

**EXAMINATION OF GOVERNANCE FOR COLLECTIVE  
INVESTMENT SCHEMES**

**FINAL REPORT**

**Part I**



**OICJ-IOSCO**

**A Report of the Technical Committee of the International  
Organization of Securities Commissions**

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## I. INTRODUCTION

During its Amman meeting on May 17<sup>th</sup> of 2004, the IOSCO Technical Committee (“TC”) approved the mandate proposed by Technical Committee Standing Committee on Investment Management (“SC5”) regarding “Examination of Governance for Collective Investment Schemes.” The mandate directs SC5 to establish broad general principles for Collective Investment Schemes (“CIS”) Governance based on a review of both its past work and the results of a survey concerning CIS Governance in SC5 member jurisdictions.

The TC has not previously examined CIS Governance in a comprehensive manner. The TC has, however, undertaken a number of projects that relate to CIS Governance that may inform about the TC’s development of the general principles of CIS governance.<sup>1</sup> In addition, IOSCO’s Principles of Securities Regulation 17-20, which relate to CIS (the “CIS Core Principles”), can give information about the identification of the principles of CIS Governance.<sup>2</sup>

The CIS Core Principles are specifically aimed at the regulation of the world’s securities markets. In contrast, the general principles of CIS Governance may focus on the role of other entities, including the Regulator, in CIS Governance. The Core Principles and broad general principles of CIS Governance are, however, complementary. They share the ultimate goal of investor protection.

The general goal of investor protection is not to protect investors from suffering any market-driven loss, but rather to enable investors to understand the risks that pertain to investments in specific CIS.<sup>3</sup> The goal of investor protection relates to, among other things, the prevention of misleading, manipulative and fraudulent practices. It is also related to the prevention of loss due to malfeasance or negligence on the part of those that organize and operate the CIS. We also note that our work focuses on retail investors in CIS, although we recognize that institutions also invest in CIS. The paper addresses principles of CIS Governance for CIS that are marketed and sold to retail investors.

In order to pursue its work on CIS Governance, SC5 conducted a survey of its member jurisdictions. Based on the results of this survey, the TC determined that its CIS Governance work should be structured as follows. First, it agreed to define the concept of CIS governance.

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<sup>1</sup> See, e.g., Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators (May 2000).

<sup>2</sup> Principle 17 states that: “The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.” Principle 18 states that: “The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.” Principle 19 states that: “Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme.” Principle 20 states that: “Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.”

<sup>3</sup> We note that, to some degree, SC5 jurisdictions attempt, in different ways, to limit CIS investors’ exposures to excessive losses, for instance by limiting or prohibiting CIS investment in derivative instruments.

Second, the TC determined that various entities and legal structures existed or are being proposed in member jurisdictions, and that these different structures created significant differences in how member jurisdictions approach CIS governance issues. As a result of these differences, the TC agreed that it was necessary and appropriate to identify one primary general principle concerning CIS Governance – independent review and oversight of the CIS Operator’s fiduciary duties, including most notably the prevention of conflicts of interest - that applied in all SC5 jurisdictions, regardless of the structural form of the CIS. Additionally, the TC decided that it would explain how this principle of independent review and oversight applied to, or was evidenced in, the many different structural forms of CIS governance that exist or are being proposed in the jurisdictions of SC5 members. The TC also agreed to develop the principle of independent review and oversight regarding the functions that should be entrusted to the independent entity (or entities) responsible for reviewing the CIS Operator and CIS activities (“Independent Entity or Independent Entities”), including most notably the prevention of conflicts of interest. The TC will describe certain characteristics of CIS Governance that promote independent review and oversight and give the Independent Entity (or Independent Entities) authority to fulfil its tasks and functions.

The TC recognizes that there are additional CIS Governance principles that are common to member jurisdictions and supplement the primary principle of independent review and oversight of the CIS Operator’s duties, including most notably the prevention of conflicts of interest. Additional principles include:

