GOVERNANCE OF AND BY INSTITUTIONAL INVESTORS

I. Introduction and summary

1. At the March 2003 meeting of the Committee on Financial Markets, the Committee discussed various regulatory and analytical issues concerning governance of institutional investors and the role these institutions play as monitors of the corporations whose securities they hold in portfolio. As part of that exercise, the Committee took note of two surveys – one of which covered governance of institutional investors in the OECD area and a second which focused on governance activities by institutional investors]. The surveys were restricted to the three major types of institutional investors that are found in most OECD countries: collective investment schemes, life insurance companies, and pension funds. At the conclusion of the discussion of the topic, the Committee requested that the Secretariat make the results available on the OECD's Internet site, incorporating any revisions/corrections as well as any responses from Member countries that had not as yet been included.

2. In response to this request, the Secretariat has updated the surveys on governance of and by institutional investors. Based on the somewhat more complete set of responses to the two questionnaires, the present document presents a simple comparative review of governance regimes for institutional investors in the OECD area. For purposes of illustration, the results are presented by category of institutional investor.

3. As might be expected, governance frameworks for institutional investors in the OECD area have certain basic components in common, although the specifics vary across countries and across types of institutional investors. The common components include well-defined legal and regulatory environments, official supervisory oversight, accepted standards of behaviour with specific responsibilities assigned to certain designated parties (*e.g.* actuaries, trustees, depositories, etc.), internal compliance functions, rules on disclosure, and market discipline.

1) *Special legal and regulatory framework*. All institutional investors exist inside a defined institutional and legal framework, which tends to vary across different types of institutional investors, in part, because the factors affecting their solvency, the types of assets they manage, and the management of their liabilities are generally not the same. Oversight of insurers, for example, has stressed the soundness of individual insurers to ensure the protection of policyholders through a focus on technical/underwriting risks, although investment risks are also considered to be important. Oversight of securities firms, meanwhile, has been oriented towards protection of customers and investors via rules on disclosure and rules relating to internal controls and so-called "Chinese walls". There may be limited, if any, direct supervision to control risk or to ensure solvency, although there may be other types of conduct of business and trading considerations.

4. Given the importance of the legal structure in defining the nature of an institutional investor and prescribing the responsibilities of various officials, at first glance one might presuppose that the legal structure is the single dominant component of the governance regime for institutional investors. However, legal structure alone gives only a partial view of how governance systems operate in practise. Within institutional categories, one finds that some institutional investors with the same legal structure have otherwise markedly different operations and governance structures, while other entities having very

different legal forms operate in a similar way. As well, there increasingly are similarities in products and other forms of institutional overlaps and linkages across the different institutional investor categories. For instance, private pension schemes in some countries are financed with vehicles that have characteristics in common with insurance companies, in the sense that the liabilities of both life insurers and many pension funding vehicles have long horizons, and both the life insurance and pension business are often conducted via products employing collective investment schemes as investment instruments.[1] Like pension funds, many insurance products are designed to allow for a build-up of benefits during an accumulation phase followed by a subsequent payout. It follows that other components of an institutional investor's governance framework play a role in rounding out the contours of its governance regime, shaping either the governance of the institutional investor itself or the sorts of governance activities it carries out. They include:

2) *Fiduciary mandates and responsibility for investment risk.* Many institutional investors operate under fiduciary mandates, but the nature of the mandates need not be the same across the different types of institutional investors (*e.g.* a duty of care versus a duty of loyalty). Laws and regulations generally require that relevant assets are invested in the interests of the final beneficiaries (*i.e.* insurance policy holders, pension plan beneficiaries and investors in CIS). Still, a basic distinction can be drawn between arrangements that require the sponsor of a particular financial instrument to provide a <u>specific</u> return or flow of payments to investors or beneficiaries and those that do not. In particular, some products, such as standard life insurance contracts, fixed annuities or defined benefit pension schemes create a contractual obligation on the part of the sponsor to make specific payments. Under these arrangements, the sponsor assumes all the investment risks of generating sufficient income from the assets to ensure that it meets its contractual funding obligation. In some cases, supervision addresses the question of solvency (full funding). With many other types of products (*e.g.*, defined contribution pension plans, variable annuities and virtually all CIS), the sponsor of the product merely agrees to invest the assets on behalf of the beneficiary or investor and, thus, has no such specific obligation to generate a given investment result. In these cases, the beneficiary bears the investment risk and usually has the responsibility to decide on the investment management strategy.

3) *Tax status.* Institutional investors usually operate under special tax regimes. In many cases, the tax status of these instruments is more favourable than if the equivalent amount of savings were simply held in the form of a banking or securities account. The favourable tax status is accorded in exchange for the investor's or beneficiary's agreement to defer use of the savings for a certain time and only for a specified purpose. Pension plans are a classic example in which the beneficiary agrees to forego use of the assets in the plan until retirement age in exchange for deferred tax treatment during the accumulation phase. Some insurance products and those collective investment products that are qualified to be included in pension plans also are normally not taxed initially, although most other collective investments generally are taxable.

4) *Investment strategy.* All institutional investors gather assets and deploy those assets to achieve their designated investment objective. However, against the backdrop of different legal and regulatory frameworks, fiduciary mandates and tax status (and the institutions' own risk preferences), different types of institutional investors generally have different investment objectives. Some institutions are highly risk averse, while others are more inclined to invest in riskier assets with higher expected returns. Some investment funds are actively managed; others use passive investment strategies based on indexing to broad market benchmarks. Some institutional investors have long investment horizons, reflecting the long-term nature of their liabilities. Retirement products, in particular, typically involve contributions over many years and provide benefits in terms of income for another prolonged period. There are, however,

[1] See, for example, E. Phillip Davis, "Portfolio Regulation of Life Insurance Companies and Private Pension Funds" (2001), *Financial Market Trends*, No. 80, October, pp. 133-189.

contractual savings schemes in which funds are accumulated for much shorter periods, as in the case of savings accumulated to make a down payment to purchase a home or to finance higher education. Collective investment products are very flexible and can be used either inside a longer-term contractual savings scheme, or as a means of executing an investment strategy of any shorter horizon.

5. The assets held by institutional investors may be managed in-house, externally, or through some combination of the two approaches. In many countries, it is becoming more common for institutional investors to delegate the management of at least a share of the funds they control to professional fund managers, who develop asset allocation strategies and make investment decisions on behalf of their institutional investor clients.[2] The exact relationship between the institutional investor and the investment manager depends upon the structure of the industry and the nature of the investment mandate. For example, professional asset management is one of the basic components of the package of services embedded in a CIS. Among other types of institutional investors, an insurance company is more likely than a pension fund to manage a large part of its funds in-house, with larger institutions generally being more inclined than smaller institutions to use in-house fund managers. Many insurance companies have developed skills in fund management through managing their own portfolios and have begun to market these skills to other institutions, especially in the case of generic asset classes such as domestic bonds and equities. Many insurance companies also have sizable real estate portfolios and, hence, may have significant expertise in managing that asset class as well. However, for specialised asset classes, even insurers are likely to rely on external fund managers.

6. All of the various strategies are designed to achieve specific investment objectives, consistent with the nature of the institutional investor's liabilities and operating environment. Among the main objectives of an institutional investor are (1) to earn an adequate return on funds invested and (2) to maintain a comfortable surplus of assets beyond liabilities. Different institutions reach different conclusions as to how these objectives are best achieved, including the degree to which active strategies are employed. Activism can be measured along two dimensions: investing versus monitoring. "Passive" investors are ones who simply try to match the returns from a broad average of securities at the lowest possible management fee. To that end, most major pension funds and insurance companies hold a significant portion of their equity portfolios in an indexed form, and index funds have merged as a distinct category of CIS. The rationale behind passive strategies is the belief that it is extremely difficult to consistently out-perform the market and that the best strategy may, therefore, be simply to replicate a broad market index. This approach may be contrasted with that of "active" investors, who believe that some securities or market segments may either be overvalued or undervalued by the market. These institutions may trade rather frequently and sell assets that no longer meet the objectives of their declared investment strategy, which may be to pursue a specific approach (growth, income, value etc.) but may simply be just to hold a diversified portfolio.

7. In the monitoring/governance arena, these activist roles are often reversed. Investors who actively manage their portfolios may actually be quite passive when it comes to asserting their rights as owners of corporations and obliging corporate management to act in the interests of investors. For example, part of the suite of services offered by most collective investment institutions is their professed ability to make good stock selections. Managers of such portfolios attempt to enhance the value of their portfolios by adjusting their holdings in accord with their assessment of corporate valuations and market conditions. They may be more inclined than other investors to simply sell shares in companies that are seen to under

[2] Fund managers may work in four different basic types of institutional set-up: 1) in the fund management or trust departments of banks; 2) in separately capitalised fund (or money) management companies, which may be owned by banks, securities firms or insurance companies; 3) in independent money management companies (firms not affiliated with a bank, insurance company or securities firm); and 4) in the in-house fund management departments of large insurance companies and pension funds.

perform rather than incur the costs of engaging in active monitoring. This behaviour can be contrasted with that of other institutional investors, who tend to trade less frequently and are more inclined to engage in active dialogue with the management of the companies whose stock they hold. Indexation is an example of an investment strategy that requires the investor to hold equities for the long term in order to replicate the index. Institutions following indexed strategies are committed to holding onto shares and, thus, in the interests of fulfilling their fiduciary mandates and enhancing the returns on the assets held may be inclined to put pressure on the management of underperforming firms.

