INTERNATIONAL FINANCE AND CAPITAL MARKET: TRUST AS A LEGAL COMPONENT OF CONNECTEDNESS BETWEEN ENGLISH, AMERICAN AND BRAZILIAN LAWS

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ABSTRACT: According to March 2016 data from ANBIMA – Brazilian Association of the Financial and Stock Markets Entities, in a 12-month period, the funds industry net worth reached 3 trillion BLR in Brazil, including investments, redemptions and collections. It is a relevant financial volume, causing investment funds to be important instruments for collection of savings and addressing of financial resources to the most diversified financing projects. In addition, the collapse of certain financial conglomerates in Brazil in the past years, involving funds administered and managed by companies of these conglomerates, has evidenced the importance of rules and studies directed to the relationship between the investment manager and the investors of investment funds. Thus, due to the economic relevance of the investment funds for Brazil, and also the importance of the investors' rights within the funds industry, this paper aims to perform theoretical investigation about the fiduciary relationship between the investment manager and the respective investors or "cotistas" of the investment funds, especially from the perspective of the English and the American laws. Therefore, the purpose is to identify the origin and the essential characteristics of this relationship, the risks that it might generate for the investor and the duties imposed by it to investment managers. Accordingly, the proposal is to consider the historical origin of the fiduciary relationship and the theoretical grounds supporting it, applied to the investment funds in England, in the United States (called "investment companies") and in Brazil. Based on such theoretical knowledge and under the focus of the fiduciary duties applicable to the investment managers, the standards of conduct contained in the

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instructions of the CVM – Brazilian Securities and Exchange Commission – are evaluated, in order to elucidate the characteristics of the fiduciary relationship in light of CVM rules. The conclusion is that the operational principles of the trust, derived from the English laws and the fiduciary duties of loyalty and diligence arising out of the American laws, are essential characteristics for the configuration of a fiduciary relationship between the investment manager and the investor (or "cotistas") of investment funds in Brazil.

KEYWORDS: Fiduciary relationship; trust; trustee; mutual fund; investment companies; investment funds; loyalty duty; diligence duty; investment manager; abuse of authority; information asymmetry; conflict of interests.

GLOSSARY OF TERMS

ANBIMA – The Brazilian Association of the Finances and Stock Markets Entities is an entity that represents heterogeneous institutions of the Brazilian stock market, such as: commercial and multiple banks, investment banks, funds asset managers and investment managers, brokers and distributors of securities and equity managers. http://portal.anbima.com.br/.

BACEN – The Central Bank of Brazil is a federal governmental entity member of the Brazilian Financial System, linked to the Brazilian Ministry of Treasury and created by Law no. 4.595, dated from December 31, 1964. http://www.bcb.gov.br/pt-br/paginas/default.aspx.

CMN – The Brazilian Monetary Council is the Brazilian governmental agency in charge of issuing general guidelines for the good operation of the Brazilian Financial System and was created by the Brazilian law no. 4.595, dated from December 31, 1964. https://www.bcb.gov.br/?CMN.

CVM – The Securities and Exchange Commission of Brazil is a governmental entity linked to the Ministry of Treasury and created by the Brazilian Law no. 6.385, dated from December 07, 1976, with the purpose of regulating, inspecting and developing the Brazilian securities market. http://www.cvm.gov.br/.

CRSFN – The Brazilian Financial System Appeals Council is a second level administrative part of the structure of the Ministry of Treasury, as set forth in the Brazilian Law no. 9.069, dated from June 29, 1995. http://www.bcb.gov.br/crsfn/crsfn.htm.

ICVM – Normative Instruction of the Securities and Exchange Commission of Brazil.

IOSCO – The International Organization of Securities Commissions is an international instrumentality that gathers the securities regulators of the whole world, recognized as a standard setter in the securities market. http://www.iosco.org/.

PAS – Sanctioning Administrative Proceedings carried through by CVM in order to investigate and judge eventual illicit acts or violations of the CVM rules or of the laws related to the Brazilian stock market.

GDP – Gross Domestic Product.

SEC – U.S. Securities and Exchange Commission.

INTRODUCTION

Which reasons have driven us to prepare this paper? According to surveys, the Brazilian funds industry net worth, not considering the pension fund, corresponded to approximately 48% of the Brazilian GDP in December, 2014[2]. Moreover, according to ANBIMA's data from March, 2016, in a 12-month period (YTD), the funds industry

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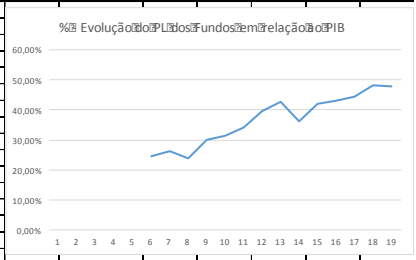
	PL dos FUNDOS em bilhões	PIB em bilhões	%
1993			
1994			
1995			
1996			
1997			
1998			
1999			
2000	297.104,3	1.202.377,00	24,71%
2001	344.413,4	1.316.318,00	26,16%
2002	355.003,0	1.491.183,00	23,81%
2003	515.616,1	1.720.069,00	29,98%
2004	612.634,8	1.958.705,00	31,28%
2005	739.009,1	2.171.736,00	34,03%
2006	939.668,9	2.369.484,0	39,66%
2007	1.159.876,3	2.718.032,0	42,67%
2008	1.126.053,9	3.107.531,00	36,24%
2009	1.403.137,0	3.328.174,00	42,16%
2010	1.671.272,3	3.886.835,00	43,00%
2011	1.941.598,5	4.374.765,00	44,38%
2012	2.270.545,6	4.713.096,00	48,18%
2013	2.469.375,7	5.157.569,00	47,88%
2014	2.690.619,3	5.521.256,00	48,73%



Moeda: Reais

Fonte PL: Relatório de Evolução do PL dos fundos de Investimento no Brasil ANBIMA / Janeiro 2014 http://portal.anbima.com.br/informacoes-tecnicas/estatisticas/patr-liq-rentab/Pages/default.aspx

Fonte PIB: Anuário Estatístico do Brasil 2015 IBGE / Tabela 7.5.1.2 Produto Interno Bruto PIB http://biblioteca.ibge.gov.br/visualizacao/periodicos/20/aeb_2015.pdf

% - Evolução dos Fundos em relação ao PIB → % - Evolution of the Funds' net worth in relation to the GDP

Source – PL dos Fundos em bilhões → Funds' net worth in billions: Relatório de Evolução do PL dos fundos de investimento no Brasil - ANBIMA / 10.22.2015 - http://portal.anbima.com.br/informacoes-tecnicas/estatisticas/patr-liq-rentab/Pages/default.aspx

Source – PIB em bilhões → GDP in billions: Anuário Estatístico do Brasil 2015 - IBGE / Tabela 7.5.1.2 - Produto Interno Bruto - PIB - http://biblioteca.ibge.gov.br/visualizacao/periodicos/20/aeb_2015.pdf

net worth reached 3 trillion BRL (Brazilian Reais) in Brazil[3], including investments, redemptions and collections. These figures clearly evidence the economic relevance of the funds industry.

In addition, in the past years, banking scandals in Brazil involving financial conglomerates and the investment funds managed by members of those conglomerates[4] have evidenced frailty of the relationships between the investment managers and the respective investors of the funds managed by these institutions. Consequently, it is observed that these cases have generated broad assessment of the rules and responsibilities of the investment managers of investment funds by CVM[5]. Such changes include the ones carried through in order to emphasize the standards of conduct of these professionals[6]. These rules forbid practices aimed at breaching the fiduciary relationship established between the investment manager and the investors and, simultaneously, impose them the duties of diligence and loyalty[7] as abstract standards

[3] According to ANBIMA's data from March/2016. Available at: < http://portal.anbima.com.br/informacoes-tecnicas/boletins/fundos-de-investimento/Documents/BoletimFI_201603.pdf >. Accessed on: June, 06, 2016.

[4] Examples: *Santos Asset Management and Cruzeiro do Sul DTVM.* For further information about Banco Santos's bankruptcy, we suggest consulting the website of its bankruptcy assets: http://www.bancosantos.com.br. Result from PAS 01/05 by CVM involving several irregularities in the administration of funds sponsored by the Bank: http://www.cvm.gov.br/export/sites/cvm/noticias/anexos/2008/20081126_press_2.pdf. The case was judged by CVM in 2008. For further information about Banco Cruzeiro do Sul's bankruptcy, we suggest consulting the website of its bankruptcy assets: http://www.bcsul.com.br. Regarding the administrative proceedings involving the funds administered by Cruzeiro do Sul DTVM, consult the CVM Accusation Term number RJ 2011/12660: http://www.cvm.gov.br/export/sites/cvm/decisoes/anexos/0007/7289-1.pdf. The case is still being weighed by CVM, but operations leading to the funds collapse started in January/2008.

[5] Refer to FERREIRA, Renato Luis Bueloni. Fundos e Clubes de Investimento. *In:* SOUZA JÚNIOR, Satiro (coordenador). **Mercado de Capitais**. Editora Saraiva, São Paulo, 2013, pp. 188-189.

[6] Idem, p. 189.

[7] Articles 2, § 4 and article 16, I and II, "b" of Instruction 558/15 and 92, I of Instruction 555/14. **(i) - ICVM 558/15:** "**Art. 2, § 4**. The managers have to perform their consulting activities with loyalty towards their clients, avoiding practices that might impair the fiduciary relationship maintained with them and, when facing a situation of conflict of interests, inform the client that they are acting under conflict of interests and tell them the sources of such conflict, before rendering the consulting"; "**Art. 16**. The investment managers of securities portfolio have to: **I** – perform their activities in good-faith, with transparency, care and loyalty towards their clients; **II** – perform their duties in order to: (...) b) avoid practices that might impair the fiduciary relationship maintained with their clients"; / **(ii) - ICVM 555/14: "Art. 92.** The investment managers and the asset managers, in their respective spheres of activities, are obliged to adopt the following standards of conduct: **I** – perform their activities always pursuing the best conditions for the fund, dedicating the care and diligence that every active and honest person assigns to the administration of their own business, acting in a loyal manner towards the interests of the investors

of conduct that must be observed in any business performed during administration and management of funds.

However, although the regulation has followed up the economic successes and the banking scandals, the Brazilian legal literature on investment funds in Brazil is still scarce[8] compared with the literature of other countries on their own home scenarios and is mainly related to the duties of the ones that administer and work with management of funds. In the countries that adopted the common law, such as the United States and England, the legal literature on the fiduciary relationship and the duties applicable pursuant to such relationship, involving collective investment arrangements, is broad and filled with studies on the most diversified aspects of this topic[9]. The studies range from philosophical concepts about the origin of the fiduciary relationship[10], comprising definitions of characteristics of what is understood as the loyalty duty, up to analyzes of precedents related to the role of trustee performed by the investment manager of the investment funds[11].

Hence, due to the economic importance of the topic, its relevance for protection of the investors in investment funds and the scarcity of studies, this paper will be aimed at investigating the origin and the characteristics of the fiduciary relationship between the investment manager, and the respective investors in investment funds in Brazil. The duties arising out of this relationship, the duties of diligence and loyalty included, will also be investigated.

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and of the fund, avoiding practices that might impair the fiduciary relationship maintained with them and answering for any infringements or irregularities that might be performed under their administration or management".

[8] Conversations held with market professionals and surveys made: (i) in the digital libraries of USP, FGV and UFMG; (ii) in the websites of CNPQ, JSTOR, SSRN; and (iii) in the physical libraries of the law schools of USP and FGV-SP.

[9] About this finding, refer to FRANKEL, Tamar. **Fiduciary Law**, 2011.

[10] Refer to SZTO, Mary**.** Limited Liability Company Morality: Fiduciary Duties in Historical Context. **Quinnipiac Law Review** – Volume 23, 2004, Issue 1, p. 94, Connecticut/USA. Available at: http://www.quinnipiac.edu/academics/colleges-schools-and-departments/school-of-law/student-life/law-review-and-journals/quinnipiac-law-review/past-issues-archive/volume-23-2004-issue-1/. Accessed on: January, 20, 2015.

