

## White paper on Governance of Collective Investment schemes (CIS)\*

### Introduction

Collective Investment Schemes (CIS) have been one of the most significant developments in financial intermediation during the past few decades. OECD data indicate that CIS assets have been rising sharply as a share of national income and a share of financial assets in most Member countries. In addition to functioning as an effective vehicle for individuals to implement their preferred investment strategies, CIS already play a major role in providing for retirement income. This role is likely to grow in coming years, as increased responsibility is placed on the average citizen, as opposed to governments or companies, in meeting critical needs such as education, retirement and health care. In this context, CIS can be used, either alone or in combination with other forms of institutional savings, such as pension funds and insurance products, to enable individuals to meet their financial planning goals.

Overall, the experience of the investing public as well as policy makers has been highly positive. CIS have enabled even fairly small investors to participate in the strong growth of capital markets in the past two decades. CIS make it possible for relatively small investors to obtain diversified investment portfolios with professional management at reasonable cost and to execute a widening range of investment strategies. Consequently, CIS have been instrumental in raising the financial sophistication of the population.

Over the years, both regulators and the CIS industry have realised that it is important to maintain robust systems to avoid conflicts of interest and to protect CIS investors. More recently, in the context of the current review of governance in

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\* This White Paper originated as a discussion note that was considered by the OECD's Committee on Financial Markets. It also benefited from comments from members of IOSCO's Standing Committee 5 on Investment Management. An earlier draft was posted on the OECD website and comments were received from the private investment management industry and other interested parties. The White Paper is being made public in order to contribute to the current debate on improving governance of collective investment schemes (CIS). It can also be accessed at [www.oecd.org/daf/financialmarkets](http://www.oecd.org/daf/financialmarkets).

the corporate and financial sectors by the OECD, as well as in response to a number of reported cases where CIS have fallen short in fulfilling their duties to investors, officials concerned with the structure and regulation of financial systems in OECD countries have been increasingly interested in the governance of CIS. Officials concerned with the structure and regulation of financial systems include those in finance ministries and central banks who are concerned with the overall functioning of financial systems as well as officials directly involved in financial market oversight.

The concern of officials with the functioning of the CIS sector has several sources. In the first place the efficiency of the financial system, of which the CIS sector is an increasingly important part, has a significant impact on macroeconomic performance as reflected in indicators such as growth, inflation and income distribution. It also affects the ability of the economy to respond flexibly to challenges such as the application of technology to economic problems, structural adjustment and ageing populations. The growth of CIS is one manifestation of the growing reliance on capital markets and on institutional investors, as opposed to on-balance sheet lending by banks, in financial intermediation. Intermediation through the capital market has the potential to promote greater efficiency in the economy, provided that a sound institutional, legal and regulatory framework is in place. Additionally, intermediation through the capital markets can best promote efficiency in the real economy if institutional investors and asset managers can be relied upon to deploy assets on behalf of investors.

Secondly, financial officials have a strong concern with financial stability. In this connection, financial markets have been shaken by serious crises in the past two decades. In some cases, crises have resulted in losses of national income, costly official rescues and sizable losses to individuals. Therefore, public policy has a major interest in identifying measures that enhance systemic stability through transparent markets and well-supervised institutions with sound governance regimes.

Finally, investor protection is a major objective of public policy in the financial sector. It is recognised that capital market activity inherently involves risk taking and thus the goal of investor protection is not to prevent investors from incurring losses that occur due to developments in financial markets. Rather, it is to assure that a solid framework exists in which risk is voluntarily assumed under fair and transparent conditions.

The concept underlying CIS is simple. CIS are a form of institutional investment through which individuals pool their funds and hire professionals to manage their investments, with each investor entitled to a proportional share of the net benefits of ownership of the underlying assets. Whatever its legal form, a CIS generally consists of: i) a pooling of resources to gain sufficient size for portfolio

diversification and cost-efficient operation and *ii*) professional portfolio management to execute an investment strategy. In its broadest sense the operation of a CIS can be conceived of a set of arrangements through which a CIS operator, inside an established legal, regulatory and market framework, offers the public a vehicle embodying a specified investment mandate communicates essential facts about the CIS to investors and implements the investment strategy on an ongoing basis. In most cases, the CIS also contains a set of legal, institutional and market-based safeguards to protect the interests of the investor. Somewhat analogously to the task often postulated for the governance regime of an operating company, the governance regime of a CIS is designed to align the interests of the CIS with those of its investors and to provide equitable treatment for those investors.

CIS are not exclusively used by small investors. Sophisticated individual investors and institutional investors also use CIS. However, owing to their critical role as an investment instrument for smaller savers and to their widespread applicability in providing for their future needs for retirement income, it is imperative to have systems that adequately protect the interests of small investors. Additionally, the equitable treatment of various categories of investors is a key objective in constructing a sound system of governance for CIS.

The most commonly used vehicle for collective investment is the open-ended CIS in which investors may buy and sell units at net asset value at rather frequent intervals. This paper is specifically meant to apply to open-ended CIS that are marketed to the general public.

The CIS sector is characterised by complex agency relationships and asymmetry of information and market power. Large amounts of assets are owned by a dispersed group of investors with incomplete information. The assets are under the control of institutions with considerable power to control flows of information. These asymmetries of power and information require transparent and disciplined procedures to ensure equitable treatment of investors.

Even the most sophisticated investors tend to concentrate their analytic efforts on the relative performance, risks and costs of CIS as well of the suitability of each CIS for the investor's objectives. Relatively little effort is ever expended on assessing the governance of CIS, except in cases where serious lapses in governance come to light. Indeed, by the nature of the governance process, it would be impractical for the individual investor to assess governance systems of CIS. At the same time, individual investors cannot make informed decisions unless the governance process functions satisfactorily. Consequently, it is incumbent upon public policy, the CIS industry and individual CIS to assure that robust governance structures are constructed and maintained to safeguard the interests of investors and maintain their confidence.

This emphasis on the internal governance of the CIS is consistent with the paradigm of modern financial supervision in which the supervisor relies increasingly on the internal governance and risk management procedures of the supervised entity and on market discipline and less on direct controls on the supervised entity. The governance system of all financial institutions is expected i) to monitor management on behalf of shareholders and stakeholders such as depositors and ii) to ensure that all supervisory, regulatory and risk management requirements are met. Official financial supervision is concerned mainly with assessing the adequacy of governance systems and taking remedial actions when shortcomings are found.

The purpose of this paper is to suggest those elements that constitute a robust regime of governance for consideration by policy makers and by the CIS industry. Private market participants and officials may wish to consider the analysis in this paper when assessing their own CIS systems and considering improvements.

This paper is intended to be consistent with and to build upon the work of other international bodies. In particular, the International Organisation of Securities Commissions (IOSCO) has developed a detailed set of principles of securities regulation, which include principles for the proper regulation and supervision of collective investment schemes, and a detailed methodology to allow assessment of the extent of implementation of those principles.<sup>1, 2</sup> The suggestions in this paper are not intended to supersede or conflict in any way with those principles. Rather, they seek to provide additional analysis to OECD members and the global CIS industry on designing and establishing an effective CIS investment framework.

This paper covers six areas: I. The legislative and regulatory framework; II. rights of investors; III. the role of the private sector; IV. market discipline and market infrastructure; V. transparency and disclosure; and VI. the internal governance of the CIS. In the first part of each section the issue is discussed. At the end of each section, a brief conclusion is presented.

