

**CONFLICTS OF INTERESTS  
OF  
CIS OPERATORS**



**OICJ-IOSCO**

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## 1. Introduction

The success of collective investment schemes (“CIS”) as a vehicle for retail investors springs from two key attributes: they permit the pooling of funds so as to take advantage of economies of scale and reduce investment costs (both transaction costs and information costs); and they enable retail investors access to professional management of their investment funds at a reasonable cost.

Investors place their funds with, and their trust in, the operator<sup>1</sup> of the CIS to act in their best interests. They reward the operator through their loyalty and the payment of fees. Their trust, and their confidence in the CIS as an investment vehicle for their funds, can be threatened if they believe the CIS operator is not acting in their best interests.

The separation of the “ownership” of the funds from its management, which is necessary in order to take advantage of the pooling of the funds, carries the potential for the interests of the CIS operator and CIS investors to diverge.<sup>2</sup> This gives rise to potential conflicts between the self interest of CIS operators and interests of investors in CIS. Such conflicts of interest, in the absence of proper control mechanisms, not only adversely affect the interests of investors but also have the potential to undermine investor confidence in CIS as an investment vehicle.

The general “Principles for Regulation of Collective Investment Schemes” (“the Principles”) adopted by IOSCO in October 1994 therefore recognise the importance of dealing with conflicts of interests that arise in the management of CIS, as such conflicts are inevitable in the course of management of CIS. It provides, in Principle 6, that:

“The regulatory regime should recognise that an operator of a CIS may have interests that if exercised without restraint would conflict in a material way with the interests of investors. Regulatory authorities should respond to this risk by ensuring that a regime provides for the exercise of management responsibilities with full regard to the best interests of investors. Such a regime may be general in nature, relying on the concept of “fiduciary responsibility” as interpreted domestically. Equally, the establishment of detailed regulations designed to monitor potential conflicts of interests between operator and investors is recognised as an acceptable regulatory method.”

The Principles also contain an inclusive list of the most common types of conflicts of interest situations that arise, such as:

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<sup>1</sup> The term “Operator” of CIS is used in this paper to include CIS managers.

<sup>2</sup> This conflicts of interest problem is not restricted to CIS. For example, the same problem arises with respect to the management of large public companies where the ownership of the corporation is dispersed amongst many shareholders who appoint a board of directors to manage the company in the best interests of the company as a whole.

- principal transactions between CIS and its affiliates;
- transactions where a CIS and its affiliates jointly participate;
- soft commissions;
- lending and borrowing to or from affiliates;
- purchase of an affiliate’s securities or securities underwritten by an affiliate;
- use of affiliated brokers; and
- employees’ transactions for their own account.

The Principles then go on to describe the type of regulatory responses commonly used in member jurisdictions to address such conflicts of interests. Those regulatory responses range from:

- the duties of a CIS operator to act in the best interests of investors;
- the powers of regulatory authorities to impose sanctions on and monitor the conduct of CIS operators;
- direct prohibition of certain conduct likely to give rise to conflicts of interests;
- detailed regulatory requirements that restrict the manner in which certain conduct, likely to give rise to conflicts of interests, can be carried out,
- disclosure to investors and the regulator; and
- independent review of the conduct of CIS operators by third parties.

The purpose of this Paper is to revisit the issue of conflicts of interests of the CIS operator for the purpose of:

- making a more detailed analysis of the types of conflicts of interest situations that arise in the course of the operation and management of a CIS;
- identifying regulatory responses adopted by member jurisdictions to address those conflicts, including some case studies; and
- exploring the way forward in dealing with conflicts of interests to promote investor protection.

This Paper, and another paper titled “Delegation of Functions”, stem from and, form part of, the broader project undertaken by IOSCO Technical Committee Working Group on Investment Management, to identify the “Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators”.

## 2. Detailed Analysis of the Types of Conflicts of Interests

For convenience of analysis, those activities of a CIS operator which are likely to give rise to conflicts of interests are divided into two broad areas:

- investment selection activities; and
- other CIS management activities.<sup>3</sup>

### ***Investment Selection Activities***

Investment selection activities of a CIS operator can give rise to conflicts of interests in situations such as:

- principal transactions involving a CIS and its affiliated parties;
- transactions using affiliated party intermediaries; and
- joint transactions with affiliated parties.

