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Cover Page Footnote

I want to express my sincere gratitude to Professor Paul Dykstra and Professor Paulita Pike for sparking my interest in this topic and Professor John O'Hare for his thoughtful guidance. Special thanks to my fellow editors on the Northwestern Journal of International Law and Business for their meticulous edits. I am grateful to my parents, Simon and Lucy, and lastly, to my cat, Amar. All errors are my own.

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Abstract

The investment funds sector has always been a major player in the financial industry globally. As such, many countries with mature financial markets have enacted regulations to govern the activity and management of investment funds. The U.S. Securities and Exchange Commission (SEC) enacted the Investment Company Act of 1940(the Act) as an effort to restore investor confidence in investment funds and safeguard investors from future abuses after the market crash in 1929.[2] *On the other hand, emerging financial markets started to take part in regulations in the hope to attract more investors and outside resources. The Capital Market Authority of Saudi Arabia (hereinafter CMA) enacted the Investment Funds Regulation (hereinafter the Regulation) in 2006, as the Sovereign aims to turn the State into an investment powerhouse.*[3] *Due to the newness of the Regulation, an analysis of the Act will be helpful for the CMA to improvise the Regulation and avoid mistakes.*

This paper will first focus on four areas of the Investment Company Act of 1940, analyzing the strengths and weaknesses of the Act with suggestions provided. It will then offer an analysis of the Investment Funds Regulation of Saudi Arabia and discuss areas for improvement based on the analysis of the Investment Company Act of 1940.

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2 *See* Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677, 681-82 (1969).

3 *See* Message from HRH Prince Mohammed Bin Salman Bin Abdulaziz Al-Saud, VISION 2030 KINGDOM OF SAUDI ARABIA, https://vision2030.gov.sa/en/vision/crown-message (last visited Feb. 01, 2020).

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I. INTRODUCTION-HISTORY OF THE INVESTMENT COMPANY ACT OF 1940

The Securities Act of 1933 and the Securities Exchange Act of 1934 represented the beginning of federal securities regulation. They are still the basic Acts regulating the purchase, sale, and issuance of securities. These Acts protect the public in trading the traditional type of securities, commonly referred to those issued by corporations, traded through an exchange and over the counter market. However, the proliferation of investment companies in the 1930s and the rapid increase in size of such companies called for a regulatory scheme at the federal level.[4] The market crash in 1929 which led to the depression in the 1930s evidenced that there were evils and abuses in the operation of investment funds.[5] The SEC, in an effort to restore investor confidence in investment funds and safeguard investors from future abuse, enacted the Investment Company Act of 1940.[6] The Act compels any "investment company" to register under the SEC.[7] Companies registered as such are subject to the full disclosure requirements of the Act.[8]

Many of the provisions in the Investment Company Act are intended to curtail fraud and conflicts of interest. Section 36(a) under the Act authorizes the SEC to impose injunctions on investment companies defined by the Act. The SEC was unwilling to provide injunctive relief to prevent stigmatizing advisors. Due to the existing conflict in the industry of gross misconduct and misuse, injunctive relief would create a huge adverse impact on the industry. Due to the SEC's reluctance to bring an action, Congress enacted Section 36(b) to authorize shareholders to bring actions against persons associated with the fund for matters related to breach of fiduciary duty, and lack of independence or compensation for service.

Congressional intent of the bill may be drawn by tracing congressional and legislative records.[9] However, summarizing any congressional or legislative record is beyond the scope of this article. Despite the noted limitation, two aspects of the congressional hearing are worth mentioning:

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4 *See* SEC, DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, xvii (1992), https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

5 U.S. CONG. COMM. ON ENERGY & COMMERCE SUBCOMM. ON TELECOMM., CONSUMER PROT., & FIN., 99TH CONG., RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES: A REPORT 73 (Comm. Print 1986).

6 *See What We Do*, SEC, https://www.sec.gov/Article/whatwedo.html (last modified June 10, 2013).

7 *Id.*

8 *Id.*

9 Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677, 681-82 (1969); *See also*, Richard H. Farina, John P. Freeman & James Webster, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME L. REV. 732 (1969).

1. Both the industry and the SEC agree on the issue that a set of regulations is necessary to control abuses and evils and restore investor confidence in the investment field. [10]

2. The jointly sponsored bill received the endorsement of the SEC and the endorsement of the industry. [11]

In fact, given the rarity of a jointly sponsored bill which simultaneously represents both the desire of the industry and the SEC to regulate investment funds, such an accomplishment was rather astonishing.[12] Moreover, it is very unusual that the industry was willing to subject itself to regulation. The fact that the Act reached industry and regulatory consensus represented the very intent to protect public investor interest. Subsequent interpretation of the Act or reconciliation of any ambiguity presented should thus take this core value into consideration.

II. WHAT IS DEFINED AS AN INVESTMENT COMPANY?[13]

In order to become an investment company, the Act requires an entity to issue securities.[14] In addition to issuing securities, it has to hold and trade securities. The Investment Company Act of 1940 outlined a subjective test and an objective test to define an investment company.

The difficulty in defining an investment company lies in making the distinction between an operating company and an investment company, the latter of which is subject to SEC registration and extensive substantive

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[10] Senator Healy mentioned "I have heard but one witness, out of all those who appeared here, who went on the witness stand and said that there should be no regulation." *Hearing on S. 3580 before a Subcomm. Of the Senate Comm. On Banking and Currency*, [hereinafter *Hearings*] 76th Cong., 3d Sess., pt.2, at 1051.

[11] Hearings, *supra* note 10, at 1053.

[12] North, *supra* note 8, at 684.

[13] 15 U.S.C. § 80a–3 (2020).