[11] Refer to (i) SCOTT, Austin W. The Fiduciary Principle. **California Law Review** – vol. 37, No. 4, 1949; (ii) CONAGLEN, Matthew. **Fiduciary Loyalty - Protecting the due Performance of Non-Fiduciary Duties**. Portland, USA: Hart Publishing, 2010; (iii) FRANKEL, Tamar. **Fiduciary Law**, 2011; (iv) RICHARDSON, Benjamin J. **Fiduciary Law and Responsible Investing**. Routledge Research in Finance and Banking Law. Routledge, New York. 2013; and (v) CARNELL, Richard S. et al. **The Law of Financial Institutions**. New York, USA: Wolters Kluwer Law & Business, 2013.

We intend to answer two questions, which will assist us with the study of the presented topic. They are closely related to the theoretical aspects of our subject matter, for they seek to study the origins and the essential characteristics thereof. Thus, the following questions are proposed:

- What is understood to be the fiduciary relationship between the investment manager and the investors of investment funds[12]?

- What is the origin of the fiduciary relationship and what are its essential characteristics?

To answer these questions, we will study the origins of the fiduciary relationship, starting with the English trust and then analyzing the first collective investment structures in England and the appearance of the investment companies in the United States. Afterwards, we will ascertain the influence of these countries' legal cultures on the decrees and regulations of the first investment funds in Brazil, still in the 40's. Finally, based on the judicial decisions on the English and American[13] legal literature and already aware of the North-American legal system's influence on the structuring of the Brazilian investment funds, we shall discuss the essential characteristics of a fiduciary relationship between investment managers and investors of funds.

Thus, we understand that it is possible to answer the formulated questions by presenting the characteristics of such fiduciary relationship.

[12] It should be emphasized that the investment funds considered in this paper as object of analysis are the ones defined and regulated by CVM instruction number 555/14 (e.g.: stock funds, fixed income funds, multimarket funds and foreign exchange funds). Although other structured and special character funds have the same characteristics (e.g.: credit rights investment funds – FIDCs – and real estate investment funds, by methodological reason, whenever the "investment funds" expression appears in this survey, consider the ones constituted and regulated pursuant to the provisions set forth in CVM instruction 555/14.

[13] Opting for the international literature, mainly the one generated in the common law countries, such as England and the United States, derives from the fact that the object of this paper's research was better developed in these countries through the doctrine, the case law and the normative construction.

1. THE TRUST AND THE COLLECTIVE INVESTMENT MECHANISMS IN ENGLAND, IN THE UNITED STATES AND IN BRAZIL – A SHORT HISTORY OF LEGAL TRANSPLANTATION

A theoretical assessment of the influence of the trust in the Brazilian laws is described in this item. This paper starts with the analysis of the historical connection between the English, the American and the Brazilian stock market laws, bearing the trust as a shared element. The trust is the legal basis for the fiduciary relationship between the investment manager and the investor of investment funds, in Brazil, in the United States or in England. It is also the legal ground for the fiduciary duties of diligence and loyalty to which the investment managers of investment funds are submitted in the United States and in Brazil. Moreover, although it is not the specific topic of this paper, it is possible to observe the transplantation of the legal principles of the trust from England to the United States and to Brazil, when the collective investment structures of these countries are formed.

Thus, we start by explaining the appearance of the trust in the medieval England, where we find the establishment of the collective investment schemes based on the legal trust structure, which later on will be conveyed to the United States, where the need to define fiduciary duties to be observed by the trustees, investment managers of those funds, comes forth. Afterwards, we assess the migration of these collective investment structures to Brazil, introducing in the local financial industry the legal principles of the investment funds operation, in the way they are currently known by us, and bringing along, in their composition, the foundations of the trust. Finally, we expose the consequences of such migration on the fiduciary relationship between the investment manager and the investors in investment funds.

In addition, considering the success of the investment funds' industry in Brazil, we might say that it has also been a successful process of legal transplantation[14].

[14] Milhaupt and Pistor emphasize, concerning the regulatory harmonization and standardization of legal standards and regulations: "...standardization and legal harmonization, far from being means for building effective legal systems around the world, are to be approached with considerable caution" (MILHAUPT and PISTOR, 2008, p. 216). They call up the attention to this point because, before any specific implementation of a legal solution characterized by the transplantation of legal principles from one country to the other, it is important to assess the social, legal and economic characteristics of the concerned countries. Otherwise, there is the risk of falling into the same non-adaptation issue in case of entire transplantation of legal structures.

By the end of the 19th Century, and the beginning of the 20th Century, the principles of the trust were transplanted from England to the US collective investments industry. From there, they were duly adapted to the economic and social conditions of the receiving country, the United States. Later on, by the end of the 40's and the early 50's, Brazil became the receiving country. Here, the investment funds industry was still in its embryo phase, but the assumptions related to the fiduciary duties arising out of the trust were transferred from the United States and adapted to the Brazilian economic reality, as reported by the Brazilian legal doctrine.

This item is initiated precisely within this theoretical analysis, where we will be presenting a brief history of the influence of the trust in the investment funds industry of England, United States and Brazil.

1.1. The arising of the 'use' and of the 'trust'[15] in the English medieval laws and its relevance for the composition of collective investment structures

> *Uses*[16] were the product of Roman devices, Salic influence[17], and theological notions of property. The article turns now to the *trust*, the next link in the genealogy of fiduciary duties (SZTO, 2004, p. 96).

The need to rely on the relationships between investment managers and investors, as well as the first collective investment structures, are rooted on the 'trust' of the medieval English law[18]. The legal basis of the 'trust' starts to be developed in

[15] For a detailed study on the history of the trust and its uses in Brazil we suggest reading: (i) SALOMÃO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996; (ii) CHALHUB, Melhim Namem. ***Trust* – Perspectivas do Direito Contemporâneo na Transmissão da Propriedade para Administração de Investimentos e Garantia**, 2001; (iii) FOERSTER, Gerd. **O *Trust* do Direito Anglo-Americano e os Negócios Fiduciários no Brasil**, 2013; and (iv) WALD, Arnoldo. Algumas Considerações a Respeito da Utilização do "Trust" no Direito Brasileiro. **Revista de Direito Mercantil, Industrial, Econômico e Financeiro**. Ano XXXIV (Nova Série) – Número 99 – July-September/1995. São Paulo: Editora Revista dos Tribunais, 1995.

[16] "The 'use' preceded the 'trust' and it was the mean applied in the attempt to by-pass the restrictions that attached the assets to the suzerain" (CHALHUB, 2001, p. 19).

[17] According to item 3.3, *Salic law*, considered here as part of the German medieval law (SZTO, 2004, p. 93).

[18] According to FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 92. Although it is possible to trace down the historical origins of the fiduciary relationship and its duties to the law of the ancient peoples, it is understood that, for the purposes of this paper, we must start by the trust in the medieval English law, which is sufficient to provide historical support for the composition of the current collective investment

England with the conquest of the Normans in 1.066 (CHALHUB, 2001, p. 17). They implement a new legal culture that, little by little, by decisions of the English courts, gives rise to the legal system of the 'use' and, later on, mainly due to the works and decisions issued by the chancellery courts[19], the legal character of the 'trust' is created. This system, in turn, bears the same "fiduciary root" existing in the legal system of the Roman Fiduccia, i.e., the factor of trust (VASCONCELOS, 2007, p. 39), which will permeate the operation of the trust.

The legal system has been being consolidated and, up to these days, is used for several purposes, including the structuring of collective investment mechanisms[20], in which the investors' protection within the fiduciary relationship formed between them and the investment managers has become an essential basis for the development of those means.

The origin of the fiduciary duties of diligence and loyalty[21], as currently known, is linked to the English law, more specifically to the land property right during the medieval period. The property of the land in the English feudal system was fractionated, therefore, the direct domain over the land was not verified, since it

structures and the fiduciary relationship between the investment manager/asset manager and shareholder of investment funds. For detailed studies about the history of the fiduciary relationship and its duties, we suggest reading the following: (i) SZTO, Mary. **Limited Liability Company Morality: Fiduciary Duties in Historical Context**, 2004, p. 94; (ii) SCOTT, Austin W. **The Fiduciary Principle**, 1949; (iii) YOUNGDAHL, Jay. The basis of fiduciary duty in investment in the United States. *In:* **Cambridge Handbook of Institutional Investment and Fiduciary Duty**. HAWLEY, James P. Et al. New York: Cambridge University Press, 2014; and (iv) FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 92.

[19] "The Chancellor, at that time almost always a jurist of clerical origin, examined the complaints addressed to him as an actual judge, but following a process based on the canonic rite, therefore totally different, in its principles, to the process followed by the common law courts. The substantive principles applied by him were mainly derived from the Roman law and from the Canonic law, less archaic than the rules of the common law, addressed to greater concern with the interests of justice and of good administration, by which the Chancellor's jurisdiction ends up conquering the sympathy of the King". (FOERSTER, 2013, p. 51).

[20] "From its historical origin reproduced here up to the contemporary times, the trust has been consolidated as an adaptable legal mechanism used for diversified purposes, all of them bearing in common the nominal title of property by a person obliged to administer it in benefit of a third-party. Its precise system of law was defined by jurisprudential and even legislative way in the subsequent periods, in an evolution that has not been concluded until our days. The applications of the trust have also evolved with the transfer from the mercantilism to the industrial and financial capitalism, and the concept exceeded the sphere of means for organization of private property to become a legal mechanism verified in the business arrangement and in the organization of **collective investment arrangements**" (emphasis added) (SALOMÃO NETO, 1996, p. 19).

[21] "To understand the common sense underpinning of fiduciary duty, a brief overview of the history of the concept and operation of trusts is constructive" (YOUNGDAHL, 2014, pos. 1066).

belonged to the lord or suzerain and the useful domain belonged to the tenant. The lord made the concession of the useful domain to the tenant so that the latter could – by the granted land – guarantee his living while rendering the services asked by his lord, which could bear economic, political or military nature[22].

However, there were certain rights and obligations affecting the free disposal of the land by the tenant. In case of death of the latter, for instance, the domain over the land returned to the lord, in the absence of heirs or in case of serious crimes perpetrated by them. Upon death of the tenants with minor heirs, the property remained under the domain of the lord until the heir became of age. Pursuant to those limitations and hindrances related to the transfer of property to heirs, derived from abuse of authority by the feudal lords, the tenants reacted, giving rise to the character of the 'use', which historically preceded the 'trust'. By the law of use, the tenant transferred the land to a third party (trustee)[23] so that the latter would administer the asset in benefit or for the use of another. Real examples of application of the use can be seen by observing the knights that participated in the crusades and left their assets under use, including the land, to a person of their trust to administer them in favor of their spouses and children[24].

Notwithstanding, the use did not have legal protection before the common law courts in case the trustee acted in disloyalty before the tenant, generating unjust enrichment of the one who had been left as responsible for administering the asset (the trustee), because their relationship was strictly based on the trust[25]. The impaired tenants started to appeal to the chancellery courts, created in parallel to the common law courts[26] and with jurisdiction in the person of the Chancellor (advisor of the king),

[22] Refer to CHALHUB, Melhim Namem. ***Trust* – Perspectivas do Direito Contemporâneo na Transmissão da Propriedade para Administração de Investimentos e Garantia**, 2001, p. 9.

[23] We decided to refer to him as "trustee" in order to get a clear understanding of the fact that such third party, also in the middle age, played a role similar to that of the trustee from the Roman law or the *Salmann (intermediary)* in the German medieval law. In the character of the use, the trustee was referred to as *feoffee*.

[24] Refer to FABIAN, Christoph. **Fidúcia – Negócios Fiduciários e Relações Externas**, 2007, p. 135.

[25] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**. São Paulo: LTr Editora, 1996, p. 13.

[26] "As already considered, the 'common law' has been developed under the strict dependence over formalist processes and, after a notorious expansion during the 13th century, it suffered from an effective

asking for their intervention. In the beginning, the Chancellor was usually an authority with religious formation and with knowledge in Roman law[27]. In the orders from the chancellery courts or equity, the Chancellor issued order against the person of the trustee (the defendant, proposed by the tenant) so that the latter would observe what had been agreed upon in the use. In case the order was not observed, the trustee was subject to penalties, such as detention. With the success of the chancellery orders, these courts started to be constantly used to solve problems involving trustees acting with dishonesty towards the use agreement. Such frequent use resulted in the legitimation of this legal character[28].