### Principal transactions involving a CIS and its affiliated parties

A principal transaction in this context means a situation where a CIS enters into a transaction with an affiliated party (ie an associated party) as a principal. The term “affiliated party” generally encompasses those parties who may be affiliated with the CIS, such as the CIS operator, the custodian<sup>4</sup> and their affiliates.<sup>5</sup>

Possible conflicts of interests that can arise as a result of principal transactions involving affiliated parties, and some of their consequential effects, include:

- purchase of securities from an affiliate at an inappropriate price (ie higher than the market value), or where they do not meet the CIS’s objectives;
- purchase of securities underwritten by an affiliate, where those securities are inappropriately valued or do not meet the CIS’s objectives;
- sale of the CIS’ securities or investments at an inappropriate price (ie lower than the market value) in order to meet the affiliates’ other obligations;
- exchange (ie cross-trades) of the securities of the CIS for the securities of an affiliate where the securities of the affiliate are valued incorrectly, illiquid or do not meet the CIS’s objectives;<sup>6</sup>

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<sup>3</sup> There is some inevitable overlap between the above two categories of activities, because investment selection is generally an integral part of a CIS operator’s activities in managing a CIS. However, given the significance of the investment selection function in the management of a CIS, it is considered appropriate to treat these activities under two distinct categories.

<sup>4</sup> Under the US regime, a custodian is not an affiliate of the CIS operator merely due to its role as a custodian.

<sup>5</sup> In many member jurisdictions, the term “affiliates” or “associates” has a very specific and complex definition. As these definitions are not always consistent, no attempt is made to adopt a specific definition in this Paper. However, the regulatory practices identified in Part 3 of the Paper seek to rely on whatever the individual definitions adopted in member jurisdictions to define those terms.

<sup>6</sup> Note a CIS and its affiliates may exchange investments other than securities which belong to them.

- restrictions resulting from trading in securities of affiliates due to knowledge or perceived knowledge of price sensitive information, which could lead to untradable investments of the CIS; and
- the CIS operator being subject to pressure to act (eg vote) in a certain way in the interest of the affiliate, which may not be appropriate for the CIS.

#### **Case Studies**

In an Australian case, a CIS allowed affiliates to invest in the CIS without requiring those affiliates to pay money up-front to enable the CIS to meet minimum subscription requirements on paper. This subsequently placed the CIS in financial difficulty, which resulted in the regulatory action to remove the CIS operator and wind up the CIS.

In a Canadian case, a CIS operator invested CIS funds in securities underwritten by an affiliated party contrary to the legal restrictions applicable to such transactions and, also to help the issuer reach minimum subscription standards, which led to the regulator imposing sanctions on the CIS operator and its officers involved in the decision making.

In a French example, a number of CIS funds investing in real estate bought from a related real estate company real estate which were clearly over priced, which led to regulatory actions involving pecuniary sanctions against the company.

In a Hong Kong case, a CIS operator acting as the investment manager for a bond fund, bought for that fund a significant number of bonds issued by an affiliated company, and subsequently sold back those bonds to that company. These transactions raised the possibility that the CIS operator was manipulating the market price of those bonds in the interests of the related company issuer, rather than acting in the best interests of the investors in the bond fund it managed, which led to the regulator's intervention.

In a Luxembourg case, a CIS purchased from its CIS operator unlisted securities which were issued by the CIS operator as a part of the latter's own share capital. The securities were shortly thereafter sold back to the CIS operator at a price lower than the purchase price. These transactions were made using prices based on quotations provided by an affiliate of the CIS operator, resulting in significant losses being suffered by the CIS and its investors. The regulator ordered the CIS operator to indemnify the CIS for the losses it had suffered.

In a similar case in Mexico, a CIS invested in shares of a company in the same group as the CIS operator when, in fact, the issuer company was insolvent. This led to the CIS operator being ordered by the regulator to repurchase those securities at the price at which they were sold to the CIS.