Definition of Investment Company

(a)Definitions

(1) When used in this subchapter, "investment company" means any issuer which—

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

[14] *Id.*

regulations. An operating company is defined as a parent corporation possessing enough voting stock of another company or a subsidiary. The operating company maintains control over the subsidiary's course of business and oversees its management decisions.

On the other hand, an investment company is one that conducts its business solely on investing its pool of money in diversified securities.

The subjective test, Section 3(a)(1)(A), holds that "any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading securities."[15] This definition is rather simple; if an entity holds or represents itself to the public as a company, solely conducts investment business, then such entity falls under the investment company definition.[16]

The objective test, Section 3(a)(1)(C) holds that the entity "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[17] In this statistical requirement, if an entity has over 40% of its assets in securities, then it shall be labeled as an investment company.

Notwithstanding the subjective and objective test, no company is an investment company if it (1) is primarily engaged, directly or through a wholly owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities; (2) declares to be primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (a) through majority owned subsidiaries or (b) through controlled companies conducting similar types of business; or (3) is a company all of the outstanding securities of which are directly or indirectly owned by a company excepted from the definition of investment company by (1) or (2) above. Any entities that fall under these categories will be considered an operating company.

However, private funds avoid painful restrictions by forming the fund to qualify for an exception from being considered an investment company. Private funds like venture capital funds, hedge funds, and private equity funds generally rely on exemptions under Section 3(c)(1) and Section 3(c)(7). In fact, ensuring the fund falls under these two exemptions is the most important first step for a new private fund. Avoiding investment company registration under the Act allows a fund to steer away from SEC requirements.

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[15] 15 U.S.C. § 80a-3(a)(1)(a).

[16] *See SEC v. Presto Telecomm., Inc.*, 237 F. App'x. 198 (9th Cir. 2007).

[17] 15 U.S.C. § 80a-3(a)(1)(c).

Section 3(c)(1)

Under Section 3(c)(1), a company that has outstanding securities beneficially owned by less than 100 persons and is not making or planning to make a public offering of its securities will be excluded from the definition of an investment company under the Act. This provision is rational and represents the core value of the Investment Company Act of 1940.

Congress enacted the Act with the intention to provide extensive protection to investors investing in mutual funds after the 1930 market crash.[18] The Act was designed to mitigate and eliminate the condition that adversely affects investors' interests and public national interests as a whole.[19] If an entity qualifies to be an investment company, then it is subjected to subsequent requirements that are intended to offer protection to investors.

It may seem odd at first glance. Companies that satisfy this exemption still have investors. Even though the investor pool is small, these investors still fall under the investor definition provided by the Act. By offering such an exemption, the Act seems to oddly exclude these investors from protections. However, when the investor pool is small such that there are only 100 or fewer investors, these investors have better access and control over the fund and the investment manager.

Comparatively, when a fund has numerous shareholders spreading across the country or even the world, it is already burdensome to gather proxies from all shareholders, not to mention the fact that they will need to unite together to exert influence on the fund manager. With less than 100 beneficial owners, investors could easily act jointly to maximize their benefits. Self-help in this instance is adequate to protect these investors from the abuses and evils the Act was designed to prevent.[20]

The Act provides that beneficial ownership by a company would generally be counted as one person. Under this provision, if a public investment company, with a large number of shareholders, holds a certain amount of securities in a Section 3(c)(1) fund, the company as a whole will be considered as one beneficial owner of that Section 3(c)(1) fund.

Some offshore funds may try to utilize this exemption to circumvent

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[18] *See* North, *supra* note 8.

[19] *Id.* at 680.

[20] "The major abuses which have caused these [investment companies] to fall into disrepute may be grouped as follows:

(1) Removal of funds from control of those who supply them,

(2) Conflicting interests of management,

(3) Pyramiding,

(4) Excessive management charges and hidden fees, and

(5) Management's use of control."

Richard B. Tolins, *Investment Company Act of 1940,* 26 CORNELL L. REV. 77, 83 (1940).

the 1940 Act. Imagine this scenario: a few investment companies, trying to evade Investment Company requirements and involvement in investment strategies and structure that are prohibited by the Act, jointly created a wholly owned subsidiary fund. This fund then comprises only a handful of beneficial owners, and each of these "owners" owns a large percentage of the fund along with a variety of other securities in their portfolios. This, at first glance, seems permissible under the Act. Thus, the fund is exempted from the investment company requirements. However, these beneficial owners are investment companies with shareholders that the Act aims to protect. Prohibiting those investment strategies and structures were essential for the success of the protection. The Act limited leverage investing, for example, to mitigate the adverse effect during a market downturn. If investment companies are able to dodge the radar of the Act, shareholders' interests will be left unprotected. This runs afoul of the core value and the original intention of the enactment of the Investment Company Act of 1940.[21]

The Act provided a solution to prevent circumvention. In Section 3(c)(1)(A), the Act provided an Attribution Rule. Under this rule, if an investment company owns more than ten percent of the securities in a 3(c)(1) fund, the number of this investment company's shareholders will be attributed to the number of shareholders of a Section 3(c)(1) fund. That being said, if these investment companies were to jointly create a fund to qualify for 3(c)(1) exemption, they need to ensure, aggregately, their shareholder number will not exceed 100. The enactment of the Attrition Rule further guaranteed public shareholder interest. It not only prevents collusion among investment companies, but also prohibits investment activities that could reinforce a market crash.

Section 3(c)(7)

Other than Section 3(c)(1), private funds could also get an exemption from Section 3(c)(7). This exemption permits a private fund to have an unlimited number of investors provided that the securities are (1) owned exclusively by qualified purchasers and (2) not and will not be subjected to public offering. Under Section 2(a)(51)(A), qualified purchasers are persons who own at least \$5 million in investments.[22] The reasoning for this

[21] *Hearings*, *supra* note 10, at 1050.