- CIS Legal and Regulatory Framework. The legal and regulatory framework under which a CIS operates will impose standards relating to fiduciary obligations, operations (e.g., rules relating to the valuation and custody of assets), disclosure or transparency, conflicts of interest, and financial reporting. The supervisory and/or regulatory authority oversees and enforces compliance with this framework.
- Investor Rights. CIS investors have certain fundamental rights that may arise from various sources, depending on the SC5 jurisdiction, including the legal and regulatory framework or the CIS’s own organizational documents. The fundamental rights may include, but are not limited to: operation of CIS for the benefit of their investors; entitlement to certain information about the CIS; rights to exit the CIS; and, possibly, the right to vote on certain matters. Investor rights vary among SC5 member jurisdictions.
- Internal Controls. Internal controls are internal policies and procedures that help ensure that CIS are operated consistent with applicable legal requirements and for the benefit of CIS investors. The controls may require compliance officers or persons fulfilling a similar role to oversee a CIS’s operation consistent with the internal controls.
- Transparency. Transparency refers to the information that CIS provide investors and the markets generally, about CIS operations, including areas such as fees, expenses, investment activity and personnel. Transparency promotes, among other things,

market competition among CIS and investors' understanding of the risks presented by their CIS investments.

- **Market and Industry Participants.** Market and industry participants can strengthen CIS Governance by developing codes of conduct, assisting in the development of better rules and standards for CIS, helping to educate CIS Investors and helping to ensure that investors make CIS investments that are appropriate to their needs.

Some of these principles have been addressed by the TC in other papers.<sup>4</sup> SC5 intends to continue to address, as appropriate, other principles of CIS Governance during the working program assigned to SC5 by the Technical Committee over the coming years.

## II. DEFINITION AND SCOPE OF CIS GOVERNANCE

**Corporate Governance.** The concept of Corporate Governance has been broadly developed. Corporate governance has been described in the following manner:

Corporate Governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which a company's objectives are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently. Good Corporate Governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment.<sup>5</sup>

The TC believes that the concept of corporate governance can provide useful guidance for developing the definition of CIS Governance. A definition of CIS Governance, however, must recognize the differences between the nature and purpose of CIS and the operating companies in which they invest. In addition, the definition must recognize the fact that CIS are structured and regulated differently among SC5 jurisdictions.

**CIS Governance.** CIS Governance can be defined as "*a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS Investors<sup>6</sup>, and not in the interests of CIS insiders*".

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<sup>4</sup> See, e.g., "Final Report of Elements of International Regulatory Standards on Fees and Expenses of Investment Funds (2004)", "Collective Investment Schemes as Shareholders: responsibilities and disclosure, report to the Technical Committee (2003)", "Investment management risk assessment : marketing and selling practices, report to the Technical Committee (2003)", "Conflicts of interests of CIS Operators (2000)".

<sup>5</sup> OECD Principles of Corporate Governance (Jan. 2004).

<sup>6</sup> Including both resident and potential investors.

A framework for CIS Governance must reflect the unique nature and purpose of CIS. CIS are a vehicle for pooling the investments of individuals in order to obtain professional management of the investors' pooled assets. The purpose of a CIS is to successfully invest the pooled assets for the primary benefit of CIS Investors.<sup>7</sup> As a consequence, a robust CIS Governance framework should seek to protect, through oversight and review, the CIS assets from loss due to malfeasance or negligence on the part of those that organize or operate the CIS and should strive to ensure that investors are adequately informed of the risks involved in their investment and the rewards they can obtain, and above all that the CIS is operated in the investors' best interests at all times<sup>8</sup>. Accordingly, efficient disclosure requirements, accounting, valuation, reviewing and auditing standards should be in place in order to make sure that the risk-performance equation of the CIS is adequately managed. The major role of CIS Operators is primarily to execute investment strategies on behalf of well-informed investors while investors must be able to select the desired level of risks and potential rewards amid a reliable market environment.

The TC believes the operation of CIS potentially entails conflicts between the interests of those who invest in CIS and those who organize and operate the CIS ("insiders" or "CIS Operators"). In particular, CIS could be subject to the risk that those that organize or operate the CIS, although being legally committed to the fiduciary responsibilities of acting on behalf of the best interests of investors, will use the CIS's assets for their own gain to the detriment of CIS Investors. There are many different ways in which this could occur.<sup>9</sup> For instance, CIS Operators could rid themselves of unattractive securities that they own by dumping them into the CIS, or CIS Operators could obtain rebates from third parties in connection with transactions for the CIS or could inaccurately value or inflate their assets in order to avoid showing poor performances. A robust CIS Governance framework should, therefore, seek to minimize or otherwise address conflicts of interest and to ensure that the interests of well-informed investors in CIS are well protected and managed in the best conditions.