8. Historically, however, many institutional investors have not fully exercised this responsibility and it is often debated whether institutional investors as a group are particularly well-suited to the role of corporate monitors. Various explanations have been offered for the lack of action. In some jurisdictions, institutional investors are under no legal obligation to vote and in many cases the voting rights have been left with fund managers or custodians whose motivations to vote are uncertain. In other cases, voting rights flow up the organisational chain. Many fund managers argue that their function is to obtain an adequate financial return for their clients or beneficiaries and not to control management. They contend that monitoring is an expensive proposition with a sizable free-rider problem that makes it difficult to justify the cost. Many have argued, therefore, that the better alternative is active analysis and portfolio selection.

9. In some jurisdictions, shareholders have few legal rights to compel corporate management to act in any particular way. Legal and other requirements may oblige banks or other custodians to support management unless they have a specific written instruction from the shareholder to do otherwise. Such rules, which often work in combination with the use of bearer shares, can make it difficult for shareholders to cast votes. A serious impediment stems from the widespread practice in some OECD countries of imposing measures that impede the full use of voting rights. Among the barriers to shareholder control have been the assignment of special additional voting rights to certain categories of shareholders; the issuance of non-voting shares or depository receipts, which unlike regular shares, do not have voting rights; the use of capped voting; and the refusal to register certain kinds of shareholders for voting. Other impediments are rules limiting the scope for proxy voting and the requirement for physical attendance at the annual general meeting in order to vote. In addition to these specific barriers to effective voting, ownership structures characterised by intensive inter-company holdings and complex capital structures (such as pyramids) have also tended to entrench management.

10. Nonetheless, governance practices in most Member countries are changing. The governance problems highlighted in the recent spate of corporate defaults and episodes of misreporting have led to wider acceptance of the need for autonomy of the audit function, appropriate procedures for determining who sits on boards of directors and committees, and the importance of the monitoring role of banks and shareholders. As a result, investors increasingly are demanding that companies respect international standards of disclosure and transparency and institutional investors have begun to more actively assert their ownership rights. Additionally in most OECD countries, corporate governance practices are developing that make it easier for shareholders to obtain necessary information and to influence the company through voting and through legal redress. As well, the role of boards is being defined more precisely to include effective oversight of management and allied interests for the collective benefit of shareholders and other stakeholders. The next sections summarise these developments for each major institutional investor category.

II. Collective Investment Schemes

Governance of CIS

11. CIS go by many names, such as mutual funds, investment companies, unit trusts, etc. The legal structures of each of these vehicles differ somewhat, but the underlying principles are the same. All CIS

offer individual investors a means of pooling their funds and hiring professionals to manage their investments. Since CIS do not, in principle, involve a commitment to pay the investor a specific return, there is little supervision to control the risk being assumed by the CIS or to ensure its solvency. There are, however, strong requirements of disclosure and transparency and rules are enforced to assure that the CIS is operated in accord with accepted norms. All Member countries also stipulate internal control systems in which final responsibility for oversight is located. Each system has defined a role for an outside party to exercise an oversight function over the operator of the CIS and the agents of the operator ensure that standards are observed.

Table 1 Legal structure for CIS in OECD countries

Contractual	***Corporate***	***Trust***	***Contractual or corporate***	***Contractual or trust***	***Corporate or trust***	***Contractual corporate or trust***
Austria	Poland	New Zealand	Belgium		Canada	Australia[2]
Denmark	Mexico	Singapore	Czech Rep.		Ireland	Hong Kong, China[3]
Finland			France		Japan	United States[4]
Germany			Greece		Netherlands	
Hungary			Italy		United Kingdom[1]	
Norway			Korea			
Portugal			Luxembourg			
Slovakia			Spain			
Sweden			Turkey			
Switzerland						

1. CIS can also exist as partnerships, but this form is much less common.

2. CIS structured as investment companies do not come within the definition of “managed investment scheme” and are regulated as any other company, rather than as a CIS.

3. The definition of CIS does not mandate a particular legal structure.

4. There is no specific legal requirement as to the form of a CIS in the US; CIS can be in the form of a trust, limited partnership, corporate limited liability company, etc.

12. Generally speaking, the internal governance structures of CIS reflect these legal forms. Countries that offer the corporate form typically assign a key role to the board of directors (especially independent directors) of the entity in assuring that the fund operates in the interests of investors. With the contractual form, the independent depository, which may have some ownership linkages to the operator, often plays an important oversight role, while the trust form generally relies on independent trustees to perform a significant oversight role. In countries where more than one legal form is possible, different entities may be assigned the internal oversight role, depending on the particular form. Australia is a notable exception in that all three legal forms are possible, but in each case responsibility for internal oversight rests with a single “responsible entity”. Some countries (Austria, Belgium, Italy, Poland, Portugal, Slovakia and Switzerland) have established joint responsibility or in some cases strict legal liability to two or more entities. Hence, the groupings of countries based on internal oversight are not the same as for legal structure.

Table 2 Responsibility for internal oversight of CIS

Management Company	*Bd. of Dirs.*	*Trustee*	*Depository*	*Custodian*	*Sponsor*	*Joint responsibility*
Canada	Czech Rep.	Hong Kong, China	Czech Rep.	Hong Kong, China	Turkey	Austria[2]
Greece[1] Hungary Luxembourg[1] Netherlands[1] Norway[1]	Denmark Finland France Greece Hong Kong, China	Ireland Korea New Zealand Singapore United Kingdom	Finland France Luxembourg Spain United Kingdom	Hungary Ireland		Belgium[3] Italy[4] Poland[5] Portugal[6] Slovakia[7]
Spain[1] Sweden	Korea Luxembourg Mexico Netherlands Spain United Kingdom United States					Switzerland[8]

1. Its board of directors.

2. The management company and depository.

3. Board of directors of the CIS (or management company) and depository.

4. Board of internal auditors of the CIS (or management company) and depository.

5. Board of directors of the CIS, the depository and in some funds the Investors Council or Board of investors.

6. The management company and depository (joint liability).

7. Board of directors of the management company and depository.

8. Board of directors of the management company and custodian bank.

13. The CIS sector is typically characterised by complex agency relationships. Although a few CIS are offered by companies that engage only in CIS management, most CIS are affiliated with other financial organisations, such as banks, securities houses, or insurance companies. The parent company of the investment management company will often use its own marketing system (*e.g.* bank branch network or insurance sales force) to market its own "proprietary" funds. The existence of ownership linkages with other financial institutions poses a potential conflict of interest. Even in the absence of such relationships, there is the risk that fund managers will not manage assets in the interests of the investors. A variety of governance measures have been introduced to prevent such potential conflicts of interest from becoming reality. In some cases the law requires the formation of a specialised investment management company, but even where a separate investment management company is not legally required, this is the most common form of organisation in the CIS business. Other measures include industry self-regulation via codes of conduct and adequate disclosure to permit sufficient market scrutiny. The majority of countries impose specific requirements on operators, managers or other official parties. In some countries, multiple measures are imposed. Most, but not all, countries impose limits on transactions with connected parties.

Table 3 Legal measures to ensure that a CIS operates in the interests of investors

Measures defined in terms of			
Role of or independence of board members	***Organisational structure***	***Internal controls***	***Requirements imposed on operators/managers, trustees, etc.***
Denmark	Austria	Austria	Australia
Finland	Belgium	Singapore	Canada
Japan	Germany	Czech Rep.	France
Mexico	Greece	Italy	Hong Kong, China
Norway	Netherlands	Sweden	Hungary
United States	United Kingdom	United Kingdom	Ireland
	United States	United States	Italy
			Japan
			Korea
			Luxembourg
			Netherlands
			Norway
			Poland
			Portugal
			Singapore
			Slovakia
			Spain
			Turkey
			United States

Table 4 Codes of conduct for CIS operators

Statutory code of conduct	***Industry or other non-statutory code of conduct***	***None***
France	Austria	Australia
Germany	Hungary	Belgium
Greece	Italy	Canada
Hong Kong, China	Portugal	Czech Republic
Hungary	Switzerland	Denmark
Italy		Finland
Japan		Ireland
Korea		Luxembourg
Norway (limited)		Mexico
Poland		Netherlands
Portugal		Sweden
Singapore		Turkey
Slovakia		
Spain		
United Kingdom		
United States		