[22] Investment Company Act of 1940, 15 U.S.C.A. § 80-2(a)(51)(A) (2006). This section defines a "qualified purchaser" as:

> I. [A]ny natural person who owns not less than \$5,000,000 in investments, as defined by the Commission;
>
> II. [A]ny company that owns not less than \$5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estate of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;

exemption is rational: people with $5 million or more in assets are wealthy and sophisticated investors. They are not in need of the protection offered by the Act. Wealthy individuals considered under the Act often possess the knowledge of investment and are willing to appreciate a more risky investment for a more sizable return. Even if they suffer a loss through a risky investment, they will have sufficient financial means to hedge against the loss. Further, they will often have access to financial and legal advisors. They are able to protect their interest and exert influence over the fund in the event of abuses and evils. In fact, the protection they hold may even be more effective than those provided by the Act.

Restriction on Borrowing and Senior Securities

Section 18 of the Act strictly limits open-end investment companies from issuing multiple classes of shares. Some scholars have argued for a more relaxed regulation on issuing senior securities and borrowing so as to offer investors more options, tailoring to their risk-comfort level.[23] However, this section will argue that the restriction on borrowing and leverage investing has been effective. The provision offers great flexibilities for the SEC to make amendments incorporating modern investment trends without compromising investors' economic interests.

To address the effectiveness of the provision, one has to first consider the characteristics of open-end funds. Open-end funds, unlike closed-end funds, offer redeemable securities. There is no limitation on the growth of the fund, investors can easily opt-in and opt-out by redeeming their shares at any time. An open-end fund cannot refuse redemption and must provide cash payment to shareholders when requested.

Section 18(f)

Section 18(f) restricts leveraged capital structures which are usually achieved by borrowing or issuing preferred stock. As a result, an open-end fund cannot issue senior securities.[24] A fund may, however, borrow from banks if it maintains a 300% asset coverage for all such borrowings.

First, Congress did not impose an absolute prohibition on leverage

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III. [A]ny trust that is not covered by clause (II) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (I), (II), or (IV); or

IV. [A]ny person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

[23] John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343, 344-45 (2013).

[24] A senior security is a type of security that ranks as more superior in terms of payout.

investing. In fact, it permits leverage investing with well-defined limits. Initially, the SEC developed a broad concept for "senior securities" that included any kind of indebtedness. Over the years, the SEC has permitted trading of derivatives, so long as the fund has equivalent stock in its portfolio or high liquid securities in a segregated account to fulfill its obligations incurred from derivatives transactions. The segregated account freezes certain liquid assets of the fund, rendering them unavailable for sale. These assets are marked to the market daily, thus allowing the fund to constantly monitor its coverage level and maintain proper risk level. This account functions as a limit on the amount of leverage which the investment company may undertake.[25] The result of having this segregated account is that the fund can achieve leverage through a derivatives transaction without creating senior securities.

In general, a fund would want to involve leverage investing to take advantage of the favorable market or borrow to obtain liquidity for redemption. While a fund may sell its assets to increase liquidity, this process generally takes more than a few days. A bank can provide adequate liquidity in less than two days. However, when an open-end fund borrows, its assets may decrease while the value of the loan stays intact. In order for the fund to have the liquidity to meet the portfolio coverage in case of an influx of shareholder redemption, a fund may need to sell securities during a declining market. In that sense, the fund not only suffers exacerbated loss from leverage investing in a declining market, it is also forced to sell assets at lower value. This destroys investor confidence and thus leads to more redemption, leading to more liquidity needs and creating a vicious cycle.

Moreover, leverage investing increases the volatility of the common shareholder's investment. Senior securities created by leverage investing magnify losses suffered by the common shareholder during economic downturns. These shareholders not only suffer share value shrinkage, but are also punished for assuming more risk in their investment due to this inferior capital structure. During fund liquidation, where senior securities receive priority payouts, junior capitals run the risk of losing even their principal payments. The heavy restriction is thus effective in preventing huge losses and further represents Congress's attempt to restore public confidence in mutual funds after the market crash in 1929.

III. INDEPENDENT DIRECTORS REQUIREMENT

One of the major provisions in the Act is the requirement for independent directors. Under the Act, the board of a mutual fund must contain a minimum percentage of independent directors. Furthermore, the Act outlines very detailed criteria in determining the independence of an independent director. This provision is distinctive in that no other federal

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[25] TAMAR FRANKEL & KENNETH E. BURDON, INVESTMENT MANAGEMENT REGULATION 283-84 (5th ed. 2015).

statutes mandate a minimum requirement on independent directors.

This provision seems logical at first, considering the large number of dollars at stake.[26] According to research conducted by the ICA, registered investment companies manage twenty-one percent of household financial assets in the United States.[27] Before the enactment of the Act, absent an independent director requirement, directors were usually affiliates selected by fund advisers. As such, these directors tended to vote in favor of the advisers in board meetings, providing advisers the chance to use fund assets to advance their own financial interests at the expense of the shareholders. Thus, independent directors are necessary to prevent advisers from abusing their positions and to ensure public economic interest.

Under present law, a mutual fund board must have no less than forty percent of directors that are "disinterested" persons in the company. A director is an interested person in the company if: that director is *inter alia* affiliated with the company, its investment advisor, or its principal underwriter; has acted as, been employed by, or partnered with legal counsel for the company in the preceding six months; has loaned money or property to the company or its adviser's accounts in the preceding six months; or is within the "immediate" family of a person who is affiliated with the company.[28] Additionally, an independent director of an investment company cannot have a *material* business or professional relationship with the investment companies, its investment adviser, or its principal underwriter, or have been a partner or employee of a person who has done so, within the past two fiscal years.[29] In simple words, independent directors cannot own a single share of the investments or business of the investment adviser. This concept passes through to sub-advisers. Everything that relates to an investment adviser will relate to sub-advisers.

