This note, prepared by the Secretariat, is for discussion under item 4) of the Agenda.

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CORPORATE GOVERNANCE AND COLLECTIVE INVESTMENT INSTRUMENTS

1. At its meeting of October 1999, the CMF agreed that, in view of the growing importance of the collective investment sector, work should be undertaken to improve understanding of the corporate governance of Collective Investment Schemes (CIS) in Member countries. The Secretariat produced a note for the March 2000 CMF meeting [DAFFE/CMF(2000)5] that summarised preliminary findings and proposed further work. The Committee agreed that this work should continue but also suggested that the revised note should focus on the institutional structure of governance systems, especially institutional mechanisms to assure investor protection and mitigate conflicts of interest.

2. In response to this request, the Secretariat has expanded its information base on supervisory standards, legal structures, organisation and governance of CIS, using a variety of sources. The IOSCO Technical Committee’s Working Party 5 on Investment Management (WP5), which specialises in CIS, had circulated a questionnaire to its members, most of which are OECD Members, and 16 jurisdictions replied. This questionnaire covered "decision making structures in CIS", a concept that was very close to that of CIS governance. This information was supplemented by an extensive research effort by the Secretariat. The results of this inquiry are presented in DAFFE/CMF (2000)26.

3. The present note summarises the main points that emerged from the research effort and presents issues for discussion at the meeting of the CMF on 10-11 October 2000. Points for discussion are found at the end of this note. A companion note with suggested points for discussion for the meeting with representatives of the financial services industry (9 October) has been circulated as document DAFFE/CMF(2000)27.

I. Background

4. CIS are investment vehicles that offer individuals a means of taking advantage of opportunities in the capital market. Whatever the legal structure, the underlying concept is that the investor purchases an instrument that gives certain rights to a proportional share in the risk and rewards of a collectively owned pool of managed assets. A CIS consists of three components: 1) a pooling of resources to achieve sufficient size for portfolio diversification, reduced costs and cost-efficient trading; 2) a legal/governance structure for operation of the CIS, including institutional arrangements for investor protection; and 3) professional portfolio management to execute a defined investment strategy.

5. The CIS sector is characterised by special agency relationships and asymmetry in market power and information. Therefore, the risk is present that promoters of these instruments will abuse agency relationships. In the simplest case, operators of a CIS could misrepresent assets in the portfolio or the value of the portfolio or make false representations concerning the investment strategy followed or the risks involved.

6. In addition to outright fraud, there is a possibility of conflict of interest, i.e. that CIS operators might manage assets in their own interest or those of affiliated financial service companies rather than in the interest of investors. There would be potential conflicts of interest even if all portfolio managers of CIS worked only for the CIS. However, the risk of conflict of interest is even greater since most CIS are affiliated with other financial institutions, such as banks, securities houses, or insurance companies. The parent company will often act as “distributor” or “promoter” using its own distribution system, such as a bank branch network or insurance sales force to market its own “proprietary” CIS. CIS services are usually provided through a specialised investment management company (or operator), which is often a subsidiary of the parent financial group. Even in cases where the CIS is a freestanding legal entity, the facilities of the fund belong to the investment management company and fund managers are employed and
compensated by that company. The investment management company normally initiates most key activities concerning the CIS regarding the creation of new funds, the execution of investment policies and other strategic issues in the CIS (fees, marketing strategies, etc.).

7. There are numerous specific possible conflicts of interest. The CIS could be used to support issues of securities underwritten by the parent organisation, by directing trades to affiliated market intermediaries, rather than obtaining best execution or by trading excessively ("churning" the portfolio) in order to increase the commission income. Since costs are directly incurred by the investment management company, which operates a large number of funds and often shares facilities with other members of the financial group, fair ways must be found to allocate expenses.

8. One approach to conflicts of interest would be for CIS regulators to impose highly restrictive rules and wide-ranging prohibitions. For example, fees, expenses and commission levels could be fixed and all dealings with related parties prohibited. Most analysts believe that this approach would be excessively rigid. Instead, most countries have created well-defined but flexible governance frameworks consisting of two parts: 1) accepted standards of conduct combining official rules and industry best practice; and 2) institutional systems in which certain designated parties are charged with scrutinising the activity of the CIS for conformity with those standards.

Development of Standards

9. Standards emerge as a result of laws and regulations as well as industry best practices. OECD member countries with well-developed CIS sectors have been perfecting standards domestically for decades. There have also been considerable international efforts to agree on acceptable standards over the years.

10. Three major international efforts to develop standards between the early 1970s and the early 1990s deserve mention:

- The CMF in 1971 began the process by issuing “Standard Rules for the Operations of Institutions for Collective Investment in Securities” 4. With problems of fraudulent marketing in some Member countries and no other international body taking the lead, a need was perceived for a clear statement on what constitutes minimum standards in order to encourage Members to rectify deficiencies.

- In 1985, the EC Council approved the UCITS Directive. In addition to deepening consensus on standards, the Directive aimed at promoting cross-border business since any CIS meeting the criteria in the Directive was potentially eligible for distribution throughout the EC.