Table 5 Countries imposing other legal measures to address conflicts of interest

Restrictions on connected party transactions	***Specific disclosure requirements regarding conflicts of interest***	***Regulatory requirements or industry standards regarding***		
		Compliance function	**Internal controls**	**Risk management**
Australia	Australia	Australia	Czech Republic	Czech Republic
Belgium	Belgium	Austria	Italy	Italy
Canada	Canada	Canada	Japan	Japan
Czech Republic	Czech Republic	Czech Republic	Korea	Korea
Finland	Denmark	Finland	Norway	Singapore
France	Finland	France	Poland	Spain
Germany	France	Hong Kong, China	Portugal	Switzerland
Greece	Germany	Ireland	Singapore	United Kingdom
Hungary	Hong Kong, China	Italy	Slovakia	United States
Ireland	Ireland	Japan	Spain	
Italy	Italy	Korea	Switzerland	
Japan	Japan	Mexico	United Kingdom	
Korea	Korea	Netherlands	United States	
Mexico	Mexico	Norway		
Poland	Netherlands	Poland		
Portugal	Norway	Portugal		
Singapore	Poland	Singapore		
Slovakia	Portugal	Switzerland		
Spain	Singapore	United Kingdom		
Switzerland	Slovakia	United States		
Turkey	Spain			
United Kingdom	Switzerland			
United States	Turkey			
	United Kingdom			
	United States			

14. Looking across the various measures and at the groupings of countries that have implemented them, one is hard pressed to identify a single unifying factor that determines why different countries are found in one or another group. For example, extracting from Table 5 information for countries that have only the contractual form of CIS would produce results like the ones shown in Table 6. The absence of a readily discernible pattern to the responses helps to illustrate a point made earlier in the discussion, namely that the governance structure of CIS schemes in the OECD area is not based solely on legal form. By the same token, legal form alone does not convey sufficient information to determine how a particular CIS will operate and whether and to what degree it exercises its rights as a shareholder.

Table 6 Measures to address conflicts of interest in countries with contractual schemes

	Restrictions on connected party transactions	Specific disclosure requirements regarding conflicts of interest	Regulatory requirements or industry standards regarding		
			Compliance function	Internal controls	Risk management
Austria	⊗	⊗	✓	…	…
Denmark	⊗	✓	⊗	…	…
Finland	✓	✓	✓	…	…
Germany	✓	✓	⊗	…	…
Hungary	✓	⊗	⊗	…	…
Norway	⊗	✓	✓	✓	…
Portugal	✓	✓	✓	✓	…
Slovakia	✓	✓	…	✓	…
Sweden	⊗	⊗	⊗	…	…
Switzerland	✓	✓	✓	✓	✓

Explanation of symbols: ✓ = yes; ⊗ = no specific requirements; … = not reported in the survey.

Governance activities by CIS

15. As noted previously, the central concept underlying CIS is the pooling of funds for scale and diversification benefits, with professional management of the funds according to a pre-specified investment strategy. Fund managers actively compete for mandates to manage funds from pension plans, foundations, life insurance companies, and retail investors. The relationship between end-investors or beneficiaries of many institutional investors and their fund managers is similar to that between shareholders and managers in the corporate context, in the sense that the same sorts of agency problems can arise. To mitigate the consequences of agency problems, fund managers are often given only short-term mandates and are subjected to frequent performance evaluations, with renewals of the mandate and the fund manager's compensation tied to the manager's relative investment performance.[3]

16. Some analysts argue that the use of short mandates and other performance-based measures induce fund managers to focus more on short-term results than might otherwise be optimal. Moreover, the argument holds that some fund managers are dissuaded from being active as corporate monitors by pressures to achieve benchmark results, and instead, tend to do a considerable amount of trading.[4] There are, by contrast, fund managers that make a point of explicitly engaging in active dialogue with the management of companies believed to be under performing and urging the targeted managers to take

[3] For instance, individuals can move readily easily into and out of most CIS, and there is a wealth of publicly available information regarding the performance of the schemes.

[4] Of course, "voting with the feet" does have a certain governance aspect to it, especially when carried out by high-profile investors.

specific actions to improve their company's performance. Determining what degree of activism is desirable is still a subject of some controversy, but many funds have moved to a somewhat more active stance on monitoring than was the case in the past and industry associations in a few countries have proposed codes of conduct that encourage more active participation in corporate governance. In some other countries, the law requires that CIS give due consideration to corporate governance issues, while in a few others, both statutory and industry codes exist.

Table 7 Countries with statutory or non-statutory codes on CIS voting

Statutory code	*Industry or other non-statutory code*	*None*
Denmark	Australia	Belgium
Finland	Austria	Canada
Greece	Italy	Czech Republic
Italy	Poland	Hong Kong, China
Japan	Portugal	Hungary
Korea	Switzerland	Ireland
Norway		Luxembourg
Portugal		Mexico
Slovakia		Netherlands
Turkey		Spain
United Kingdom		
United States		

17. In the majority of countries responding to the questionnaire, the responsibility for exercising proxy votes or other voting rights with respect to the shares held in a CIS' portfolio rests with the management company of the CIS, in a few cases, through its board of directors (Table 8, column 1). In a smaller number of cases, this responsibility is given to the Board of directors of the CIS itself. Other entities are given the responsibility in a few other countries (*e.g.* trustees in Canada and the United Kingdom or fund operators in Japan and Mexico). As would be expected, countries having more than one legal form, allow for either one or another entity to be assigned the responsibility depending on the legal form of the CIS (*e.g.* board of directors of the CIS, trustees or custodians in Hong Kong, China). There is not, however, a precise one-to-one mapping between legal form of the CIS and the entity vested with voting rights.

Table 8 Entity authorised to make voting decisions regarding shares in CIS portfolio

Management Company	***Bd. of Dirs. of CIS***	***Trustee***	***Depository***	***Custodian***	***Sponsor or Operator***
Australia[1]	Belgium	Canada	United Kingdom	Hong Kong, China	Japan
Austria	Denmark	Hong Kong, China			Mexico
Belgium	Finland	United Kingdom			
Canada	Hong Kong, China				
Czech Rep.	Ireland				
Denmark	Italy				
Finland[2]	Luxembourg				
France	Spain				
Germany	Turkey				
Greece	United States				
Hungary					
Ireland					
Italy					
Korea					
Luxembourg					
Netherlands					
Poland					
Portugal					
Slovakia[2]					
Spain					
Switzerland					

1. For unregistered schemes. For registered managed investment schemes, the Responsible Entity.

2. Through its Board of directors.

18. In most countries, laws or regulations allow the voting rights under the control of a CIS to be delegated to another entity. Across countries that allow the transfer of voting rights to a proxy rules vary as to whether the proxy must be directed to vote in a certain way (*e.g.* in Austria, Italy, and Poland) or whether voting decisions may be left to the proxy's discretion. Some countries prohibit such transfers outright (Finland, Ireland, Japan, Spain, and Turkey), and even in countries that allow voting rights to be delegated to a proxy, usually the voting function may be transferred but not the legal responsibility.

Table 9 Rules on delegation of voting rights by CIS

Delegation of voting rights permitted	*Delegation of voting rights prohibited*
Australia	Finland
Austria[1]	Ireland
Belgium[2]	Japan
Canada[3]	Spain
Czech Republic	Turkey
Denmark	
France	
Germany	
Greece	
Hong Kong, China	
Hungary	
Italy[4]	
Korea	
Luxembourg	
Mexico	
Netherlands	
Norway[5]	
Poland[6]	
Portugal	
Slovakia	
Sweden	
Switzerland	
United Kingdom[7]	
United States[6]	

1. Only in connection with an explicit order about how to exercise the rights.

2. But said transfer must not limit the autonomy of the management of the CIS.

3. Subject to limits based on manager or trustee's statutory duty of care and other legal obligations.

4. But the exercise of voting rights cannot be delegated permanently to another entity; the proxy can be given only for a specific shareholder meeting; and the proxy must specify the delegated entity and the voting instructions.

5. Subject to approval by board members elected by the unit holders of the CIS.

6. But those rights must be exercised in the interests of the investors.

7. To the depository or custodian.

19. CIS offer investors a means of improving returns by pooling their resources to reach sufficient size for portfolio diversification and other scale benefits, but they do not, in principle, represent a promise to pay a return of any particular rate. The legal framework and regulatory regime operate to ensure that major abuses do not occur, but they are not intended to prevent or minimise losses to investors. Rather, the investor bears a lot of the responsibility for the investment result by opting in to particular investment strategies and levels of risk. In such an environment, close monitoring is essential. Fortunately, in most cases, rules mandate that CIS provide investors with relevant information, concerning for example the assets and their valuation, fees, commissions and costs, and financial performance. In addition, comparative analyses of the performance of all CIS, with extended analyses and commentary, regularly appear in the specialised financial press. Through rules on transparency and disclosure, as well as

voluntary reporting by some CIS, individual investors acquire the capability to monitor the investment performance of each CIS. The availability of information to investors has been a major force behind the growth of the CIS sector over the past decade or so.

20. It is an open question, however, whether investors' appetites for information are limited to performance statistics alone or extend to other types of information. Some members of the CIS industry have argued, for example, that investors do not appear to place sufficient importance on funds' disclosures regarding their proxy votes to warrant the expense that would be entailed in collecting and publishing the information.[5] However, the view in some official circles is that such information is a necessary component of the disclosure requirements for the CIS sector and a number of countries require CIS to disclose information as to how the shareholder rights on assets held in portfolio are exercised (Table 10).