While this provision protects investors' financial interests and fends off potential abuse, it is both overinclusive and underinclusive.

Underinclusive

Congress's rationale when drafting this provision was that directors

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[26] "The net asset for all U.S. investment companies amounted to \$21.4 trillion by the end of 2018." INVESTMENT INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 32 (59th ed. 2019), https://www.ici.org/pdf/2019_factbook.pdf.

[27] *Id.* at 34.

[28] 15 U.S.C. § 80a-2(19)(A)(i)—(vi) (2000); *see* 15 U.S.C. § 80a-2(a)(3) (Defining an 'affiliated person' as "(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person").

[29] 15 U.S.C. § 80a-2(19)(A)(vii).

who are not interested persons pose less risk of conflicts of interest. Thus, these directors strengthen independent checks on the management board and its investment decisions. Congress and the SEC, on multiple occasions, concluded that a relationship is material if it influences the director to act in a manner that advances interests other than those of the shareholders. House committee reports declaring "substantial financial . . . relationships"[30] further confirmed Congress's belief that a material relationship is characterized by monetary elements. However, self-interest often lacks direct financial motives. Relationships may not be driven purely by pecuniary incentive, but nonetheless lead one to fame or business connections which, in turn, result in advancements in other facets.

People tend to make numerous business connections through participation in clubs. Under the current law and Congress's interpretation on materiality, such business connections do not raise the matter of interestedness. However, people who are able to join luxury sport clubs are often successful, wealthy business individuals. Money may not be the most important element in their career pursuits. Participating in the decision-making of an investment company allows them to secure more societal influence and increase their prestige. While the lack of monetary affiliation between the director and the adviser may allow the director to be independent in his judgment, there remains the risk of potential abuse.

A director may be more prone to side with the investment adviser in board decisions because of the established relationship, maintenance of that connection, or the desire to be recommended by the adviser for future, unrelated business opportunities. Further, a 'golf buddy' would not have been invited by the adviser to take a board seat if that individual's vision did not align with that of the adviser.

The Act requires independent directors to select other independent directors; however, the advisers select the group of independent directors when the fund is initially formed. Thus, subsequent independent directors selected by 'golf buddies' of the adviser are not entirely independent. One may argue, due to criticism of 'invite your dentist,' that independent boards are more often filled with business school faculties in modern days.[31] However, an occasional celebrity figure or sports legend could still end up in a board seat.[32] While celebrities or sport legends may know nothing about the financial industry, academics often lack practical business experience and tend to err on the side of being too theoretical in their decisions. Excessive theoretical understanding of the industry will likely lead to impracticality and, in the end, impair the interests of the fund.

[30] Investment Company Amendments Act of 1970, H.R. 91-1382, 91st Cong., at 13 (1970).

[31] James Sterngold, *Why Mutual Fund Guardians are Failing*, WALL ST. J. (June 14, 2012, 5:11 PM), https://www.wsj.com/articles/SB70001424052702303815404577336251534419564.

[32] *Id.*

Overinclusive

Under the statutory language, an interested person is one who has executed any transaction with the investment company or the adviser of interest in the investment company.[33] Further, institutional investors that own 5% or more of a fund are affiliated parties, and the Act prohibits transaction with such affiliates. Thus, a person is interested if he or she has transacted with an affiliate.

Before the statute's enactment, advisers were involved in larceny and embezzlement, while directors were reinforcing the misconduct due to their personal and financial ties with the advisers.[34] The SEC was unwilling to issue injunctive relief out of concern that it would stigmatize investment company advisers.[35] Due to the lack of action from the SEC, Congress implemented the independent director rule and interested person standard to ensure director independence and to thwart potential conflicts of interest.[36] While this rule was effective in safeguarding shareholders' interests at the point of enactment, the rule needs to be updated to encompass modern investment trends.

The interested person standard did not anticipate the emergence of fund families. Since this standard applies to sub-advisers, an independent director for a fund group that has 100 funds, which each has 50 sub-advisers, cannot have any economic interest with the advisers of those 100 funds or the 5000 sub-advisers. Consider mega-fund managers like The Blackstone Group. If it were to become a sub-adviser of Allstate Insurance, Blackstone may encounter a list of thousands of potential affiliates. If Allstate needs to elect an independent director for one of its investment funds, its selections will be very limited due to the large list of affiliates.

It is inevitable that funds as large as The Blackstone Group have a broad network and do business in every industry. The complex nature of these funds' transactions also requires investment decisions informed by knowledgeable business experts. Typically, individuals with specialized expertise have extensive business and financial connections. An individual's economic interests with the advisers/sub-advisers may be only one investment in his or her diverse portfolio. This business connection may not even amount to a material level with respect to the individual's whole investment profile. Crossovers and overlaps are inevitable when the financial industry is so interconnected. Under the current standard, a negligible economic interest in the adviser's or sub-adviser's business leads to a conclusion of lack of independence and impaired judgment. While the fund may seek exemption from the SEC, filing for an exemption is usually

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33 15 U.S.C. § 80a–2(a)(19)(A)(v).

34 North, *supra* note 8, at 678; Walter Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, COLUMBIA L. REV. 1, 4 (1968).

35 H.R. Rep. No. 2337, 89th Cong., 2d Sess. at 142-43 (1966).

36 North, *supra* note 8, at 678; Werner, *supra* note 32, at 7.

a time-consuming process.

The existence of such a strict standard deters potential candidates from taking board seats in fear of jeopardizing their own business interests or violating SEC regulations.