- In 1994 IOSCO issued its own Principles for the Regulation of CIS.

11. There was great similarity in these early statements concerning standards. All recognised that the CIS is to be operated in the interests of the investors. On the most basic level, all three statements stipulated that supervision must be adequate to ensure that laws, regulations and industry practices are observed and that the operator acts in accord with stated objectives. The regulator must have adequate means to investigate actions and the power to carry out supervisory functions. The supervisor should license each operator and each product offered. The OECD and IOSCO explicitly stated that means must be found to adjudicate conflicts of interest between the investors and the operator.

12. All stipulate that the assets of the CIS will be held by a custodian, having some independence from the CIS operator, in a way that satisfies the supervisors that the CIS assets are accurately reported.
The operator must be willing to redeem shares at the request of the investor at net asset value (NAV). The CIS is obliged to explain the principles of pricing and valuation that are used in calculating NAV and the supervisor must approve these principles. The IOSCO Principles specify that assets must be valued at market prices. All sets of standards also indicate that CIS should have limits on concentration and all address issues related to borrowing, short sales and maintenance of liquidity.

13. Disclosure is an important element in all sets of standards. Disclosure requirements will normally cover the structure and governance of the fund, meaning that persons and companies fulfilling certain key roles (investment manager, advisement adviser, trustee, custodian, director, distributor etc.) must be identified and the basis for remuneration of all of these parties explained. Disclosure requirements usually also cover fees, commissions and expenses. Investors must be informed about the fund investment objectives, portfolio holdings, portfolio valuation and performance, as well as particular risks being assumed. Policies concerning the use of leverage and derivatives must also be explained.

14. The channels for disclosure are also included in all sets of principles. The CIS must issue prospectuses and annual and semi-annual reports that contain required disclosure. The obligation to avoid misleading assertions when advertising and the responsibility of the supervisor to prevent false or misleading advertising are stressed.

15. Following the initial statements of its principles of regulation in 1994, IOSCO has been taking the lead in enlarging international consensus. Most of the work of IOSCO has taken place through its Working Party 5 on Investment Management of the Technical Committee, which brings together supervisors of the largest and most advanced markets in the world. This work has been complemented by other work on CIS by the Emerging Markets Committee of IOSCO, which has sought to extend that work to other IOSCO members.

16. IOSCO has elaborated on principles already stated and, at times, new questions have been addressed. For example, several sets of guidelines were developed further elaborated principles of pricing and valuation. The concept of conflicts of interest, which was that first mentioned in the 1994 principles, was further elaborated in the 1997 “Principles for the Supervision of CIS Operators,” which provided more detailed definitions of conflicts of interest, including principal transactions between the operator and affiliated companies, soft commissions, lending and borrowing among affiliates, purchase of securities underwritten by affiliates and use of affiliated brokers. The duty of the CIS to monitor and disclose connected party transactions was specified as well as the requirement to develop protective arrangements (sometimes called Chinese walls) when a CIS operator is affiliated with a company engaged in other activities. The definition of conflicts of interest was sharpened with the identification of excessive trading (i.e. churning) cash commission rebates. Specific ways in which the regulatory authority could take action to ensure that any such activities are in the interest of investors and to sanction violations were identified.

II. Investor Protection and Governance Systems of CIS

17. The setting of standards is only the first step in building an adequate investor protection framework. Each operator must implement institutional procedures to ensure that standards are observed. The internal oversight procedure consists of the internal compliance processes of the CIS and a review by designated independent parties within the CIS structure as provided by domestic law and practice.

A. Internal Compliance Procedures

18. There is broad agreement that the CIS operator (in some cases with the collaboration of the board of directors of the fund) is responsible for designing systems to monitor compliance with laws and
regulations and to be sure that actual investment policies are consistent with those laid down in the fund prospectus. Many countries specifically require the operator to have written procedures describing policies that in turn are subject to review by the supervisory authority. The responsibility for ensuring that these functions are fulfilled is assigned to the compliance department. The compliance department will often be the main ongoing point of contact with the regulator. Further, it is the responsibility of the regulator to license only those operators who can demonstrate the capability to implement a compliance programme.

19. Some countries’ regulations require the naming of a compliance officer and/or the elaboration of a compliance plan. Sometimes, it is required that the compliance function be separated from the management structure of the CIS operator and report directly to the board of directors of the fund, the investment manager or to the trustee. Even if the regulatory regime does not mandate an independent compliance function and the task is left to the CIS operator, the operator retains full accountability for all infractions. In most cases, it is permissible for the asset management company and the parent company to have a common compliance department. (However, Canada requires a separate compliance department at the investment management company level.) All countries require an internal auditor to monitor the reports and statements of the CIS.

B. Legal Structures for CIS

20. While the objective of building legal structures for CIS is similar in all OECD countries, there are wide differences in actual legal structures and governance mechanisms. There are three basic legal structures for CIS in place in OECD countries:

- In the corporate form, the CIS is a separate corporate entity in which the assets are owned by the investment company and the investors are shareholders of the investment company.