## **I. Legal and institutional environment**

### ***Legal framework***

While the potential benefits of a strong CIS sector are evident, experience clearly shows that collective investment should only take place through a formal legal and regulatory framework including a robust governance regime for CIS. When promoters of investment schemes are allowed to solicit funds from the broad investing public for collective investment without a well-defined legal and

regulatory framework, the risks are high of breach of the obligations of operators toward investors and of destabilisation of the financial system. The risk is particularly high since CIS typically manage assets on behalf of dispersed groups of investors who must depend on the governance system for critical aspects of monitoring of the CIS. Some of the investors may be high net worth individuals or institutions. However, CIS also attract the savings of smaller savers many of whom lack the time, financial sophistication and resources to analyse data in great depth or to take action against promoters.

Governance failures in CIS can span a wide range of problems. Chronicled abuses have included simple theft or misappropriation of assets, sales or redemptions at inappropriate valuations, deceptive promotion techniques, unclear title to assets, negligent or self-interested investment selection or management, poor disclosure about essential details of the undertaking, unreasonable fees, unenforceability of the obligations of the promoters and lack of an accountable party from whom redress can be sought. Some schemes have become insolvent, leading to very large losses for some investors. Some schemes may avoid the outright abuses categorised above but they may still operate primarily to the benefit of the promoters and other insiders rather than investors.

Reliance on market forces alone to force disclosure or on the legal system to provide redress after abuses have already occurred is insufficient. Furthermore, the toleration of collective investment activities operating outside the recognised legal framework for CIS undermines confidence in the entire financial system and may pose risks for financial stability.

Reflecting these considerations, most countries, including all countries with well developed financial markets, have enacted a body of legislation specifying the terms under which CIS may be offered. Such a framework is part of the broader system of capital market organisation and oversight.

Many countries make exceptions for larger, professional and sophisticated investors, who under carefully specified conditions may be authorised to form private investment partnerships targeted to more specialised investors. Such arrangements may entail lower costs and greater flexibility for the investor, but usually are characterised by higher risk, less liquidity and fewer safeguards for investors.

In nearly all OECD countries, basic laws specify the legal forms in which CIS may be offered to the public and also specify that an internal governance system must be established for each CIS. A number of legal forms for CIS are found in major OECD countries. These legal forms reflect each country's legal system and its own history. Some jurisdictions permit only one legal form of organisation for CIS while others allow more than one form. In analysing the legal structures of CIS in Member countries, an analysis by the OECD Secretariat identified three major

forms that were present in OECD countries, the corporate, trust and contractual forms.<sup>3</sup> Other analysts may categorise structures differently.

No legal form or governance regime for CIS has been accepted as inherently superior to other systems. Thus, each country must choose its own means of implementing international principles. In implementing international principles for CIS governance in their own jurisdictions, countries will wish to make use of the experience of countries that are acknowledged to have high quality CIS sectors.

While the legal framework and regulatory regime are intended for the protection of investors, it is important to make absolutely clear to investors that the objective of the legal and regulatory system is not to prevent or minimise losses to investors where such losses occur through developments in capital markets. CIS are market-based investment vehicles and they are not subject to the same prudential controls and safeguards as banks and insurance companies, for example. The principle that the investors must bear all inherent risks in their investment decisions, which characterises all capital markets investments, is valid in the CIS sector as well. The objectives of the investor protection regime are to protect investors against fraud, negligence and conflict of interests, to ensure that each CIS observes the rules of fair and transparent operation and that investors are adequately informed of the risks involved in their investment. The CIS executes investment strategies on behalf of investors while the investor selects the desired degree of risk.

It is advisable for the legislative framework and regulatory practice to be adapted to the level of development of the CIS sector and of the capital market generally. As markets grow more sophisticated and investors gain more experience and access to information, the authorities will tend to allow greater scope to innovate and to introduce new products.

### *Conclusion*

All collective investment schemes (CIS) that are promoted to the investing public should be required to operate through a recognised legal and regulatory framework. A sound legal and regulatory framework is one that encourages the development of an environment conducive to informed risk-taking. There is no universally accepted best legal form for CIS.

### ***The supervisory and regulatory authorities***

A robust supervisory and regulatory system is essential for the functioning and development of the CIS sector. The purposes of supervision and regulation for CIS are: i) to ensure that the interests of investors in CIS are protected and ii) to

bolster confidence in the CIS sector. In most cases, the legislation establishing the framework for the conduct of CIS business designates an official body that is responsible for CIS oversight. Usually, this is the same body that is responsible for capital market oversight, but in some countries responsibilities are shared with other bodies. In some cases the legislation governing CIS sets detailed rules, but in other cases significant rule-setting discretion will be left to the regulatory body. Generally, in more developed systems greater flexibility resides with the regulatory body, reflecting the greater complexity of financial products in those jurisdictions. Where necessary, the regulatory authority drafts regulations pertaining to all important aspects of CIS business not covered in legislation and enforces the laws affecting CIS and associated regulations.

In proposing new regulations, it is considered good practice for the regulatory authority to consult with affected parties as fully and openly as possible. Although the regulatory authority is expected to consult widely, final decisions should be based upon whether the proposed change advances the two objectives specified in the preceding paragraph rather than whether the measure in question is supported or opposed by the industry.

In order to carry out its functions, the regulatory authority requires sufficient staff with adequate training and remuneration. The regulatory authority also requires adequate legal power and independence to accomplish its investigatory and enforcement missions.

The functions of the regulatory authority include the granting of authorisations to engage in CIS business and the exercise of regulatory oversight over persons seeking to engage in CIS business. The regulatory authority reviews applications from persons or companies seeking to act as CIS operators, investment advisers or distributors. The regulatory authority may make a determination that they have the qualifications to engage in such business or may simply verify that they have no record of criminal or regulatory transgressions. In some cases, the supervisory body sets minimal capital requirements. The authority usually requires that each CIS submit documentation showing that the CIS has complied with all relevant norms and certifies that each CIS has met those norms. Following initial approval of CIS, the regulatory authority exercises ongoing supervision in respect of authorised CIS and periodically verifies continuing conformity with laws and regulations.

The regulatory authority ensures that each CIS establishes an internal system of governance consistent with the legal framework and that the system of governance is designed to ensure observance of laws, regulations and standards of investor protection. Following authorisation the regulatory authority verifies that an adequate system of governance is maintained.

In keeping with the concept underlying modern financial supervision, the authority tends to rely first on the internal governance procedures of each CIS and on market discipline to enforce laws and rules and to uphold standards. This is in keeping with the precept that primary responsibility for the conduct of a CIS lies with the operator of the CIS, not the regulatory authority. Generally, the regulatory authority will only issue directives or take direct enforcement action when there is reason to believe that internal governance systems and market discipline have not been sufficient to accomplish this purpose.

A considerable amount of cross border business takes place in the CIS sector. Cross border business requires some coordination between the regulatory authorities in the jurisdiction where the CIS is domiciled and the jurisdiction where the investment is made. In most cases of cross border investment, the regulatory authority in the jurisdiction where the CIS is offered to investors assumes primary responsibility.

### *Conclusion*

The regulatory authority plays a decisive role in creating the framework for CIS governance. One of the key roles of the regulator is to ensure that firms offering CIS have created the appropriate framework for governance.