Recommendations

The independent director rule permits "friends" of the advisers to be elected while prohibiting individuals with negligible business interests from taking positions. In order to mitigate the risk of including one's 'golf buddies' and impairing board decisions, the SEC should prohibit some relationships not driven purely by pecuniary interest and expand materiality to include relationships that lead to self-serving goals at the expense of shareholders' interests.

Consider Delaware's statute governing interested directors, under which transactions are not void if the company can provide full disclosure and obtain good faith authorization from shareholders.[37] Similarly, full disclosure and shareholder ratification could cleanse any taint of conflicting interest from a potential 'golf buddy' candidate.

One may argue shareholder ratification is costly; however, shareholder ratification may not always be exercised. Such a measure only provides shareholders the right to exercise if they are concerned about a 'golf buddy' relationship after full disclosure. The shareholders could, in holding with requirements under Rule 14a-8,[38] request a shareholder vote before the candidate assumes office. While Rule 14a-8(i)(8) allows a company to omit a shareholder proposal if it relates to the election of officers, shareholder requests regarding the election of independent directors should be exempted from Rule 14a-8(i)(8). One may also argue that, given the redeemable nature of a mutual fund, a shareholder could simply redeem the shares and abandon his or her stake due to concern about a director; such shareholders would not exercise their ratification rights. However, a shareholder ratification provision could function as a psychological barrier to directors that intimidates those non-pecuniary but interested relationships mentioned above. This ratification process also thwarts future shareholder litigation concerning an interested director.

When available, shareholder ratification, or the lack of a proposal for ratification, demonstrates that the election of the individual was in the interest of a majority of shareholders.

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[37] DEL. CODE ANN. tit. 8, § 144(a)(2) (2006) (Stating that "[t]he material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders[.]").

[38] 17 CFR § 240.14a-8. (Hereinafter "Rule 14a-8").

IV. DE MINIMIS FACTOR TEST

In addition, the SEC should impose a de minimis standard to Section 2(a)(19) to address the overinclusive problem which unnecessarily disqualifies individuals from serving as independent directors. This section proposes the adoption of a factor test to determine the independence of a potential candidate who has economic interest with the adviser or sub-adviser. Under such a standard, independent directors and the board would be provided business judgment rule protection if they can provide well-reasoned justification and evidence for each factor when determining the directors' independence.

A director who has economic interests with an adviser or sub-adviser should still be considered independent given:

i) the beneficial interest the potential candidate owns is immaterial in relation to the entire portfolio; such immateriality should be a subjective judgment with respect to the potential independent director.

The prohibition on material and beneficial relationships arises from the concern of judgment impaired by such relationship. However, if the beneficial interests do not appear material from the candidates' perspectives, their judgments are unlikely to be impaired based on the interests they have with the advisers. Coming up with a numerical percent is outside the scope of this paper. However, potential candidates must be able to demonstrate that the concerned beneficial interests constitute a minor portion of their total assets.

ii) the potential director's economic interest with the adviser/sub-adviser is minor when compared to the whole company's (company of the adviser or sub-adviser) interest.

The question posed when measuring this factor is whether the potential director's ownership of the adviser's or sub-adviser's company is material with respect to the company as a whole. In this case, materiality can be interpreted both from a subjective and objective standard. Subjectively, the company should not view the director's economic interest in the company as material compared to the rest of the shareholders. Objectively, the economic interest that a potential director has in the company should be minor, such that substantial economic gain cannot be derived from that particular interest by favoring the adviser in business judgments as a director.

iii) attenuation of the economic interest.

Currently, if a partner in the Hong Kong office of a law firm had acted as a legal adviser for the adviser in the prior year, a partner in the New York office of the same law firm would be disqualified from serving as an independent director. This standard holds even if the New York partner has never encountered the Hong Kong partner and has no knowledge of the previous advisory relationship. However, this type of attenuated interest is not the type of interest that Congress intended to prohibit when it adopted the provision. If the interest is attenuated such that it does not rise to materiality with respect to the potential candidate, it is unlikely that judgment will be impaired.

iv) level of happenstance of the economic interest given the nature of the potential candidate's investment strategies.

If investing in a diverse set of securities is the potential independent director's ordinary course of investment, it is likely that an economic interest with the adviser is merely incidental to the director's portfolio investment strategy.

No factor shall be considered more important than the others. In fact, all factors should be considered interconnected. For example, factor (iv) alone cannot determine the independence of a director without considering the substantive impact of factors (i) and (ii).

Because this proposal substantively relaxes the current standard, one may worry that it could lead to abuses akin to those prior to the enactment of the Act. However, mutual funds are registered companies under state law. As such, the independent board is governed by fiduciary duties under state corporate law. Corporate fiduciary duties require the independent board to exercise diligence in its judgments. As such, a potential candidate must provide reasonable justifications backed by evidence for each factor. The independent board, bound by corporate fiduciary duties, then scrutinizes the justifications and exercises its best judgment in voting.

12b-1 fee; Maybe it is time to end it

In 1980, the SEC adopted rule 12b-1 to permit open-end management investment companies to bear expenses associated with the distribution of their shares.[39] Rule 12b-1 thus passes certain selling costs to shareholders through charges against fund assets.[40] This creates a conflict of interest: managements are allowed to pass costs that benefit themselves to shareholders who receive no gain from the process.

The SEC initially implemented a 12b-1 fee to encourage sales and stimulate fund asset growth, benefiting both shareholders and management. As the fund grows larger, the lower the operating cost is for a fund, thus achieving economy of scale. For example, if fund assets grow larger, the fund possesses more negotiation power to reduce the percentage of management fee paid to the management. Meanwhile, with the percentage fall on the management fee, shareholders will be able to realize a larger percentage of return. This sounds like a double win situation. Yet after many years of implementing the rule, there is no appearance of a double win.[41] Rule 12b-1 failed to generate positive financial benefit to fund

[39] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11414 (Oct. 28, 1980), 45 Fed. Reg. 73898 (Nov. 7, 1980).