#### **Transactions using affiliated party intermediaries**

Transactions envisaged in this context encompass a CIS' principal transactions with a party which is generally not directly affiliated or associated with the CIS, but are entered through the use of an "affiliated party intermediary". The term "affiliated party intermediary" is used in this Paper to refer to parties such as agents, brokers and other CIS where they are affiliated to parties who are considered as affiliates of the CIS (eg the operator or custodian of the particular CIS or their affiliates).<sup>7</sup>

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<sup>7</sup> As the terms 'affiliate' and "associate" attract jurisdiction specific definitions, no attempt is made in this Paper to define such terms.

Possible conflicts that could arise as a result of CIS transactions using affiliated party intermediaries include:

- paying excessive commissions or fees to an affiliated party intermediary used for buying or selling securities or other investments of a CIS;
- the CIS operator having arrangements to share commissions or other benefits derived by an affiliated party intermediary used for buying or selling securities or other investments of the CIS which are not passed on to the CIS;
- when a CIS operator delegates its CIS management functions, there is a risk that the delegated manager may pass transactions either through itself or its affiliates, with the potential to double charge commissions to the CIS;
- when acting as the agent of the CIS, the affiliated party intermediary receiving payments or kickbacks (eg soft dollar arrangements) from the other party to the transaction;
- not achieving best execution terms or undertaking unsuitable transactions (eg churning) to generate increased margins or commissions for the affiliated party intermediary; and
- where there are inadequate Chinese Walls in place between the CIS operator and the affiliated party intermediary, the opportunity for the latter to front run the CIS.

#### **Case Studies**

In a German case, a CIS operator which operated both retail funds (ie public offer funds) and institutional funds (ie special funds) had arrangements with its custodians and brokers under which it received kickback payments. The regulator became alerted to this because the audit reports of the CIS operator revealed that while it obtained a low management fee, there was a large income derived from the turnover of securities of CIS. The regulator required the CIS operator to terminate the kick back arrangements with custodian and brokers where public funds were concerned and to disclose such arrangements to investors in special funds.

A CIS operator regulated under the regulatory regime in the Netherlands, was found to be deriving a substantial part of its income by acting as a broker for the funds it managed. As this raised the possibility of conflicts of interests, particularly because the CIS operator was privy to price sensitive information relating to the funds, a special inquiry has been commenced into the conduct of the CIS operator.

#### **Joint transactions with affiliated parties**

Joint transactions with affiliated parties are where a CIS and its affiliates (such as the operator or custodian of the CIS or their affiliates) jointly enter into a principal transaction with a third party.

Possible conflicts that could arise as a result of joint transactions involving affiliated parties include:

- opportunity for the affiliated party to negotiate terms of the transaction (eg the maturity of privately placed securities to be jointly purchased) to the detriment of the CIS and in its own interest;
- opportunity for an affiliated party intermediary to make preferential allocation of assets, which promotes the interests of the CIS operator rather than the CIS;
- acquiring holdings in a target company between the CIS and the affiliated party, which may allow the affiliated party (eg the CIS operator) a degree of control over the target which it may use in its own, rather than that of the CIS', interest;
- creation of false markets for the investments jointly purchased, leading to overvaluation of the CIS interests which will disadvantage incoming investors; and
- opportunity for the affiliated party to fund other inappropriate affiliated investments.

#### **Case studies**

In a US case, a registered CIS operator employed a portfolio manager to manage a portion of assets of its own employee profit-sharing plan and two other CIS. The portfolio manager placed orders for the purchase of futures without prior or simultaneous designation of accounts to which those trades were to be allocated, thereby being able to designate the relevant account after observing the subsequent price movements in the market. The portfolio manager then allocated to the profit sharing plan those trades with the more favourable execution prices and to CIS, the trades with less favourable execution prices, which resulted in detriment to CIS investors. This conduct of the portfolio manager and the registered CIS operator amounted to breaches of the prohibitions under the US regime against joint transactions without the prior approval of the regulator. Therefore, the registered CIS operator was ordered, among other things, to compensate the two CIS for the financial loss they suffered as a result of the above conduct of the portfolio manager and the CIS operator's failure to adequately supervise the portfolio manager to avoid conflicts of interests.

In another US case, certain affiliated companies that were under the common control of an individual formed a group with the intent to pursue a leveraged buyout of a corporation (target). The group included two CIS and their CIS operator and the controlling individual was the CEO and President of the CIS operator, who made all the investment decisions for the group of companies. The group acquired nearly 30% of the stock of the target company. The regulator was successful in taking enforcement action against the affiliated companies for breaches of the prohibitions against joint transactions without the prior approval of the regulator.