The CIS Governance framework in SC5-member jurisdictions, including how the framework addresses conflicts of interest, will reflect the legal structure of CIS in the jurisdictions. In the SC5-member jurisdictions CIS are typically organized under two structures: (1) investment funds, as a trust or contract with individual investors ("contractual model"), and (2) investment companies, often structured as corporations ("corporate model").<sup>10</sup> Depending on the structural form, a number of different entities, including a variety of Independent Entities, such as the CIS Regulator, CIS Investors, CIS Operators, CIS Auditors, Broker-Dealers, CIS Boards of Directors, CIS Trustees and Depositaries, Independent Review or Compliance Committees or Advisory Boards to CIS, Self-Regulatory Organizations and insurance funds can play a role in the CIS Governance framework.

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<sup>7</sup> We recognize that CIS Operators and others benefit from a CIS though compensation for the services that they render to the CIS.

<sup>8</sup> The definition of a CIS Governance regime, should not, however, disregard that commercial mechanisms and competition, together with the need to preserve and enhance firm reputation are factors that continually enhance the alignment of CIS Operator and investor interests.

<sup>9</sup> See Conflicts of Interests of CIS Operators (May 2000).

<sup>10</sup> Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators (May 2000) at 1.

SC5-member jurisdictions agree that, as a primary principle, CIS Governance must provide for the independent review and oversight of the CIS Operator’s duties, including most notably the prevention of conflicts of interest. However, as a result of structural differences between the various CIS models within SC5 jurisdictions, both the scope of the duties that are subject to oversight, and the entity or entities that provide independent review and oversight, vary between the jurisdictions.

In fact, various entities in SC5 jurisdictions can provide independent review and oversight. In each SC5 jurisdiction, the CIS Regulator can itself provide occasional independent review and oversight of the CIS Operator. In addition, in some SC5-member jurisdictions, laws and regulations mandate that certain other Independent Entities have a major role in independent review or oversight.<sup>11</sup> Our work regarding independent review and oversight will focus on the role of Independent Entities.

The responsibilities of Independent Entities with respect to a CIS and CIS Operator vary among SC5 jurisdictions, depending in large part on the structural model for CIS in that jurisdiction. Regardless of the structural model, the main goals of the Independent Entity or Entities are to oversee and address conflicts of interest, ensure compliance with obligations and protect the interests of CIS Investors<sup>12</sup>.

### **III. MODELS OF CIS GOVERNANCE IN SC5 JURISDICTIONS**

The survey conducted among SC5 members allowed the identification of two main models from which a CIS Governance structure could be developed:

- Corporate Model;
- Contractual Model.

The survey additionally identified a hybrid of the two main models from which a CIS Governance structure could similarly be developed – the Hybrid Corporate and Contractual Model (“Hybrid Model”).

In all models, and as noted in IOSCO report ‘conflicts of interest of CIS Operators’<sup>13</sup> of May 2000, “*there is an overriding responsibility on CIS Operators to act in the best interests of investors*”.

However, the way such responsibility has to be accomplished, as well as the monitoring procedures to ensure that the associated fiduciary duties (and also regulatory obligations) are

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<sup>11</sup> Independent and Internal Auditors may also act as Independent Entities.

<sup>12</sup> It should be noted, however, that the extension of investors’ rights and duties may vary according to the structure of the CIS.

<sup>13</sup> This report together with another entitled ‘Delegation of Functions’ form the work undertaken by IOSCO with the objective of identifying the ‘Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators’.

respected, varies among SC5 jurisdictions even within the same model. For example, different solutions have been adopted regarding how to ensure the safekeeping of CIS assets.

In fact, within each of these models it is possible to identify different review and oversight structures that can be implemented to ensure the effective fulfillment of fiduciary and regulatory obligations by the CIS Operator.

For the Corporate Model, the oversight<sup>14</sup> of fiduciary and regulatory obligations, as well as the safekeeping of CIS assets, can be ensured to some extent either by a:

- Board of Directors;
- Depositary;

With regard to the Contractual Model, the above mentioned functions can in some extent be ensured by a:

- Depositary;
- Trustee,

complemented in certain SC5 jurisdictions by other types of Independent Entities, like the CIS Regulator and the Auditor for certain governance functions.

While for the Hybrid Model, the oversight for the above mentioned functions can in some extent be ensured by a Supervisory Board, respectively at the CIS or CIS Operator level, or by an Independent Review or Compliance Committee<sup>15</sup>.