Faced with this new reality, the English crown suffered strong losses due to the decrease in the collection of the "heritage tax", as by that time the use had basically replaced the will[29]. This resulted in the publication of the "Statute of Uses", ending in the almost extinction of the use. However, the chancellery courts found means to validate the legal character of the use, even faced with a law that reflected the payment collection interests of the crown. Hence, "two or more uses started to be successively constituted in the same instrument and the effect of the "Statute of Uses" would be to simply extinguish the former, and the others were confirmed" (SALOMÃO NETO, 1996, p. 16). With the practice of constituting two uses disseminated by approval of the chancellery courts and aiming at differentiating the latter use from the former, the constitution of the latter use was named as 'trust'[30]. Functioning identically in the use, in the trust the ownership of a certain asset, material or immaterial, chattel or real estate, is transferred by the settlor to a third party referred to as trustee (the trusted one), who shall exercise the property rights transferred to them in benefit of the *cestui que trust* or

process of sclerosis, resulting from the routine of the men of law. It has seen the formation, around it, of a rival system, likewise the ancient Roman civil law was gradually replaced by the Pretorian law. This system is known as 'equity' " (FOERSTER, 2013, p. 48).

[27] "The modern trust developed most strongly in English law from **civil law antecedents** as a device to overcome feudal restrictions on the transfer of land" (emphasis added) (RICHARDSON, 2013, p. 107).

[28] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, p. 15.

[29] Refer to FABIAN, Christoph. Fidúcia – **Negócios Fiduciários e Relações Externas**, 2007, p. 136.

[30] "*Trust* means confidence, but it does not arise out of the law or of the right, but out of the honesty and consciousness of the trustee – thus, the return of the asset or its delivery to *cestui que trust*, was merely a duty of consciousness of the trustee, which implementation is guaranteed by judicial intervention" (CHALHUB, 2001, p. 20).

beneficiary (the one that trusts or the *beneficiary* of the trust). As a consequence, it is possible to observe that the property rights over the assets given in trust are ascertained to more than one holder.

Concerning the trust factor[31], it continues to be necessary also in the relation existing by means of trust, even with the operation of the English courts[32]. Although with operation of the court, the trustee can abuse the power held by him, selling, for instance, the real estate to a third party in good faith or even destroying such assets[33]. It is understood that the same factor, i.e., the trust, is essential for the investor to transfer their financial funds to the investment manager of an investment company in the United States or an investment fund in Brazil, which has operational principles similar to those of the trust.

Due to the exposed content, the trust can be understood as a relationship of confidence or, in addition, a fiduciary relationship[34] between the settlor and the trustee and between the latter and the beneficiary, whereby the trustee is accountable for maintaining or using the property right vested in them in benefit of the former – the *beneficiary*[35]. Regarding the affinity of the trust with the structuring of the collective investment arrangements in England and in the United States and, indirectly, with the investment funds in Brazil, Aguiar Júnior (2012, p. 290) helps to summarize it:

[31] In Portuguese language: "confiança".

[32] "The great secret of the trust rests here not anymore over the ownership, but over the models of trust and consciousness imposed by the court. The solution given by the court to the beneficiaries of a trust, express or implied, is not to agree with them due to a type of property right to which they are entitled, but just because this right is contrary to the trustee's consciousness of being in default towards his function or abusing it" (WORTLEY, *apud* CHALHUB, 2001, p. 26).

[33] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, p. 78.

[34] Due to the relevance of the confidence in the relationship formed by the trust and in order to link the expression "confidence" to the expression "fiduciary", it is verified that the word *Fiduccia*, which gives rise to fiduciary, has the following Latin meanings: "(...) confidence, security, hope, firmness, certainty, faith, good-faith, punctuality, accuracy (in compliance with a duty), trust, deposit, fiduciary assignment (relying on the good-faith, with moral obligation of refunding under certain conditions at a certain time and place)". (VILLAÇA, 1988, p. 121). "(...) the term fiduciary is borrowed from civil law. The Roman laws defined a fiduciary heir as a person who was an instituted heir and who was in charge of delivering the succession to a person designated by testament. (...) Fiduciary may be defined as "to be in trust, in confidence" (RAHAIM, 2005, p. 5).

[35] Refer to BOGERT, George G. et al. **Cases and Text on the Law of Trusts**. New York: Foundation Press, 2008, p. 2.

> Adapting, by its flexibility, to the mercantile activity, the trust served as a role model for institution of investment funds, where the trustee, or a company created to raise the saving, exercises the ownership of the amounts included in the funds, and the settlor ordinarily also appears as the beneficiary *(cestui que trust)*.

In fact, in the next items it will be verified that the collective investment mechanisms in England, in the United States and in Brazil have, in a similar way, the same structure of the trust described and defined in this item. This does not mean that in Brazil there are legal concepts that allow a double ownership system, like in the English system, but that there is, in the case of the investment funds, an operational mechanism where an individual or legal entity (investor) transfers to a third party (trustee or investment and asset manager), based on confidence, their financial resources. This way, the third party – the *trustee* or the *investment manager-asset manager* – will administer these funds according to the investor's interests. This occurs even with other names or variations, according to the legal 'outfits' adopted in the collective investment structures of other countries, like England and the United States.

Now we shall follow on with the assessment of the collective investment mechanisms in England, legally structured based on the trust.

1.2. The 'unit trusts' and the collective investment mechanisms in England

As a consequence of the appearance of the trust in England, in 1868 the 'Foreign and Colonial Government Trust'[36] was created in the country. The trust is a collective investment structure built in England through the 'unit trust'[37]. It was a special type of trust aimed for the small investor, used until today in England and in the United States. We can say that the unit trust is a minor change in the structure of the original trust, aiming at reaching investors with smaller financial potential.

[36] Although in Holland and in Belgium investment funds with trust-based structures already existed, these were not aimed for the small investors, like the fund created in England in 1868. Refer to investment company: *Edendragt Maakt Magt*. Refer to ROUWENHORST, Geertuwenhorst K. **The Origins of Mutual Funds**. New Haven/USA: Yale International Center for Finance, 2004, p. 5. Available at: <http://ssrn.com/abstract=636146>. Accessed on: Jan. 22. 2015.

[37] "(…) *units* representing a pro rata share in the portfolios" (FRANKEL, 2011, p. 521).

Regarding its operation, the trustee, or the company assigned to raise the savings, exercised ownership of the values and assets that comprised the investment fund, and the fund's settlor also participated as a beneficiary. Thus, we have the constitution of the first 'unit investment trust'[38] in England, a collective investment structure through which the retail investors contributed with individual capital, forming a fund aimed for investments in debt bonds of foreign governments[39]. The investors of the fund – the owners of units – were authorized to receive, at the instance of the redemption, the invested principal and the additional profits, according to the provisions set forth in the folder and in the unit representative certificate[40]. The British fund invested in foreign government debt bonds traded in the London Stock Exchange, disseminating the invested capital in a varied portfolio of governmental bonds[41].

From the regulatory point of view, the fund was regulated by the Joint Companies Act 1862, which limited the investors' responsibility to the total individual subscribed capital. Currently, the collective investment structures can be created by means of trust or investment company, according to the Financial Services and Markets Act 2000 (FSMA)[42].

1.3. The unit trusts and the mutual funds in the United States

[38] In the United States, the unit investment company is an investment company with powers to issue securities and also invest in other securities, such as governmental debt bonds (*bonds – considered as securities in the United States*), Refer to FRANKEL, Tamar. **Investment Management Regulation**. Anchorage: Fathom Publishing Company, 2011, p. 519. In England and in the United States, the governmental bonds are included in the category of securities.

[39] Refer to FRANKEL, Tamar. **Legal Duties of Fiduciaries**. Anchorage/USA: Fathom Publishing Company, 2012, p. 291.

[40] Idem, p. 292.

[41] The instruments that composed the portfolio included governmental bonds from Argentina, Brazil, Egypt, Italy, Peru, Chile and United States - Refer to BULLOCK, Hugh. **The story of Investment Companies**. New York: Columbia University Press, 1959, p. 2.

[42] Refer to CARVALHO, Mário Tavernard Martins. **Regime Jurídico dos Fundos de Investimento**, 2012, p. 45.

Originally from England, the '*unit investment trusts (unit trusts)'* [43], structured as trusts, adapted to the American culture. In the United States, they developed linked to large banks, with portfolio specialization and highly leveraged, unlike what was verified in England (where the investments were conservative in comparison to the American ones)[44]. Thus, in 1889 the New York Stock Trust is created, the first investment company similar to the British fund set up in 1868.

In the 20's, an investment company was created bearing the unit trust format as well, but aimed for investments in specific securities ***(fixed** unit investment trust).* According to the agreements celebrated between investment managers and the fund's securities portfolio asset manager *(trustee),* few or no power of discretion was left to the trustee to decide upon which securities to invest, except for the ones determined in the agreement[45]. However, around 1931, due to the US great depression, new investment companies – investment funds in Brazil - were created ***(flexible** unit investment trust).* In these funds, the investment managers granted greater power of discretion to the trustees – securities portfolio asset managers – hoping that the financial returns would then be increased[46]. As a side effect of such flexibility and increased discretion for the trustee to manage the fund, the need to define rules of conduct applicable to the trustee was confirmed, these rules were based on the fiduciary duties owed by them to the fund's investment manager[47]. In England, flexible unit investment trusts were also adopted, whereby the investors granted flexibility and discretion to the funds' investment managers, also giving rise, in that country, to the fiduciary duty of loyalty owed by the investment manager to the investor[48].

[43] "The Unit Investment Trust is an investment company organized solely by trust and issuing "instruments or redeemable shares, each one representing an ideal and non-divisible part in a unit (block) of securities and specified (…)" (ASHTON, 1963, p.170).

[44] Refer to CARVALHO, Mário Tavernard Martins. **Regime Jurídico dos Fundos de Investimento**, 2012, p. 46.

[45] Refer to FRANKEL, Tamar. **Legal Duties of Fiduciaries**. Anchorage/USA: Fathom Publishing Company, 2012, p. 292.

[46] Idem, p. 292.

[47] Idem, p. 292.

[48] Idem, p. 293.

In 1932, similar to the current mutual funds[49] [50] and inspired by the unit trust[51], among other things, two investment companies responsible for administering the securities portfolios of third parties, created the 'Bullock Fund' and the 'Massachusetts Investor Trust'[52]. They became prominent for enabling investments: (i) at smaller values and focused on small and medium investors, similar to the unit trusts; and (ii) in stock traded stock representative instruments. The *mutual funds*, unlike the funds structured as unit trust, granted greater discretion to the fund's securities portfolio investment manager. On the other hand, the *unit trusts* were specialized in more conservative investments, focused on governmental debt bonds, with few or no granting of discretion to the fund's investment manager-asset manager (the trustee). Anyway, in both there were fiduciary principles applied in the relationships between investment managers and investors, based on the trust[53], and allowed daily redemption, either of the units – in the case of the unit trusts – or of the stocks, in the case of the mutual funds.

In summary, in the United States the 20's was typically recognized for the unit trusts and the 30's saw the rising of the mutual funds[54], aimed at greater profits in

[49] A mutual fund is a collective investment vehicle, structured in a manner that is similar to the joint-stock companies or limited liability companies of the USA. The mutual fund pools money from many investors and administers it in favor of these investors, investing in stocks, securities or in cash. The investor, considered to be a shareholder of the mutual fund (as they hold shares representing the "fund"), is entitled to redeem these shares with the mutual fund and recover the invested money (free translation from the *SEC/Investor Information on Mutual Funds*). Available at: < http://www.sec.gov/answers/mutfund.htm>. Accessed on: Feb. 10. 2015.

[50] "The first time the word "mutual" ever crept into official language was in the Revenue Act of 1936, which permitted "mutual investment companies" that distributed their taxable income to their investors or shareholders to be themselves relieved of federal taxes on such income. But it was not until the 1940s that management investment companies, divided by SEC into "open-end" and "closed-end", gradually began to refer to the "open-end" variety as mutual investment companies and, in due course, as mutual funds". (BULLOCK, 1959, p. 73).

[51] Authors such as ROUWENHORST (2004, p. 5) in an article published by the University of Yale make clear that there is no historical difference between unit trusts and mutual funds, so that the origins of both are found in Holland in the 18th Century, with the Foreign and Colonial Government Trust, based on the principles of the trust being the historical origin of the unit trust and of the mutual trust in England, not evidencing any initial difference in the two alternatives of collective investment vehicles. Refer to Geertuwenhorst K. **The Origins of Mutual Funds**, 2004, p. 5.

[52] Refer to BULLOCK, Hugh. **The story of Investment Companies**, 1959, p. 72.

[53] Refer to SIN, Kam Fan. **The Legal Nature of the Unit Trust**. New York, USA: Oxford University Press, 1997, p. 8.