- Under the trust form the CIS is organised as a “trust,” a concept of Anglo-Saxon law in which an identified group of assets is constituted and managed by trustees for the benefit of another party (the beneficiary). The investor is a beneficiary of the trust and owns units of the trust.

- In the contractual form the investor enters into a contract with an investment management company, which agrees to purchase a portfolio of securities and manage those securities on behalf of the final investor. The investor owns a proportional share of the portfolio.

21. The laws of some countries allow for only one legal form for collective investments, while others allow for more than one. Thus, the United States and Mexico only recognise the corporate form. Several countries, (e.g. Belgium, Czech Republic, France, Greece, Italy, Luxembourg, Spain and Turkey) have both corporate and contractual forms while Denmark, Germany, Portugal, Sweden and Switzerland only have the contractual form. Some other countries (United Kingdom, Ireland, Canada and Hong Kong, China), which traditionally had the trust form, have now authorised corporate CIS. Japan and Korea previously only had contractual CIS, but have recently introduced corporate CIS.

C. The Operation of CIS in Member countries

22. The classification by legal structures is not sufficient to understand how the CIS governance mechanism operates in practice. The investment management company is a significant part of the process in all cases. At the same time, each governance regime has assigned a role for an outside party having some independence from the CIS operator to exercise an oversight function. Those entrusted with the oversight function are expected to have some degree of independence from the operator and to exercise their duties in the interests of the final investors. The degree of independence and the range of issues on which the outside party can share decision-making power with the investment management company differ
The United States Mutual Fund System

23. Although many countries have corporate CIS, the “mutual fund” as found in the United States is unique. Each mutual fund is organised and governed in many ways like an operating corporation, with a board of directors having sizeable oversight responsibility and significant legal liability. (Insurance against lawsuits for mutual fund directors is now mandatory.) The function of the board of directors is to represent the shareholders of the fund (i.e. investors) by examining a wide range of actions by the fund manager and the directors of the asset management company. In order to do this, the directors will receive reports from the compliance function, the custodian and the auditor.

24. The decision to establish the fund is taken by the investment management company. Once the fund is in operation, the board of directors monitors the fund managers with respect to observing accepted standards and avoiding conflicts of interest. The board reviews the fund’s contract with investment advisers annually. The investment adviser is frequently an affiliated company and the directors must determine that the contract with the adviser is consistent with the interests of investors. The board is generally responsible for monitoring the compliance programme of the fund, including compliance with rules concerning pricing, valuation, portfolio diversification and liquidity as well as limits on activities such as investments in illiquid securities or derivatives and the use of credit. The board must verify that investment policies have been in keeping with rules and restrictions as specified in the prospectus. The board also selects the auditor and custodian and monitors transactions with affiliates. Committees on audit, pricing, legal compliance and nominations are usually organised to give detailed attention to these topics.

25. Directors are expected to monitor performance in the light of the fund’s objectives. At a minimum, the fund’s investment posture should be consistent with the objectives stated in the prospectus. If the portfolio manager of a given fund were to under-perform their peer group and /or the benchmark index consistently, the board should seek a satisfactory explanation from the directors of the investment management company. In practice, decisions to change portfolio managers are likely to be taken at the level of the investment management company, but as a last resort the directors of the fund could replace a portfolio manager.

26. The independent director is a keystone of the system. Much of the effort to strengthen the governance system for the mutual fund industry has involved the independent directors. Existing laws require that 40 per cent of directors be independent. The industry and its regulators have given considerable attention to independent directors and their role in protecting the interests of small investors. Thus, the Investment Company Institute formed a special advisory group that released a set of recommendations in June 1999 concerning duties of independent directors and the definition of best practices to strengthen a “culture of independence”. The report recommended that two thirds of directors should be independent of the parent company. Means of selecting, evaluating and compensating directors were discussed and the duties of independent directors were specified. In October 1999, the SEC released for public comment proposed changes in regulations that would strengthen the legal accountability of independent directors and further specify the duties of such directors. An increase in the required number of independent directors is also being considered.

Continental European systems

27. Most countries in continental Europe have systems of CIS governance based upon the contractual system, in which the CIS is viewed as a portfolio management agreement between the investor and the investment management company. The contractual form of CIS is known under various names, such as the fonds commun de placement (FCP) in Belgium, France, and Luxembourg and the Kapitalanlagefonds
(KAF) in Germany and Switzerland. In the contractual form, the final responsibility for the CIS resides in the investment management company and its directors, who are mandated to act in the interests of the investors. They are seen as ultimately responsible for ensuring that policies are formulated and communicated on all relevant points, that adequate monitoring mechanisms are in place and all standards are observed. These directors of the investment management company are usually required to be independent of the management of the fund management company, but often are linked to the parent company.