A summary of the main characteristics of the above mentioned models, namely in what regards the role of Independent Entities, is presented hereunder.

## **IV. Corporate Models**

### **A. Corporate Model 1 - Board of Directors**

In CIS organized under the corporate form, investors become shareholders by acquiring shares of a company whose principal objective is to invest in a portfolio of securities. The acts of purchasing and redeeming CIS shares are generally processed through an authorized distributor that acts on behalf of the CIS.

The management of the CIS's securities portfolio is conducted by an Investment Adviser (CIS Operator) which is appointed through a contract approved by the Board of Directors

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<sup>14</sup> This as first level of oversight since other Independent Entities like the CIS Regulator, the Auditor and the CIS Shareholders/Unitholders also play an important role in this field.

<sup>15</sup> In some SC5 jurisdictions this oversight is complemented by other types of Independent Entities such as the CIS Regulator, the Auditor and Self-Regulatory Organizations, among others.

of the CIS<sup>16</sup>. The Investment Adviser has a fiduciary duty to act in the best interests of CIS Shareholders.

Nevertheless, as noted in IOSCO report ‘Conflicts of interest of CIS Operators’, “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. This gives rise to potential conflicts between the self interest of CIS operators and interests of investors in CIS”.

Therefore, in this model the Board of Directors of the CIS plays a central role in the Governance structure. The Board of Directors is responsible for overseeing at a first level the CIS’s operations and the CIS Operator and other service providers, such as CIS Distributors, as well as for monitoring conflicts of interest. The action of the Board of Directors is therefore decisive to ensure the protection of CIS Shareholders interests.

A detailed description of the functions assumed by the Board of Directors in each SC5 jurisdiction that allows this form of CIS model is presented in **Appendix 1**.

Moreover, **Flowchart 1** describes schematically a possible global CIS Governance structure for the designated ‘Corporate Model – Board of Directors’. The scheme includes other Independent Entities such as the CIS Regulator and Auditor, as well as shareholders that jointly with the CIS Board of Directors form the set of key entities destined to ensure a proper CIS Governance structure<sup>17</sup>.

## **B. Corporate Model 2 - Depositary**

In this model, the Depositary is responsible for the oversight of the CIS and CIS Operator activities as well as for the custody of the CIS assets. For the purpose of this mandate and in so far as the "overview activity" is concerned, the functions of the Depositary can be compared – but not stated as equivalent - with the activities exercised by the Board of Directors in the previous model.

A detailed description of the functions assumed by the Depositary in each SC5 jurisdiction that allows this form of CIS model is presented in **Appendix 2**.

Additionally, **Flowchart 2** describes schematically a possible CIS Governance structure for the designated ‘Corporate Model – Depositary. As in flowchart 1, the scheme also includes other key Independent Entities which should ensure an adequate CIS Governance structure.

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<sup>16</sup> In certain situations it may so happen that CIS are directly managed by its Board (“self-managed” CIS).

<sup>17</sup> Mechanisms such as the prohibition/restriction of transactions with affiliated parties or shareholder voting requirements could also be seen as an integral part of a CIS Governance structure.



## V. Contractual Models

### A. Contractual Model 1 - Depositary

Differently from the case of CIS under the corporate form, in the contractual type investors buy unit shares that provide them interest in a portfolio of diversified securities that does not have legal existence for itself.

Because of this, CIS does not have the legal capacity to contract on its own and therefore the management of its portfolio has to be entrusted to a Management Company.

Similarly to the corporate model cases in which the CIS Operator functions are assumed by an Investment Adviser, the Management Company becomes committed with the fiduciary duty of acting exclusively on behalf of CIS Unitholders best interests.

For the purpose of this mandate, Depositary can nonetheless be compared with the ones described in the previous model.

Again, a detailed description of the functions assumed by the Depositary under the contractual type in each SC5 jurisdiction that allows this form of CIS model is presented in **Appendix 3**.

**Flowchart 3** describes schematically a possible CIS Governance structure for the designated 'Contractual Model – Depositary. The scheme includes again other key Independent Entities which should ensure a proper CIS Governance structure.

### B. Contractual Model 2 - Trustee

CIS under this type of contractual form are denominated Unit Trusts (UT) and are established and governed by a trust deed.