[40] *Id.*

[41] *Id.*

shareholders. Moreover, it did not reduce expenses the way the SEC expected when it drafted the provision.

A study conducted by the SEC compared funds of similar size with and without 12b-1 plans. It showed that the average expense ratio for 12b-1 funds is higher than that of non-12b-1 funds.[42] In other words, 12b-1 fees did not reduce fund expenses, even after subtracting the 12b-1 fees from total expense. Further, the study found that both 12b-1 and non-12b-1 funds exhibit economies of scale in expenses, but the scale is not produced by a lower 12b-1 fee. In fact, the 12b-1 fee changes minimally as the fund grows larger.

A possible explanation for this failure could be attributed to the long-term impact of a fee. Long-term investors may be less drawn to a 12b-1 fund that "permits existing shareholders to pay for bringing new shareholders into the fund."[43] One may argue that the growth induced by a 12b-1 fee can generate economies of scale and thus offset the 12b-1 fee.[44] However, it is unlikely that a fund may grow to the size needed in order to achieve economies of scale in a short period of time. In fact, it would take an equity fund 62 years to generate a sufficient scale of economies to offset the 12b-1 fee.[45] Given a shareholder does not retain their capital in a single fund for such a long period, the scale generated by a 12b-1 fee does not provide the shareholder any significant financial benefit.

Ironically, non-12b-1 funds have also experienced positive annual growth of approximately 4%, comparable to the 4% additional growth attained by 12b-1 funds.[46] If a fund is able to attain similar growth without implementing the fee, it would generate fewer expenses and thus higher equity per share. Shareholders may be better off in a non-12b-1 fund.

As technology advances, investors are becoming more comfortable with online platforms. With the increase in financial information transparency and the ease to access analysis online, the role of the broker is becoming less prominent. Modern investors intending to invest in funds would not search for "the best broker" in a search engine. In fact, fund characteristics and objectives are apparent with a few simple clicks on the internet. Investors are able to make decisions according to their investment preferences with the available information online. They are able to enroll in a mutual fund without any outside assistance.

Unlike when 12b-1 was enacted, a modern-day broker is not bringing in as many new assets to a fund. With the reduced need for a broker to

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[42] LORI WALSH, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS, 12 (2004).

[43] Flanagan, Ronald Kindschi & Spectrum Admin., Inc., SEC Release No. 29-315, 71 SEC Docket 1415, 1417 (Jan. 31, 2000).

[44] Walsh, *supra* note 41, at 12.

[45] *Id.*

[46] *Id.*

expand the fund, a 12b-1 fee seems rather dispensable. In all, 12b-1 fees should be eliminated.

V. SAUDI ARABIA INVESTMENT FUNDS REGULATION

The History

Investment funds initially started in commercial banks in most Islamic countries. However, such funds did not receive much enthusiasm from investors. Muslim investors fear that participation in such funds runs the risk of violating Sharia Law, which prohibits trading with interest or investment in alcohol, gambling, etc. With the establishment of Sharia supervisory boards to certify Islamic financial products as being Sharia compliant, Sharia compliant investment funds started to emerge in commercial banks. The Kingdom of Saudi Arabia, in fact, was the first to enter the mutual fund field.[47] The national bank of Saudi Arabia, currently called NCB Capital Co., founded the first mutual fund in December 1979.[48] However, mutual fund regulations were not issued until the beginning of 1993.[49] By the end of 1998, the number of investment funds reached 114.[50] To date, Saudi Arabia is considered the largest market for mutual funds in terms of market share,[51] representing SR 290,141.10 million (equivalent to approximately $77 billion in U.S. Dollars).

Element	2017			2018			Change (%)
	Public	Private	Total	Public	Private	Total	
Number of Funds	273	270	543	249	293	542	-0.2%
Number of Subscribers	238,445	4,047	242,492	332,567	3,939	336,506	38.8%
Asset Value (million SR)	110,232.8	141,631.8	251,864.6	111,861.6	178,279.5	290,141.1	15.2%

19-Including Exchange Traded Funds (ETFs) and Real-estate Traded Funds.

Image from Capital Market Authority of The Kingdom of Saudi Arabia Annual Report 2018.

The Capital Market Law authorizes the Capital Market Authority to regulate the activities taken by investment funds, portfolio managers, and

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47 *Mutual Funds*, CAP. MKT. AUTH. OF THE KINGDOM OF SAUDI ARABIA 2, https://cma.org.sa/en/Awareness/Publications/booklets/Booklet_3.pdf.

48 *Id.*

49 *Id.*

50 Mohammad M. Hariri, *Sharia Compliant investment funds in Saudi Arabia-A Critical Perspective*, 32 (2013) (unpublished D.Sc. dissertation, University of Dundee) (on file with the University of Dundee Library).

51 *Id.*

fund advisors.[52] The Capital Market Law requires the CMA set forth regulations, rules, and instructions that govern the structure and operation of investment funds. The regulatory framework for investment funds has significantly developed since its first enactment.[53] The approach taken by the Capital Market Authority, the body which regulates capital markets activities in the Kingdom of Saudi Arabia, is both risk-based and compliance-based.[54] Nonetheless, more transparency and procedural improvements are needed to provide a more proper regulatory scheme for the CMA and the industry.

In order to better assess the procedure, one needs to understand that the CMA was given rule-making authority and enforcement power by authority of the Kingdom to protect investors, reduce systemic risk, ensure fair and efficient trading, and transparency of the capital markets.[55] In that sense, the principles behind the Investment Fund Regulation enacted by the CMA is analogous to that of the Investment Company Act of 1940.