[54] Idem, p. 73.

the stock market, mainly because of the economic crisis that burst out in the beginning of the 20th Century.

Nowadays, the unit trusts are organized in the United States by means of trust and, the mutual funds, by means of joint-stock companies or limited liability companies.

From the functional perspective, the mutual funds issue and distribute redeemable shares for investors[55]. They must have enough liquidity and investments to proceed with redemptions whenever requested by the investor/shareholder, and always pay the investor/shareholder in net values, right after the taxes, giving the investor the right to ask for redemption any business day and have his request liquidated by the fund's investment manager on the subsequent business day[56]. Differently from the unit trusts, the mutual funds have a portfolio asset manager and a board of directors, equally responsible for observing their inherent fiduciary duties in the relationship with the investor/shareholder[57]. Furthermore, it is important to explain that the investors (shareholder) do not acquire the shares of the mutual funds in the stock exchanges, but actually directly from the fund's authorized distributors. Likewise, the investors do not sell their shares in the stock exchange, it is the investment managers who are responsible for redeeming the shares, returning to the investor/shareholder the money invested by them with the due earnings, according to the case[58].

The unit trust, collective investment vehicle and legally structured as trust, is categorized as investment company[59] [60] together with the mutual fund**,** according to

[55] Refer to CARNELL, Richard S. et al. **The Law of Financial Institutions**, 2013, p. 645.

[56] Idem, p. 645.

[57] Idem, p. 645.

[58] Idem, p. 645.

[59] "Investment Companies are financial intermediaries that sell shares to the public and invest the proceeds in a diversified portfolio of securities. Each share sold represents a proportional interest in the portfolio of securities managed by the investment company on behalf of its shareholders. The type of securities purchased depends on the company's investment objective" (FABOZZI and MODIGLIANI, 2009, p. 76).

[60] The *unit investment trusts*, together with the *mutual funds* (both *investment companies*), correspond to the Brazilian investment funds, with the 'units' being securities representative units that comprise the portfolio of the unit investment trusts. Irrespective of the type adopted to make collective investments, the resources of the fund are always administered by and their title is held by a separate legal entity. In the

the Investment Company Act from 1940[61]. As pointed out above, the unit trusts were used as tools to divide large values or statement of the securities issued and traded in the stock exchanges, in order to allow small investors to equally access the US stock market, and they hold this function until the present days[62]. The operation of the unit trusts can be further detailed by the agents that carry through their operations. Thus, the unit trust is comprised by: (i) sponsors-depositors. They are responsible for building the unit trust and sometimes act as distributors of the units. As depositors, the sponsors constitute securities portfolios and deposit them to the trustee, who turns them into units[63]. After that, these units are distributed to the investor audience who may later on redeem them according to the provisions of the leaflet prepared for the constitution of the unit trust; (ii) trustees. They are responsible for being the legal holders of the assets included in the portfolio of the unit trusts before the third parties (legal title), as well as for issuing, holding in custody and administering the units. They also administer the revenues and distribute them according to the portfolios of the unit trusts. In addition, the trustees must report, on an annual basis, to the investors (unitholders) any interests and earnings received due to the administration and custody, as well as the distributed quantities of units[64]. Finally, they are responsible for keeping the incorporation documents and reports of the fund for inspection by SEC[65].

It can be noticed that the unit trusts, as collective investment vehicles, were, by the end of the 19th century in England and during the 20's in the United States, the precursors of the current collective investment vehicles in these two countries, together with the joint-stock companies and the limited liability companies (e.g.: mutual funds)

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case of the mutual funds, these resources are kept by the fund managing company. In the case of the unit trusts, the resources are administered by and their title is held by the trustee.

[61] "The Investment Company Act of 1940 was enacted to protect investors entrusting their savings to others for expert management and diversification of investments which would not be available to them as individuals" (HAZEN, 1995, p. 955).

[62] Refer to FRANKEL, Tamar. **Investment Management Regulation**. Anchorage/USA: Fathom Publishing Company, 2011, pp. 520-521.

[63] Idem, p. 521.

[64] Idem, p. 522.

[65] Idem, p. 522.

of the 30's in the United States. Although currently the vehicles are no longer used for collective investment, having lost strength to the mutual funds[66], they appeared, together with the latter, as legal solutions aimed for the small and medium investors who, deprived from the investment in public instruments and shares due to the high quotations and to the complex procedures of investment in the stock exchange and in the general stock market, were presented with a way to participate in the investments and in the wealth circulating in this market.

Furthermore, they serve as parameters to enable understanding of the principles that guide the operation and the fiduciary relationships existing in the structures of the investment funds in Brazil, as the unit trusts and the mutual funds bring along principles materialized on the fiduciary duties of diligence and loyalty applicable to the trustee and to the investment managers in the United States[67]. In this respect, Professor Joanna Benjamin (2013, p. 224) explains that the investors are benefited against practices that conflict with their interests due to the fiduciary duties applied to the trustee or to the investment managers of collective investment arrangements. Moreover, according to Benjamin (2013, p. 224), whether these collective investment arrangements are legally structured in the format of joint-stock companies where the investors are shareholders or in the format of unit trusts in which the investors are beneficiaries of the *trustee*.

As a result of the 1929 crisis and due to later regulatory reactions starting with the Investment Company Act from 1940, the doctrine, the legislation and the courts of the USA started to develop and apply fiduciary principles[68] in cases that

[66] According to the United States Investment Company Institute - ICI, in 2013 the deposits in mutual funds exceeded the deposits in unit trusts: "**Mutual funds reported $167 billion in net inflows in 2013**; other registered investment companies also recorded positive net inflows. On net, investors added **$152 billion to long-term mutual funds.** Money market funds accounted for the other $15 billion. Mutual fund shareholders reinvested $189 billion in income dividends and $228 billion in capital gains distributions that mutual funds paid out during the year. Investor demand for exchange-traded funds (ETFs) continued to thrive, with net share issuance (including reinvested dividends) totaling $180 billion. **Unit investment trusts (UITs) had new deposits of $56 billion, up 28 percent from 2012**, and closed-end funds issued $10 billion in new shares. Available at: <http://www.icifactbook.org/fb_ch1.html>. Accessed on: Feb. 10. 2015.

[67] Refer to FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 96. According to her, and considering that mutual funds have shareholding legal structure: "Corporate law adopted **fiduciary principles** that derived from trust law". (emphasis added).

[68] "In less than a decade, the Congress passed major statutes to correct securities practices thought to have exacerbated the general economic collapse. One of the primary accomplishments of this legislation was to

involved problems between investment managers of investment companies *(*unit trusts or mutual funds*)*, mainly related to conflicts of interests, with the following being remarkable: (i) irregular reimbursement of amounts that did not belong to the investment manager, but to the investment company; (ii) unequal treatment assigned by the investment managers to investors holding equal rights; (iii) contractual default with investments not allowed by the funds' regulations; and, mainly, (iv) absence or inexistence of transparency when rendering information to the investors[69].

The purpose was to change the focus of an exclusively contractual relation and the responsibilities pursuant to it, that might not be reflected as a balance between investors and investment managers (example: asymmetric information), to a fiduciary relationship, with greater attention to the duties of loyalty and diligence imposed to the ones that render services of administration and management of the collective investment vehicles structured by means of unit trusts or mutual funds. Under this reality, a diffusion of the principles of the trust over the modalities of collective investment, with highlight to the fiduciary duties,[70] was verified in the United States. Among the measures aimed at fighting conflicts of interest between investment managers and investors in collective investment arrangements, a high point would be the enactment of the Glass-Steagall Act, in 1933[71], which prohibited the banks from joining and, under the same executive command, performing typical investment activities (e.g.: going public) and typical commercial bank activities (e.g.: distribution of investment companies' quotas to the investor audience through bank branches)[72]. Another measure applied by the Investment Company Act from 1940 was the prohibition of commercial

restore the commitment of investment management law to observance of the traditional fiduciary **principles of reasonable care and loyalty**" (emphasis added) (BINES e THEL, 2004, p. 10).

[69] Refer to BINES, Harvey E. et al. **Investment Management Law and Regulation**. New York, 2004, pp. 16-17.

[70] Idem, p. 11.

[71] In 1999, the Glass-Seagall Act was revoked by the Gramm-Leach-Bliley, enabling the return of commercial and investment operations under the same administrative command within the same financial conglomerate.

[72] Refer to BINES, Harvey E. et al. **Investment Management Law and Regulation**. New York, 2004, p. 11.

transactions between companies and subsidiaries investment managers of unit trusts or mutual funds belonging to the same financial conglomerate[73].

The fiduciary principles of diligence and loyalty are also found in the relationships between the investment manager and the investor of investment funds in Brazil, as these were inspired by the trust, specifically by the legal concepts already existing in the United States (unit trusts and mutual funds), having in mind that in Brazil the concept of the trust is not accepted in the way it is known in the Anglo-American legal system[74].

1.4. The investment companies and the investment funds in Brazil

Due to its flexibility, the trust not only served as model for institution of the collective investment structures in England and in the United States, but also to the investment funds in Brazil[75]. The funds are linked to the concept of the trust in what concerns the fiduciary duties applicable to the investment managers and/or asset managers[76], also because, like in the unit trusts and the mutual funds, investors deliver capital to an investment manager so that the latter makes the necessary investments in their behalf. Thus, after a certain period of time, the investor is able to redeem the quotas of the fund with profits over the investments initially made[77].

Although not similar to the current format of an investment company, the joint-stock companies were the first collective investment vehicles in Brazil, in the beginning of the 40's[78]. Later on, the condominium format arose, being first adopted by

[73] Idem, p. 11.

[74] Refer to FABIAN, Christoph. **Fidúcia – Negócios Fiduciários e Relações Externas**, 2007, p. 101.

[75] Refer to AGUIAR JÚNIOR, Ruy Rosado. Aspectos dos Fundos de Investimento. *In*: MUSSI, Jorge, et al. **Estudos Jurídicos em Homenagem ao Ministro Cesar Asfor Rocha**. Ribeirão Preto: Migalhas Editora, 2012, vol. 3, p. 286.

[76] Idem, pp. 291-293.

[77] In this respect, refer to CHALHUB, Melhim Namem. **Trust – Perspectivas do Direito Contemporâneo na Transmissão da Propriedade para Administração de Investimentos e Garantia**, 2001, p. 86.

[78] Thus, aiming at regulating an already established commercial reality, in 1945, inspired by the US Investment Company Act from 1940, the Decree-Law no. 7.583/45 is enacted, which did not produce any new legal concept, having only assigned the character of legality to a legal mechanism that, at that time,

the *Crescinco* fund, in 1957[79]. That fund was constituted based on the regulations of the US investment funds, reflecting the influence of that legal system on the composition of the first investment fund in Brazil[80].

Wald (1990, p. 18) explains that an investment company in the Brazilian law has to be understood taking into consideration the influence exercised by the US law on the laws of the Brazilian stock market, mainly due to "characters analogous to the trust", like the investment company. According to the author (1990, p. 23), the investments in funds can be made in the name of the investment manager and at the interest of the shareholder, a process similar to the trust and also accepted in countries with Roman tradition, such as Portugal and France. Finally, corroborating a similar reasoning related to the origin of the Brazilian funds, Fabian (2007, p. 101) states that the investment funds in Brazil were inspired by the American investment companies, which can be comprehended as the unit trusts or the mutual funds.

Still regarding the influence of the trust on the relationship existing between the investment manager and the investors of investment funds and on the establishment of the fiduciary duties, Dotta (2005, p.110) explains that such relationship is grounded "(...) on the strict confidence granted by the former to the latter regarding the attention towards their savings, who will be operating with the savings in the market, on the other hand, the investment managers bear the duty of acting in the most transparently possible manner (...)".

Hence, we can verify, up to this point, that the trust was the composition matrix of the collective investment arrangements in England and, later on, in the United States. With the influence of the US legal system on the investment funds industry in Brazil, we observe that the operational structure of the trust has, although indirectly, also inspired the operation of the Brazilian funds, the confidence being an essential

sought to emulate the operation of the shareholding US investment companies, equivalent to the US mutual funds, i.e., investment societies (ALONSO, 1971, p. 64).

[79] Refer to CARVALHO, Mário Tavernard Martins de. **Regime Jurídico dos Fundos de Investimento**, 2012, p. 58. The condominium format was the structure found during the 50's to replace the investment societies that did not prove to be adequate for collective investments which required freedom of redemption to the investors who wanted to exit from the respective collective investment structures.