A UT is a CIS under which the property is held in trust for the beneficiaries of that trust. Subscriptions from investors are pooled together and then used to purchase a portfolio of assets managed by the Manager (CIS Operator). Investors receive units in proportion to the amount of money invested.

Nevertheless, this model can be compared with the one previously presented since the functions performed by the Depositary are exercised by an entity designated as the Trustee, which is responsible for both the oversight of the CIS Operator and also the safekeeping of the CIS assets.

The key entities of CIS Governance for UT are therefore the CIS Operator and the Trustee.

A detailed description of the functions assumed by the Trustee in each SC5 jurisdiction that allows this form of CIS model is presented in **Appendix 4**.

**Flowchart 4** describes schematically a possible CIS Governance structure for the designated ‘Contractual Model – Trustee’.

In some jurisdictions these two possible players are complemented by additional Independent Entities which can ensure a proper CIS Governance structure that represent the interests of shareholders and are in charge of certain reviewing aspects of the governance function.

## **VI. Hybrid Corporate and Contractual Model - Supervisory Board/Review or Compliance Committee**

In this model presented on the next page, notwithstanding the structure of the CIS, in practice it is the CIS Operator who is responsible for the day to day oversight and operations of the scheme, and who stands in a fiduciary relationship with CIS Investors. Although Depositaries, Auditors, Boards or Trustees can play a role in the protection of the fiduciary duty of the CIS Operator, in this model it is a separate Independent Entity which has the explicit task to oversee certain functions of the CIS Operator and the various CIS it operates, in particular in the area of conflicts of interest.

In this model, a Supervisory Board at either the level of the CIS itself or at the level of the Management Company, or an Independent Review or Compliance Committee, play or are proposed to play a central role in the Governance structure, monitoring the CIS Operator’s compliance with fiduciary and regulatory obligations. This Independent Entity may be complemented by additional entities including, the Board of Directors of the CIS, the Auditor and the CIS Regulator. A detailed description of the functions assumed by this Supervisory Board/Review or Compliance Committee is presented in **Appendix 5**.

Additionally, **Flowchart 5** describes schematically the CIS Governance structure for the designated ‘Hybrid Corporate and Contractual Model – Supervisory Board/Review or Compliance Committee’. The scheme includes again other key entities that should ensure a proper CIS Governance structure.

**Chart 1**, presented below, provides a global view of the existing models and respective sub-models in each SC5 jurisdiction and identifies also the various Independent Entities that ensure the review of the CIS Operator and CIS activities.

**Chart 1**

**Models of CIS Governance  
in SC5 Jurisdictions**

	<b>Corporate Model 1</b> <i>Board of Directors</i>	<b>Corporate Model 2</b> <i>Depositary</i>	<b>Contractual Model1</b> <i>Depositary</i>	<b>Contractual Model2</b> <i>Trustee</i>	<b>Corporate and Contractual Model</b> <i>Supervisory Board/Review or Compliance Committee</i>
AUSTRALIA					
BRAZIL					
CANADA					( a )
FRANCE					
GERMANY					
HONG KONG					
IRELAND					
ITALY					
JAPAN					
JERSEY					
LUXEMBURG					
MEXICO					
NETHERLANDS					( b )
PORTUGAL					
SPAIN					
SWITZERLAND					
UNITED KINGDOM					
UNITED STATES	( c )				

( a ) A proposed rule requiring an independent review committee is expected to be in effect in 2006.

( b ) Governance structure to be implemented; presently, the Dutch regime fits corporate model 2 and contractual model 1.

( c ) This U.S. response does not include U.S. unit investment trusts which may be organized under a trust indenture but issue securities that represent an individued interest in a unit of specified securities. Nor does this U.S. response include unregistered pooled investment vehicles.

**VII. BROAD GENERAL PRINCIPLES OF CIS GOVERNANCE**

CIS Governance is defined in this document as a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated in the interests of CIS Investors, and not in the interests of CIS insiders.

Within this scope, it should be reminded that it was the purpose of this mandate to articulate broad general principles for CIS Governance focusing particularly in the field of the independent review and oversight of the CIS Operator’s duties and on the structure implemented for the prevention of conflicts of interest.

As discussed below, SC5 member jurisdictions agree that, as a primary principle, CIS Governance must provide for independent review and oversight of the organization and operation of the CIS. In each SC5 member jurisdiction, Independent Entities are the primary source of independent review and oversight.