In another US case, an affiliated company of a CIS (in which the CIS held certain stock), informed the CIS that it was purchasing the shares of another company (target) to enable the affiliated company to effect a merger with the target. CIS then purchased certain stock of the target company, followed by further purchases of the stock of the target company by the affiliated company. The affiliated company then proposed a merger with the target company citing the combined holdings of the CIS and the affiliated company. Enforcement actions were successfully taken against the affiliated company for engaging in a joint transaction with the CIS (although there was no formal agreement) without the prior approval of the regulator. Court also found that the affiliated company and the CIS had acted together in such a manner that the CIS "was no longer a completely free agent as to the ... shares [it] had purchased".

### ***Other CIS management activities***

There are a number of areas in which CIS management activities that fall outside the investment selection and related processes noted above may give rise to conflicts of interests. The key areas in which such conflicts may arise include:

- fees and charges levied by the CIS operator;
- use of CIS assets for marketing the CIS;
- employee remuneration and employee transactions on own account;
- selection of directors, custodians and depositories who are not independent of the CIS operator; and
- CIS operator's trading on own account.

### **Fees and charges levied by the CIS operator**

CIS operators are entitled to receive certain fees and other compensation for managing the CIS. The management of a CIS generally encompasses the provision of administration and other services that are integral to the management of the CIS. As a result, any management fees which a CIS operator is entitled to receive from the CIS are generally intended to cover the administration costs that a CIS operator would incur in the management of the CIS and their profits. However, a CIS operator may have certain discretions when determining the fees and charges that it can levy to the CIS, and how those services are to be obtained.

Therefore, when CIS operators levy their fees and charges to the CIS, certain conflicts of interests can arise. Such conflicts of interests include situations where a CIS operator:

- charges fees based on the performance of the CIS, which may provide an incentive for the CIS operator to take undue risks with the assets of the CIS to increase its fees;
- (or an affiliate of the CIS operator) provides administrative services (eg. record keeping, registration, research etc.) to the CIS, which may provide an incentive for the CIS operator to charge the highest possible fee and provide less expensive services;
- delegates its investment management functions, which may provide an opportunity for double charging the CIS for investment transactions which are passed through the delegated manager or its affiliates because the management fees should generally cover such costs and should not be charged to the CIS separately;<sup>8</sup>
- provides other agency services (eg. foreign exchange conversion transactions), which may provide an incentive for the CIS operator to charge a mark-up on such transactions;
- receives goods or services from a third party either independently or jointly with the CIS, which may provide the opportunity for the CIS operator to:

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<sup>8</sup> Delegation of functions is the subject matter of a separate Paper currently under preparation.



- charge the cost of the services or goods entirely to the CIS. For example an inflated audit fee charged to the CIS to cover the cost of the audit of the CIS and the CIS operator; or
- receive discounts on the services it obtains, which may be covered by increased charges paid by the CIS; and
- has the ability to indemnify the CIS operators and their officers out of the CIS funds, which may provide the incentive for the CIS operator to engage in wilful wrongdoings, or act recklessly in disregard of the interests of the CIS and CIS investors.

#### **Case Studies**

In an Australian case, a CIS outsourced many of its operational activities to affiliated parties and paid fees for their services in advance. The affiliated parties promptly spent the funds on their other activities and went into liquidation. As the CIS did not have funds to find replacement services, the CIS and the CIS operator were wound up through regulatory intervention.

In a UK case, a CIS operator delegated its fund management functions relating to three overseas CIS funds it managed to an external fund manager. The CIS operator allowed the external fund manager to levy its fees directly to the three funds for a period of four years, when in fact those fees should have been reimbursed out of the management fees the CIS operator charged to the three funds. The CIS operator was found to have acted without due care, skill and diligence in allowing this to happen and therefore ordered to compensate the three funds for the losses they suffered as a result of the double charging of fees.