### ***Standards, principles and best practices***

Countries in which CIS are well established have been perfecting standards within their domestic financial systems sector for decades. At the same time, there has been considerable sharing of experience among officials responsible for CIS oversight in various countries and articulation of common standards. As a result, a considerable body of international standards and best practices has evolved over the past few decades. The major objectives of international cooperation in CIS regulation include: *i*) to strengthen domestic legal and regulatory foundations for CIS in order to achieve greater investor protection; *ii*) to encourage equivalence in regulatory framework for funds for the purpose of eliminating cross-border barriers and facilitation of cross-border CIS offerings; and *iii*) to limit the potential for cross-border CIS activity to affect investors' interests adversely.

A small number of international bodies have played central roles in developing international standards. In 1971 the OECD issued "Standard Rules for the Operations of Institutions for Collective Investment in Securities".<sup>4</sup> This statement of principles represented a consensus among official bodies responsible for CIS on what minimum features should be required before a CIS could be authorised.

These Rules, which were accepted by the OECD Council, formed the basis for later work in achieving global standards.

In subsequent years, the International Organisation of Securities Commissions (IOSCO) has assumed the leading role in setting global standards as part of IOSCO's broader mission of promoting international cooperation among securities market regulators. In 1994, IOSCO issued "Principles for the Regulation of Collective Investment Schemes", and in 1997 issued "Principles for the Supervision of CIS Operators".

Both the OECD Standard Rules and the subsequent work of IOSCO address the basic features that all CIS should have in order to be acceptable for public offerings. Such features include an adequate legal and regulatory framework, the segregation of the CIS assets, the role of the depositary/custodian, norms for valuation of assets and the redemption of positions and the obligations of full disclosure.

The IOSCO statement of Objectives and Principles of Securities Regulation of 1998 contain four principles (numbers 17-20) that apply to CIS. The IOSCO Principles are one of the 12 global standards recognised by the Financial Stability Forum. IOSCO has also developed a detailed Methodology to measure the degree of compliance with its Principles. The Principles and the Methodology are used by the IMF and World Bank in Financial Sector Assessment Programmes under which the quality of financial market oversight is measured and needs for improvement are identified.

The initial statement of basic principles by IOSCO in 1994 gave rise to an ongoing effort to develop more detailed standards in the CIS sector. Part of the work of IOSCO involved the issuance of more specific standards covering issues such as oversight of operators or valuation of assets. Other documents provide factual information or analyses about policies and mechanisms in the major markets, without enunciating specific standards. The Emerging Markets Committee of IOSCO also has undertaken some work on CIS that is especially adapted to the needs of its members.

The IOSCO Technical Committee recently approved a mandate to establish broad general principles for CIS governance building on IOSCO's prior work, including the IOSCO Core Principles. IOSCO's Standing Committee 5 on Investment Management will prepare more detailed or additional principles that reflect the differences in the legal frameworks among SC5's members.

One result of this process of international cooperation has been the development of consensus concerning the characteristics of an acceptable CIS that may be offered to the investing public and of practices that CIS operators should be obliged to follow. A considerable body of norms and standards is available as

countries seek to develop their own CIS sectors and as they assess the conformity of proposed domestic rules to international principles.

International cooperation has also proceeded on a regional level. Most notably, the European Commission has also been actively promoting international standards among EU members. In 1985, the EC Council issued its initial Directive concerning “Undertakings for the Collective Investment of Transferable Securities” (UCITS). Additional UCITS Directives pertaining to CIS were issued in 2002. The objective of the UCITS Directives extended beyond the setting of standards and international norms that was undertaken by the OECD and IOSCO. The EC Directives aimed at encouraging harmonisation of domestic rules governing CIS within the EU and the facilitation of cross border dealings in particular types of CIS. The UCITS Directives lay down binding harmonised rules for management companies and CIS across the EU. The Directives contain basic governance principles that require EU member states to specify rules to implement the principles in their own jurisdictions. CIS meeting those criteria may be distributed through the EU.

Despite agreement on international principles for CIS governance, no legal form or governance regime for CIS has been acknowledged as inherently superior to other systems. Thus each country must choose its own means of implementing international principles. In implementing international principles for CIS governance in their own jurisdictions, countries may wish to make use of the experience of countries that are acknowledged to have high quality CIS sectors.

### *Conclusion*

Domestic standards and practices should be consistent with internationally accepted standards and principles developed by recognised international bodies. The legal and governance forms and practices in countries where high quality CIS sectors are found constitute an additional source of standards.

## **II. Rights of investors**

### ***Basic rights of investors***

Investors in CIS have rights that are granted by the laws and regulations governing all CIS in the relevant jurisdiction as well as by the rules of the CIS. This section specifies some basic investor rights that are typically recognised in all jurisdictions with strong CIS sectors. Investors have the right to expect competent management from the CIS, including accurate valuation of assets and the maintenance of accurate records of investors and their positions in the CIS, and to be protected against fraud negligence or conflict of interest. However, investor

protection mechanisms are not intended to protect the investor from any loss that may result from the faithful execution of a stated investment policy.

Investors are entitled to a proportional share of the benefits of investment of the assets of the CIS. The CIS assets will normally be held in such a form that the investors' claims to the assets of the CIS remain fully independent of the financial status of the operator, the investment adviser, the custodian or any other party. Each CIS has an obligation to establish systems that value the investments of the CIS and of the position of each investor accurately and in accord with transparent principles. The right to accurate valuation is particularly important since it determines the investor's position upon acquiring or redeeming units and in determining the current value of the investment.

Investors have a right to be informed about certain key features of the CIS, including the investment policies of the CIS, the assets held by the CIS and their valuation, financial performance, and costs and expenses of the CIS. The investor also has a right to be informed about how the CIS will use ownership and control rights, particularly voting rights that the CIS may have in companies in which it invests.

Investors in CIS may include individual investors of varying sizes and institutional investors. All investors in the same class are entitled to equitable treatment. Violations of this notion occur when the CIS uses different procedures for calculating net asset value (NAV) for different categories of investors or allows some investors to trade units of the CIS under conditions that are more favourable than those accorded to other investors. However, CIS may vary fees and commissions among categories of investors and classes of shares, provided that fee schedules are disclosed in a transparent manner

The legal and regulatory framework is expected to function to ensure that these rights are respected. The approval process will assure that CIS may only offer products that recognise these rights. In cases where investors allege that their rights have been violated, the legal and regulatory framework will make provision for investors to seek redress.

### *Conclusion*

The regulatory system, industry standards and each CIS should recognise certain basic rights of investors and maintain structures to protect those rights. Basic rights include protection against the insolvency of an operator or an investment manager. Investors have the right to management of the CIS in their sole interest. Investors have a right to competent management. Investors have the right to be informed about key issues related to the CIS and particularly about any issues

that will affect the value of their investment. Investors have the right to be informed about the use by the CIS of governance rights in companies in which it has invested. The CIS should treat all investors in the same class equally. In addition, investors in one class should not benefit to the detriment of any other investor. Investors should have the means to obtain legal redress through the regulatory regime and the legal system in cases where rights have been violated.

### ***Right of exit***

One of the essential characteristics of open-ended CIS is that investors can redeem their positions in the CIS at times of their own choosing within the bounds of the constitution or internal rules of the CIS. In general, positions in open-ended CIS may be redeemed at net asset value (NAV), which is the market value of all assets in the CIS net of expenses divided by the number of units in the CIS. A redemption fee may also be levied. The offering documents of the CIS explain when and how NAV is calculated for the purposes of redemption.

By contrast, in closed-ended funds, which are traded on exchanges, the operator has no responsibility to redeem positions. In the case of closed-end funds, which do not provide for the possibility to redeem the investment out of the CIS assets at frequent intervals, the offering documents should clearly disclose this fact, indicating the conditions under which the investment can be redeemed.