28. European CIS, whether corporate, trust or contractual, are structured around the existence of an independent depository (which must be an “institution subject to public control”). The investment management company appoints a depository who exercises some oversight functions comparable to those of directors in the US mutual fund system. These functions include verifying portfolio holdings, calculating NAV and determining that investments and liquidations are effected at appropriate prices. The depository also is charged to some degree with ensuring that portfolio holdings are consistent with the objectives of the fund and that related party transactions are known to the directors of the investment management company and certified as in the interest of shareholders.

29. The depository is required to be a separate company from the parent company, but ownership linkages between the depository and the parent company are often allowed. The depository has the role of ensuring that obvious 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 depository are subject to scrutiny by the auditor. The depository does not have the function of the directors of a mutual fund in evaluating performance of the manager or changes in investment objective and related policies. The board of directors of the investment management company makes those decisions.

30. The main responsibility of the investment management company is to observe the stipulated standards, to pursue the investment objective as effectively as possible and to disclose fully at least as much information as is required. In cases where breaches of laws or neglect of duty occur, there is some possibility to hold the directors of the investment management company legally responsible. On balance, however, the investor’s main defence is to liquidate the investment.

31. Although the view of the CIS as an agreement between the investor and the investment manager only strictly describes the contractual form of CIS, there is a tendency in Europe to perceive the contractual form as the basic form for all CIS. As mentioned above several countries in Europe have corporate forms of CIS. However, even if the CIS has a corporate form, there is usually no requirement for independent directors. (Belgium may be an exception in this regard.) The investment company, investors and regulators all see the corporate form as functionally equivalent to a contractual form, with ultimate responsibility residing with the directors of the fund management company rather than with the directors of the fund.

The trust system

32. Under the trust system, where a CIS is usually called a “unit trust”, the ultimate responsibility for the fund lies with the investment management company, but the trust structure represents a powerful mechanism for independent surveillance. Trustees have all the fiduciary obligations imposed by trust law as well as additional obligations under securities legislation. The basic document describing the unit trust is known as the “trust deed”. The trust deed specifies the identities of the investment manager, the trustee and the depository, specifies the investment objective as well as any limits on fund activity, such as concentration, use of credit, short sales or derivatives. The trustee must be approved and registered as a trust company by the competent authorities. The trustee must be entirely independent of ownership linkages to the investment manager. Most trustees are banks or wholly owned subsidiaries of banks, but
the same bank cannot have subsidiaries that act as trustee and engage in asset management work for the same fund. The trustee and the depository may reach an agreement on how to divide some tasks, e.g., the safekeeping of client assets or the calculation of NAV.

33. The trustee notes breaches of compliance and requires corrective action. When such action is not taken, the trustee contacts the board of the investment manager and/or the regulatory authorities. While the investment manager will usually be the first place where complaints are addressed, disgruntled unitholders have recourse to both the trustees and the regulatory authority. In addition to their core surveillance work, some trustees do NAV calculation, maintain register, perform periodic tests of valuations, if performed in-house, and may also act as custodian.

34. The trust system is found in the United Kingdom, Ireland, Australia, New Zealand, Canada, Singapore and Hong Kong, China. However variations among trust systems are significant.

35. The unit trust form was the traditional form of CIS in the United Kingdom and Ireland but both are becoming increasingly integrated in the European CIS market -- the United Kingdom as a fund management centre and Ireland as an offshore CIS centre. In line with thinking in most European markets, the CIS industry and the regulators perceive the CIS, including those legally organised as trusts, to be an investment management agreement between the investment manager and the investor. In both countries, the corporate structure is gaining in significance at the expense of the unit trust structure. In Ireland, most UCITS that are offered to the European market are in corporate form. In the United Kingdom the corporate form (known as Open-ended Investment Companies or OEICs) was introduced in the 1990s, partly because it was seen as more easily understood by international investors. The two bodies responsible for the operation of an OEIC are the authorised corporate director (ACD) and the depository, with roles very similar to those of the manager and trustee of a unit trust. The ACD has primary responsibility for managing and administering the OEIC. There is no requirement for a full board of directors and no requirement for independent directors. Either the trustee or the depository of an OEIC is responsible for ensuring compliance with regulations.

36. Australia had the traditional unit trust system through the early 1990s, when problems of large losses, illiquidity and difficulties of trustees in effective monitoring led to a prolonged reappraisal of existing structures. Significant changes in the legal regime for CIS were included in the Managed Investments Law of 1998, under which Australia moved from a system of dual responsibility (investment manager and trustee) to one of a single “responsible entity” (RE). The CIS is required to have a constitution (instead of a trust deed) and must demonstrate a capability to carry out investment management business and to meet the regulatory requirements. The RE must file a compliance plan with the regulator. The RE has responsibility for management of the scheme as well as for enforcement of all investor protection norms as specified in the laws and regulations and by the internal rules of the CIS. The RE may delegate some functions but still retains responsibility. When less than half of the directors of the RE are independent, a compliance committee must be established to monitor compliance with the compliance plan, to report its findings to the RE or to the regulator when the RE does not take appropriate action, and to conduct ongoing assessments of the plan. Investors may vote on certain important issues.