#### Use of CIS assets for marketing the CIS

Where a CIS operator can use CIS assets for marketing the CIS, conflicts of interests may arise because there is a greater incentive for the CIS operator to spend excessive amounts of CIS assets on marketing efforts. Although any new business generated through marketing may not benefit existing investors of the CIS, the CIS operator may have the opportunity to benefit from such activities where:

- it is entitled to charge increased management fees based on the volume of assets under its management;
- there are service and administrative charges it can claim for new sales; and
- it may be able to make arrangements with the persons providing marketing services to obtain direct or indirect benefits (eg soft dollar commissions) on new sales which are not passed on to the CIS.

#### Employee remuneration and employee transactions on own account

Conflicts of interests that may adversely affect the interests of CIS investors may arise:

- in relation to remuneration arrangements that employees have with the CIS operator; and
- also where the CIS operator allows employees to engage in transactions on their own account without adequate controls to minimise employees' activities which are not in the best interest of CIS investors but their own.

For example, performance bonus payments to CIS employees may create an incentive for inappropriate risk taking by employees, particularly if there are no penalties attaching to such conduct. Where employees are allowed to have their individual portfolios, they may front run using price sensitive information or allocate favourable trades to personal accounts and non-favourable trades to the CIS.

#### Selection of directors, custodians and depositories who are favourable to the CIS operator

Conflicts of interests may arise where a CIS operator has a discretion when appointing directors, custodians and depositories, as they may have the incentive to select persons who are likely to make favourable decisions to the CIS operator rather than act in the best interest of the CIS and CIS investors.

#### Trading on own account

Where a CIS operator undertakes trading on own account, there is a potential for conflicts of interests to arise.

#### **Case Studies**

A Hong Kong registered fund manager acted for a number of overseas funds including a Luxembourg CIS. This fund manager, along with a director of an international fund management company, traded in highly volatile exchange traded options and made late allocation of trades, whereby the fund manager was able to allocate trades with favourable price movements to its own account and trades with non-favourable prices to the CIS account, resulting in significant personal profits for the fund manager and losses to the CIS funds for which it acted. The Hong Kong regulator, after investigating the pattern of the preferential late allocation adopted by the fund manager, revoked the registration of the fund manager and ordered it to compensate the CIS funds for the losses they suffered as a result of this conduct.

The Luxembourg regulator ordered the relevant CIS to compensate all investors in the Luxembourg fund, which suffered losses as a result of the action of the Hong Kong fund manager which led to the compensation payment to the CIS.

### **3 Regulatory Responses to Address Conflicts of Interests**

The regulatory responses used in member jurisdictions to address conflicts of interests that arise in the investment selection and other CIS management activities are often not the same, although there is some degree of commonality as to the broad types of regulatory mechanisms that are being used. The regulatory mechanisms which are used to address conflicts of interests share a common regulatory objective, which is to ensure investor protection by eliminating or minimising the adverse impact of any possible conflicts of interest of the CIS operator and its affiliates on the CIS and its investors. Implicit in such regulatory mechanism that deal with conflicts of interests is also a recognition that provided there are adequate and appropriate restraints, some transactions involving affiliated parties may be beneficial to CIS investors.

It is also important to note that although it is possible to identify distinct types of conflicts of interests and their possible impact, it is not practicable to identify in relation to each identified type of conflicts of interest, the specific regulatory mechanism used to address it. This is because very often a combination of the regulatory mechanisms available to a regulator is used to address any specific conflicts of interest. Therefore, in this part of the Paper, the type of regulatory mechanisms used by regulators are identified with some examples of how they are being used and, where possible, some case studies.

The range of regulatory mechanisms that are used by member jurisdictions to address conflicts of interests include:

- general duty imposed on the CIS operator to act in the best interests of CIS investors;
- review/oversight of a CIS operators' activities by an independent third party;
- direct prohibitions of transactions which are likely to give rise to conflicts of interests;
- review and/or approval of certain transactions by the regulator or an independent third party where they raise conflicts of interests;
- disclosure of information relating to conflicts of interests to investors and/or regulators;
- detailed standards and procedures that must be followed by a CIS operator;
- restrictions relating to certain conduct;
- use of Codes of conduct that deal with conflicts of interest situations; and
- regulator's power to monitor and impose sanctions in appropriate cases.