For some funds the nature of the underlying assets may be such that immediate redemption is not appropriate. For example, in some countries there are specific CIS which invest in residential or commercial real estate, or that hold mortgages. These assets are not immediately realisable. In the case of such CIS, the key principle is that assets are fairly valued so that investors know the value of their interest at any time, and that the rights of redemption provide a clear process for determining the price at which redemption will take place and the period within which the payment should be made. To avoid any possible market manipulation, the price should be determined as near as possible to the day of the redemption request. In cases where redemption are made at infrequent intervals and requests must be submitted long in advance of the time of redemption, the procedures by which the NAV will be calculated must be highly transparent and plainly disclosed to investors.

Redemptions are normally made in cash. In certain cases, CIS may be permitted to deliver securities instead of cash. Additionally, some institutional investors may prefer delivery in securities rather than cash. If such redemptions are permitted, they should take place on terms that are equitable for all investors.

In cases of significant market disruption where a market price cannot be fairly determined, it may be necessary for redemptions and subscriptions to be suspended. Any such suspension should be limited as far as possible, in the interests of preserving investor confidence. The constituent documents, or the regulatory system, should set clear parameters within which suspensions might be allowed.

### *Conclusion*

Investors should be able to redeem their investments in open-ended CIS at regular intervals and under transparent conditions.

## **III. The role of the private sector**

### ***Industry associations, self regulatory organisations (SROs) and firms***

While a strong regulatory regime is indispensable in maintaining a strong CIS sector, the private sector has an important role in promoting high standards. To some degree, it is the role of the supervisory authority to define what is legally permissible and to impose sanctions for transgressions. While the private sector is obliged to respect these rules, it also has the capability to encourage firms to go beyond what is strictly required and pursue the best possible business practices.

The promotion of high standards of business conduct is clearly in the collective interests of firms in the CIS industry because one of the foundations upon which the industry rests is public confidence. To the degree that investors believe that the industry can be trusted to act as their reliable agents, investors' willingness to commit funds to the sector will rise. In instances where firms have been found to have been pursuing practices that were contrary to the interests of investors, significant losses of business will often ensue along with loss of reputation and possibly damaging legal actions. Similarly, revelations of misdeeds on the part of a small number of firms may have damaging consequences for the public perception of the entire industry. With heightened public attention focused on the apparent failures of some firms to accord equitable treatment to all investors, it is quite possible that industry associations and firms will be obliged to enhance efforts to develop stronger codes of conduct to convince the investing public and legislators that governance systems are robust.

In some jurisdictions, industry associations are designated as self regulatory organisations (SROs) and some of their standards are recognised as binding by the authorities. SROs are sometimes allowed to impose sanctions for infractions of rules. In other cases, industry associations have no explicit rule-making function. Whether or not the industry association is recognised as an SRO, these groupings

often engage in research for the CIS industry to highlight issues and develop common positions. These bodies often develop codes of conduct or other standards for the CIS industry. Industry associations have the advantage that they can go beyond what is legally required and identify higher standards to which market participants can aspire while applying peer pressure on their members to meet those standards. While industry codes are not legally enforceable in the same way as legislation and official regulations are, they supplement regulation by promoting best industry practice.

In addition to action at the industry level, each firm can at its own initiative formulate policies that are more rigorous than those required by laws or industry practice. For example, in many countries market competition has encouraged many CIS to go beyond legally required disclosure requirements and make even more information available to investors. In many countries, firms began publishing corporate governance statements before disclosure of governance practice was compulsory. With rising concern with CIS governance firms are likely to attach a high priority to satisfying investors that their governance systems are sound and that their practices reflect a strong commitment to the protection of investor rights.

Associations representing retail investors in their capacity of consumers of financial services also have the potential to contribute to an improvement in business practices of CIS.

In the process of strengthening governance in the CIS sector, both industry associations and individual firms will probably have to devote significant resources to defining acceptable norms of practices carefully and to reviewing current practices to determine where improvements can be made.

Alongside the work done by international organisations in developing global standards, international groupings of CIS industry associations, private institutions and service providers have taken significant initiatives in disseminating best practices globally. This international network of public and private cooperation has enabled all countries to share experience and to utilise techniques and products that have proven effective in other countries.

### *Conclusion*

Industry Associations, self-regulatory organisations (SROs) and private firms engaged in the CIS sector have an important role to play in raising standards of integrity and developing best practices.

### ***Responsibilities of distributors and financial advisers***

The governance system for CIS mainly entails the relations of the CIS and the investor. However, various other parties may engage in active contact with the investor and assume various roles in introducing the CIS to investors and soliciting the investment. In fact, investors often have more direct contact with intermediaries of these kinds than with the CIS. Those recommending investments assume various degrees of responsibilities for recommendations made to the investor. Any party offering CIS to investors must not misrepresent the product, the associated risks or the costs. As the degree of active promotion increases, the responsibility of those making such promotions also increases.

The CIS may minimise distribution costs through techniques such as direct mail, press or Internet advertising while offering only a limited range of ancillary services, such as investment counselling. In this case, it must be made clear that the investor is responsible for examining the offering document carefully to be sure that the investment is consistent with his/her objectives and risk tolerance and to seek professional advice when in doubt.

Other parties may serve as an intermediary between the CIS and the final investor and take a more active role in recommending the investment and thereby may incur greater liability. A distributor may be affiliated with the operator or may offer products from several operators. Typically, commissions from sales of the CIS are a main source of revenue for the distributor. The investor often solicits the expertise of the distributor in selecting products. While the distributors may only recommend a limited range of instruments to investors, they may not mislead the investor concerning the nature of the investment or its costs and are responsible for the suitability to the investor.

Independent financial advisers will usually market a wider range of investment instruments as well as CIS, and offer a broad advice on asset management in order to assist investors in meeting their financial planning objectives. Such advisers will have the greatest responsibility regarding disclosure and suitability of the CIS and may also have other responsibilities depending on the nature of the financial advising.

### ***Conclusion***

Parties, such as a distributor or financial adviser, who market the CIS and/or make investment recommendations, incur responsibility for the suitability of the investment to the investor and for the accuracy of information provided in connection with marketing.

#### **IV. Market discipline and market infrastructure**

Sound internal governance and official supervision work best in transparent markets in which informed investors scrutinise and compare the performance and services of CIS, as well as other investment instruments. One pillar of such a market is a financially literate investor base. In order to enable the population to assume its increased responsibilities, investor education is likely to be an increasingly important task in the future, both as part of the general education system and through special investor education. A solid grounding in the use of investment instruments and in financial planning enables the individual to make use of disclosed information. The government, the regulatory authority, the financial services industry and individual firms all have important parts to play in improving financial literacy.

With specific reference to the CIS sector, quantitative and qualitative information on the performance risks and costs of CIS and their capability to meet the objectives of investors have expanded considerably in recent years, particularly in advanced markets. The expanded availability of information partly results from official disclosure requirements. Information provided by CIS themselves as well as by independent investment advisers are important additional sources of information. At the same time, the financial market infrastructure has become more efficient at analysing the data that are released and communicating information to investors and in presenting the data on a comparable basis. The general press, the financial press and specialised periodicals provide extensive information on performance and costs while discussing the utilisation of CIS to achieve various investments aims. Many publications regularly present and compare CIS costs and performance on a standardised basis.