Restriction on Borrowing

The Investment Fund Regulations has two provisions which specifically discuss borrowing. Under Article 40(h), the borrowing of a public fund must not exceed 10% of its net asset value. Providing the primary objective is to protect investors and promote a more transparent environment for investors, this limitation seems to be effective. However, this limitation is in need of refinement.

The problem presented with this limitation is that the provision did not provide a coverage requirement for such borrowing.

Under a booming economy, leverage investing allows investors to magnify their return. This can be shown by a simple calculation: suppose an investor owns $100 and borrows $50. Under an economic boom, an investor is able to obtain 10% of the return. The investor will receive a return of $165 with leverage compared to only $110 without leverage. However, if the mutual fund falls, the investor will lose twice as much with leverage. Existing laws do not offer any protection to the investor.

The Investment Fund Regulations provide no clear liquidity requirement. While the Regulation requires all money market funds to

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52 *See* CAPITAL MARKET LAW, CAP. MKT. AUTH. 16, https://cma.org.sa/en/Rules Regulations/CMALaw/Documents/CMALaw.pdf.

53 *See* IMF, SAUDI ARABIA: FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE– DETAILED ASSESSMENT OF OBSERVANCE OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 9 (2011).

54 *Id.*

55 *See Capital Market Authority*, CAP. MKT. AUTH., https://cma.org.sa/en/AboutCMA/ Pages/AboutCMA.aspx (last visited Sept. 21, 2020).

ensure liquidity equaling to at least 10% of the fund's net asset,[56] such requirement is not applicable to all open-end funds. The Regulation did require fund managers use their best efforts to ensure that the investment fund is sufficiently liquid in order to meet anticipated redemption requests; it did not provide a uniform standard.

Without a coverage threshold, a fund manager lacks the information to properly assess the risk of borrowing. As previously discussed, with a coverage test requirement, a fund is able to maintain the value of assets compared to the value of the loan. In case of an economic downturn, a fund may be forced to sell its assets to meet the portfolio coverage requirement. With such, a lot of American mutual funds will choose not to borrow. Similarly, the CMA should adopt more transparent and clear guidance that assists Saudi open-end funds to better assess the risk and the need for borrowing.

Another provision concerning borrowing is Article 64. This provision requires a fund manager to use his or her best effort to retain sufficient liquidity to meet redemption requests. If the manager finds that, for the benefit of the fund, the money available in the fund is insufficient to meet redemption requests, the manager may borrow. Borrowing to meet redemption requests, however, is not subject to the 10% limit set out in Article 40(h).[57] This provision directly conflicts with the purpose of enactment of Article 40(h). More severely, it is contradictory to the principles behind the whole Investment Fund Regulations.

An authority restricts public funds from borrowing to protect investors' interest and prevent potential market crashes. Such prohibition requires the fund manager to actively monitor the liquidity of a fund and sell or purchase assets as needed. As such, it imposes a limit on the level of risk a fund is able to take, which in turn ensure market stability and investor confidence. However, this cannot be achieved if fund managers are able to borrow from banks to meet redemption requests.

Article 64 serves as a safe harbor for investment fund managers. This creates the potential for them to exploit their very own responsibility as fund managers. First, they do not need to continuously monitor liquidity to ensure adherence to the background principles of the Regulations. Second, they are able to borrow and there is no limit on the borrowing, which opens the door for them to be more reluctant in their investment decisions. Third, and the most important point, shareholders who redeem faster than others during an economic downturn are benefiting at the expense of the remaining shareholders. Shareholders who remain in the fund end up facing lower assets but higher debt.

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[56] *Investment Funds Regulation*, CAP. MKT. AUTH. 30 (2006), https://cma.org.sa/en/RulesRegulations/Regulations/Documents/IFRs%20Regulations-%20Final%20English.pdf.

[57] *Id.* at 37.

Recommendations

In light of Article 40(h) and Article 64(b) and (c), it appears that Saudi Arabia does not have a concrete concept for fund borrowing. Its approach is deficient because it opens the gate for potential abuses and does not offer safe protection for investors. In addition to the current 10% borrowing limit, the CMA needs to impose a definite liquidity requirement. As the exact number for coverage requirement demands extensive numerical analysis and market research, it is thus not within the scope of this article. Nonetheless, the CMA should consider the U.S. approach of requiring an asset coverage requirement of 300%. While one may argue that the 10% limit in Article 40(h), by itself, functions as an asset coverage requirement, Article 64(c) provides backdoor access to circumvent this coverage requirement. To provide a better understanding and clear regulatory framework for fund managers, the two provisions, Articles 40(h) and 64(c), concerning borrowing should be viewed in conjunction with each other, such that an asset coverage requirement, if legislated, can be applicable to both borrowing to invest and borrowing to meet redemption requests.

Power of the Authority to Remove and Replace the Fund Manager/Fund Board in a Public Fund

Similar to the U.S. Investment Companies Act of 1940, the Investment Fund Regulation in Saudi Arabia provides tremendous power and authority to the CMA. Distinct from other regulatory frameworks, the Regulations provide the CMA the power to remove and replace public fund managers.[58]

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[58] Article 20: Power of the Authority to Remove and Replace Fund Manager. Investment Fund Regulations of The Kingdom of Saudi Arabia. The Article provides:

a. The Authority shall have the power to remove a fund manager in relation to a particular investment fund and to take any action it deems appropriate to appoint a replacement fund manager for that investment fund or to take any other measures it deems necessary in the event of:

1) the fund manager ceasing to carry on management activities without notification to the Authority under the Authorised Persons Regulations;

2) the cancellation by the Authority of the fund manager's relevant authorisation(s) to carry on management activities under the Authorised Persons Regulations;

3) a request by the fund manager to the Authority to cancel its relevant authorisation to carry on management activities;

4) the Authority believing that the fund manager has failed, in a manner which the Authority considers material, to comply with the Capital Market Law or its Implementing Regulations;

5) the death, incapacity or resignation of a portfolio manager who manages the assets of the relevant investment fund, if no other registered person employed by the fund manager can manage the assets of the relevant investment fund or the assets of the funds managed by the portfolio manager;

One may argue the Saudi investment fund industry is still in its youth, thus more authoritative monitoring is necessary to ensure its healthy development. However, this provision provides excess authority to the CMA without giving concrete guidance to investment fund managers.