### General duty to act in the best interests of investors

Although expressed in different ways, in all member jurisdictions, there is an overriding responsibility imposed on CIS operators to act in the best interests of investors. This duty is often used in member jurisdictions as the premise upon which CIS operators are required to adopt procedures and controls to avoid or mitigate conflicts of interests and to ensure that there is fair treatment of all investors. For example, under the regulatory regime in Luxembourg, because of this duty, CIS operators are not permitted to enter into direct or joint transactions with the CIS or use related party intermediaries where the CIS operator or its affiliates stand to gain any improper advantage.<sup>9</sup> Under the French regime, the duty that a CIS operator must carry out its activities with loyalty, diligence, neutrality and impartiality to the exclusive benefits of the CIS investors, while respecting the integrity of the market, provides the basis to require CIS operator to take necessary steps to reduce the risk of potential conflicts of interests including the adoption of internal procedures such as separation of functions which are likely to give rise to such conflicts.

Sometimes this duty can also be expressed as directly relevant to certain types of situations which give rise to conflicts of interests. For example, under the US regime, a CIS operator

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<sup>9</sup> This also means, under the Luxembourg regime, such transactions can be undertaken by a CIS operator where the transaction is carried out on an "arm's length basis".

is deemed to have a fiduciary duty with respect to the receipt of compensation for the services. This duty, when combined with a range of other regulatory mechanisms used, such as the right of CIS investors and the regulator to sue for any breaches thereof, and the requirements for periodical review by the CIS's board of the justifiability of the fees in light of the services provided, addresses conflicts of interests that arise in relation to fees and charges of the CIS operator under the US regime.

In some jurisdictions, such as in Canada, the duty of the CIS operator to act in the best interests of investors is relied upon as an additional safeguard against possible conflicts of interests of the CIS operator, as there are specific prohibitions and restrictions against trading with, through or in securities of, affiliated parties.

The above examples illustrate the versatile and extensive use made in member jurisdictions of the general duty of CIS operators to act in the best interests of CIS investors to address conflicts of interests that arise in the operation and management of a CIS.

### Review/oversight of a CIS operators' activities by an independent third party

In most member jurisdictions, there are requirements for review/oversight of CIS operator's activities by persons independent of the CIS operator. This provides a regulatory mechanism to eliminate or minimise the effects of CIS transactions which are likely to have an adverse impact on the interests of CIS investors because they are tainted with conflicts of interests of the CIS operator and its affiliates. Entities which are charged with the review/oversight responsibilities are not uniform across member jurisdictions. For example, while under the regulatory regimes in the UK and Hong Kong there is an independent trustee who is charged with the responsibility for oversight of the CIS operators' activities, this function is exercised under the investment company regime in the US by the independent directors of the company's Board. In Australia, independent directors of the CIS operators or, alternatively, a compliance committee, discharges this function. Independent auditors are also vested with specific compliance responsibilities in some member jurisdictions.<sup>10</sup>

### Direct prohibitions

In some member jurisdictions, certain types of transactions which are likely to give rise to conflicts of interests are generally prohibited, subject to very limited circumstances in which they can be carried out.

For example, under the US regime, there are direct prohibitions against:

- a person affiliated to a CIS knowingly buying property from or selling property to the CIS;
- a CIS purchasing, during an underwriting, any security where a principal underwriter of the security has certain affiliated relationship with the CIS; and

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<sup>10</sup> In some member jurisdictions such as in Ontario, where currently there are no independent review or oversight requirements relating to CIS operators' activities, there are regulatory initiatives to incorporate such requirements.

- a CIS' joint transactions involving affiliated parties, except where such transactions fall within the rules where the regulator has granted limited exemptions.<sup>11</sup>

Similarly, the Canadian regime also contains similar restrictions and prohibitions against which discretionary relief can be provided by the regulator in specified circumstances where the regulator can be satisfied that the circumstances of the transaction are less likely to pose risks to investors' interests.<sup>12</sup>

#### Review/approval of transactions by the regulator or an independent third party

The review or approval of transactions which are likely to give rise to conflicts of interests is a regulatory measure widely used in member jurisdictions. Such review or approval can be undertaken by a regulator, as in the case of some exemptions from the prohibitions against affiliated party transactions under the US regime, or by an independent party such as the trustee, as in the case of fees and charges of the CIS operator which are subject to oversight by the independent trustee under the UK regime. Similarly, under the Hong Kong regime, CIS transactions involving affiliates require prior approval of the trustee.