Specialised service providers have emerged who gather data from CIS, present the data in a consistent and intelligible manner and disseminate the data. In the past such services were frequently only available at high costs to specialists such as investment advisers, but low cost distribution to the public is becoming commonplace. The data supplied through these channels complement data supplied by CIS, distributors or independent advisers.

Information technology has significantly expanded the access of investors to information. In advanced markets, investors can obtain practically instant access to an immense variety of information about CIS on a comparative basis via the Internet. This development is to be strongly encouraged.

Most investors will not make use of the full range of analytic tools that are currently available. Nevertheless, the fact that substantial numbers of investors do analyse information carefully and that the financial press and specialised service

providers are scrutinising such data provides a powerful incentive for CIS to act transparently, to improve performance and service and to control costs.

### *Conclusion*

The authorities, SROs, industry associations, individual firms active in the CIS industry and service providers should foster the development of the market infrastructure in which CIS operate. Investor education can improve financial literacy and assist investors in making informed decisions. Relevant information is best made available through many channels such as the general press, the financial press, specialised CIS publication and analytic services. Information technology is a powerful tool for the dissemination of relevant information.

## **V. Transparency and disclosure**

### *The prospectus and periodic reports*

A rigorous system to require high levels of transparency and disclosure is essential to the sound functioning of the CIS sector. Information is usually provided in two forms: i) An offering document, usually a prospectus that explains basic characteristics of the CIS and ii) ongoing information that is presented in periodic reports. These documents should be prepared in comprehensible language.

The offering documents describe the basic features of the CIS and how it will operate. Topics covered typically include the identification of the parties responsible for the CIS, such as the operator and investment manager, as well as those assuming key oversight roles such as the trustee, the depositary (custodian) and the auditor. The offering document also will provide a full explanation of the fees and commissions that will be charged as well as sales and distribution costs.

The investment policy, including any restrictions on investments, must be explained. As markets mature and investors become more sophisticated, increasingly complex investment strategies can be executed. For example, equity funds now often focus on a particular size of companies, the industry sector and/or the financial characteristics of companies that will be targeted. Details are often provided about the investment selection process, such as a selection process focusing on industry sectors or on individual companies, or intensive company visits or use of quantitative models. Such details assist investors in understanding the investment style being followed.

The kinds and degrees of risk that the CIS will assume must also be explained. At a minimum the basic risks associated with an asset class and any further risks that the operator intends to assume as part of the investment style need to be specified. If the CIS has taken measures to limit risks through the use of derivatives or external guarantees, the nature of risk management techniques must be explained. Risks should be explained in understandable language.

Some CIS are designed to provide investors with protection, in whole or in part, against loss of principal. The investment style may include the use of techniques to limit the risk of loss on a “best efforts” basis. Alternatively, risk can be minimised using guarantees of a third party (in some jurisdictions “guaranteed funds” may only be offered with an external guarantee). Final responsibility for guarantees and any limitations inherent in the risk mitigation techniques must be explained.

In addition to informing investors about the basic characteristics of the CIS prior to the investment, the operator has the obligation, subsequent to the investment, to provide information to investors regarding any material changes in the CIS, such as changes in investment policy, investment restrictions or the investment manager or significant pending lawsuits. In some jurisdictions, fundamental changes in investment policies must be approved by investors.

CIS must provide information concerning investment performance on an ongoing basis. Reports to investors usually are provided at least once per year, but semi-annual reports are common. These reports typically are provided in written form, but use of information technology is increasingly common.

Quantitative information must be provided on the assets of the CIS and their valuation, portfolio turnover, investment performance, as well as costs and expenses including brokerage fees incurred in executing the investment strategy.

In addition to simply providing numerical data on performance, CIS often voluntarily provide discussion explaining the factors that influenced fund performance, the views of the investment manager on the performance of the CIS and of the markets in which it invests and how the investment strategy is likely to evolve in the future. At least one report per year must include financial statements certified by an independent auditor.

In addition to information provided through periodic reports, CIS usually provide daily or weekly information on NAV that is disseminated electronically and/or through the financial or general press.

It is essential for investors to be able to compare costs and investment performance of competing CIS. Typically, performance will be measured in standardised time periods (such as one, three, and five years.) In some markets, it is

standard practice to present data on performance compared to benchmark indices and *versus* peer groups pursuing the same investment style. This practice is to be encouraged. CIS should present data in forms that are comparable to those of other providers while the regulatory authorities, SROs and market competition should encourage standardisation in the presentation of costs, fees, performance and risk/return data.

While it is recognised that all material information must be disclosed, in some jurisdictions, consensus is emerging that disclosed information was too voluminous and the style of presentation made the material difficult to understand. Thus in some jurisdictions a “simplified prospectus” is now favoured in order to make disclosed material readily understandable to investors.

CIS have the obligation to inform investors about how ownership rights attached to assets in their portfolios will be used. Information about ownership rights are used can be useful in monitoring conflicts of interest. The main ownership rights are proxy voting rights, but CIS may also have other rights such as the right to participate actively in shareholder meetings or to become involved in legal actions involving portfolio companies. Some “active value” funds have an explicit policy of active engagement with management and boards of companies in their portfolios. Other CIS may engage in such actions on occasion.

In the past, CIS generally tended to see the exercise of ownership rights as a secondary issue and investor demand for such action has not been strong. However, many CIS have policies of voting their shares. This issue may well gain in importance with the rising interest in improving corporate governance practices and the growth in assets under management in the CIS sector. Thus, a recent IOSCO document concluded that ownership rights are only to be exercised in the interests of investors, although this does not necessarily mean that CIS must vote their shares, and that CIS governance policies should be disclosed.<sup>5</sup>

In some jurisdictions, the regulatory authority has already mandated considerable disclosure on the use of CIS ownership rights. Moreover, many CIS operators have voluntarily formulated “corporate governance statements” explaining how ownership rights in shares in which the CIS invests will be used. These statements are available in written form and/or are on the internet sites of the operator. Clearly, it is in the interests of investors to have as great transparency as possible in the use of ownership rights. The obligation to inform investors must be balanced against the costs of disclosure and the need to protect market sensitive information. The exact balance that is struck in each jurisdiction may be determined by law, regulation or industry practice.

A distinction must be made between i) mandatory disclosure, which occurs through the channels identified in the preceding paragraphs and ii) promotional

material, which is designed to capture the attention of prospective investors in order to market a specific CIS. Promotional material may present information in less balanced and less rigorous ways than would be acceptable in the more formal channels of mandatory disclosure, but may not make false or misleading statements.

Additionally, some CIS operators will provide investors with material, such as investor newsletters, which may serve to inform and to educate the investor as well as to assist in marketing. Regulators and SROs have an interest in developing guidelines about acceptable use of promotional technique. In any event, promotional and informational material is subject to limitations in the assertions that may be made and must always stipulate that full description of the investment is found in the offering document.

### *Conclusion*

The CIS has the obligation to provide investors with sufficient information to make informed decisions about investment in the CIS, both at the time of the initial investment and in subsequent updating reports to investors. The CIS is responsible for informing investors about the use of any ownership and control rights that the CIS may have in companies in which it invests.

### ***Fees, commissions and expenses***

One important area in which CIS operators as well as other parties, such as distributors and financial advisors, may use their information advantage to the detriment of investors is fees, commissions and costs. Fees and commissions may be charged in a wide variety of ways. Investors may not have the capability to determine whether fees are reasonable or to assess whether they are high relative to those of competitors, and it may not be obvious whether additional services offered by one provider are sufficient to justify higher fees. It is clear that fees and expenses affect total performance. Full and transparent disclosure and competitive pressure that restrain the level of fees and expenses are defining characteristics of a fair market.