37. In Canada regulation of collective investment business takes place at the provincial level, although Ontario often tends to be a leading force in setting regulatory practice. The unit trust system has been used, but there are notable differences between Canada and other countries using the trust system. For many years, Canada characterised investments in CIS simply as devices to obtain portfolio management expertise, rather than as acquisition of shares in a legal entity. Thus the concept of CIS governance was neglected to some degree. The legal framework has not been strong and the role of key parties has not been well defined. The trustee has not been required to be independent of the investment manager. At the same time, the authorities have imposed many restrictions on the operations of CIS that
many in the industry believe have hampered the operation of the industry. Instead of relying on the internal governance mechanisms of CIS to mitigate conflicts of interests, the approach has been to issue blanket prohibitions. For instance, it is forbidden for CIS to purchase primary market securities underwritten by affiliated financial institutions. Since there are a relatively small number of institutions active in the primary market, this is a very significant obstacle to CIS participation in primary offerings.

38. Over the past two decades, the Canadian governance system has been under extensive review by both official and industry groups. None of these reviews was conducted in the context of any crisis, and the two most recent reports were commissioned due to the rapid increase in CIS assets. A 1995 report to the Ontario Securities Commission (the Stromberg report) noted that there was no party in the Canadian structure who is responsible for independent review of the fund operators or who is unequivocally mandated to act solely in the interests of investors. The report recommended the legal requirement of an independent board or comparable body with oversight responsibilities. It also called for the establishment of independent audit committees with some defined responsibilities, for example in terms of the allocation of expenses to funds and the approval of annual financial statements. The Report also suggested a movement away from strict prohibitions to flexible governance arrangements and codes of best practices for fund managers and for investment funds. The report also called for more comprehensible authorisation procedures on the part of regulators. A recent report (the June 2000 Erlichman report) repeated similar criticisms and mapped out possible ways in which a robust governance structure could be erected.

39. In Hong Kong, China both open-ended corporate funds and unit trusts are permitted. Regardless of legal form, there are strict regulations to limit conflicts of interest, including separation of function within financial groups and strong oversight of related party transactions. A “Fund Manager Code of Conduct” sets out the conduct requirements for persons whose business involves the management of collective investments while a “Code on Unit Trusts and Mutual Funds” governs the authorisation requirements for CIS and on-going obligations of CIS Operators.

40. In Singapore the unit trust is the predominant form of CIS. Unit trusts are covered by the Companies Law as well as under the Securities Law. Investment Managers are licensed and regulated under the Securities Act. Each fund usually has a compliance unit that ensures that the managers are acting in accord with regulations and the rules of the fund. The regulator spot-checks the performance of firms to be sure that the compliance department is performing its functions properly.

Japan and Korea

41. In Japan the traditional form of CIS has been the Securities Investment Trust. However, the trust concept is not deeply rooted in the Japanese legal system, and this system has many attributes of a contractual system. The trust is established by a trust deed between a management company and a trustee who serves as custodian of the CIS assets. Each management company is subject to licensing and supervision. The Investment Trusts Association (“ITA”), which operates as an officially licensed self-regulatory organisation, monitors compliance with its own Conduct of Business Rules, guidance and recommendations. Conduct of Business Rules cover matters such as self-dealing and conflicts of interest, pricing of units and marketing of units including rules regarding advertising. The ITA has a Fair Practice Commission, which determines disciplinary measures to be taken against member companies in case of violation of the rules.

42. Changes in legislation in December 1998 made it possible to establish corporate CIS. The new Investment Trust Law, which will go into force in April 2001, re-designates existing SIT as Non-discretionary Investment Trusts (“NIT”). The corporate form of CIS will be called Investment Corporations (“IC”), having the status of a juridical person established for the purpose of investing in negotiable securities. They must entrust certain functions, such as asset management, custody of the fund
assets, the general business administration and the subscription of investment units to outside companies (e.g. ITMCs, asset custody companies or general business administrators.) The investment management company will hire employees. An IC must be registered with the regulatory authority.

43. The board of directors of ICs consists of executive directors, who may be employees of the company and supervisory, i.e. independent, directors. Employees of the promoter and related securities companies cannot serve as supervisory directors. They may demand at any time executive directors, ITMCs, asset custody companies and general business administrators to report the situation related to the business and the assets of the IC, and may conduct investigations if necessary for performing the duties. The number of supervisory directors must exceed the number of executive directors at least by one. Both executive and supervisory directors are liable for damages.

44. The investment management companies are required to exercise good faith in the interest of the beneficiaries when giving directions related to management of the trust property or managing ICs. Certain trades that involve conflicts of interest are prohibited. For example, the law prevents persons or companies that have influence over the action of the investment management company from giving instructions to the ITMC to carry out trades for the purposes of profiting themselves or their clients.

45. It is not yet clear how the IC is expected to operate in practice. However, it would appear that the new system aims at introducing some elements of American type mutual fund governance practices, with oversight by independent directors into the Japanese market. At the same time it would appear that alongside the new model based on US mutual funds, traditional Japanese “investment trust” structures would be permitted.