#### Disclosure of information relating to conflicts of interests to investors and/or regulators

Disclosure is also a widely used regulatory measure in the member jurisdictions to effectively minimise the adverse effects of those CIS transactions which raise conflicts of interests. Disclosure is generally regarded as serving a variety of purposes such as facilitating compliance monitoring by the regulator, subjecting the CIS operators' activities to public scrutiny and to enable the CIS operator to obtain informed consent of investors to transactions which are likely to raise conflicts of interests. Particularly, in most member jurisdictions, conflicts of interests that arise in the context of CIS operator's fees and charges are generally addressed, among other measures, through disclosure requirements relating to such fees and charges, which should be made to investors.

#### Detailed standards and procedures that must be followed by a CIS operator

There is a wide variety of conduct standards and procedures that are used in member jurisdictions to address conflicts of interests that arise in relation to CIS transactions. Such conduct standards include:

- specific procedures that are directly relevant to a particular transaction, such as:
  - the prior approval of the regulator or trustee, or investor consent, for such a transaction; and

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<sup>11</sup> SEC exemptions are intended to ensure that the terms of the transaction are fair, and in some cases, require the that an independent party, or the SEC, approves the transaction.

<sup>12</sup> Factors that are taken into account by the regulator to establish that it is less likely that the transaction will pose risks to investors' interests include a non-commercial purpose for the transactions (eg to effect a reorganisation), the application of objective pricing standards and structural and operational arrangements that would support an assumption that the individuals responsible for the management of the CIS were not being influenced by the interests of the affiliated party.

- the requirements for arm's length transactions;
- general compliance procedures that must be put into place by the CIS operator, such as Chinese Walls, monitoring mechanisms and record keeping requirements, that are designed to address conflicts of interest problems; and
- specific conduct standards of general application which can eliminate or minimise the adverse effects of conflicts of interests, particularly risks such as churning and unsuitable investments for CIS, such as the requirements for:
  - suitability;
  - a reasonable spread; and
  - best execution.

For example, under the Canadian regime, in addition to the requirements for disclosure in prospectuses of the fees and charges paid to the CIS operator and affiliated parties, any performance based fees to be paid to such parties are subject to specific additional requirements. Those requirements include objective benchmarks against which performance is to be measured, and the inclusion in the calculation of fees and charges, losses, as well as gains.

#### Restrictions relating to certain conduct

In most member jurisdictions, there are general prohibitions relating to certain conduct which have the effect of minimising the adverse effects of conflicts of interests, such as the prohibitions against:

- insider trading; and
- misleading and deceptive conduct.

Compliance mechanisms such as Chinese Walls and monitoring of the CIS activities by independent third parties are often used, in combination with other compliance mechanisms, to ensure compliance with those prohibitions.

#### Use of Codes of Conduct to deal with conflicts of interests

Codes of Conduct can set out standards that must be followed by CIS operators when entering into transactions which are likely to give rise to conflicts of interest problems. There are divergent practices in the member jurisdictions with regards to their use of Codes of Conduct as a regulatory measure to deal with conflicts of interests of the CIS operator. The range of Codes used vary from formal Codes of Conduct developed and issued by a regulator which have a statutory backing (ie they can be formally enforced by the regulator) to purely voluntary Codes of Conduct which are implemented at industry level.

For example, Hong Kong relies on non-statutory Codes of Conduct issued by the regulator which set out conduct standards required to address conflicts of interest problems (eg the requirements for arm's length transactions where affiliated parties are involved); and CIS operators are required to comply with those Codes to obtain and maintain their registration. Under the US regime, there are specific statutory requirements for CIS operators to have Codes of ethics that govern personal securities transactions of employees of CIS operators,

which are subject to compliance monitoring by the CIS's Board. Similarly, the regulatory regime in France relies on a Business Code of Conduct which deals with conflicts of interests of CIS operators which is implemented at the industry level and endorsed by the regulator. In contrast, in Luxembourg, the industry based Code of Conduct which deals with CIS operators' conflicts of interests is neither endorsed by the regulator nor has any statutory backing.