In addition to the standard fees for operating the CIS and managing the portfolio, many CIS charge fees that vary according to the performance of the CIS. Some CIS also charge fees that are used to defray marketing costs. Some CIS are subject to sales fees at the time of sale and/or at the time of redemption. Fees are often divided by the operators among the operator, investment manager, service providers, distributors and investment counsellors. Often the distribution of fees is not explained in a transparent manner.

CIS incur expenses which are passed on to the final investors. Normally, investors will want to examine expenses carefully and compare expenses of competing CIS. The investor may conclude that higher expenses are justified by better services or investment results. A CIS may incur comparatively high expenses by inefficient operation. Alternatively a CIS may incur high expenses by dealing with affiliated service providers (*e.g.* brokers, advisers etc.) at uncompetitive rates. The use of techniques such as “soft commissions”, rebates and the sharing of fees among operators, managers and distributors all complicate the transparent presentation of costs and give rise to possible conflicts of interest.

The difficulties in identifying the full extent of fees, commissions and expenses and in assessing the relative costs of competing CIS are magnified when information regarding fees and expenses is not presented in a uniform manner by competing CIS. Therefore it is good practice to promote standardisation in presentation.

The most desirable means to achieve an equitable fee structure is through strict disclosure standards and market discipline. In order for market discipline to be effective, strong disclosure requirements need to be imposed on CIS operators and parties involved in distribution while requiring the highest possible consistency in disclosure. Simultaneously, investor education and the financial press can sensitise investors to the need to monitor fees and expenses. Regulations normally specify the information that must be disclosed in the offering documents and periodic reporting and may set rules regarding information provided in advertising and promotional material. It is desirable for efforts of the regulatory authority to be supplemented by the efforts of the CIS industry and SROs to set standards that encourage transparency and consistency. It is considered good practice for CIS to include a discussion of their fees structure, with a comparison to industry standards, in material that is disclosed to investors.

While market discipline is the preferred way of obtaining an equitable fee structure, in some cases the regulatory authority may decide that an official determination of some fees, the prohibition of certain fees or official ceilings on some charges are the only practical way of obtaining a fair fee structure or of removing conflicts of interest. In order to maintain a fair fee structure the authorities may also decide to limit or impose conditions on transactions between the CIS and its affiliates.

Regulatory practices, industry standards, policies of firms and market infrastructure should ensure a high degree of transparency concerning fees, commissions and costs. In some cases, the authorities may decide that direct regulation or limitation is necessary in order to achieve an equitable fee structure or to minimise conflicts of interest.

### *Conclusion*

Regulatory practices, industry standards, policies of firms and market infrastructure should ensure a high degree of transparency concerning fees, commissions and costs. Transparency and market competition are the strongly preferred means to achieve a reasonable fee structure, but in some instances the authorities may decide that direct regulation or limitation is necessary.

## **VI. The internal governance of the CIS**

### ***Governance structure***

As noted previously, CIS by their nature have complex structures. The arrangements that the CIS operator may have with other parties may add to this complexity. The investor may have direct contact with an intermediary such as a distributor or investment adviser rather than the operator. As a result, it may not immediately be clear with whom the investor has entered into an agreement to provide CIS services. Therefore, each CIS should have an entity with final accountability for the CIS in case of failure to execute the agreement as specified or in cases in which rules concerning the fair treatment of investors are not respected. Typically, that entity is identified through legally binding instruments, such as laws, regulations or EU Directives. The entity that is finally accountable for the CIS may delegate some functions of the CIS, but nevertheless remains accountable for any failure of any party to whom responsibilities are delegated to fulfil those responsibilities.

In most cases the entity with final accountability is the operator of the CIS. The board of the operator, meaning the board of directors in companies with single board structures or the supervisory board in case with two-tier boards, has final responsibility for assuring that adequate systems are in place and that the management of the operator is adequately monitored. In case of US mutual funds, where each fund is organised as a separate corporation, the board of directors of each fund has final accountability. In Australia, the CIS is required to designate a Responsible Entity for this purpose.

As regulated entities, CIS are subject to governance paradigms that differ somewhat from those of other companies. The operator offering the CIS to the public is usually organised in the corporate form. As in all corporations, one function of the governance system of the CIS operator, as elaborated in the OECD's *Principles of Corporate Governance*, is to monitor the management in order to protect the interests of the owners of the operator, and possibly the interests of recognised stakeholders. In addition, as a regulated entity, each CIS must construct and

maintain systems to ensure that the CIS has operated in accordance with relevant laws, regulations, standards and policies while fulfilling its fiduciary and/or contractual obligations to its investors. In most cases the responsibility for observing that such standards have been respected is the board of the operator. In the case of US mutual funds, where the investors in each fund are the shareholders in the investment company, the board of each investment company has the responsibility to determine that the fiduciary duty to investors is observed.

The internal governance structure of the CIS is designed to monitor the management of the CIS with respect to *i*) execution of investment policies and *ii*) protection of the interests of investors. The board of the entity with final accountability also has responsibility for selecting parties responsible for oversight functions, such as the depositary or custodian, the internal and external auditors and the compliance function.

The investment policy is specified in the offering documents of the CIS. For example, the CIS may invest in equities, fixed-income assets, money market assets, real property, some subsets of these categories (*e.g.* growth equities or investment grade bonds) or some combination of those assets.

The investment policy may indicate the degree of risk that will be assumed when executing the policy. The investment policy may set quantitative limits or guidelines for investments in certain categories of assets and may also prohibit or limit use of certain techniques or products, such as repurchase agreements, short sales or derivatives.

As markets mature, CIS operators tend to offer CIS with increasingly sophisticated investment styles. To execute the policy, an investment strategy is often used to guide investments for a particular period of time, such as a quarter or a year. The process of investment management usually entails periodic assessment of performance and modifications to the investment strategy. In many cases, all or part of this function is delegated to an investment manager, but the entity designated as having final accountability retains responsibility for assuring that investment policies are executed as well as for the performance of the investment manager.

In addition to maximising financial return to investors within the parameters stipulated by investment policies, some CIS may have investment policies that encompass ethical, social or environmental objectives. Even if it is not stipulated in the offering document, it is assumed that investment policies will observe all applicable laws and regulations, including those pertaining to ethical, environmental and social matters. However, CIS may also pursue investment policies, as explained in their offering documents that go beyond the requirement to comply with laws. For example, investment policies may include screening procedures to

eliminate companies that pursue objectionable practices or actively seek companies pursuing desirable practices. A CIS with a social, environmental or ethical investment policy will frequently have a policy of actively using ownership rights, such as proxy voting, in support of that policy. The entity with final accountability is responsible for assuring that such policies are executed.

In addition to executing the investment policy, the governance system includes a set of mechanisms and procedures whereby both internal and external parties who are responsible are assigned tasks that assure that the CIS operates in accordance with laws, regulations, and the policies of the operator, that investors are accorded equitable treatment, that conflicts of interest are resolved and that the CIS operates in accord with high standards of integrity.

### *Conclusion*

Each CIS should designate an entity that is accountable for the fulfilment of fiduciary or contractual obligations to investors and against whom redress may be sought. It is the responsibility of each CIS to maintain systems to ensure *i)* that its stated investment policies are executed and *ii)* that the CIS respects norms and standards regarding the treatment of investors and minimises or resolves conflicts of interest between the investor and other interested parties.