Table 10 Rules relating to disclosure of voting guidelines and actions

Disclosure of voting actions required	*Disclosure of internal guidelines on voting required, but not actual voting actions*	*Disclosure of information on voting not required*	*Actions or official positions on voting practices taken by*	
			Individual CIS	**Industry assoc. or other official bodies**
Finland	Mexico	Australia	Canada	Australia
Italy	Slovakia	Austria	Finland	Austria
Korea[1]	Turkey	Belgium	Hong Kong, China	Greece
Portugal		Canada	Korea	Italy
United States		Denmark	Netherlands[7]	Japan
		Greece	United States[7]	Korea
		Hong Kong, China[2]		Netherlands
		Japan		Norway
		Netherlands[3]		Switzerland
		Norway		United Kingdom
		Poland[4]		
		Spain[5]		
		Switzerland[6]		
		United Kingdom		

1. Required if the actions on proxy votes affects the management of companies.

2. Information on voting policies is disclosed in response to direct requests, but is not usually disclosed voluntarily.

3. Only some specialised CIS exercise their voting rights.

4. Fund management companies provide such information for certain types of funds.

5. A draft bill under consideration would oblige management companies to disclose such information.

6. Information must be provided by the management company upon request of a unit holder.

7. CIS are not in favour of mandatory voting and disclosure.

[5] See, for example, the "Comment Letter" from the U. S. Investment Company Institute in response to the Securities and Exchange Commission's request for comment on its Paperwork Reduction Act burden estimates with respect to the proposed form on which mutual funds would be required to file their corporate proxy voting records.

21. In both “insider” systems, in which ownership is concentrated among identifiable groups of insiders, including family interests, allied industrial concerns, banks and holding companies, and “outsider” systems, which are characterised by more diverse ownership, there is an inherent principal-agent problem that creates a need for shareholders to exert some form of control over management, while remaining sufficiently separate from management to carry out portfolio re-balancing activities without violating insider trading rules. Voting actions receive considerable attention in these discussions of corporate governance as one of the essential means by which shareholders can control management. Other mechanisms to address the potential conflicts of interest between owners and managers include active dialogue between management and shareholders, the use of public criticism, formal associations of investor groups, especially of institutional investors, and representation on boards, although the latter is admittedly rarely done in practise. Most mutual funds have a stated investment policy that the fund will not invest for the purpose of controlling or influencing the management of portfolio companies. Consequently, investment advisers of such funds rarely go beyond the simple voting of proxies.

22. Numerous factors can influence shareholders’ incentives to monitor firms. Some of these factors are particular to the country or environment in which the investor operates (e.g., legal system, institutional arrangements), while others are particular to the investors themselves (e.g., size, investment horizon and institutional culture). In examining the influence of the legal environment on monitoring activities by institutional investors, several scholars[6] have argued that the monitoring capacity of institutional investors has been hampered by excessive regulation. These arguments may have merit, in the sense that regulations in some jurisdictions expressly prohibit certain categories of institutional investors from acquiring direct control or a dominant influence over the management of a company in which they hold shares. For example, OECD countries generally have not allowed CIS to have materially significant participation in the companies in which they invest.

23. The argument is not entirely one-sided, however, and some regulatory or legislative rule changes have been quite favourable for active monitoring, such as those that remove or lessen restrictions on communication among groups of shareholders. As a consequence of these sorts of reforms, domestic and international associations of institutions have developed and private firms that specialise in representing the interests of groups of institutions to corporate management have become active. In general, institutional investors have greatly advanced their capacity to understand the financial situation and goals of companies, to communicate their concerns about corporate performance with management and to be able to vote more effectively than they have in the past, although they have not always done so.

[6] Black, Bernard, 1990, Shareholder passivity re-examined, Michigan Law Review 89: 520-608.

Table 11 Factors apart from voting that influence monitoring activities of CIS

Regulatory measures or industry practices to promote monitoring activities	***Restrictions on shareholdings or on exercising control of companies***	***"Acting in concert" limitations***	***CIS allowed to name members to or to sit on corporate boards of directors***	***Effectiveness of CIS as corporate monitors recently reassessed***
Czech Republic Italy Japan Portugal Slovakia United Kingdom	Austria Belgium Canada Czech Republic Denmark Finland France Germany Greece Hong Kong, China Hungary Ireland Italy Japan Korea Luxembourg Mexico Norway Poland Portugal Singapore Slovakia Spain Switzerland Turkey United Kingdom	Finland Greece Poland[1] Portugal[2]	Canada Czech Republic Finland Hong Kong, China Japan Korea Mexico Netherlands Norway Poland Slovakia United Kingdom[3]	Australia Czech Republic Korea Poland United Kingdom

1. In the case of substantial block of shares in relation to acquisitions and takeovers.

2. The management company is obliged to manage each CIS individually and in the exclusive interest of unit holders.

3. It is possible but doesn't tend to happen outside venture capital firms.

24. Many analysts have argued that effective institutional governance requires access to relevant information and an ability of institutions to build coalitions. The survey results suggest that most OECD countries do not impose explicit restrictions on the ability of CIS to communicate among themselves or act through industry associations for purposes of corporate monitoring, although limits on the percentage that may be invested in any one issuer are common. As well, the evidence suggests that the majority of CIS are either not active monitors or not particularly effective.

III. Insurance Companies

Governance of insurance companies

25. In contrast to the CIS sector where, for example, some countries allow only the contractual form of CIS and others only the corporate form, almost all countries allow for more than one legal form in their life insurance sector. In particular, most OECD Member countries allow insurance undertakings to exist either in the form of *companies limited by shares* or *mutual societies*, although the structure of these legal forms is not the same in all countries. In addition, some countries allow insurance undertakings to be structured as co-operative societies, and in a few countries there may be other special arrangements as well such as provident societies (Table 12).

Table 12 Legal structures for life insurance companies

Corporate	***Mutual***	***Other (e.g. Co-operatives and Provident societies)***
Australia	Australia	Belgium
Austria	Austria	Czech Republic
Belgium	Belgium	France[2]
Canada	Canada	Hungary
Czech Republic	Denmark	Italy
Denmark	Finland	Spain
Finland	France	Sweden
France	Germany	Switzerland
Germany	Hong Kong, China	United Kingdom
Greece	Hungary	United States
Hong Kong, China	Ireland	
Hungary	Italy	
Ireland	Japan	
Italy	Korea	
Japan	Mexico	
Korea	Netherlands	
Mexico	Norway	
Netherlands	Poland	
Norway	Portugal[1]	
Poland	Spain	
Portugal	Sweden	
Slovakia	Turkey	
Spain	United Kingdom	
Sweden	United States	
Switzerland		
Turkey		
United Kingdom		
United States		

1. Although no company has adopted this form.

2. Provident societies.

26. Whatever their legal or ownership structure, all insurance companies are exposed to various technical (actuarial and underwriting, investment, etc.) and non-technical risks. Against this backdrop and taking into account the essential role the insurance sector plays in market economies, it is not surprising that the insurance sector in most countries is fairly closely supervised, especially as regards the treatment of assets that cover technical provisions. A guiding principle for authorities in most OECD countries is to prevent default, with a view toward protecting the interests of policyholders, the insured and the beneficiaries of insurance contracts, as well as any third parties that may have direct claims against an insurer under an insurance agreement. There are various ways in which Member countries attempt to meet this objective, beginning with strict licensing requirements up-front, accompanied by specific solvency and technical requirements, accounting requirements and investment regulations. The interests of the insured are usually protected by general consumer protection regulations and insurance companies are also subject to ongoing supervision. That said, supervisors do not interfere in the management of an insurance company under normal circumstances, and given the prevalence of the corporate form for life insurance companies in the OECD area, it is perhaps not surprising that the board of directors of the companies feature prominently in the internal governance structures of life insurance companies in many countries (Table 13, column 2). Still, as is the case for CIS, internal governance structures do not map precisely into legal structures.

Table 13 Internal governance structure of life insurance companies

Responsibility for internal monitoring rests principally with:					
Senior Management	***Bd. of Dirs.***	***Actuary***	***Internal auditors***	***External auditors***	***Supervisory board***
Canada	Australia	Australia	Austria		Austria
Hong Kong, China	Canada	Austria	Canada	Canada	Czech Republic
Korea[1]	Czech Republic	Canada	Denmark	Denmark	Germany
Mexico[1]	Denmark	United Kingdom	Hungary	Japan	Hungary
France[2]	Greece				Japan
	Hong Kong, China		Italy		Poland
	Italy		Korea		Switzerland
	Korea[3]		Slovakia		
	Mexico		Sweden		
	Netherlands				
	Norway				
	Portugal				
	Spain				
	Sweden				
	Turkey				
	United Kingdom				

1. Compliance officer.

2. Senior managers generally have considerable actuarial skills.

3. Outside director.

27. In all OECD Member countries, the underwriting of insurance risks is restricted to licensed insurance companies, which serves the duo purpose of preventing unsound entities from entering the business and keeping insurance underwriting separate from non-insurance activities. Although insurance

companies are allowed to distribute financial products other than insurance, including pension products, and banks and other financial services providers generally may distribute insurance products, rules in place in most countries prevent a full mixture of insurance with banking or other non-insurance activities. Moreover, in most OECD Member countries, the simultaneous pursuit of life and non-life insurance is not permitted and with few exceptions, separate licenses are typically required for each class of insurance business or for multiple categories grouped under a common umbrella. These restrictions are intended to ensure that the funds to be set aside (and preserved under strict supervision) for paying insurance claims are not endangered by the unknown or uncontrolled risks of unrelated business. In particular, there are requirements to ensure that the reserves from the life insurance business are protected.