46. In Korea, two types of CIS are found. The traditional Securities Investment Trust (“SIT”) is a contractual scheme and the Securities Investment Company (“SIC”) is a corporate type, which were legally authorised in December 1998. No open-ended funds have yet been allowed, but some closed-ended SICs have enjoyed conspicuous growth.

47. The SITs are the dominant players in the Korean market. The SIT is based on a relationship among three parties: the investment trust management companies (“ITMCs”), the custodians (generally banks) and the investors. A SIC is a “paper company” composed only of financial assets (money or securities). It does business by contracting with independent companies for services such as the management and safekeeping of the assets and sales of the shares.

48. There have been major problems in the CIS sector in Korea since the crisis of 1997 that revealed basic flaws in the governance system. Seven management companies have ceased operations due to insolvency. The threat of forced restructuring and prospective credit losses in the Daewoo group, which had massive amounts of fixed-income paper outstanding, raised the possibility of widespread insolvency of SITs. A large-scale redemption of bond funds became a threat to systemic stability when investors became aware of the risk of insolvency of ITMCs.

49. The fact that the standard of prudence and investor protection fell short of accepted global norms aggravated the structural weaknesses in the Korean CIS sector. In order to address these structural problems, in early 2000 the Securities and Exchange Act and Securities Investment Trust Business Act were amended to enhance governance structures based on global standards. Highlights of the proposed changes include the following: 1) For ITMCs with total assets under management of more than 6 trillion won, more than half of the total number of directors should be independent directors and the company should establish an audit committee, two thirds of which must consist of independent directors. 2) Every ITMC should set internal control standards to ensure that the management and employees comply with the concerned laws and operate their own trust property for the best interest of their beneficiaries. 3) Every
ITMC should also appoint compliance officers to examine and monitor its compliance with the internal control standards. In addition, the requirements of minority shareholders to exercise their rights in ITMCs are made comparable to those of listed corporations. The Financial Supervisory Service (FSS) has also established detailed guidelines to promote the effective operation of the board of directors, audit committee, and compliance officers based upon the amended laws. For example, the specific roles of compliance officers, the board of directors, senior management, and on-site managers should be clearly defined in the bylaws of ITMCs in order to maximise compliance with the law.

Mexico

50. In Mexico corporate CIS are the predominant form. Two types are found: 1) an ordinary fund which invests primarily in transferable securities and 2) a special fund for debt and money market instruments. CIS operators are independent corporate entities organised with the sole purpose of CIS portfolio management, operational services and shares distribution. Securities brokerage firms and commercial banks may also assume overall responsibility for management and performance of the functions of the CIS. Safekeeping of CIS assets (non-government securities) is accomplished by a securities depository institution (INDEVAL). The Bank of Mexico carries out custody of government securities. Decision-making concerning CIS investment strategies and portfolios composition is centred in their investment committees, whose members should be appointed in special stockholders meetings to guarantee independence of the CIS investment decision making process from the trading process carried out by their operators.

51. To ensure fairness and impartiality in the daily valuation process, Mexican law requires that valuers should be independent from the CIS themselves, their operators and issuers of securities held in their portfolios. In addition, to avert conflicts of interest, the supervisory authority prohibits CIS from buying securities owned or managed by any other member of the same financial group to which the operator belongs.

D. Conclusions

52. The OECD countries have developed a broad array of institutional mechanisms to enable the CIS sector to develop. The fact that only very few countries have had major crises in the CIS sectors and that CIS have become major repositories of wealth suggests that existing governance mechanisms have succeeded in building confidence in this sector. At the same time, the fact that fraud and misallocation of funds occurred in several European countries before the introduction of adequate legal frameworks and that a serious systemic crisis arose in Korea, where international standards were not effectively enforced, provides clear evidence that such safeguards are needed.

53. The internal governance procedures are the first step in the entire process by which the activities of CIS are subjected to successive layers of monitoring. Other crucial elements in the process are:

- **Industry self-regulation.** In many countries industry associations have developed codes of conduct and exercise some self-regulatory functions, such as reviewing promotional material. In many cases, self-regulatory bodies take the lead in promoting Codes of Conduct.

- **Official Supervisory Oversight.** By prior authorisation and periodic review, the adequacy of internal monitoring procedures and conformity with standards is assessed.

- **Scrutiny by the market.** Adequate disclosure enhances the capability of investors to undertake independent scrutiny. In cases where inadequate governance procedures are in place or where standards are not observed, investors can take legal action or lodge complaints with regulators.
Perhaps, most importantly, any practice that leads to diminished returns to investors will lead to a decline of funds under management. Particularly in advanced competitive markets, this is the sanction most feared by CIS operators.