[80] Refer to ASHTON, Peter Walter. **Companhias de investimentos**, 1963, 41.

element between the investment manager and the investor in funds – or "cotistas" of investment funds.

In light of the exposed content, we proceed in order to examine the fiduciary duties arising out of the fiduciary relationship and which, in turn, are applied to the investment manager of investment funds in Brazil.

2. THE FIDUCIARY RELATIONSHIP BETWEEN THE INVESTMENT-ASSET MANAGER AND THE INVESTOR OF INVESTMENT FUNDS AND THE DUTIES OF DILIGENCE AND LOYALTY – THE INFLUENCE OF THE DOCTRINE AND THE JUDICIAL DECISIONS OF THE ENGLISH AND AMERICAN COURTS

As how the investment funds were structured in Brazil is already known, bearing in mind the influence played by the trust in the composition of these collective investment mechanisms and the importance of the US legal system for the studies of the fiduciary relationship between the investment manager and the investors, the next step will be a detailed examination of the essential characteristics of the fiduciary relationship and the duties of diligence and loyalty.

Here, in addition, the concepts and examples of the fiduciary relationship are grounded and studied based on the English and US doctrines and on the court decisions of these countries. Why? Due to the strong presence of principles arisen out of the trust and of the investment funds in the Brazilian stock market, mainly when composing the fiduciary relationships between the investment manager and the investors.

2.1. The fiduciary relationship between the investment-asset manager and the investor of investment funds

The English and the American courts, as well as the laws of these countries, hardly define what the fiduciary relationship[81] is. The origin of such phenomenon is

[81] The US Uniform Trust Code, for instance, does not define fiduciary relationship, it just cites and explains the functioning of the types or categories of relations that are usually considered to be fiduciary – Refer to *Uniform Trust Code § 103 (20) / Sections 801-817*.

mainly derived from the common law system, in which the law or the rules are created based on precedents, in a case-by-case, inductive basis. On the other hand, in the civil law system, the definition starts with the general character of the rule and moves on to the real cases, in a deductive manner. Thus, a definition of what a fiduciary relationship might be is not natural and might impair the search for its characteristics (FRANKEL, 2012, p. 6). Hence, the courts prefer to leave open the definition of what a fiduciary relationship might be, because, once the definition is established, relationships that could be considered fiduciary according to the freedom of judgment of the judge and to the real case (and which have not been pursuant to a law) would result in damages to the potential beneficiary[82] [83].

In Brazil, concerning the investment funds' industry, the fiduciary relationship and the duties applied to the investment managers are mentioned in the CVM instructions that regulate the constitution and the operation of these funds[84]. These are open and broad rules, submitted to interpretation solely in light of the real case, not containing elements that may equally help with the characterization of the fiduciary relationship.

However, even faced with this reality, it is possible to obtain elements that might assist with establishing parameters to characterize a relationship as being fiduciary. Richardson (2013, p. 110) and Scott (1949, p. 541) distinguish, based on the trust, two common characteristics of the fiduciary relationships, which are the confidence assigned by the beneficiary in the services rendered by the trustee and the discretion that the trustee must have over the assets and goods rendered.

Furthermore, according to Scott (1949, p. 541), the greater the dependence to be exercised by the trustee in relation to the assets of the settlor/beneficiary[85], the

[82] Refer to FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 2.

[83] "In *Lloyds Bank Ltd v. Bundy:* it is neither feasible nor desirable to attempt closely to define the relationship, or its characteristics, or the demarcation line showing the exact transition point where a relationship that does not entail that duty passes into one that does" (CONAGLEN, 2010).

[84] ICVM 555/14 and ICVM 558/15.

[85] For the study developed in this chapter and in the subsequent chapters: beneficiary; investor or shareholder bear the same sense assigned, until now, to the shareholder of investment companies or to the investor of investment funds.

greater will be the level of the loyalty duty and diligence imposed on the trustee. Therefore, in this scenario, someone in a position of trustee is subject of a greater loyalty duty in relation to the beneficiary (e.g.: to refrain from taking positions in situations of conflict of interest towards the beneficiary) than a member of a company's Board of Directors, considering that to perform their job they do not have to be the holder or the custodian of the company's assets.

Therefore, it is understood that a fiduciary relationship must have two elements, without which it is not verified. They are the confidence that must exist between the trustee and the beneficiary (in which case they can also be the settlor or the one that transferred the assets to the trustee) and, pursuant to such confidence, the granting of discretion to the trustee so that they may properly administer such assets. Otherwise, if these elements are not present, the relationship may be solely contractual or a donation, but it certainly does not refer to a fiduciary relationship.

On the other hand, Frankel (2011, p.6) characterizes the fiduciary relationship based on other elements, besides the confidence and discretion, although they are equally present in the author's studies. These elements are found, if not in every fiduciary relationship, at least in most of them, including the relationships between the beneficiary and the trustee, the investment managers of investment funds and the investors. To Frankel (2011, pp. 6-10), there are four possible characteristics that can be identified when the fiduciary relationship is formed. They are:

(i) service providers. The first characteristic sets forth that the majority of trustees – the investment managers, for the purposes of this paper – are service providers, in contrast to product suppliers. These services have high level of specialization, such as securities portfolios management services, investment managers of investment funds, real estate brokers, publicly traded company investment managers, etc.

(ii) discretion. In order to properly render the services, these service providers or trustees must act with freedom and discretion[86] [87]. In other words, the client

[86] To emphasize the understanding that the discretion of the funds' investment manager is essential to enable him satisfactorily administer the fund, refer to the vote of the Director Marcelo Trindade in Minutes of the Board's Meeting no. 20, dated 05.22.2001, in the Proc. RJ2001/1857. In the words of that Director: "In fact, there are actually funds *(*blind trusts*)*, where the manager's absolute discretion is an

or the investor must necessarily transfer, to the service providers, the property of an asset, chattel or real estate and/or power of discretion.

The asset manager, for instance, is responsible for evaluating the shares traded in the Stock Exchange, for the earnings of the investment company with interests paid by the public instruments, for selling or buying assets with the best price and performance for the fund's portfolio. In addition, the stock exchange market, for instance, is volatile, requiring quick investment or divestment decisions with the funds' securities portfolio. In this context, the lack of expertise might result into irreversible losses for the fund's portfolio. In case the asset manager has to report to the shareholder or ask for their approval whenever a decision about a certain investment has to be made, the asset manager might lose chances of financial profits and investments for the portfolio. Thus, it is verified that the transfer of power of discretion, by the investor or investment manager to the asset manager, is essential to avoid losses for the shareholder of investment companies or for the investor in investment funds in Brazil.

It is also important to point out that, due to the information asymmetry existing between the investment manager and/or the asset manager and the investor, the transfer of this power, either to the asset manager and/or to the investment manager of investment funds, implies the possibility of the latter abusing the power assigned to them. The abuse creates situations of conflicts of interest that end up inducing the trustee (the investment manager and/or the asset manager) into practicing acts that impair the investments of the investor.

Hence, we can conclude that the characteristics (i) and (ii) are totally applicable to the investment managers and/or asset managers of investment funds in the

essential characteristic". Available at: <http://www.cvm.gov.br/port/descol/resp.asp?File=2001-020D22052001.htm>. Accessed on: Sept. 03, 2014.

[87] To emphasize the understanding that the discretion of the funds' investment manager is essential to enable them to satisfactorily administer the fund, refer to the vote of the Director Marcelo Trindade in Minutes of the Board's Meeting no. 20, dated 05.22.2001, in the Proc. RJ2001/1857. In the words of the Director: "In fact, there are actually funds *(*blind trusts*)*, where the manager's absolute discretion is an essential characteristic". Available at: <http://www.cvm.gov.br/port/descol/resp.asp?File=2001-020D22052001.htm>. Accessed on: Sept. 03, 2014.

United States and, specially, in Brazil. These characteristics are necessary to assist the operation of the asset managers and investment managers and their relationship towards the funds' investors.

(iii) beneficiary's risk. Transfer of powers and/or ownership of assets and rights to the trustee or, in this specific case, to the investment manager and/or asset manager of investment funds naturally places the investor in a position of risk towards the trustee or towards the investment manager or the asset manager. These, after taking possession of the investor's financial resources, might not perform the services they promised[88] according to the provisions of the regulation that formed the trust or the investment company or, in the case of Brazil, the investment fund;

(iv) costs of the relationship of trust. The costs for the trustee in the attempt to establish a relationship of trust, honesty or integrity towards the beneficiary/investors (or "cotistas") can be greater than the benefits of an already constituted fiduciary relationship, in which case there will be high probability of abuse or misuse of the power assigned by the beneficiary or by the investor to the trustee or to the investment manager-asset manager.

The characteristics presented by Frankel derive from relationships of trust, always keeping in mind that it reflects the main and better known type of fiduciary relationship, which is not, however, the only one[89]. This emphasizes the understanding that the characteristics considered by Frankel are equally applicable to the relationship between the investment manager-asset manager and investors of investment funds[90].

In other words, fiduciary relationships are the ones that occur in an environment of trust or confidence between the investment manager-asset manager and

[88] In this sense, there is an illustrative decision from CVM, in which the investment manager of securities portfolio, after holding possession of the financial resources of a teachers' association decides to settle the debt with a securities broker company instead of investing and administering or properly managing the teachers' capital. Available at: <http://www.cvm.gov.br/port/descol/respdecis.asp?File=4222-0.HTM>. Accessed on: May 04.2014.

[89] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, p. 37.

[90] In this respect, also refer to RICHARDSON, Benjamin J. **Fiduciary Law and Responsible Investing**, 2013, p. 110.

investor, combined with the exercise of control and discretion by such managers over the administration of a securities portfolio of investor[91].

After defining fiduciary relationship and its characteristics, we will now study the duties of diligence and loyalty applicable to the investment managers and asset managers, holding a position similar to that of the trustee inside the collective investment mechanisms.

2.2. The duties of diligence and loyalty applicable to the investment-asset managers

We will be considering, in this item, the duties of diligence and loyalty, starting with the reasons that lead to the appearance of these duties and then proceeding to specific studies about each one of them.

2.2.1. Abuse of power and information asymmetries in the fiduciary relationship

The deviations caused by the fiduciary relationship in the behavior of the investment-asset managers of investment funds, i.e., their abuse of power and the information asymmetries, generate other deviations or anomalies, such as the violations resulting from conflicts of interests, secondary or secret remuneration and breach of secrecy or confidentiality.

When assessing the general characteristics of the fiduciary relationship, we observe problems or side effects derived from the relationship itself. Why? Due to the specificities of its structure. After all, investment-asset managers of investment funds exercise specialized activities which are desired by the investors. These activities, in turn, can be performed through transfer of power and financial resources by the investors to the investment managers. In other words, the activity of administration and management of investment funds or of third parties' capital is performed only upon[92]: (i) substitution of the investors for the investment managers when contracting service

[91] Idem, p. 110.

[92] Refer to FRANKEL, Tamar. Fiduciary Law. **California Law Review**, 795, 1983, p. 7. Available at:<http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=2137&context=californialawreview>. Accessed on: May 10, 2014.

providers and managing a securities portfolio; and (ii) assignment of powers, by the investors to the investment managers, so that the latter is able to take effective actions in benefit of the former.

In this case, we are facing a situation where the abuse of power by the investment or the asset manager of investment funds becomes a possibility, as, in the case of the funds, some characteristics facilitate the abuse of power. For instance, it is easy to change, in favor of the fund, accounts and figures as the investment managers deal with several accounts and the investors cannot keep proper control and monitoring over such professionals. Another characteristic is the fact that investment funds increase the investment manager's exposure towards the market and their peers, forcing up competition for greater financial returns and attraction of investors, which might promote anti-ethical or inappropriate behaviors in the pursuit of better returns.

When investment managers operate in financial conglomerates, the scenario displayed in the former paragraph may worsen as these acts may also benefit their own organizations, to the detriment of the interests of investors (BINES, 2004, p. 9).

Thus, due to the described characteristics above, inherent to the very operational structure of an investment company, the possibility of abuse of the power held by an investment or asset manager of investment funds is a variable that has to be taken into account by regulators.

Another important focus uses an economic analysis key, i.e., to assess the reasons that lead to the existence of those rules, through the information asymmetry[93] between the investment manager, and/or the asset manager and the investor of investment funds. In the fiduciary relationship, information is distributed unequally as the investment-asset managers can use their specialized knowledge and expertise in administration and management of capital and securities portfolio to their own benefit and to the detriment of the investors who – whether being individuals or legal entities – hold limited knowledge or scarcity of time, for instance, to invest in investment funds.