28. In addition to formal licensing requirements, OECD Member countries usually impose other requirements on insurance undertakings, including legal requirements as to the legal structure of the undertaking, accounting requirements (balance sheet reporting, proof of minimum capital, etc.), technical requirements regarding insurance underwriting, and managerial requirements (*e.g.* fit and proper tests). As noted previously, there may be specific provisions regarding investments by the insurer. Ongoing supervision exists to ensure that the various requirements are met all the time. This extensive legal and regulatory infrastructure is intended foremost to ensure the solvency of insurance undertakings and their ability to meet at all times their commitments towards the insured.

29. In the process, rules in most countries establish suitability and other requirements for members of an insurance company's governing body and require the participation of various other bodies such as actuaries and auditors in the internal oversight of the life insurance company. While the specifics tend to vary across countries, the various measures are an important component of the governance structure of insurance companies in that they help guard against conflicts of interest. As is the case with other categories of financial services, the insurance business is subject to potential conflicts of interest between owners and managers, but with an added potential conflict involving policyholders. Obviously, given the different legal forms of insurers, the nature of the conflict varies depending on whether the insurance undertaking is structured as a share company or as a mutual. In the case of the former, there is the classic potential conflict arising from the separation of ownership from control. In addition, given the typically medium to long-term nature of insurance contracts and the asymmetry in market power and information between the insurer and the insured, the risk is present that the company will be managed in a way that abuses the implied fiduciary obligations to policyholders and beneficiaries. With the latter, the roles of policyholders and owners are combined, which in theory should relieve any potential tension between building sufficient reserves to cover all risks and making an adequate distribution to owners via dividends.[7] However, since ownership interests in many cases are non-transferable in these structures, management actually may gain a measure of increased discretion, which would need to be counterbalanced by some other control mechanisms.

30. Various aspects of the legal and regulatory infrastructure for insurance companies address potential conflicts of interest. Some of these measures apply generally to all share companies, such as rules concerning directors' duties and restrictions against connected party transactions, while others are particular to the insurance business itself, including specific redress arrangements, rules on asset separation, and the separation of life insurance from non-life insurance and other not-insurance related business.

31. As Table 14 shows, most OECD countries have established 'fit and proper' requirements for directors and/or other senior officers of insurance companies. Upon closer inspection of the detailed responses to the questionnaire, one finds that suitability requirements come in two basic forms: positive

[7] See the discussion in "Governance of Insurance Companies: Proposal for Draft Guidelines" DAFFE/AS/WD(2003)1.

attributes that admit persons who meet certain requirements focused on professional experience, educational level, ability, reputation and general knowledge of the insurance business; and negative attributes that disqualify persons based on their age (*e.g.* minors), financial status (bankruptcy), legal status (criminal record) or relationship to other officers (family member, corporate relationship, etc.). While all OECD Member countries require insurance companies to submit financial reports at lest annually comprising the balance sheet and profit and loss accounts, only a few mandate disclosure specifically as a means of addressing conflicts of interest. It is important to note as well that countries increasingly are placing much greater reliance on the role of actuaries in resolving conflicts of interest between management and shareholders and above all policyholders in life insurance companies.

Table 14 Legal and structural measures to address conflicts of interest in the insurance business

Countries imposing specific measures defined in terms of:					
Suitability requirements for senior officials, directors, etc.	***Audit function***	***Internal controls (e.g. separation of assets, related party restrictions)***	***Legal responsibilities for managers, directors, etc.***	***Special rules on disclosure***	***Special redress mechanisms***
Australia	Hungary	Australia	Australia	Australia	Denmark[4]
Austria	Italy	Austria[2]	Austria	Austria	Spain
Belgium	Portugal	Canada	Greece	Belgium	
Canada		Greece	Italy	Canada	
Czech Republic		Italy[2]	Mexico	Finland	
Denmark		Japan	Netherlands	Hong Kong, China	
Finland[1]		Mexico		Hungary	
Greece		Norway		Italy	
Hong Kong, China		Poland		Japan	
Italy		Portugal		Korea	
Japan		Slovakia		Mexico	
Korea		Spain		Netherlands	
Mexico				Portugal	
Netherlands				Slovakia	
Poland				Spain	
Portugal				Turkey	
Slovakia				United Kingdom	
Spain					
Sweden					
Switzerland					
Turkey					
United Kingdom					

1. Supervision of the insurance business addresses conflicts of interest.

2. Includes required separation of life and non-life insurance businesses.

3. Mutuals are required to have a code of conduct, including specific rules regarding temporary financial investments.

4. A complaints council has been established for the industry.

32. In most OECD Member countries, the annual accounts have to be approved by an auditor, who must be independent of the insurance company. The auditor must review the company's bookkeeping and financial reports to ascertain their compliance with the legal provisions of the country concerned and must certify the correctness of the final documents. As part of the audit function, the auditor also expresses his views regarding the company's financial situation. In addition to auditors and actuaries, who are required in almost all Member countries, life insurance companies in a few countries also are required by law to appoint other officials to their governance structure. For example, in Mexico, each company must have a compliance officer, who is responsible for monitoring the company's compliance with the norms prescribed by the insurance supervisory body. In Slovakia, each company must establish a supervisory board, which is authorised to require the internal audit division to carry out internal checks when necessary. The supervisory board also is responsible for approval of the auditor. Other bodies that may participate in an insurance company's governance structure on an optional basis include custodians, benefit providers and asset managers. In Canada, boards of directors must establish an *audit committee*, which works with the auditor and actuary of the company and reviews the company's financial statements, investments and transactions, and other relevant information. In addition, there must be a *conduct review committee*, which oversees related party transactions and similar practices.

Table 15 Obligatory and optional members of the governance structure of insurance companies

Actuary[1]	*Auditor*[1]	*Asset manager*	*Custodian*	*Internal control officer*	*Other*
Australia	Australia	Australia[2]	Australia[2]	Hungary	Canada[5]
Austria	Austria	Austria[3]	Netherlands[2]	Mexico[4]	Norway[6]
Belgium	Belgium	Germany[3]	Norway[2]		Slovakia[7]
Canada	Canada	Norway[2]	Sweden[2]		
Czech Republic	Denmark	Poland[2]			
Denmark	Finland				
Finland	Hungary				
Hungary	Italy				
Italy	Japan				
Japan	Korea				
Korea	Mexico				
Mexico	Netherlands				
Netherlands	Norway				
Norway	Poland				
Poland	Slovakia				
Slovakia	Spain				
Spain	Sweden				
Sweden	Switzerland				
Switzerland	United Kingdom				
Turkey					
United Kingdom					

1. Obligatory unless otherwise noted

2. Optional

3. *Treuhänder* – monitors assets covering technical provisions

4. Compliance Officer

5. Audit Committee and Conduct Review Committee

6. Benefit provider

7. Supervisory Board

33. Mutuals account for a non-trivial share of the insurance business in some OECD countries (*e.g.* France, Germany and the United States) and where that is the case, some specific provisions have been incorporated in the governance structure to take into account the particular issues raised by the various forms of mutual ownership. As noted previously, however, the majority of insurance undertakings in the OECD area are incorporated as share companies, which gives primacy to the role of shareholders and other stakeholders in the governance of the companies. To that end, many countries have placed considerable reliance on transparency and disclosure for governance purposes, with various other measures introduced to ensure the solvency of the insurance company and the veracity of its published financial reports. Many elements of the governance regime for insurers are common to all corporate businesses (*e.g.* rights and responsibilities of board members), while in a few cases, measures have been introduced specifically to take account of the nature of the insurance business itself (*e.g.* the increasing role of actuaries).

Governance activities by insurance companies

34. In all OECD countries, insurance companies are subject to investment regulations, ostensibly to protect policyholders, but in times past investment regulations have been used as well to direct funds toward specific sectors and to prevent insurance companies from acquiring and exercising undue influence within the broader financial markets. In many countries, a distinction is made between the treatment of the assets representing the technical provisions, which are the basis for satisfying the claims of the insured, and those assets covering the other liabilities. With few exceptions (Japan, Norway and Turkey), there is no regulation regarding free assets. Where they exist, investment regulations take two basic forms: (1) quantitative requirements with fixed percentages for individual categories of assets, versus (2) so-called “prudent person” rules, which lack specific percentages and are based instead on the expectation that the company will avail itself of the information needed to deploy its assets in the best possible ways to meet its fiduciary responsibilities and other legal obligations.