**The Independent Entity’s or Independent Entities’ main purpose should be ensuring that when faced with a conflict, CIS Operators respect the applicable rules, their contractual obligations and their duties, from “an outside, although objective and informed, perspective”, and therefore protect CIS Investors from divergent behaviors of the CIS Operator.**

Many SC5 jurisdictions impose a fiduciary duty on CIS Operators to act in the CIS Investors’ best interests. Independently of the form or model under which a CIS is organized, CIS

Operators should always be subject to the fiduciary duty of acting for CIS Investors in the best possible way. The respect for this duty constitutes a core fundamental principle of CIS management.

Nevertheless, as noted in this paper, CIS often entail a separation of the ownership of the CIS from its management which carries the potential for the interests of the CIS Operator and CIS investors to diverge. Therefore, in order to ensure that the CIS Operators do not deviate from their duties it is fundamental that their activity be properly monitored **by Independent Entities**.

In many SC5 member jurisdictions, CIS Operators must maintain appropriate controls and implement an internal structure of compliance responsible for monitoring compliance with their contractual obligations and the rules that are applicable to the CIS management activity. Many CIS Operators employ a compliance officer to help assure compliance with the rules and allow proper information to be passed to the persons responsible for enforcing fiduciary duties.

**The role and concept of Independent Entities assumes different forms among the various CIS Governance structures, although the aim is to provide an “outside perspective” to meet the goal of CIS Governance – the protection of CIS Investors.** For example, in some jurisdictions with a “corporate model – Board of Directors,” Independent Entities refers to the status of certain directors as unrelated to the CIS or other significant entities such as the CIS Operator and also refers to the percentage of directors on the CIS Board of Directors that are independent. In certain other jurisdictions, Independent Entities refers to the CIS Regulator and its corresponding regulatory requirements that seek to ensure that the trustee and CIS Operator are functionally, or economically, separate entities (“Chinese walls”), such as by requiring that there be no common board members or directors among the two entities or by prohibiting entities that are subsidiaries of one another. Other regulatory requirements may impose restrictions that eliminate or reduce conflicts of interest such as restrictions on investments by the CIS in securities issued by a related entity. In other jurisdictions, Independent Entities refer to a Supervisory Board or an Independent Review or Compliance Committee or advisory board of the CIS. All SC5 member jurisdictions seek to promote an environment in which the Independent Entities are separated or insulated from the conflicts inherent in the operation of the CIS so each Independent Entity can fulfill its oversight and review responsibilities. (See Appendices for additional detail concerning independence).

**Independent Entities should be empowered with sufficient conditions to exercise its functions in an effective and independent manner<sup>18</sup>.** The Independent Entity also should have sufficient powers to authorize or issue guidance to the CIS Operator regarding operations that may conflict with CIS Investors’ interests and to work with the entity responsible for an additional check of the CIS activities and accounts (e.g., CIS Auditor). Independently of the nature of the entity primarily responsible for overseeing the CIS Operator (Board of Directors, Depository, Trustee or any other type of independent oversight committee<sup>19</sup>), the Independent

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<sup>18</sup> Independent entities should not, nonetheless, be empowered to an extent that would enable them to undermine or impair the choices made by individual investors or interfere in areas that should be of the exclusive responsibility of the CIS operator (e.g. investment discretion within the CIS rules).

<sup>19</sup> In certain jurisdictions, CIS Auditors, independent review committees or Advisory Boards of the CIS, and Self-Regulatory Organizations have their obligations and reporting lines organized accordingly in order to play this role.

Entity should be able to establish and to report to relevant bodies (board of director of the asset management company, regulatory authorities, external auditor) policies for the prevention and resolution of conflicts of interest, namely those that may arise between the CIS Operator or its related parties and investors. The Independent Entity also should have sufficient economic or financial resources to enable it to exercise its functions. The full responsibility endorsed by these entities and the possibility, in some jurisdictions for them (Depositaries and Trustees for instance) to compensate unitholders or to ensure that unitholders are compensated when damages happen can be a key condition for the efficiency of the working of this Independent Entity model.

**The nature of the Independent Entity depends upon the structural model for CIS in an SC5 member jurisdiction.** In the context of the “corporate model – Board of Directors,” the Board of Directors and the independent directors, in particular, serve as the Independent Entity. Independent directors are intended to serve as “watchdogs” who provide independent oversight of CIS management, and who have primary responsibility for overseeing at a first level the CIS’s operations and the CIS Operator’s activities and other service providers, such as CIS Distributors, as well as overseeing conflicts of interest, with the ultimate objective of protecting the interests of CIS Shareholders.