[93] "First, it is important to identify what such important information for the operation of the economic agents may be. Although some authors refer to it only as a generic information on the quality of the assets traded in the market (VARIAN, 1999, p. 641), this definition is extremely restrictive. In fact, the information referred herein corresponds, to a great extent, to Hayek's economic knowledge. It is the practical or functional information, the knowledge about the conditions for operation". (YAZBEK, 2007, p. 42).

"(..) the holders of investment funds' quotas would not be able to assess the investment options adopted by the investment managers or even their actions" (YAZBEK, 2007, p. 189).

Therefore, it is worth stating that the information asymmetry derives, considering analysis of the economy, from a failure of the financial market, impeding its full efficacy and explaining the various regulation activities intended for mitigating such asymmetry[94], including, among them, the rules that govern the conducts of the investment-asset managers.

Once the main characteristics of the fiduciary relationship are understood, as well as the risks represented by them to the investors, it is possible to assess the duties imposed on the trustee (the investment or the asset manager of investment funds)[95].

2.2.2. The duties of diligence and loyalty applicable to investment-asset managers of investment funds

Due to the potential abuse of power and the information asymmetry derived from the fiduciary relationship, the need to impose duties on the investment managers, which can mitigate the *side effects* of this relationship, arises.

As a result of the negative effects produced by the fiduciary relationship, there are duties imposed on the investment managers. These duties have become inherent to the fiduciary relationships. Hence, as the relationship with the investor is fiduciary, the duties of diligence and loyalty apply to the investment manager, as explained by Salomão Neto (1996, p. 43):

> The consequence of a certain relationship being considered as fiduciary is the imposition of strict duties of diligence and loyalty, exceeding the mere honesty, as derived from a classical excerpt from Judge Cardoso in the case *Meinhard vs. Salmon*, decided in the New York Court of Appeals:

[94] Refer to YAZBEK, Otavio. **Regulação do Mercado Financeiro e de Capitais**, 2007, p. 189.

[95] For the study developed in this chapter and in the next ones, trustee and investment manager-asset manager assume the same sense assigned, until now, to the investment manager and to the asset manager of investment funds.

> *Many forms of operation allowed in the current world to the ones relating under market conditions are forbidden to the ones connected by fiduciary bonds. A trustee is obliged to something stricter than the moral prevailing in the market. Not only honesty, but the scrupulous required by the most delicate honor, is then the standard of conduct (...).*

In these cases, the companies imposing control mechanisms over the operation of the investment-asset manager are not limited to the ethics self-imposed by the citizens or to the control of organized investors' associations or the market. These mechanisms are not completely effective. The standards of conduct that come with the duties imposed by the State, such as the duty of loyalty and diligence to the investment-asset manager, are necessary to mitigate the unbalance of power and knowledge between them and the investor[96].

Thus, for the analysis, the functioning of the duties of diligence and loyalty will be assessed through the perspective of studies involving trusts and trustees.

2.2.2.1. The diligence duty or the duty of care

The investor in investment funds – when relying on the expertise, technical capacity and diligence that shall be used by the fund's investment managers to administer the financial resources of such investor –, assumes that the investment managers will be working with the due diligence imposed on them by the fiduciary relationship existing between these managers and the investors. This duty is related to the diligence, prudence, attention and expertise that shall be devoted by the investment managers when performing their services or managing the capital of the investor[97]. According to a decision proclaimed by a court in the United Kingdom[98], preserving the

[96] "Fiduciary duties are linked to the definition of fiduciary relationships. The duties aim at reducing entrustors' risks. The first is posed by the entrustment of property or power to fiduciaries, and the fiduciaries' possible temptation to abuse the entrustment" (FRANKEL, 2011, 106).

[97] Refer to FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 169.

[98] According to professor Eduardo Salomão, the rules related to fiduciary duties are "of a very old generation in the 'common law', tending to be identically reproduced in the United Kingdom and in the United States of America, the latter accepting the jurisprudential influence of the former in the entirety" (SALOMÃO NETO, 1996, p. 44). That explains why, in this item, the decisions from the courts of the United Kingdom and of the United States are mentioned according to the criterion of the best example and clarification of the addressed subject, with no concern here to differentiate whether if it is the example or the concept that applies better in the United States or in the United Kingdom.

analogy with the investment manager, the trustee must administer the trust according to all the diligence which an ordinary and prudent person would take to manage his own business[99].

Moreover, also according to a classical US decision[100], in order to act according to the proper diligence duty, the trustee or the investment manager must observe how a prudent person manage their own business: avoiding speculating with third parties' financial capital, but adopting the same diligence they would have with funds of their own, considering all the safeguards needed to protect the actually invested capital. This decision was implemented, in the United States, the duty of the prudent person/investor, applicable to the trustees who worked as investment portfolio managers or investment managers. This rule has become important to assess whether the trustee has indeed taken the diligence required from them in their position, observing if they were prudent to make a certain decision in a specific situation[101]. Finally, the diligence duty is connected to the prudence and the diligence when acting as a trustee, as observed by Professor Eduardo Salomão (1996, p. 44):

> The duty of diligence is the first of the fiduciary duties of the trustee. It would be, under the terms of a jurisprudential decision of the United Kingdom, obliged to administer the "trust" with all the precautions that an ordinary and prudent person would take to administer their own business. This declaration, although becoming classical for its repetition, must, however, be made with restrictions because of the fact that, in many occasions, the trustee is expected to apply the prudence and the diligence that are not ordinary for the prudent common person, something that the "trustee", as already analyzed above, cannot do. Anyway, this refers to the application of the abstract criterion of guilt that was, as a rule, applied to cases in general in the Roman Law.

Furthermore, it is worth questioning if the trustee has to be directly held responsible when they cannot accomplish the results promised by them upon constitution of the trust or their undertaking of the title of trustee even when failures, not derived from lack of diligence or diligence on their part, have occurred and impeded them from accomplishing the expected result. The Anglo-American jurisprudence

[99] Refer to *Speight v Gaunt* (1883) 9 App Cas 1.

[100] Refer to *Harvard College v. Amory* – 1830, 26 Mass. 446, 9 Pick. 454.

[101] Refer to BINES, Harvey E. et al, **Investment Management Law and Regulation**. New York: Aspen Publishers, 2004, p. 4.

demands the trustee to work with the diligence and competence of the ordinary and prudent person and not with the objective responsibility[102] [103] [104].

However, if the trustee is a specialized professional and has announced that they hold differentiated qualities in relation to the market of their operations, as well as the possibility of obtaining results above the ones expected by the beneficiaries in ordinary contracting of the same services (e.g.: financial returns above the average of the market), the Anglo-American courts will take these individual qualities into account and, in a real case, impose greater strictness when assessing the applicable diligence duty[105].

In a fiduciary relationship, the trustee's responsibility can, in relation to their diligence duty, be mitigated by the agreement celebrated with the settlor/beneficiary. Clauses that limit or exclude the trustee's responsibility are disregarded or limited by the American and English courts, if they have the purpose of "(...) benefiting the dishonest or very negligent trustee" (SALOMÃO NETO, 1996, p. 46). Examples of clauses of this nature encompass the ones that exclude the responsibility of the trustee "(...) for the loss of any property of the "trust" that has not been originally received by them" (SALOMÃO NETO, 1996, p. 46). Professor Eduardo Salomão explains that the eventual efficacy of this clause would allow the "appropriation, by the trustees, of funds and earnings arising out of the trust" (SALOMÃO NETO, 1996, p. 46), stimulating the dishonesty and the lack of loyalty of the trustee towards the beneficiary.

Finally, in Brazil, before carrying on the assessment of the loyalty duty applied to the investment-asset managers, the criterion used to ascertain the lack of

[102] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, p. 46.

[103] DOTTA (2005, p. 128), when considering the civil responsibility of the investment managers of investment funds, for instance, follows the same logic: "In this line, we conclude that, according to the administrative and legal standardization of the investment funds, their investment managers cannot be held liable if they take correct actions, as the guilt element included in the standards issued by the regulating instrumentalities and applicable laws has been made relevant. Therefore, there is no special rule foreseeing the objective responsibility of the investment managers of investment funds".

[104] We recall that during the performed research, no judicial or administrative decision has been found in Brazil that could help us understand those problems under the perspective of the fiduciary relationship between the investment managers-asset managers and investors of investment funds.

[105] Refer to DOTTA, 2005, p. 46.

diligence is the abstract concept of guilt[106]. According to this criterion, the investment-asset manager can only be disapproved or rejected for their conduct when, after evaluating the conditions of the real case, it is valid to state that they should have acted in another manner and they did not[107]. In this case, as elucidated by Professor Arnoldo Wald (2012, p. 124), a comparative analysis of the agent's conduct to that of the average person, i.e., of the diligent family person, is performed. In the particular case of the investment funds, it is considered that the diligent investment-asset manager is the one that observes and complies with the arrangements set forth in the standards of conduct contained in the CVM instructions, mainly in the rules established in instructions number 555/14 and 558/15[108].

The considerations about the loyalty duty are presented below.

2.2.2.2. The loyalty duty

In Brazil, there has not been found any doctrine or jurisprudence about the loyalty duty, within the scope of the investment funds industry, that could assist with the comparison to the works developed in the common law countries.

On the other hand, based on the legal key of the trust, it is found that in the fiduciary relationships the loyalty duty is the one through which the investment and asset managers are obliged to put the interests of the investors first, so that their own interests, or the interests of third parties, are not considered by them under any circumstances[109]. Based on the understanding from the several cases judged in the

[106] Art. 186 of the Brazilian Civil Code: "The one that, by volunteer action or omission, negligence or imprudence, violates the right and causes damage to others, even if exclusively moral, performs illicit act".

[107] Refer to GONÇALVES, Carlos Roberto. **Direito Civil Brasileiro – Responsabilidade Civil – Vol. 4**. São Paulo: Editora Saraiva, 2013, p. 322.

[108] When comparing this subject in common and civil law, Professor Salvo Venosa (2014, p. 28) explains that "It is not different from the area of the Common Law, which seeks for the parameter of the reasonable person. With this standard, it is avoided, as far as possible, the subjectivism when ascertaining the guilt". He adds that "the agent is not guilty because they acted by deviating from the moral, but because he did not apply the average social diligence".

[109] Refer to RICHARDSON, Benjamin J. **Fiduciary Law and Responsible Investing**, 2013, p. 116.

United States related to the role of the trustees that act as investment managers of portfolios/investments or investment funds, for instance, there were rules related: (i) to the obligation of avoiding conflicts of interest in relation to the beneficiary/investor; (ii) to the obligation of not delegating their responsibility to third parties; (iii) to the obligation of committing to an impartial conduct towards different beneficiaries/investors to whom they – trustees – render services of assets administration[110]; (iv) to the prohibition of or to the establishment of conditions to the trustee's power to assets from the actual trust; (v) to the prohibition of or to the establishment of conditions to the trustee's power to sell the assets of the trust to the institutions or companies where the trustee themselves hold commercial interest; (vi) to the prohibition of or to the establishment of conditions to the trustee's power to sell their own assets or rights to the trust administered by them, i.e., to perform business between them and the trust; (vii) to the prohibition of the trustee's power to use the trust's assets in their own interest; and (viii) to the prohibition of or to the establishment of conditions to the trustee's power to receive commissions that have not been contracted with the beneficiary/investor, but which are received from third parties due to the position held in the trust[111].

According to the doctrine and the jurisprudence of the United Kingdom and the United States, related to the investment of collective investment arrangements, the loyalty duty encompasses the following duties[112]: (i) the trustee shall avoid conflicts of interests with the beneficiary/investor; (ii) the trustee shall refrain from obtaining secondary or secret profits; (iii) the trustee shall keep secrecy towards the information obtained in administration of the trust, not benefiting from privileged information; and (iv) the trustee shall inform the beneficiary/investor about the activities and financial transactions of the trust, profits, losses and other information established in specific regulations.

[110] Idem, pp. 116-117.

[111] Refer to BINES, Harvey E. et al, **Investment Management Law and Regulation**. New York: Aspen Publishers, 2004, p. 4.

[112] Refer to (i) FRANKEL, Tamar. **Fiduciary Law**, 2011, p. 106; and (ii) SCOTT, Austin W. **The Fiduciary Principle**, 1949, pp. 543-546.

