



# **Conflicts of Interest in the Investment Management Sector**

**Sixth Tokyo Round Table on Capital Markets  
Reform in Asia.**

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# Collective Investment Schemes (CIS): Background

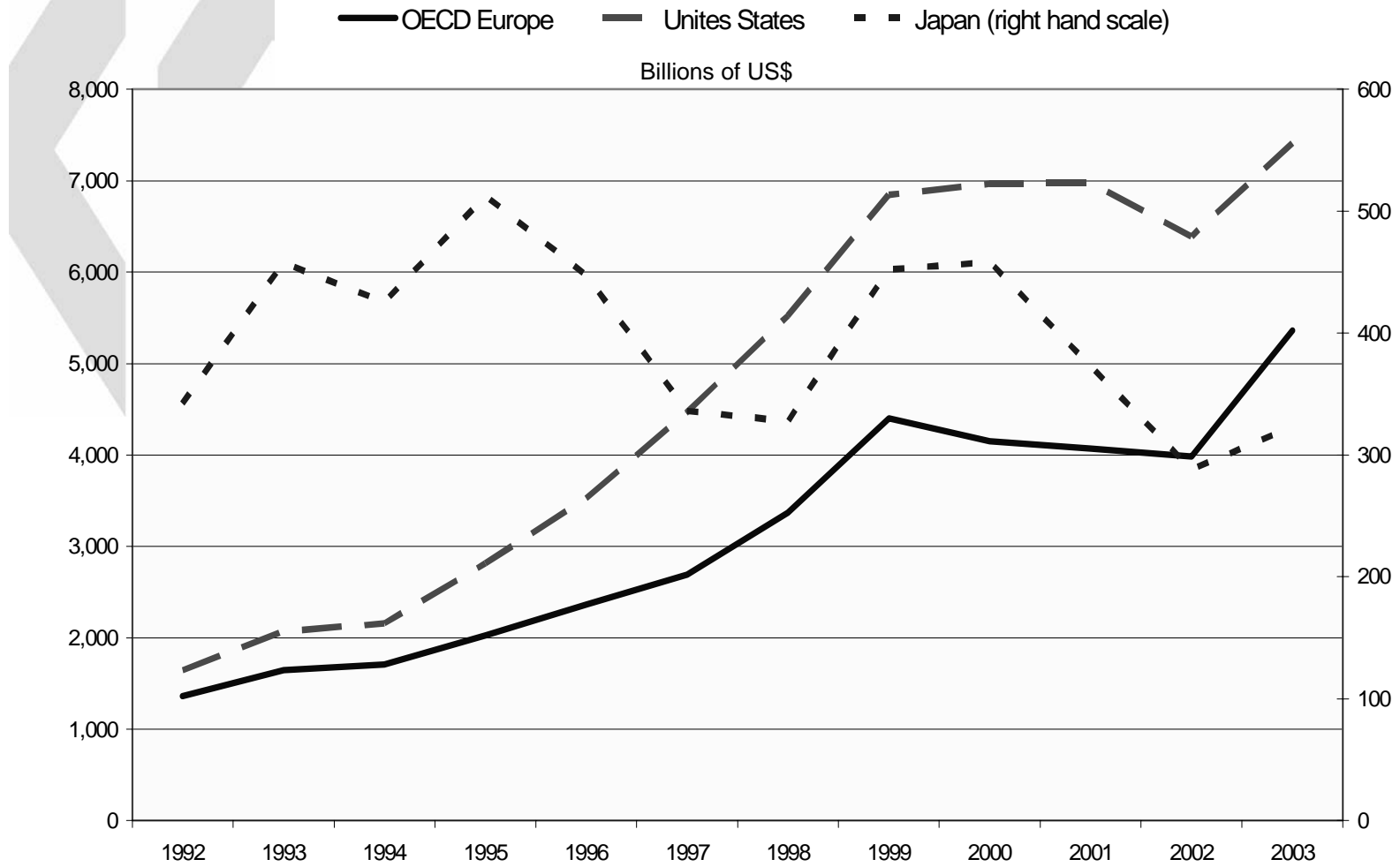
- Boom in Capital Markets 1980-2000
- Individuals increasingly prefer institutional investment to direct investment
- Pooling of savings by many small investors
  - Small investors cannot afford diversified portfolios
  - Small investors cannot make informed portfolio selection



# Characteristics of CIS

- Defined legal and governance structure
  - Special laws
  - Diversity of legal structure
  - Regulatory systems
  - Disclosure
- Professional management
  - Investment policy
  - Low cost execution
- Safeguards for investors

## Growth of CIS Assets, 1992-2003



Sources: FEFSI, ICI and the Investment Trusts Association, Japan

# Agency Dilemma in CIS

*Large pools of assets under control of financial institutions investors with limited ability to monitor*