In the contractual models, as well as in the “corporate model – Depositary” in which its functions resemble more a contractual form, the above mentioned functions of an Independent Entity may be exercised either by the Depositary or by the Trustee. While in the Hybrid Corporate and Contractual Model, these functions are exercised by certain other independent oversight entities. For example, in certain SC5 jurisdictions, a Supervisory Board or an Independent Review Committee of the CIS may also serve as Independent Entities, providing independent oversight and monitoring of certain aspects of CIS Operator’s decision-making. The Depositary, Trustee or other independent entities should, desirably, be legally, economically or functionally independent from the CIS Operator.

When the Depositary, Trustee or certain other independent entities are not legally and economically independent from the CIS Operator, it should have sufficient conditions to act independently from the CIS Operator’s interests, for example by imposing a requirement of different directors between the CIS Operator and Depositary or a requirement for a separate review committee or by making the Depositary jointly responsible for possible misconduct or fraud of the CIS Operator.

In any case, and whatever the model and the role played by the various Independent Entities, the Regulators should strive to ensure that all relevant functions of the CIS are properly covered and monitored by one or the other entity, or by itself, based on the governance principles and procedures in place.

**The delegation of the oversight responsibility entrusted to the Regulator, Board of Directors, Depositary, Trustee, Auditor, Supervisory Board or Independent Review or Compliance Committee of the CIS, self-regulatory organization or any other independent oversight entity should not, as a general principle, be allowed, although some functions entrusted could be outsourced to other entities .** Therefore, the effective and permanent

control of the CIS and CIS Operator activities, either directly or through the use of outsourced entities, should be exercised by the entity responsible for those functions (Regulator, Board of Directors, Depositary, Trustee, etc.) in order to ensure proper investor protection.

As mentioned in the introductory part of this paper, SC5 will develop in a subsequent report the precise functions and tasks that should be entrusted to Independent Entities.

## **APPENDIX 1**

### **Corporate Model 1 - Board of Directors**

Under the **United States (U.S.)<sup>20</sup> and Mexico** laws, CIS board of directors, which are subject to fiduciary duties established under the law that applies to directors of others businesses, such as the duties of loyalty and care<sup>21</sup>, are namely responsible for exercising the following specific tasks:

- CIS Operator's Contract. The CIS Operator's contract, and the annual continuance of the contract, must be approved by the board and by a majority of the CIS's independent directors;
- CIS Accountant. Generally, the CIS accountant must be selected by a majority of the CIS's independent directors which must be subsequently ratified by the CIS shareholders at the forthcoming annual meeting of CIS shareholders. The selection of the accountant does not need to be submitted for ratification by the CIS Shareholders if the CIS's board has established an audit committee composed entirely of independent directors that is responsible for overseeing the CIS's auditing and accounting processes;
- Audit Committee. The CIS board must annually determine and disclose whether there is an Audit Committee financial expert. When there is no separate Audit Committee, then the Board of Directors itself is the Audit Committee. The Audit Committee also must pre-approve certain engagements with the CIS's independent Auditor;
- Code of Ethics. The CIS's Board of Directors, including a majority of the CIS's independent directors, must approve the CIS's code of ethics, the code of ethics of each CIS Operator and the principal underwriter and any material changes to these codes;
- Proxy Voting Policies. The CIS's Board of Directors approves the policies and procedures relating to the voting of proxies in connection with portfolio securities;
- Compliance Procedures and Compliance Officer. The CIS's Board of Directors, including a majority of the CIS's independent directors, must approve the written compliance procedures and policies of the CIS and each service provider. The approval must be based on a finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws. The CIS board, including a majority of the CIS's independent directors, must approve the

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<sup>20</sup> Various references in this paper to "U.S. law" reflect the views and regulatory requirements of the U.S. Securities and Exchange Commission, and do not necessarily reflect regulatory requirements of the U.S. Commodity Futures Trading Commission, or business practices by the commodity pool industry.