Taking these comments in account, the loyalty duty is materialized in the duties of avoiding conflicts of interests and secret profits, keeping secrecy and informing the beneficiary/investor in investment funds.

2.2.2.2.1. Loyalty duty – the duty of avoiding conflicts of interests

Preserving the analogy with the investment manager of investment funds, the duty of avoiding conflicts of interests sets forth that the trustee cannot carry out business with the trust managed by themselves, even if such business can generate commercial advantages or profits to the trust. The obligation of avoiding conflicts or interests does not require that the act is necessarily harmful to the trust, it is enough a scenario where the trustee is, even if passively, under a situation of conflict of interest in relation to the beneficiary/investor. This rule remains valid even after the trustee (investment manager and/or the asset manager) stops managing the trust or investment funds, as they could carry through business aiming at avoiding future results, already counting with their exit from the trust[113].

2.2.2.2.2. Loyalty duty – conflicts of interests inside financial conglomerates

Within financial conglomerates[114], the administration of trusts or investment funds, even when companies are created aimed exclusively at administering third parties' capital, can be influenced by interests that are not the ones of the beneficiaries of the trust or of the investors[115]. The commercial areas (e.g.: loans) of investment

[113] Refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, p. 49.

[114] According to the definition of the Brazilian Central Bank, a financial conglomerate is understood as "the set of financial entities directly connected, or not, by shareholding or effective operational control, characterized by common administration or management, or by the operation in the market under the same brand or trade name ". Source: Accounting Plan of the Brazilian Financial System Institutions - Cosif 1.21.1.2 – Available at: <http://www.bcb.gov.br/glossario.asp?Definicao=1406&idioma=P&idpai=GLOSSARIO>. Accessed on: Feb.20. 2015.

[115] Example: *Banco Santos's* case. In November, 2004, BACEN declared the beginning of the administrative intervention process in *Banco Santos*. Among the consequences of this intervention, BACEN determined that the investment funds managed by *Santos Asset Management*, belonging to the financial conglomerate of Banco Santos, should provide 100% of the value of the assets included in the

banks (e.g.: mergers and acquisitions) and of third parties' capital administration (e.g.: management of investment funds' portfolios), that operate inside the same financial conglomerate, may exchange relevant[116] or even confidential[117] information, generating financial losses to their clients, including the investors of the managed funds.

Bines and Thel (2004, p. 9) explain that situations that create conflicts of interest and stimulate breach of the trustee's loyalty duty to the beneficiary/investor are worsened when they operate in financial conglomerates, as the trustee or the investment manager can favor their own organizations to the detriment of the beneficiaries' interests.

2.2.2.2.3. Loyalty duty – the duty of avoiding secret or secondary profits

The rule related to the prohibition for the trustee of obtaining secondary or secret profits due to their position or functions performed in the trust does not allow them to receive any remunerations other than the ones authorized by the settlor of the trust or beneficiary or the ones already set forth in a specific agreement[118]. It is worth highlighting that the prohibition of incidental profits remains, even when the trust cannot use an opportunity arising out of specific circumstances. The trustee is not allowed to claim that the business opportunity that generated secondary profits could not be used by the trust[119]. Obviously, the forbidden secondary profits also include the

portfolio that were structured, administered or issued by *Banco Santos*. Available at: <http://www.cvm.gov.br/export/sites/cvm/sancionadores/anexos/sancionador/2008/20080826_PAS_2205.pdf>. Accessed on Oct.20. 2014.

[116] According to the sole paragraph of article 60, §1 of ICVM 555/14: "§ 1. Any act or fact that might influence, in a considerable way, the amount of quotas or the decision of the investors of purchasing, selling or keeping these quotas".

[117] For deeper study about classified and confidential information, it is possible to consult the PAS RJ 2009/13459, where CVM considers confidential information as the one that might also encompass other people from the same company, while classified information involves the opposition between insider/outsider, in which the person who is inside the institution or the investment manager (insider), in relation to the shareholder (outsider), has information not yet held by the latter. Available at: <http://www.cvm.gov.br/export/sites/cvm/sancionadores/anexos/sancionador/2010/20101130_PAS_RJ20 0913459.pdf>. Accessed on: Mar. 05. 2015.

[118] Idem, p. 49.

[119] Idem, p. 49.

ones where the trustee receives remuneration to violate, by passive or active means, the duties of loyalty towards the settler or beneficiary of the trust or the investment fund.

2.2.2.2.4. Loyalty duty – the duty to keep secrecy

Regarding the secrecy duty, it shall be deemed as breach of the fiduciary duty of loyalty towards the beneficiary of the trust if the trustee uses information obtained pursuant to their position in their own benefit or conveys it to third parties that may use it against the interests of the trust. Moreover, according to the US doctrine and jurisprudence, there is breach of the secrecy duty when the information has been accidentally obtained by the trustee and they use it to the detriment of the interests of the trust or equally convey it to third parties, impairing the trust[120]. In addition, the information deemed to be generally known in the market where the trustee operates will not be protected by the duty of secrecy imposed to the trustee[121] or the investment manager.

2.2.2.2.5. Loyalty duty – the duty to inform

According to Maudsley and Hanbury (1985, p. 534) the beneficiaries/investors have the right to be informed – by the trustee – about the accounting operations, financial information and any other information eventually affecting the daily activities of the trust – or investment fund - or which might conflict with the interests of the beneficiary – or the investor.

Frankel (2011, p. 130) explains that it does not refer to a mere duty to inform, derived from the loyalty duty towards the beneficiary/investor, but actually to an obligation of accountability or rendering of accounts to the one that granted them powers. According to her, the trustee must equally inform about the assets procured pursuant to the power and financial resources transferred to them by the beneficiary. In addition, the information supplied must be periodical, complete and apprehensible, i.e., easily understandable.

[120] Refer to SCOTT, Austin W. **The Fiduciary Principle**, 1949, p.553.

[121] Idem, p. 553.

Based on such theoretical knowledge and under the focus of the fiduciary duties applicable to the investment-asset managers, we will now move on to the assessment of the main standards of conduct contained in the CVM instructions, aiming at testing the characteristics of the fiduciary relationship and the duties of diligence and loyalty towards the referred legal rules.

3. CONSIDERATIONS ABOUT THE NORMATIVE SYSTEM OF THE INVESTMENT FUNDS INDUSTRY IN BRAZIL UNDER THE FOCUS OF THE FIDUCIARY RELATIONSHIP AND THE DUTIES OF DILIGENCE AND LOYALTY

In this chapter, we will be assessing the main rules issued by CVM concerning the funds industry in Brazil, under the focus of the fiduciary relationship and the duties of diligence and loyalty.

3.1. The Law 6.385/76 and the CVM's legitimacy to impose fiduciary duties to the investment-asset managers of investment funds

Currently, the investment funds are subjects to the rules contained in Law 6.385/76[122] in the CMN resolutions and in the CVM instructions, as are investors and the agents that participate in the rendering of administration, management, bookkeeping of the issuance, amortization and redemption services for quotas and custody of the financial assets that compose the portfolio of the fund[123], among other service providers.

BACEN and CVM divided the function of regulating and inspecting funds until 2001, when the Law 10.303/01 amended the article 2 of the Law 6.385/76[124]. Due

[122] Although the Law 4.728/65 continues to be in effect, it is obsolete and it is not object of analysis in this paper.

[123] Financial assets are defined by the article 2 of the CVM instruction 555/14. Among them, general securities are put in evidence, like collective investment agreements, derivatives, shares, debentures and other assets. Public debt bonds are not considered securities in Brazil.

[124] Article 2 of Law 6.385/76. "Article 2. The following are securities subject to the regime of this Law: (…) V – the quotas of investment funds in securities or clubs of investment in any assets; (...)".

to such change, the quotas of the funds were expressly considered as securities[125], together with shares, debentures, derivatives and others. Hence, since 2001, the function of regulating and inspecting investment funds, their investment-asset managers has been of exclusive responsibility of CVM.

Still based on the Law 6.385/76, CVM holds the power to ascertain, using an administrative process, illegal acts and non-equitable practices performed by the investment managers of investment funds and other market stakeholders, with the possibility of applying fines, warning penalties and suspension of the authorization or registration to exercise activities of funds administration and management[126]. CVM is also responsible for issuing normative instructions, in order to regulate the market of securities, the operation of the funds and the conducts of their investment managers. Finally, the Law 6.385/76 established authority for CMN and for CVM when setting forth that they are responsible for protecting the market investors against "illegal acts" of investment and/or asset managers of securities portfolio (article 4, IV, "b").

At this point, due to the express authority assigned to CVM by the Law 6.385/76, aiming at defending the interests of the investors, the question placed here is about the normative function of CVM about the questions related to the funds industry, specially about the conducts of investment-asset managers.

According to Santos, Wellish and Barros (2006, p. 69), the Law 6.385/76 belongs to the category of the "chart-laws, provided with low normative density and specifically aimed for the matters that bear peculiar technical complexity and the sectors constantly subject to changes bearing technological and properly economic order". The Law 6.385/76 sets forth general principles, standards that must serve to guide regulation of more technical and dynamic subjects that require promptness in the adaptations or amendments of their rules[127]. We can state that the investment funds are included among these technical subjects, in which CVM, provided with powers to formulate

[125] Cf. CVM Deliberation 461/03.

[126] Art. 11 of Law 6.385/76.

[127] Refer to SANTOS, Alexandre Pinheiro dos, et al. Notas sobre o Poder Normativo da Comissão de Valores Mobiliários: CVM na atualidade. **Revista de Direito Bancário e do Mercado de Capitais** – Ano 9/número 34 – Revista dos Tribunais, São Paulo, 2006, p. 78.

standards of conducts aimed for the investment-asset managers of investment funds[128], expressly mentions the existence of fiduciary relationship between the investment-asset managers and the investors of such funds[129], imposing rules that induce certain ethical behaviors necessary for the administration of third parties' capital[130]. To Eizirik (1992, p. 179), the CVM standards are legitimate, as they adapt only legal principles and concepts already established by the Brazilian law on the regulation of the securities market, preserving the assumption of legality of its acts, also because there are rare cases of judicial review of its punitive measures.

Modesto Carvalhosa (1984, p. 51-54) explains that the rules and regulations published by CVM are "actual legal standards, provided with specific coercion and efficacy, capable of substantiating decisions at the judicial and administrative levels". According to Leães (1982, p. 62), when analyzing this matter, the rules issued by CVM have: (i) "legislative qualification"; (ii) characteristic of "material law"; and (iii) "conviction of social legality and efficacy".

Also, according to the foreword of the instruction 555/14[131], CVM's authority to broadly regulate the investment funds industry is grounded on a combination of rules contained in the Law 6.385/76. According to them, the Commission is exclusively responsible for setting forth the rules that shall be observed

[128] According to the article 23, § 2 of the Law 6.385/76, "The Commission is responsible for setting forth the rules that shall be observed by the investment managers in the portfolios management (...)".

[129] Articles 2, § 4 and article 16, I and II, "b" of Instruction 558/15 and 92, I of Instruction 555/14. **(i) - ICVM 558/15:** "**Article 2, § 4**. The manager has to perform their consulting activities in a loyal manner towards their clients, avoiding practices that might impair the fiduciary relationship maintained with them and, in a situation of conflict of interests, inform the client that the latter is acting in conflict of interests and about the sources of such conflict, before rendering the consulting"; "**Article 16**. The investment manager of securities portfolio must: **I** – exercise their activities in good faith, with transparency, diligence and loyalty in relation to their clients; **II** – perform their duties in order to: (...) b) avoid practices that might impair the judiciary relation maintained with their clients"; / **(ii) - ICVM 555/14: "Article 92.** The investment manager and the manager, in their respective ranges of operation, are obliged to adopt the following standards of conduct: **I** – exercise their activities always seeking for the best conditions for the fund, dedicating the care and diligence that any active and honest person usually assigns to the administration of their own business, acting loyally towards the interests of the investors and of the fund, avoiding practices that might impair the fiduciary relationship maintained with them, and answering for any infringement or irregularity eventually perpetrated under their administration or management".

[130] Example: Article 84, §3 of ICVM 555/14: "(...) §3 The members of the boards or committees must inform the investment manager and the latter, in turn, the investors, about any situation that puts them, potentially or effectively, in a situation of conflict of interests with the fund".