First, under subparagraph 4 of paragraph a, the authority can remove a manager from his or her position as long as the authority holds a belief that the manager fails to comply with associated laws in a manner that the authority considers material.

This provision provides two considerations for removal. One, the manager fails under the authority's belief; two, the failure is material, under the authority's belief. While failure and material seem easy to understand, a clear interpretation is urgently needed. The Regulation also falls short of enforcing a concrete standard outlining the "authority's belief." Without such a standard, an investment fund manager will be constrained in performing his duties in fear of crossing the line of the authority's beliefs.

The absence of concrete definitions also leads to transparency issues. As there is no standard or definition, it provides great leeway for the Authority in their judgments. The provision not only opens the gate for preferential treatments, but it also gives rise to potential bribery. A fund manager can be easily removed by the authority for reasons completely irrelevant to a material failure to comply, but simply due to personal conflict with the authority officials. Once fluidity exists in defining material failure in the authority's belief, a lot can be done by the fund manager in private to obtain a more favorable interpretation. This runs afoul of the principles behind enactment.

A regulation is effective when it imposes a uniform standard on all participants in the industry. The legislation can then observe and obtain feedback over the years from the market. Legislators then draft amendments in accordance with the feedbacks and observations. These cannot be achieved if a regulation merely functions as a display. Not only does it prevent governing bodies from making improvements, but it also

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> 6) Issuance of a special fund resolution by unitholders of a close ended fund; or
>
> 7) any other event determined by the Authority on reasonable grounds to be of sufficient material.
>
> b. Notice of any event described in sub-paragraph (5) of paragraph (a) of this Article shall be provided by the fund manager to the Authority within (2) days of its occurrence.
>
> c. If the Authority exercises its power pursuant to paragraph (a) of this Article, the relevant fund manager shall co-operate fully in order to help facilitate a smooth transfer of responsibilities to the replacement fund manager during the initial (45) day period after the appointment of the replacement fund manager. The fund manager shall where necessary and applicable and at the discretion of the Authority, novate all of the contracts relating to the relevant investment fund to which it is a party to the replacement fund manager.

Id. at 13-14.

threatens the public interest which the Regulation aims to protect. As a result, investors will lose confidence in investing in the market.

Ensuring investor confidence is especially crucial to the Kingdom of Saudi Arabia as it has the vision of transforming the Kingdom into a global investment powerhouse.[59] The fact that the market is relatively new is already holding back some investors. If the Kingdom cannot provide adequate protection to investors, the Kingdom not only will run the risk of capital outflows but will also encounter difficulty in attracting inflow of foreign capital.

The Kingdom is currently only open to foreign institutional investors. Institutional investors who will have the capital to venture into the Saudi market are experienced financial players in mature markets. Their expectations of regulatory safeguards will be critical. Any attempt to sketch thorough guidance and an inclusive definition for "material" that qualifies "authority's belief" under the Regulation is outside the scope of this article. It is also best to leave the task to the CMA, as it retains the best understanding of the Kingdom's interest. Nonetheless, a suggestion for the governing bodies in the Kingdom: in order to reassure investors and gain their confidence, an amendment for a transparent and comprehensive regulatory provision is critical.

VI. CONCLUSION

In light of Section 2(a)(19)(A)(vii) from the Investment Company Act of 1940 and Article 20(a)(4), both regulatory bodies do not have comprehensive understandings of "material." The U.S. interpretation of "material" in the independent director context has proven to be both overinclusive and underinclusive. Nonetheless, the Capital Market Authority should refer to the Investment Company Act of 1940 when addressing the issue raised with borrowing under the Regulation.

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> The first pillar of our vision is our status as the heart of the Arab and Islamic worlds. We recognize that Allah the Almighty has bestowed on our lands a gift more precious than oil. Our Kingdom is the Land of the Two Holy Mosques, the most sacred sites on earth, and the direction of the Kaaba (Qibla) to which more than a billion Muslims turn at prayer.
>
> The second pillar of our vision is our determination to become a global investment powerhouse. Our nation holds strong investment capabilities, which we will harness to stimulate our economy and diversify our revenues.
>
> The third pillar is transforming our unique strategic location into a global hub connecting three continents, Asia, Europe and Africa. Our geographic position between key global waterways, makes the Kingdom of Saudi Arabia an epicenter of trade and the gateway to the world.

Message From HRH Prince Mohammed Bin Salman Abdulaziz Al-Saud, VISION KINGDOM OF SAUDI ARABIA 2030, https://vision2030.gov.sa/en/vision/crown-message (last visited Sept. 21, 2020).

Multiple regulatory frameworks have attempted to provide more clear understandings of "material." Nonetheless, this remains a complicated task even in mature financial markets like the United States. Saudi Arabia, in endeavoring to refine its regulation, should examine the deficit in the U.S. system. It should examine the SEC'S failures and consider recommendations provided to the SEC to address the failures. By doing so, the CMA can avoid creating ambiguities and loopholes. It can also ensure it avoids mistakes made by mature markets in the past. With a more mature financial regulatory scheme, the Kingdom will further stimulate economic growth and attract quality foreign capital.