### *Conflicts of interest*

The laws of virtually all countries stipulate that CIS are exclusively to be operated in the interests of final investors. CIS operators are normally expected to compete by offering better performance and services as well as competitive costs. However, experience has shown that CIS are highly susceptible to conflicts of interest. The operators of CIS control large amounts of assets and have significant capability to control the information that is provided to investors. Many investors are individuals who have limited capability to monitor the performance of the CIS in detail. Therefore, the risk is present that some participants in the collective investment process will abuse agency relationships.

In the simplest case, without some safeguards, operators of a CIS could misrepresent the assets in the portfolio or the value of the portfolio or make false or misleading representations concerning the investment strategy that will be followed or the risks involved. Operators can promise exceptionally high rewards in order to attract new investors into the scheme. Prior to the introduction of adequate safeguards, there were numerous instances of abuses of this kind.

In addition to outright fraud, CIS could be used to provide benefits for those in an insider relationship with the CIS, such as an operator, investment manager,

or distributor, at the expense of investors in the CIS. There are numerous possibilities for conflicts of interest in CIS.<sup>6</sup> The operator might seek to attract many investors into the fund, even if this should result in the fund becoming too large for efficient asset management. In executing the investment strategy, the investment manager might take excessive risk or may be excessively risk averse. The operator could manage the assets of the fund in such a way that it in effect tracks a benchmark index while applying charges for active management. In addition, the CIS could appoint directors, custodians or depositaries, who lack the requisite independence.

Additional potential conflicts of interest arise when CIS are affiliated with other financial institutions. Instead of operating the CIS to produce the best possible net return for final investors, they could operate it to generate revenue for affiliated companies and employees. The managers of the CIS could use the fund to support issues of securities underwritten by an affiliated organisation. The CIS might be used to purchase assets that could not be placed in a public offering or to acquire assets no longer wanted by an affiliate. The fund managers could also direct securities trades to affiliated market intermediaries, rather than seeking best execution of orders. There is also the risk that the company will trade excessively in order to increase the commission income of affiliated market intermediaries (churning of portfolios). Failure to protect information about future trades from affiliated intermediaries can allow these intermediaries to “front run”. In all of these cases, the investment manager could trade at prices or commissions that are inappropriate from the point of view of investors while allowing the operator or the affiliated intermediary to earn profit from an inside relationship. Since costs are directly incurred by the operator, which typically operates a large number of funds, and often shares facilities with other members of the financial group, equitable ways must be found to allocate expenses among CIS.

Other affiliated parties may be distributors or investment advisers who may be in a direct contractual relationship with investors. The CIS may be operated to generate fees for such intermediaries.

If CIS are affiliated with non-financial companies or industrial financial groups, they can be used as vehicles for financing affiliated companies or they can be used to manipulate securities markets for the benefit of those affiliates or to obtain strategic control of other companies.

OECD countries agree that well-defined legal and regulatory environments for CIS are needed in order to address such conflicts of interests. Efforts on the official side are supplemented by practices of firms and industry groupings to develop standards and codes of conduct as well as enforcement mechanisms. It is the responsibility of each CIS operator to establish an internal governance regime, one of whose major aims is to address such conflicts of interest and ensure that

the CIS operates transparently in the interests of investors. The governance system should include salary and bonus systems that are compatible with the obligations of the operator toward investors. In appropriate cases the regulatory authority may need to intervene, so it should be provided with appropriate enforcement powers and sanctions to provide an effective deterrent.

### *Conclusion*

The CIS must be managed exclusively for the benefit of the investors. The operators of the CIS should obtain from affiliated service providers terms no less favourable than those available from unaffiliated providers. Each CIS must develop internal mechanisms to resolve conflicts of interest.

### ***Custody and valuation of assets***

In order to assure safe keeping of assets, the CIS usually is required to nominate an entity (usually known as a custodian or depositary) to hold the assets of the CIS and also performs certain operations such as maintaining records and effecting payments. This entity entrusted with custody of assets is required to be a separately incorporated entity from the parent company, but ownership linkages between the depositary and the parent company of the CIS are allowed in some jurisdictions. Typically, the CIS and the custodian or depositary enter into a contract that specifies the obligations and functions that the custodian or depositary will fulfil. The CIS is expected to select appropriate legal mechanisms to assure that the legal enforceability of the claims of investors on the assets of each CIS are as strong as possible. In particular the claim of the investor must not be affected by the financial position of the operator or any another related party. The funds must be held exclusively for investment on behalf of the CIS investors.

The assets in the portfolio of the CIS are to be valued frequently. Most open-ended CIS in major markets are valued daily, but less frequent valuation may be permissible in cases where the assets lack liquidity. The operator specifies a technique that will be used consistently for valuing assets. For most publicly traded securities, the closing price on the recognised exchange of their primary listing is the most commonly used standard. Where assets are not traded frequently, alternative methods for valuing assets may be used. In all cases, valuation procedures must be consistent and must be transparent.

The entity is expected to maintain systems to discover pricing errors and to correct any errors promptly, including, as appropriate, compensating investors for losses caused by pricing errors from their own funds. The entity with final

accountability for the CIS is responsible for assuring that the entity entrusted with custody performs all of these functions in accord with acceptable standards.

In some jurisdictions the depositary plays an important oversight role, especially those where no outside party, such as independent directors or a trustee bank, engage in such oversight. Oversight functions include verifying portfolio holdings and determining that investments and redemptions are effected at appropriate NAV. The depositary is also charged with assuring that NAV is calculated according to fund rules and that each transaction is consistent with laws, regulations and fund policies. Examples of the latter are the selection of securities for the investment portfolio and observance of investment limits or prohibitions. In some cases the depositary is charged with asserting the claims of investors against the investment manager where the duty of the investment manager to investors may have been breached. The depositary has the additional role of assuring that obvious potential conflicts of interest, particularly in dealing with intermediaries affiliated with the investment manager and arrangements for payments in “soft dollars” are known to the directors of the fund and determined to be in the interests of investors. The activities of the depositary are subject to scrutiny by the auditor.

### *Conclusion*

The assets of each CIS must be segregated from the assets of all entities and held for the exclusive benefit of investors in the CIS. Each CIS should nominate an entity with responsibility for holding the assets of the CIS for the benefit of investors. Assets in the portfolio of the CIS should be valued regularly, using valuation practices consistent with official regulations and industry practice.

### ***Internal policies, controls and compliance***

In order for the CIS to function with integrity, it is essential to devote significant resources to the compliance function. The entity with final accountability for the CIS has the mission to make sure that policies are developed to ensure compliance with rules and those in responsible position for the CIS, or the agents of the CIS, carry out their tasks in conformity with standards of integrity. In addition to monitoring the CIS and its affiliates, the compliance function also monitors third-party agents and service providers to whom the CIS has delegated key functions.

Some countries' regulations require the naming of a compliance officer and/or the elaboration of a compliance plan. Official regulations or industry standards sometimes require that the compliance function be separated from the management

of the CIS operator and report directly to the board of directors of the operator or to the trustee. In other cases the compliance function may report to the management. Sometimes, the regulations stipulate in detail the requirements for monitoring. In other cases, the regulations simply state that CIS operators must have adequate systems to comply with relevant rules and policies while industry best practice determines the actual scope of compliance activity. In Australia for example, the CIS operator is mandated to submit a full compliance plan to the regulatory authority who in turn determines whether the plan is adequate.