54. When considering the extent to which the market can provide effective monitoring to the operators of CIS, two basic considerations arise: the degree to which there is active competition among suppliers of CIS services and the adequacy of information to investors. In most markets competition is growing rapidly. In the United States, diversification of distribution channels has been occurring for more than two decades. Originally, most mutual funds were produced and distributed by full service brokers, but discount brokers, insurance agents, independent financial planners and direct sales by mutual fund companies have become significant distribution channels. Banks, who had previously been banned from CIS business, have made major inroads. In Europe, the traditional dominance of banks and insurance companies that distributed “propriety” funds, seemed to be weakening at the end of the 1990s. Also, international competition is a fact of life in most OECD countries.

55. The availability of information, aided by advances in technology, has been crucial in empowering investors. Once mandatory disclosure requirements are fulfilled, the information-processing sector can enhance the value of this information. Specialised firms now regularly obtain information from CIS operators, present the data in a consistent way, compare the performance and disseminate the results. Some information providers also rate funds by their performance with respect to peer groups or analyse the fund’s return in relation to the risks it has assumed. The traditional means of communicating such information has been through the specialised financial press, but information technology such as the Internet is increasingly important. With growing competition, CIS operators tend to disclose more information than is legally required.

III. Other Issues Related to Corporate Governance of CIS.

Performance and cost structures of CIS

56. Most of this note has been concerned with structures for investor protection. However, in addition to fulfilling this task, the governance regime must create an institutional setting in which it is possible for the CIS operator to formulate and execute an investment strategy, communicate that strategy to investors and periodically adjust behaviour based on experience. The performance of individual asset managers and of the industry as a whole can be measured by the yardstick of how they have served their investors in terms of performance and costs. Broadly speaking, the CIS industry has provided returns that have exceeded those of alternative investments available to individuals, largely due to the excellent performance of bond and equity markets in recent years. At the same time, the way in which investment mandates are formulated and executed have been criticised. It is noted that most actively managed funds have often not performed as well as benchmark indices, suggesting that the fund manager is not adding any value. At the same time, many analysts have concluded that the portfolio holdings of a large part of the fund industry are not closely related to the investment styles described in their prospectus. Many industry critics contend that expenses have remained high and in some cases become less transparent despite the fact that technology has reduced trading costs and that economies of scale should have made much larger cost reductions possible.

57. It is a reasonable question how far the internal governance regime, as opposed to market scrutiny, can deal with these issues. Arguably, once the proper legal and governance structures and an adequate regulatory and disclosure framework are in place, market competition will be the most powerful force working to protect investors. Firms will tend to compete by offering superior returns at lower cost, while offering the range of investment options that best match investor preferences. Once the investment manager has disclosed the investment strategy, including the expected amount of trading activity that will
be used to achieve that objective, it should be left to investors to decide whether they wish to pay for additional analysis and active portfolio selection. The fact that index-tracking funds that adopt passive portfolio selection are gaining in popularity suggests that many investors are also concluding that portfolio managers have on balance not been adding value. It is also possible that, if some inherent flaws in CIS were clearly to emerge, other products might eventually gain a large share of the market currently occupied by CIS.

**Corporate governance activities by CIS**

58. Thus far the discussion has centred on the organisation and governance of investment funds. However, collective investment instruments are becoming major holders of equity and thus must decide whether and how to exercise the ownership and governance rights resulting from this ownership position. Since CIS must seek to maximise the value to investors and to make it possible for investors to liquidate positions at all times, one would expect them to be comparatively “active portfolio managers”, trying to add value to their portfolios by adjusting their holdings in accord with their assessment of corporate valuations. This can be contrasted with other institutional investors who tend to trade less frequently and try to add value by active dialogue with management, a practice characterised as “investor activism” in corporate governance. Thus, in general one would expect a CIS to trade more actively and to be less directly interested in activism than a pension fund. At the same it should be recognised that buying and selling by CIS, who on balance should be more willing to engage in active portfolio management than other kinds of institution, is part of the overall process whereby corporate management is made accountable to investors. One factor that may dissuade European CIS from active governance is the provision of article 25 of the UCITS Directive which says that no authorised UCITS shall invest in shares carrying voting rights which make it possible to exercise significant influence over the management of the issuer. Although this could be read as precluding all CIS participation in corporate governance, most market participants do not interpret it in this way.

59. Preliminary evidence indicates many collective investment companies have decided that some degree of monitoring of the governance that practices of companies in their portfolio may be useful. Thus, some funds have policies about the composition of boards of directors or dividend payment policies and regularly cast votes on related issues. Many CIS have taken some pains to develop information channels, such as shareholder information and voting services, that make it possible to establish policies on governance and to vote regularly. At times, CIS delegate their voting rights to custodians with specific instructions as to how shares are to be voted. This being said, there is controversy within the industry as to what degree of activism is desirable. For example, in France some institutional investor associations have proposed codes of conduct that would encourage more active CIS participation in corporate governance. In the United Kingdom, an officially sponsored commission (the Myner Commission) is examining the corporate governance activities of all institutional investors including CIS.