#### Regulator's power to monitor and impose sanctions in appropriate cases

Regulatory powers to monitor and impose sanctions in appropriate cases encompass a wide range of regulatory measures such as:

- approval powers, such as the power to approve (register) a CIS, its operators, trustees, custodians, or specific activities of a CIS;
- powers to obtain information from and/or relating to a CIS;
- “stop order” and “cease trading order” powers;
- powers to impose conditions relating to conduct of a CIS operator and other affiliated parties (eg a trustee);
- powers of general surveillance; and
- powers to impose sanctions such as revocation or suspension of registration, restrictive conditions and penalties, and to initiate court proceedings.

The above regulatory powers are used in the member jurisdictions in conjunction with various other regulatory measures designed to eliminate and mitigate conflicts of interests to promote better compliance by CIS operators of their obligations to act in the best interests of CIS investors.

#### **4. Exploring the way forward in dealing with conflicts of interests to promote investor protection**

The above analysis of the types of conflicts of interests and the regulatory mechanisms commonly used in the member jurisdictions to address those conflicts indicate that:

- there is a wide variety and complexity in the types of transactions that are likely to give rise to conflicts of interests; and
- the regulatory responses that can be used to address those conflicts of interests are also varied in nature and can be used in any combination depending on the regulatory framework and structures within which they are implemented.

What specific regulatory measures are used in any individual member jurisdiction to address conflicts of interests problems appears to be generally influenced by the individual preferences shown by regulatory regimes to rely on general principles or prescriptive conduct standards.

Reliance on general principles is generally premised on the assumption that prescriptive standards are more likely to lead to a check-list approach relating to compliance and also,

the emergence of avoidance mechanisms by CIS operators and their affiliates. On the other hand, prescriptive standards are generally preferred on the basis that such measures provide a higher degree of certainty for industry participants when undertaking certain transactions involving CIS. However, the regulatory responses adopted in the member jurisdictions reveal that there is greater reliance on a combination of these regulatory measures, rather than the adoption of one approach to the exclusion of the other. This also reflects the complex nature of conflicts of interests, and the resulting need for a higher degree of flexibility in the regulatory structures available within a regulatory regime to be able to effectively address such conflicts of interests without minimising investor protection.

Another factor which seems to influence the choice of regulatory responses adopted by member jurisdictions to address conflicts of interests of the CIS operator is the overall regulatory structure applicable in that jurisdiction. The range of regulatory structures used in member jurisdictions often vary between a detailed statutory framework for regulating CIS (such as in the USA) and a broad statutory framework supported by rules relating to conduct standards adopted at industry level (such as in Luxembourg). However, the regulatory framework within which most member jurisdictions operate often contain a mixture of both.

It is also important to note that a number of member jurisdictions have undergone or are undergoing (eg UK, Australia and Canada) significant changes to their regulatory structures and regulatory requirements, to keep abreast of the changes that are taking place in financial markets, such as the emergence of conglomerates, convergence of products and markets and increased cross-border activities.

The above analysis clearly indicates that in spite of some of the differences in the use of regulatory responses to address conflicts of interest problems in the member jurisdictions, each member jurisdiction clearly recognises the potential risks to investors in CIS arising from conflicts of interests of the CIS operator, and the need to address such problems through effective regulatory measures.

In undertaking this detailed analysis of the types of conflicts of interests and regulatory responses adopted in member countries to address such problems, members also recognise the need to:

- review the impact of conflicts of interests of the CIS operator on the interests of CIS investors; and
- to share information relating to regulatory developments in member jurisdictions,

to promote a better understanding of the regulatory responses adopted among members. Particularly, as there is an increasing trend in delegation of CIS management functions, not only to parties within the home jurisdiction of the CIS but also across jurisdictional barriers, there is a greater need for members to understand the specific regulatory responses to conflicts of interest problems in other jurisdictions.



The detailed analysis in this Paper is therefore intended as a starting point in providing a detailed insight into jurisdictional practices adopted by the member jurisdictions for the purposes of managing and minimising the effects of conflicts of interests, both for the benefit of the regulators who are increasingly faced with the challenge of regulating CIS operations which reach beyond their jurisdictional barriers; and persons who intend to conduct CIS business in overseas member jurisdictions.