- Asymmetry of Power and Information
  - Investors (small, often unsophisticated, dispersed)
  - Investment Manager/Operator
    - Control of information
    - Sophisticated
  - Outright Abuse: fraud / theft / misrepresentation
  - Conflict of Interest
  
- *How to assure that assets are managed on behalf of Investor?*

# 'First Generation' Reforms

- Outright abuses of agency relationship
- Theft
- Fraud
- Misrepresentation of portfolio
- Improper valuation

Solution: National and international laws, regulation and standards

- Investment Company Act of 1940 (USA)
- OECD Principles 1971
- EC/EU UCITS Directives 1985
- IOSCO Principles 1994

Issues Covered: Funds segregation, Disclosure, Valuation, Investment restrictions and policies



# Criticisms of CIS Industry

## **Long standing**

- High fees / Lack of transparency in fees and costs
- ‘Bunching’ around indexes
- Excessive trading
- Ineffective use of ownership rights in portfolio companies

## **More Recent**

- Failure to moderate excesses of pre-2000 boom
- Excessive support of incumbent management
- Late trading and market timing



# Typology of Conflicts of Interest

- Investment Manager vs. Investor
- Affiliated Financial and Non-Financial Companies
- Non-Affiliated Financial Companies

# Investment Manager vs. Investor

*Investment Manger's Objective = Maximize Assets under Management (AUM)*

*Investor's Objective = Maximum Return in Asset Class*

- Misrepresentation of investment 'Style'
- Style 'Gaming'
- *De facto* Indexing
- 'Style Drift'
- *Unclear investment policies*
- *Favoritism to certain investors (late trading, market timing)*



# Affiliated Companies

- Cross subsidization
- Allocation of costs
- Excessive trading (churning)
- Use of affiliated intermediaries
- Support of securities underwritten by affiliates
- Support of securities of companies with banking relationships
- Favoritism to certain investors (to generate earnings in affiliated companies)
- Support of affiliated non-finance companies, i.e. 'captive' finance

# Non-Affiliated Financial Companies

Disaggregation of function; 'Open Architecture'

- Operator
- Investment Manager
- Distributor
- Independent Financial Advisor

Opacity concerning the accountable entity

'Layering' of fees

Opacity concerning fees and expenses



# Use of Ownership Rights

CIS are increasingly important owners of equity

Disinclined to be active investors

- Uncertain demand from final investors (performance *not* governance)
- Financial costs of activism
- Hesitant to oppose management

*Criticism: CIS represent final owners of capital but have not pushed hard enough for better corporate governance ('Asleep at the wheel')*

# Use of Ownership Rights....cont.

## Solutions

- Disclosure of Corporate governance policies of CIS
- Industry codes of conduct
- IOSCO declaration (2003)
- US / SEC requirements for disclosure of voting



# The Nature of CIS

- Are CIS investment companies or products?
- Is the investor best protected by disclosure and the ability to exit or by internal safeguards?
- Does the operator have an ongoing fiduciary duty to the investor or is full disclosure sufficient?

# The Ultimate Weapon: Transparency and Disclosure

*Investors can liquidate positions at will*

*Investors now have access to a vast body of information to support informed decisions*

## Disclosure

- Mandatory
- Voluntary

Information increasingly available on a comparable basis, standardized presentation, ratings for :

- Performance
- Fees and Expenses
- Governance

# Investor Access to Information

Popular press

Specialized press (ex: *Money* magazine)

Information service providers

- Lipper
- Morningstar
- S&P

*Use of information technology*

recent innovation ratings of CIS governance  
(Morningstar)

Database of companies accused of malfeasance



# Strengthening Governance

- Firm level initiatives
  - Trust is an asset; firms must protect reputation
- Industry Associations
  - Voluntary Codes and Best Practices
- Official Regulation
  - Reviews of rules and practices
  - New rules
- Sanctions
- International Standards
  - IOSCO
  - EU

# Case Study: Strengthening Governance in the USA

- Internal firm reviews of practice
  - Compensation
  - Firewalls
  - Compliance
- Enlarged role for independent directors (voluntary and mandatory)
- Stronger requirements for independent and adequacy of time and information
- Governance information and ratings by Morningstar
- Global settlement (SEC and state attorneys general)
- SEC Requirements for disclosure of voting practices
- Corporate governance policies on websites



# OECD Discussion Paper on CIS Governance

- Legal and Institutional Framework
- Rights of Investors
- Role of the Private Sector
- Market Discipline and Market Infrastructure
- Transparency and Disclosure
- Internal governance of CIS

# OECD Discussion Paper: Going Forward

- Coordinated with IOSCO
- Discussed with investment management industry
- Posted on OECD website
- Comment period ended 15 September 2004
- Discussed by Financial Markets Committee October 2004
- Released in revised form