60. In addition to general equity funds where governance related activities are marginal, there are a number of funds that have pursued “active value” strategies; i.e. of producing returns for investors by taking relatively large positions and engaging in active dialogue with the management of some companies and urging the targeted companies to take specific actions. Such policies are part of the explicit investment style as explained in their prospectuses.

**International trade in services/Market access**

61. A significant internationalisation of the CIS industry has already occurred. Asset managers from the major OECD regions have become established in other markets and have made acquisitions in order to be able to gain strategic footholds in the fund management sectors of other countries. However, cross-border trade in CIS has not progressed as rapidly as other aspects of CIS business. While the UCITS directive has greatly enhanced the possibility to conduct CIS business on a pan-European scale, the scene
is still characterised by a maze of EU-wide and national rules governing funds in which some funds can be marketed throughout Europe while other can be sold only in their home jurisdiction. Thus, it is not sure whether Europe has achieved a market of continental scope comparable to that of the United States. At this time, revisions to the UCITS directive have been proposed that would broaden the range of funds available for approval as UCITS while simplifying procedures for gaining approval in all EU states. Outside of Europe, relatively little cross-border trade in CIS products takes place, partly due to difficulties in meeting specifications for products introduced in other markets.

**Points for discussion**

(i) What are the observations of delegates about the main themes that emerged at the meeting with representatives of the financial service industry on the future of the collective investment industry? What do delegates see as prospects for growth of the CIS sector, particularly in light of the impact of technological progress? Do delegates from countries where growth lagged in the 1990s expect a significant acceleration? How will the shift to funded pensions affect the growth of the sector? What main policy issues are raised by the emergence of the CIS sector as a major repository of national wealth and retirement income?

(ii) How do delegates generally assess the task of investor protection in the CIS sector? What do they see as major policy issues in respect of the governance of CIS in their respective countries at present? Have weaknesses in legal structures and governance systems been identified? What major policy changes have been introduced in recent years? Are there important initiatives being undertaken or envisaged in this regard?

(iii) From a public policy perspective, what are delegates’ views on the role of CIS “activism” in corporate governance? Should the issue of corporate governance by CIS be dealt with solely by CIS operators and/or industry and investor associations or is there a need for official action?

(iv) Do delegates see a convergence of governance systems in Europe around the contractual model? To what extent can the functions of independent directors of mutual funds, trustees and depositaries under contractual schemes be compared? What assessment can be made of the degree of investor protection in European countries, despite the absence of (or lesser reliance on) independent mutual fund directors?

(v) How far has the UCITS Directive assisted in the development of a unified European CIS market? What are the shortcomings of the Directive? Can the representative of the EC inform the Committee about amendments that are under consideration and will further improvements in the Directive be needed?

(vi) To what extent does the representative of IOSCO consider that worldwide convergence is taking place in commonly accepted standards for CIS? How far do practices diverge in application and what problems do such divergencies give rise to, particularly with regard to cross-border business? The representative of IOSCO is also invited to advise the Committee on the conclusions that can be drawn from the recent questionnaire on decision-making structures of CIS and likely future IOSCO work on this issue.
NOTES

1. This term includes several forms of open-ended instruments such as investment companies mutual funds, unit trusts, investment trusts and others as described in the text. To the extent possible, this Note uses terminology used by other international organisations, especially IOSCO.

2. A search of written material was undertaken. Contacts were initiated with CIS industry associations, who provided written material and additional insights while many of these associations have Internet sites. Information was received from consulting firms active in the CIS sector and other experts.

3. The directors of the investment management company appear to have somewhat ambiguous mandate. Normally the directors of the investment management company should be expected to maximise return to the shareholders of the investment management company and obviously institutional pressures will encourage the investment manager to behave in this way. However, according to the laws of nearly all OECD countries, the CIS should be operated in the interests of investors.

4. OECD, February 1972 [C(71)234]. The standards were approved as a set of Council Recommendations.

5. With temporarily high interest rates, a number of SITs began soliciting funds, based upon valuation practices that fell short of international norms as well as promotional techniques that did not inform investors fully about the risks involved. Fixed-income funds in Korea were not marked to market but valued at historical prices, thus enabling SITs to promise high fixed returns. However, these returns were only possible because the SITs were assuming considerable concealed risk. The size of SITs grew dramatically --from 100 trillion won at the end of 1997 to 250 trillion won at the end of July 1999, mostly due to gains in fixed income SITs.

6. For a discussion of problems in this sector see, OECD Economic Survey of Korea 2000, Annexes IV and V.

7. Since major shareholders of ITMCs are often distributors that are affiliated with large industrial companies, distributors or their parent companies often request operators to buy securities which distributors are underwriting or to lend or borrow money on a short term basis at a non-market interest rate. Even though it is prohibited in the law to transfer securities or trade between investors’ funds and a proprietary trading account of an operator, indirect trading was common. Some operators allegedly made commitments in advance about promised rate of return to investors, even though it is prohibited to do so by the law.

8. For an analysis of how various investment styles contribute to the process of corporate monitoring, see “Shareholder Value and the Market in Corporate Control,” Financial Market Trends (March 1998.).