35. The differences between the two approaches should not be overstated, as the form of investment regulation alone does not provide a complete explanation of the breakdown of assets across insurers. For example, both the United Kingdom and the United States operate under “prudent person” rules, but insurance companies in the United Kingdom generally have had a much higher equity share. Moreover, there tends in practise to be considerable overlap in the investment results brought about under the two schemes, and besides, investment regulations in many countries do not always divide neatly between the two approaches. In some countries (*e.g.* in the EU), both are used, with prudent person rules providing general guidelines, supplemented and reinforced with some quantitative limits.

36. Although the share of assets that may be invested in equities varies across countries, most member countries allow insurance companies to hold shares in companies outside the sector, including in many countries, banks (with limitations in some cases). In the process, while growth over the past decade has lagged that of the CIS sector, the insurance industry as a whole has built up sizable equity portfolios. As with other categories of financial services providers, some of the shares held by insurers serve a strategic business purpose, while others meet a basic investment need for long-dated assets to match against liabilities. What happens to the voting rights on the shares held by insurers is an open question. Many countries set limits on the percentage insurers may invest in shares of companies outside the sector, but there do not appear to be other specific barriers to monitoring activity on the part of insurance companies as a group. However, there appears to be little empirical evidence regarding overt monitoring activity on the part of insurance companies in the OECD area.

Table 16 Countries with statutory or industry codes on voting by insurance cos.

Statutory code	*Industry or other non-statutory code*	*No specific rules*
Austria[1]	Australia	Belgium
Canada	Slovakia	Czech Republic
Finland	Spain[3]	Denmark[5]
Greece	United Kingdom[4]	Hong Kong, China
Mexico		Hungary
Norway[2]		Italy
Switzerland		Korea
Turkey		Netherlands
		Poland
		Portugal

1. General regulations for limited companies, with similar regulations for mutuals.

2. Limit on the percentage of shares in a single company that may be voted.

3. General rules (code of conduct regarding temporary investments for mutuals).

4. ISC code.

5. Legislation prohibits insurers from obtaining and exercising dominant influence over non-financial entities.

37. Under normal operating circumstances (*i.e.* no bankruptcy exists), most countries allow the representation of an insurance company's shareholder rights to be delegated to another entity, usually without restriction. Switzerland is a notable exception in that it does not allow insurers to delegate their voting rights to outside third parties. In Italy, such a transfer is allowed in principle, but the exercise of voting rights cannot be delegated permanently to another entity. Rather, the proxy can only be given for a specific meeting of the shareholders. In most cases, the treatment of insurers regarding the exercise of voting rights is the same as for any other company, with responsibility for making decisions about voting and other shareholder rights being vested with the board of directors or other governing body. In a few countries (*e.g.* Denmark and Hong Kong, China) the chief executive officer and senior management share this responsibility. In a number of countries, there may be joint responsibility, while in the United Kingdom, the company itself is responsible.

Table 17 Entity authorised to make voting decisions regarding shares for insurance cos.

Insurance Company	*Bd. of Dirs. or governing body*	*General Assembly*	*Senior management*	*Other*
United Kingdom	Australia Austria Canada Denmark Greece Hungary Italy Japan Korea Netherlands Norway Poland Portugal Slovakia	Czech Republic Finland Greece Japan	Denmark Hong Kong, China	Mexico[1] Slovakia[2]
	Spain			
	Sweden			
	Switzerland			

1. It is compulsory for insurance companies to have an Investment Committee, which among its other functions makes recommendations in this regard. The Investment Committee is responsible to the Board of Directors.

2. Supervisory Board.

38. Life insurance is generally characterised by contractual relationships between the company and policyholders (or beneficiaries) that extend over many years. Usually, life insurers collect premiums for products and services well before those services are in fact rendered. The underlying products may be relatively straightforward protection products, which promise to pay the beneficiary stipulated sums in cases where a certain insured event occurs, such as accident, incapacity or death, or they may take the form of capitalisation products, which enable the policyholder to accumulate savings in tax sheltered form during an accumulation phase. The funds are then invested by the insurer to produce a stream of income the beneficiary receives during a subsequent payout phase. Given the typically long-term nature of the contracts, many of the relevant factors can change, including the rate of inflation, nominal investment returns, and even mortality rates. As a consequence of the various uncertainties and in the context of consumer protection regulations, most jurisdictions require insurance companies to disclose all relevant information concerning the insurance contract. The disclosure requirement may extend to the company's investment strategy in the case of life products containing an investment element, but it is rarely the case that insurance companies are required to disclose the exercise of any shareholder rights associated with the underlying investments.

39. In most countries, there is no precise role for insurance companies as corporate monitors. As with other types of investors, many insurers choose share selection and exit as mechanisms for corporate governance. In a small number of cases, the sector is thought to be at least moderately effective in exercising its shareholder rights, but in many other cases the issue has not been specifically addressed and the participation of insurance companies in corporate governance remains a subject of debate.

Table 18 Life insurance companies as corporate monitors

Disclosure of exercise of shareholder rights required	***Regulatory measures or industry practices to promote monitoring activities***	***Restrictions on shareholdings or on exercising control of companies***	***Effectiveness of insurance cos. as corporate monitors***		
			Effective to moderately effective	**Not effective**	**Not known**
Australia[1]	Austria	Australia	Canada	Korea	
					Australia
Slovakia	Canada[4]	Canada	Slovakia	Netherlands	Belgium
Spain[2]	Czech Republic	Denmark	United Kingdom		Czech Republic
United Kingdom[3]	Greece[4]	Finland			Finland
	Italy	Greece			Hong Kong, China
	Korea[4]	Hungary			Italy
	Mexico	Italy			Japan
	Slovakia	Japan			Mexico
	Sweden	Korea			Norway
	Switzerland[4]	Mexico			Poland
	United Kingdom[4]	Norway			Portugal
		Poland			Spain
		Portugal			Sweden
		Slovakia			Switzerland
		Spain			Turkey
		Switzerland			
		Turkey			
		United Kingdom			

1. In the case of life insurance products with investment components, there is a requirement to disclose information about the investment strategy, which may, but need not, include information about the exercise of shareholder rights.

2. General rules exist.

3. Not required, but the ISC code of best practice on activism recommends that all institutions have a publicly available voting policy.

4. Industry practices.

IV. Pension Funds

Governance of pension funds

40. Pension funds exist in most OECD Member countries as financing vehicles for pension plans or schemes. The pension plan category, in turn, is in common parlance bifurcated into "defined benefit" schemes[8], in which the sponsor of the plan agrees to provide the beneficiary with a continuing flow of benefits upon retirement, and "defined contribution" schemes, whereby the beneficiary accumulates assets in a special fund that can be used to produce a stream of retirement income. However, the differences between the two types are perhaps not as clear-cut as this characterisation would seem to suggest and such a categorisation fails to depict adequately the variety of schemes in practice in the OECD area and the varied nature in which they are financed and managed. For a complete taxonomy, numerous other distinctions must be drawn. For instance, there's the distinction between "private" versus "public" schemes. A distinction also can be drawn between "mandatory" and "voluntary" (meaning the employee has the choice of whether to join or not) schemes. In some countries, opt-out provisions are provided, while in others, one finds involuntary adhesion by workers. Another distinction is between "occupational" versus "personal" plans. Institutional arrangements in the case of occupational schemes are quite complex, but typically use either pension funds or life insurance companies as financing vehicles. In some cases (*e.g.*, Anglo-Saxon *cum* Dutch countries) the labour contract is really the focal point of regulatory/supervisory initiatives. Personal schemes typically make use of financial institutions that are themselves already regulated. In some countries (*e.g.*, in Hungary, Poland and Mexico), policy dictates the use of particular types of institutions to manage pension funds. Finally, membership in pension funds may be "closed" in which case the funds are restricted to certain employees (*e.g.* those of a particular employer or group of employers), or "open", which are not restricted as to membership.

Table 19 Nature of membership in pension funds

Open funds only	Closed funds only	Both open and closed funds
Czech Republic	Austria	Australia
Korea	Belgium	Hong Kong, China
Mexico	Canada	Hungary
Turkey	Denmark	Iceland
	Finland	Italy
	Germany	Poland
	Greece	Portugal
	Ireland	Spain
	Japan	Switzerland
	Netherlands	United Kingdom
	Norway	
	Sweden	
	United States	

41. The pension fund sector in most OECD countries operates under a complex legal infrastructure, involving interactions among social security, tax, financial and insurance activities. Pension vehicles

[8] Only a relatively small number of OECD countries (*i.e.* Canada, Japan, the Netherlands, Switzerland, the United Kingdom and the United States) make widespread use of defined benefit funded pension plans.

themselves may have independent legal personalities, as in the case of many autonomous pension funds, or they may exist in non-autonomous form as reserves or other assets (*e.g.* book reserves) that are not legally separate from the plan sponsor or administrator. Autonomous pension funds may be further delineated into institutional types – independent legal entities with legal personality and capacity – and contractual types, which are characterised by legally segregated pools of assets, but without separate legal personality and capacity. Both institutional and contractual arrangements can be distinguished according to whether plan members have legal ownership or beneficial ownership of the pension fund assets.