[131] According to the CVM Deliberation 01/78, the instructions will be used to perform the acts by which CVM, under the terms set forth in item I of the Article 8 of the Law 6.385/76, will regulate the matters set forth in that law.

by the investment-asset managers in the portfolios management, observing the policies defined by the Brazilian Monetary Council[132].

In light of the exposed content, although there are doctrines opposing the validity of CVM's normative function [133], it is understood, pursuant to the considerations of the former paragraphs, that it actually has normative competence to regulate the conduct of investment-asset managers.

Thus, after concluding the issue of CVM's legitimacy, in what concerns its competency to regulate the funds industry and once the Law 6.385/76 has been evaluated, we will proceed to the next items, where we intend to analyze the contents of the CVM instructions 555/14 and 558/15.

3.2. The characteristics of the standards of conduct that define the fiduciary relationship between investment-asset managers and investors of investment funds

The articles 2, § 4 and 16, I and II, b, of ICVM 558/15, and 92, I of ICVM 555/14, set forth standards of conduct[134] applicable to the investment managers of investment funds. These standards include, remarkably, the fiduciary duties of diligence and loyalty arising out of the fiduciary relationship between investment managers and

[132] Combination of the following articles of the Law 6.385/76: **a)** 2, V; **b)** 8, I; **c)** 19, foreword and **d)** 23, § 2. "Art. 2. The following are securities subject to the regime of this Law: (…) V – the quotas of investment funds in securities or investment clubs in any assets; (...)"; "Article 8 The Brazilian Securities and Exchange Commission is responsible for: I – regulating, observing the policy defined by the Brazilian Monetary Council, the matters expressly set forth in this Law (...)"; "Article 19. No public issuance of securities will be distributed in the market without the prior registration in the Commission"; and "Article 23. The professional exercise of administration of securities portfolios of other persons is subject to prior authorization from the Commission (…) § 2 – The Commission is responsible for setting forth the rules that shall be observed by the investment managers in managing portfolios and their remuneration (…)".

[133] (i) The argument that CVM's bureaucracy might have acted illegally when regulating an affair under the competence of the Congress –Argument in this sense, refer to MEIRELLES, Hely Lopes. **Direito administrativo brasileiro**. 20ª edição. Malheiros Editora, São Paulo, 1995, pp.82-83; and (iii) Lima e Pimenta (2011, p. 653) explain that it is "essential" to issue law setting forth the basic lines related to constitution and operation of funds, as well as to the conduct of investment managers and managers. This law could provide greater legal security to investments in funds, reducing, in their opinion, the repeated conflicts of interests between investors and investment managers and the risk of judicial claims about the regulatory power of CVM itself.

[134] Standards and rules of conduct will bear the same meaning herein.

investors of the funds. This relationship is expressly mentioned by the standards of conduct analyzed herein:

> **a) ICVM 558/15:**
>
> "**Article 2, § 4**. The asset manager have to perform their consulting activities with loyalty towards their clients, avoiding practices that might impair the fiduciary relationship maintained with them and, when facing a situation of conflict of interests, inform the client that they are acting under conflict of interests and about the sources of such conflict, before rendering the consulting".
>
> "**Article 16**. The asset manager of securities portfolio have to: **I** – perform their activities in good-faith, with transparency, diligence and loyalty towards their clients; **II** – perform their duties in order to: (...) b) avoid practices that might impair the fiduciary relationship maintained with their clients".
>
> **b) ICVM 555/14:**
>
> **"Article 92.** The investment manager, in their respective spheres of activities, are obliged to adopt the following standards of conduct: **I** – perform their activities always pursuing the best conditions for the fund, dedicating the care and diligence that every active and honest person assigns to the administration of their own business, acting in a loyal manner towards the interests of the investors and of the fund, avoiding practices that might impair the fiduciary relationship maintained with them and answering for any infringements or irregularities that might be performed under their administration or management".

The purpose of this item is to understand the characteristics of these standards in order to interpret them in light of real cases, in what concerns the relationship between the investment-asset manager and the investor of investment funds.

3.2.1. The fiduciary relationship and the duties of diligence and loyalty – the origin and the abstract model of the standards of conduct contained in the CVM instructions numbers 555/14 and 558/15

It was found that both the collective investment arrangements in the United States and in Brazil have roots in the trust. Repeating a rule of the trust legal system, we find that, in administration of a trust, the trustee is obliged to act with loyalty, prudence

and diligence such as any ordinary person would act when conducting their own business[135]. Regarding the loyalty duty, the trustee is required to use the highest level of honesty and good faith in the business conducted by them. Bogert (2008, p. 338) elucidates that the trustee must administer the property transferred to them with the highest standard of reasonable diligence, skill and caution expected from them. The US laws based on the trust and which regulate the actions of investment and asset managers of investment companies (investment funds in Brazil), the Investment Company Act from 1940 (section 36), the Investment Advisers Act from 1940 (section 203) and the Uniform Trust Code from 2000 (sections 703(g) and 802(f)) equally set forth general fiduciary duties of diligence and loyalty.

These facts show that the trust is on the root of the collective investment structures in the country, but also in the origin of the standards of conduct contained in the articles 2, § 4 and 16, I and II, b, of ICVM 558/15, and the article 92, I, of ICVM 554/14. It was observed that the characteristics of this trust system have been equally disseminated over the standards of conduct of these instructions. Thus, the enforcement of the principles of trust related to the fiduciary duties in the investment funds industry will help us to understand the rules that guide the behavior of the investment managers and asset managers in Brazil. However, it is important to repeat that the enforcement of these principles for the interpretation and study of the standards of conduct contained in the instructions 558/15 and 554/14 does not represent acceptance of the double property over the same asset. What we find is that the trust is, under the perspective of the fiduciary relationship and its duties, at the core of the reading and interpretation of the standards of conduct contained in the instructions that are object of this paper.

Regarding the abstract standard of the rules contained in the articles 2, § 4, 16, II and II, b and in the 92, I, it is observed that they follow the models of the rules that govern the conducts of the investment-asset managers of the investment funds in the United States. The US Uniform Trust Code, for instance, does not define fiduciary relationship, it just mentions and explains the operation of the species or categories of relationships that are commonly considered to be fiduciary, within the scope of the

[135] Refer to BOGERT, George Gleason. **Handbook of the Law of Trusts**. St. Paul, Minn. USA: West Publishing Co., 1921, p. 329.

investment funds, and leaves for the judge the definition and the detailing of the hypothesis for enforcement of the rule[136]. In the end, we considered that the American and English courts, as well as the US law, do not define, in a strict sense, the fiduciary relationship, and the doctrine is responsible for characterizing it by analyzing the discretion that the investment manager must have when conducting the business of the investment fund and in the trust established between the investment manager-asset manager and investor.

The purpose within the right of the common law is to leave room in the rule for the judge's interpretation, as a single regulatory provision is not capable of encompassing all the duties or behaviors requested from investment managers, from either publicly traded companies[137] or investment funds. This standard, followed in the contents of the articles studied in this item, provides the abstract models of behavior intended to be found in the investment managers of funds, including the diligence (based on the concept of abstract guilt) and loyalty (divided into the duties of avoiding conflicts of interests, avoiding secret profits, preserving secrecy of information and the duty to inform).

According to Reale (2003, p. 36), these standards adopted by CVM are ethical standards that are characterized by the expression *must be*, being necessary to value the content of the standards, identifying what it sets forth as the most adequate behavior of its addressee. It institutes not only a direction to follow, but also "the measure of the standard deemed to be licit or illicit" according to the regulators. The enforcement of these standards requires valuations by the interpreter, as they are manifested as legal phenomena with a conduct *must be.* An assessment of the contents of the standards contained in the instructions 555/14 and 558/15 suggests that only by violation and application to the real case will it be possible to know its extent. Further contributing to the understanding that we deal with abstract standards, we have also identified that the listed provisions prohibit practices – not defined – that might impair the fiduciary relationship between the investment-asset manager and the investor of

[136] Refer to Uniform Trust Code § 103 (20) / Sections 801-817.

[137] For a detailed study on the legislative standards applied to the fiduciary duties of the publicly traded companies, refer to SALOMÃO NETO, Eduardo. **O *Trust* e o Direito Brasileiro**, 1996, pp. 114-116; and CARVALHOSA, Modesto. **Comentários à Lei de Sociedades Anônimas**, 3º Vol. São Paulo: Editora Saraiva, 2014, p. 367-422.

investment funds.

In this sense, aiming at strengthening the above understanding, Yazbek (2007, p. 219) emphasizes that:

> (...) due to the nature of the financial market and the practices adopted therein, it has become increasingly common, in exercise of the regulation activities, the establishment of 'soft law' mechanisms (such as general principles of conduct, valuing honesty, correction, diligence and ethics).

Due to the exposed content, it is observed, in this item, that CVM adopts, in regard to the considered rules, an abstract standard of conduct, typical of the US law, which regulates the collective investment arrangements based on the trust. This characteristic allows the judge or the securities market authority in Brazil – the CVM – to have broad interpretation, observing the particular features of each fund, investment managers and/or asset managers and investors. As seen, these general rules are the ones imposing on such professionals the duties of acting with diligence and loyalty in order not to 'impair' the fiduciary relationship or confidence maintained between them and the investors.

Therefore, regarding the strategy adopted by CVM when setting forth general rules concerning the fiduciary duties, it seems to us that it had an appropriate reaction to the problem of abuse of power derived from the fiduciary relationship. Why? It is understood that, due to the open, abstract character of the rule, regulators and judges can act with greater discretion, serving the needs of the investors to the extent that practices or infringements that were not set forth in specific rules may then be identified and punished. In addition, general rules are automatically adaptable to the creativity of the investment managers in their eagerness to obtain increasingly higher profits to the detriment of the investors.

Moreover, with arguments in favor of the general standards of diligence and loyalty, Frankel (1983, p. 10) explains that, in order to protect the investors against the abuse of power by the funds' investment managers, abstract and pervasive rules must be imposed by administrative authorities highly specialized in financial and stock markets

(examples: SEC[138] and CVM).

In light of the exposed content and after assessing the general standards of conduct that guide the behavior of the funds' investment managers and/or asset managers in Brazil, we shall now move on to the final considerations.

FINAL CONSIDERATIONS

The research and the outcomes reflected in this paper do not only allow us to answer the questions posed in the beginning, but also show the importance of the trust and of the law in the English and American stock markets for the interpretation and study of the standards of conduct in Brazil assessed in this paper.

Concerning the questions about what is understood to be a fiduciary relationship, what is its origin and its essential characteristics, we can say that the fiduciary relationship is essentially a combination of two elements in the absence of which the relationship does not exist.

Although Frankel (2011, pp. 6-10) considers that there are four essential elements, it is understood that the primary and necessary characteristics which, in turn, result in a fiduciary relationship are: (i) the *confidence* – derived from the trust – that must exist between the investment-asset manager of investment funds and the investor*;* and (ii) the investor's granting of *discretion* to the investment manager-asset manager so that the latter can properly administer the investor's financial resources.

In addition, the fiduciary relationship equally establishes its negative side effects, such as the possibility of abuse of power (potential effect) by the investment-asset managers and the information asymmetry between them and the investor. These effects, or defects, are inherent to the fiduciary relationship, and the regulator is responsible for acting towards their reduction. Finally, two other elements that it shall always bear due to the referred side effects are the duties of diligence and loyalty imposed on the investment-asset managers. These duties are, likewise, intrinsic to the fiduciary relationship. When the relationship is formed, the abuse of power becomes a possibility, as do the information asymmetry, a non-severable defect of the fiduciary

[138] SEC - *U.S. Securities and Exchange Commission*. Available at: <http://www.sec.gov>. Accessed on: Aug. 20.2014.

relationship in the industry of funds, and the duties, which are a reality imposed on the ones intending to administer third parties' capital.

In regard to the origin of the fiduciary relationship, based on studies, rules and court decisions of the English and American courts, this study allows us to assume that the trust is found on the basis of the fiduciary relationship existing in the funds' industry. The trust is a legal phenomenon substantiated by the decisions of the English courts and which spreads across the United States, inspiring the creation of the investment funds industry in Brazil, being, therefore, considered the support for the fiduciary relationship and the duties applicable to it.

Finally, we reach to the conclusion that the intent of the Securities and Exchange Commission of Brazil, especially when enacting abstract standards of conduct, contained in the instructions 555/14 and 558/15, is to fight the conflicts of interests, the unlawful enrichment of the investment-asset managers and the lack of transparency, caution and prudence of these professionals.

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