The compliance function is responsible for ensuring that official regulations, industry practices and company policies are adequately reflected in written company policies. The compliance function spells out the obligations of all staff members and ensures that all staff or others who may act as agents for the CIS (including sales intermediaries to the extent practicable) are provided with policies in written form and receive training that explains how to carry out their obligations. Effective compliance seeks to assure that incentives to contravene rules or practices are minimised. The compliance function systematically monitors the activities of all persons acting on behalf of the CIS in order to ensure compliance with policies. Compliance officers should be available to resolve doubtful cases.

The compliance function maintains contact with other parties that maintain oversight responsibility such as the depositary, the auditors, and, where relevant, independent directors and trustees. The compliance function is frequently the first place to which investor complaints are referred for investigation and may be assigned some responsibilities in investigating investor complaints. The compliance function also maintains contacts with the regularly authority. In some jurisdictions, there is a requirement for material breaches of the law or regulations to be reported to the regulatory authority.

The compliance function (or senior compliance officer) regularly advises senior management, the board of directors (or the supervisory board) of the operator or the board of directors of mutual funds of any serious lapses in compliance. When such problems are identified, the compliance function assists in formulating a plan of corrective action. In some jurisdictions, an internal auditor monitors the reports and statements of the CIS.

### *Conclusion*

Internal policies should be instituted to ensure that actions of the CIS and of external parties acting as their agents are consistent with relevant laws and regulations, accepted industry practices and company policies. There should be ongoing monitoring of the services performed by external parties acting as the CIS's agents.

### *Independent review*

In advanced markets, it is required to designate parties that are capable of exercising independent judgement to ensure that the management of the CIS observes all laws, rules and standards of integrity. Two dimensions of the concept of independence that are worth mentioning are: *i*) sufficient independence from the management of the operator to be able to engage in effective monitoring, which is an accepted standard everywhere and *ii*) independence from all parties having any ownership, control or other business relationships with the operator, which is an additional requirement in some jurisdictions.

The entity with final accountability for the CIS plays a pivotal role in the review process. This entity selects those responsible for key oversight roles and is responsible to the regulatory authority for the adequacy of compliance systems. Using these systems on an ongoing basis, the entity ascertains whether laws, regulations and policies have been followed. In assessing whether standards of integrity have been met, the board will typically rely on information provided by entities such as the investment manager, the depositary/custodian, the trustee, the auditor and the internal compliance function as well as the regulatory authority. The entity is responsible for taking adequate action to rectify any shortcomings identified by these parties.

As noted above, in some systems the depositary performs certain key functions of independent review.

In some cases, there is no requirement for additional layers of review. For example, the EU's UCITS Directives impose no requirement for further review. However, in EU countries the depositary has very strong oversight powers and some EU members make provision for further review by outside parties. In many jurisdictions, the board must be independent of the management of the CIS but may have links to affiliated companies. In cases where the final authority for monitoring for standards of integrity rests solely with the board of the operator, it is essential to erect very robust internal safeguards to address conflicts of interest and prevent the abuse of insider positions. This obligation is particularly strong when the board members have links to affiliated companies and/or when an affiliated company acts as depositary.

Some OECD countries have somewhat different systems for review or have determined that it is advisable to designate other parties who are responsible for providing additional layers of review. Furthermore, in some cases, the additional criterion of independence from links to affiliated companies is imposed. The exact parties that are entrusted with this function differ among jurisdictions. In the United States, the practice of requiring a separate board of directors with independent directors for each mutual fund is an integral part of the governance system.

Under this system independent directors must constitute a specific minimum share of total directors in all mutual funds. At the same time, employees of the operator may serve as directors.<sup>7</sup> In Australia, it is stipulated that when independent directors do not constitute a majority of directors of a CIS, additional safeguards must be enforced. In jurisdictions where the trust form of CIS is used, the trustee, usually a bank authorised to perform trustee functions, fulfils a role of independent monitoring of certain activities, notes all breaches of compliance and requires corrective action. When such action is not taken, the trustee contacts the board of the operator and/or the regulatory authorities.

The precise criteria for independence from connections to the operator differ among jurisdictions. It is accepted that no employee of any company affiliated with the operator through ownership linkages or as a service provider is eligible to serve as an independent director. In most cases, additional criteria are imposed. In the case of trusts, the trustee bank must be entirely independent of ownership linkages to the operator.

In some cases the process of independent review is only designed to assure compliance with regulations and avoidance of conflicts of interest. In other cases, broader review powers are granted and/or the independent directors are specifically mandated to represent the interests of final investors. For example in the United States, mutual fund independent directors are expected to review the contract with the investment adviser and other service providers and to determine whether their performance has been adequate. The directors of the fund are also charged with reviewing the contracts of the investment adviser and other service providers, and for determining that the structure and levels of fees and expenses are compatible with the interests of investors.

A variety of individuals are expected to exercise oversight inside CIS. These persons include the investment managers, the compliance departments, and the boards of CIS operators and directors of mutual funds. While these individuals may operate under a general injunction to act solely in the interests of investors, the actual implementation of that mandate may not be entirely clear. It should be recognised that those who are expected to exercise oversight often have extensive links to the operator and/or financial companies closely allied to the operators. As a result, the regulatory authorities as well as industry associations, SROs and firms have an interest in translating the general mandate to act in the interests of investors into specific guidelines for those in oversight roles so as to minimise ambiguity. Additionally, it is an important task to make sure that those in such positions have the necessary independence to exercise such functions effectively as well as the incentives to act independently.

## Conclusion

The internal governance system of each CIS should provide for review by an entity that is independent of the management of the operator to determine that investor protection standards are observed and that conflicts of interest are resolved without prejudice to investors. All information necessary to fulfil this function should be made available to those performing independent review. Procedures for the selection, remuneration and motivation of those persons or entities exercising independent review should be consistent with the objective of their acting in the interests of investors and independently of management. Those who are designated to exercise oversight roles in CIS should have the appropriate training and guidance concerning standards of integrity.

## Notes

1. See International Organisation of Securities Commission, *IOSCO Objectives and Principles of Securities Regulation*, updated with references to work done by IOSCO from September 1998 to May 2003; October 2003. Principles 17 to 20 apply specifically to the regulation of CIS.
2. Moreover, the IOSCO Technical Committee recently approved a mandate to establish broad general principles for CIS governance building on IOSCO's prior work, including the IOSCO Core Principles. IOSCO's Standing Committee 5 on Investment Management (SC5) will prepare more detailed or additional principles that take into account the differences in the legal frameworks among SC5's members.
3. Thompson, John K. and Sang-Mok Choi (2001), "Governance Systems for Collective Investments in OECD Countries." OECD *Financial Affairs Division Occasional Paper No. 1* (April). The OECD study also found that the legal structure of the CIS did not convey sufficient information about how the CIS would actually operate and proposed alternative methods to categorise CIS.
4. Report by the Committee on Financial Markets of February 1972 [C (71) 234]. This Report was approved as a set of Council Recommendations.
5. IOSCO (2003), *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure*. A Report of the Technical Committee of the International Organization of Securities Commissions (September).
6. For a discussion of possible conflicts of interests and methods of mitigating such conflicts, see IOSCO (2000) *Conflicts of Interest of CIS Operators*. Report of the Technical Committee (May).
7. On June 23, 2004, the US Securities and Exchange Commission adopted a series of rule amendments that would require most mutual funds to have a chairman of the board who is an independent director, as well as to have boards of directors whose independent directors constitute at least seventy-five per cent of the board. The details of these rule amendments, including compliance dates, are being finalised.