Table 20 Nature of members' ownership title to the assets in autonomous pension funds

	Legal title	**Beneficial ownership**
Legal personality and capacity (institutional form)	Corporate form	Foundation form, trust
No legal personality or capacity (contractual form)	Individual contractual form	Collective / group Contractual form

42. In the corporate form, plan members have legal title to the pension fund assets or capital. By contrast, in the foundation form, plan members are beneficiaries of the investment returns from the assets, but do not have legal title to the assets themselves, except possibly under some rare circumstances such as bankruptcy. In the trust form, the pension fund assets are held in trust and legal title to said assets is vested in trustees, who must administer the trust assets in the sole interest of the plan participants. Plan members in the case of the individual contractual form also have legal title to the pension fund assets, while in the collective or group contractual form plan members are the beneficiaries of the investment returns on the assets.

Table 21 Legal structures for pension funds

Contractual form	***Corporate form***	***Foundation form***	***Trust form***
Australia[1]	Austria	Denmark	Australia
Czech Republic	Germany[2]	Finland	Canada
Germany	Italy	Greece	Hong Kong, China
Italy	Mexico	Iceland	Ireland
Japan	Switzerland[3]	Japan	United Kingdom
Korea		Netherlands	United States
Poland		Norway	
Portugal		Sweden	
Spain		Switzerland	
		Turkey	

1. only for Retirement Saving Accounts.

2. mutual assurance association

3. co-operative society

43. Whatever the particular institutional structure of pension funds, the long-term nature of pension arrangements and the separation of the ownership (legal or beneficial) of the assets from their management exposes institutions and individuals to a number of risks, some of which are more pertinent to public

schemes (*e.g.* questions of eligibility and adequacy of benefits), while other risks (*i.e.* financial risks such as under funding, investment risk and interest rate risk) are associated with private (read funded) schemes. In addition, there may be agency problems associated with asymmetric information, adverse selection and moral hazard, and all arrangements face the potential for fraud or other outright misappropriation of the fund assets. Against this background, government intervention is deemed necessary to avoid systemic criseis and to ensure the financial and actuarial sustainability of the private pension system in order to protect the interests of its members. However, the various distinctions in the types of pension schemes result in a number of basic institutional modalities that call for different regulatory/supervisory approaches. In the case of occupational schemes, for example, whereby the employer basically serves as a passive link between the provider and the participant worker, the role of the regulator/supervisor is principally to ensure compliance with the terms of the contract and to be sure that tax non-discrimination rules are not breached. Voluntary and mandatory schemes also raise different governance issues. The task for regulatory and supervisory authorities is to determine which type of governance framework is best suited to the plans they oversee. Not surprisingly, the specific approach to regulation of the sector varies across OECD Member countries, but in most cases typically includes some combination of prudential standards, investment regulations, and mechanisms to facilitate monitoring of fund managers, internal controls, and redress for plan members and beneficiaries.[9]

44. A key aspect of the governance structure for pension funds concerns the responsibilities of the governing body, including the suitability of serving members. Generally speaking, the governance framework of a pension fund reflects its legal form. Thus, where pension fund regulations provide for the corporate form the board of directors typically plays a key role in ensuring that the fund serves the interests of the members and beneficiaries of the plan. With the contractual form, an independent financial institution that manages the fund has this responsibility, while the trust form relies primarily on independent trustees to perform the internal oversight role. Obviously, where multiple legal forms are allowed, different entities may have primary responsibility for the internal oversight role, depending on the particular form. In addition to the main governing and oversight bodies, there typically are other specialist entities required to perform such duties as actuarial analysis, auditing, custody of assets, etc.

[9] For a complete discussion of the topic, see Annamaria Marossy and Juan Yermo, "Pension Fund Governance" [DAFFE/AS/PEN/WD(2000)14/REV2]. The OECD Working Party on Private Pensions has approved guidelines for pension governance [DAFFE/AS/PEN/WD(2001)2/REV5] and for the protection of the rights of members and beneficiaries [DAFFE/AS/PEN/WD(2002)17/REV3].

Table 22 Main governing and oversight bodies of pension funds

Internal entities					External entities	
Auditors	***Board of Dirs.***	***CEO /senior management***	***General assembly***	***Trustee***	***Management co. or plan administrator***	***Custodian***
Italy	Austria[6]	Denmark	Czech Republic	Australia	Iceland	Italy
Japan[1]	Belgium	Finland	Hungary	Austria	Italy[4]	Poland
Turkey	Czech Republic[6]	Norway	Italy[2]	Canada	Japan[5]	Portugal
	Denmark		Poland	Hong Kong, China	Mexico[7]	Spain
	Finland		Sweden[3]	Ireland	Poland[6]	Turkey
	Germany[6]			United Kingdom	Portugal	
	Greece			United States	Spain	
	Hungary				Turkey	
	Italy[2]					
	Japan					
	Korea					
	Mexico					
	Norway					
	Portugal					
	Sweden					
	Switzerland					
	Turkey					

1. In the case of Employee pension funds.

2. For *closed* funds

3. For friendly societies

4. For *open* funds.

5. For tax-qualified plans.

6. Also Board of supervisors; Supervisory Board.

7. Also Compliance Officer.

8. Pension plan control commission; pension fund control commission.

45. Rules in many jurisdictions allow governing bodies of pension funds to delegate some of their functions to external service providers, but they retain a legal and fiduciary responsibility for the operation and oversight of the fund. To ensure that members of the governing body are capable of exercising this responsibility, regulations in many OECD countries impose a number of requirements on all parties involved in the administration of a pension fund. The criteria may be used to disqualify those persons who fall into certain categories (*e.g.* in the process of bankruptcy or under administration, previous criminal offences, connected party relationship, etc.), or they may set minimum standards that acceptable candidates must satisfy (in terms of age, education, professional experience, etc.). Where plans are contractual in nature and the funds are administered by a financial institution that is already subject to official oversight,

there may no additional requirements and reliance is placed on the standard ones that are applied to financial institutions in general.

46. In executing its fiduciary responsibilities, the governing body may be obliged to seek the assistance of professional service providers for some functions. For most operational tasks, with a few exceptions (*e.g.* asset management for foundations in Italy and Japan) rules generally allow, but do not compel, pension fund governing bodies to outsource to third parties. However, regulations in many OECD countries require the services of certain external service providers. These entities include actuaries (in the case of DB plans), who project future liabilities and estimate the financial solvency of the pension plan, and auditors, who verify that the fund complies with relevant rules and statutes. Custodians are required in a few cases to provide expertise in the transfer and control of assets, as are benefits providers (often insurance companies), which take responsibility for making remittances to beneficiaries. Most OECD countries subject a pension fund's investment activities to official supervision. This oversight in some countries takes the form of quantitative investment restrictions, though typically less restrictive than for insurance companies, while other countries adhere to a prudent person rule for pension funds, with only a few restrictions, such as limits on investments in shares of the sponsoring employer. As part of this process, most OECD countries require a pension fund's investment management to be executed by persons or entities authorised to act as asset managers. In the case of funds set up in the contractual form, this function is typically carried out by banks, insurance companies or professional asset managers, but the governing body of a fund with the corporate or trust form may execute this function itself if it has the relevant authorisation.

Table 23 Other specialist bodies participating in the governance structure of pension funds[1]

Actuary	*Asset manager*	*Auditor*	*Benefit provider*	*Custodian*
Australia[2]	Hong Kong, China[3]	Australia	Italy[8]	Canada
Austria	Italy[6]	Austria	Mexico[9]	Czech Republic
Belgium[2]	Japan	Belgium	Poland[10]	Germany
Canada		Canada	Spain[11]	Greece
Denmark		Czech Republic		Hungary
Finland		Denmark		Italy
Germany		Finland		Mexico
Greece		Germany		Poland
Hong Kong, China[3]		Greece		Portugal
Hungary[4]		Hong Kong, China		Spain
Iceland		Hungary		Turkey
Ireland		Iceland		United States[12]
Japan		Ireland		
Netherlands		Italy[7]		
Norway		Japan		
Slovakia		Korea		
Spain		Mexico		
Switzerland[5]		Netherlands		
Turkey		Norway		
United Kingdom		Poland		
		Portugal		
		Spain		
		Sweden		
		Switzerland		
		Turkey		
		United Kingdom		
		United States		

1. Statutory (obligatory).
2. DB plans.
3. ORSO registered contracted-out plans.
4. Required for mandatory plans, but may be replaced by external expert.
5. External expert is obligatory.
6. For *closed* funds.
7. For *open* funds.
8. Must be an insurance company unless the fund has received specific authorisation.
9. Insurance company.
10. Special annuity company.
11. Pension management entity.
12. Must be independent of the asset manager.

