no assessment of the overall significance or importance of each of these differences, their presence and persistence is striking. Additionally, this book may serve to establish that its subject is not a ‘merely’ technical area of law, although technical and highly detailed it surely is at the levels of both regulation and private law. The questions identified above, and many others addressed by this book, have broad implications about relationships among formally discrete bodies of law and regulation and among state-authorized regulatory bodies and their regulated constituencies.

1.41

⁸⁸ Proposal for MiFID II of 20 October 2011, COM (2011) 656 final, Art 25(5)–(6).

⁸⁹ See para 2.74 (MiFID).

⁹⁰ Cox et al, *Securities Regulation*, 3, quoting Louis D. Brandeis, *Other People’s Money* 62 (1914).

⁹¹ These include the bases on which a manager may incur pre-contractual liability towards a prospective client and whether a manager must account to the client for profits or other benefits received by the manager without the client’s consent and in breach of the manager’s duty of loyalty.