Governance activities by pension funds

47. A few large-scale corporate defaults in the past couple of years have exposed conflicts of interest and other governance problems of financial institutions. In the process, these events have served anew to clarify the importance of the monitoring role of shareholders. Though this debate has been active of late, it

is not a recent development. For example, in both the United Kingdom and the United States, there have been calls for some time for greater involvement by pension funds and other institutional investors in corporate affairs. In the UK, the Cadbury Report of 1992, written in the aftermath of the Maxwell scandal, recommended that institutional investors, including pension funds, make more active use of their voting rights and seek high-level contact with companies. In particular, it recommended that institutions monitor boards closely when there is a high concentration of power in the hands of the chief executive. In the United States, the Department of Labor in the mid-1980s issued bulletins calling for non-public pension funds to exercise the voting rights attached to their equity investments "on issues that may affect the value of the plans' investment". In 1994, the Department of Labor formalised this recommendation into a requirement under the Employee Retirement Income Security Act (ERISA)[10], ruling that decisions on voting were fiduciary acts of plan management that must either be made directly by trustees or delegated wholly to external managers. Pension funds in a handful of other OECD countries also are subject to statutory rules regarding their voting decisions, while industry codes to that effect exist in a few others.

Table 24 Countries with statutory or industry codes on voting by pension funds

Statutory code	*Industry or other non-statutory code*	*No specific rules*
Canada	Australia	Austria
Czech Republic	Japan	Belgium
Finland	Netherlands	Denmark
Greece	Spain	France
Japan	Sweden	Germany
Norway[1]	United Kingdom[2]	Hong Kong, China
Switzerland		Hungary
Turkey		Iceland
United States		Ireland
		Italy
		Korea
		Mexico[3]
		Poland
		Portugal
		Singapore
		Slovakia

1. Limits on percentage of shares.

2. ISC, also Myners principles

3. Investment in shares is not allowed.

48. Public sector pension funds in the United States, such as the California Public Employees' Retirement Systems (CALPERS), while not subject to the ERISA regulations, have been active shareholders for at least a decade, but the role of pension funds in corporate governance has otherwise been muted, so far. Many private sector funds in the United States, despite having large asset bases and a long-term investment perspective, have rarely been as active as their public sector counterparts and a recent paper on occupational pension funds in the UK concludes that they, too, have not been effective as corporate monitors, in the sense that firms in which the funds are large shareholders have neither complied better with the Code of Best Practice nor outperformed their competitors.

[10] For example, in the U.S., corporate pension plans are governed by ERISA; public pension plans, bank trusts, and insurance companies are governed by the common law of trusts; and mutual funds are governed by state corporate law and the Investment Company Act of 1940.

49. As mentioned above in the context of governance activities by other types of institutional investors, numerous factors can influence shareholders' incentives to monitor firms, including the legal system and institutional arrangements under which the investors operate, as well as the size, investment horizon and institutional culture of the investors themselves. In the case of pension funds, relevant considerations arise most often in the context of investment management. For instance, funds that delegate the investment function to external fund managers might be less likely to play an active role in corporate governance than internally managed funds, because they would not able to extract any economic rents from their activism. A fund managers' interest in active corporate governance as opposed to active portfolio management also could differ to the extent that the fund is of a defined benefit versus a defined contribution nature, as this distinction might affect the investment horizon of the fund.

50. The type of plan is also an important consideration. In the case of occupational plans, for example, there are two parties involved in the administration of the pension fund – the employer or plan sponsor and the pension fund governing body. In personal pension plans, by contrast, there is only the governing body of the fund itself.

Table 25 Entity authorised to make voting decisions on shares held by pension funds

Bd. of Dirs. or governing body	***Foundation board***	***Investment manager***	***Fund managing company***	***Plan sponsor***	***Trustee***
Denmark	Netherlands	Czech Republic	Denmark	Canada	Australia
Finland		Finland	Japan		Hong Kong, China[4]
Greece		Hong Kong, China[2]	Poland		United Kingdom
Hungary		Japan	Portugal		
Italy[1]			Spain[3]		
Norway			Turkey		
Sweden					
Switzerland					

1. For *closed* funds. For *open* funds, it is the board of the financial institution that manages the fund.

2. MPF schemes

3. *Entidad Gestora*, the managing entity.

4. ORSO registered contracted-out plans. For non-ORSO registered contracted plans, it's the trustee or an authorised insurer.

51. Most OECD countries allow the representation of a pension fund's shareholder rights to be delegated to another entity. In a few cases (*e.g.* Canada, Denmark, and Sweden), voting proxies can be transferred without conditions. A few other countries allow the delegation of voting proxies, but subject to certain restrictions. In Italy, for example, such a delegation is permissible, but only in reference to a specific shareholder meeting, as in the case of insurers. Furthermore, the proxy itself must specify the delegated entity and the specific voting instructions. In Poland, representation of a pension fund's shareholder rights is only permissible in the case of Occupational Pension Funds. In Portugal, the transfer is possible, but only to credit institutions and authorised asset management institutions. Countries where such a proxy delegation is not permitted include the Czech Republic, Finland, Greece, and Turkey.

52. A factor that is often mentioned as favouring increased activism by pension funds is the large and/or growing size of their investment holdings in many countries. Given the problem of "free riders" and other spill-over effects, many analysts have argued that only a large shareholder has the incentive to undertake monitoring or other costly governance activities and the scale to have sufficient leverage over

management. Besides, large size in relation to the market makes an active approach to investment management difficult to execute, unless the institution is willing either to accept a relatively large drop in prices or to spread its sales over a long period of time. This relative illiquidity, combined with the advantages of indexing, has led some funds to invest sizeable portions of their portfolios in passively managed index funds, which effectively obliges them to hold long-term positions in certain stocks over a long period. Institutional portfolio managers following an indexed strategy must either accept a silent role in corporate affairs or take action to change management behaviour.

53. A few funds have opted for the latter strategy and a more active use of voting rights and more active interchange with management are now prominent features of the market in corporate control. However, there is still considerable heterogeneity among funds. There are substantial differences in investment strategies, goals of proposal activity, definitions of targeting success, and their propensities to publicise their views. For example, an indexed fund has an incentive to promote spill-over effects that boost the performance of the stock market overall, rather than that of specific stocks, while a fund with an active investment strategy has less incentive to publicise its governance activities, since the free-rider problem would come into play once the market learned of its intention to monitor.

54. Internal statutes and external regulations are among the factors that influence the extent to which pension funds become active shareholders of private corporations or play a silent role via purchases and sales of their holdings. Rules may impose direct or indirect qualitative controls on the role of pension funds in corporate affairs. These include for example, rules covering participation in shareholder meetings, on voting alliances between different pension funds, and on the election of boards of private corporations. One type of quantitative restrictions that has a direct impact on the extent to which pension funds can play a role in corporate governance is an ownership concentration rule. In Canada, pension funds may not own more than 30% of the voting shares of one company, while in Italy, the holding of shares is limited to 15% of the fund's assets and funds, in any case, are not allowed to control or manage the companies in which they invest. In some other cases (*e.g.* the United Kingdom), rules are expressed in terms of a fund having sufficient diversification. Many countries establish limits on investment by a pension fund in shares of the sponsoring company.

Table 26 Pension funds as corporate monitors

Disclosure of exercise of shareholder rights required	***Regulatory measures or industry practices to promote monitoring activities***	***Restrictions on share holdings or on exercising control of companies***	***Effectiveness of pension funds. as corporate monitors***		
			Effective to moderately effective	**Not effective**	**Not known**
Australia[1]	Australia	Australia	Canada[6]	Finland	Belgium
Canada	Netherlands[3]	Canada	Netherlands[7]	Hong Kong, China[9]	Greece
Japan	Sweden[4]	Czech Republic	United Kingdom[8]	Italy[9]	Hungary
Portugal	Turkey	Denmark		Korea	Japan
Spain	United Kingdom[5]	Finland		Poland[9]	Norway
Switzerland		Greece			Portugal
United Kingdom[2]		Hong Kong, China			Spain
		Hungary			Switzerland
		Italy			
		Japan			
		Korea			
		Mexico			
		Netherlands			
		Norway			
		Poland			
		Portugal			
		Spain			
		Switzerland			
		Turkey			
		United Kingdom			
		United States			

1. A fund is required to provide annual information about its investment strategy, which may, but need not, include information about general corporate governance practices.

2. Under voluntary, Myners Principles.

3. Non-binding code by the Foundation for Corporate Governance Research for Pension Funds

4. Guidelines on governance processes, internal information and control are issued by the supervisory authority for friendly societies.

5. ISC Code.

6. A few large pension funds are active as corporate monitors.

7. Funds have become more effective since the establishment of the Foundation for Corporate Governance Research for Pension Funds in 1998 (25 funds are members and manage over 80% of total assets invested by Dutch funds).

8. Trade body for pension funds, the National Association of Pension Funds monitors corporate governance and issues results from time to time, if it finds inadequate governance on the part of corporations. Occasionally this will lead to changes in practices.

9. Small size limits effectiveness.