<sup>21</sup> In the United States, the duty of loyalty generally mandates that CIS directors perform their duties in good faith and in a manner reasonably believed to be in the CIS's best interests. Fundamental to the duty of loyalty is the avoidance of self-dealing. The duty of care generally requires directors to perform their functions with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances.

designation of the CIS's chief compliance officer and such person may be removed by action of, and only with approval of, the CIS's board, including a majority of the CIS's independent directors. The CIS's chief compliance officer must meet separately, at least once a year, with the CIS's independent directors;

- Custody and Service Contracts. General fiduciary principles or a CIS's corporate documents require board review and approval of custody and service provider arrangements;
- Valuation and NAV Calculation. The CIS's directors must determine the fair value of the CIS's portfolio securities (and other assets) for which market quotations are not readily available. The CIS's directors must initially set the time or times of day when the CIS calculates its net asset value and make and approve any changes as necessary. In the case of Mexico, CIS's portfolio securities fair value is determined daily by an independent service provider called price vendor and the NAV is also calculated daily by another independent service provider called valuation company.

As noted above, the issue of independence of CIS directors assumes particular importance in the case of the United States as a key principle to ensure that the Board of Directors fulfills its mission properly.

Independent directors are intended to serve as "watchdogs" who provide an independent verification on CIS management, and who have, as already referred primary responsibility for protecting the interests of CIS Shareholders. In the United States, independent directors themselves can constitute the Independent Entity.

In the **United States**, at least 40%<sup>22</sup> of the CIS's directors must be "independent."<sup>23</sup>

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<sup>22</sup> In the case of Mexico the equivalent requirement of independence is established in one third. However decisions like the approval of the fund's code of conduct, the hiring and annual evaluation and of service providers, issuance of norms to prevent and avoid conflicts of interest and the transactions conducted with related parties, have to count with the favorable vote of the majority of independent directors.

An Independent director is such a person who has experience, is capable and has professional prestige and can not be in any case: a) an employee or officer of the fund; including persons who occupied such positions during the immediate preceding year; b) shareholders that have power of commanding officers of the fund; c) shareholders or employees of companies that provide advice or consultancy services to the fund or of any other company which pertains to the same economical group, whose income from the fund represent more than ten percent of its total sales; d) clients, suppliers, debtors, creditors, partners, board members or employees of a company that is an important client, supplier, debtor or creditor of the fund. A client or supplier is important if sales related to the fund are at least ten percent of its total sales. It's considered an important debtor or creditor when the amount of the credit is more than fifteen percent of funds or counterparties assets; e) employees or a foundation, association or societies that receive important donations from the fund. A donation is considered important if it represents more than fifteen percent of total donations received by an institution; f) director generals or high ranking executives of any company in whose board participate the director general or a high ranking executive of the fund, and g) spouses, wives or concubines and first degree or civil relatives of the persons mentioned on incises c) to f) or until third degree of the persons mentioned on incises a) and b).

<sup>23</sup> In the United States, a director is not "independent" if he or she:

- is an "affiliated person" of the CIS;
- is an immediate family member of an affiliated person of the CIS;
- acted as the CIS's legal counsel within the past two years (and any partner or employee of such a person);
- is not independent of the CIS's Operator or principal underwriter;



Most U.S. CIS, however, rely on certain exemptive rules (“Exemptive Rules”)<sup>24</sup> that effectively require an even higher percentage of the CIS’s directors be independent.<sup>25</sup> Any U.S. CIS that relies upon any one of the Exemptive Rules must comply with additional Governance Conditions.

The issue of how directors can be elected or removed is also a matter that is expressly addressed in the United States and Mexico. In this field, U.S. law requires that CIS directors must be elected by CIS shareholders, except for the case of vacancies that can be filled in any manner as long as two-thirds of the board at any time is composed of directors who were elected by the CIS shareholders.<sup>26</sup> Mexican law also states that CIS directors and their substitutes must be elected by CIS Shareholders, substitutes of independent must also be independent and the nominations of independent directors can only be revoked if all other directors’ nominations are also revoked.

If a U.S. CIS’s regular broker-dealer, principal underwriter or investment banker is a director, officer or employee of the CIS or is a person of which the director, officer or employee is an affiliated person, then at least a majority of the CIS’s directors must not be affiliated with such broker-dealer, principal underwriter or investment banker. In addition, a majority of the CIS’s directors may not be officers, directors or employees of any one bank or bank holding company, together with their affiliates and subsidiaries.

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- is a person (or an affiliated person of such a person) who, during the previous six months, executed any portfolio transactions for, engaged in any principal transactions with, distributed shares for, or loaned money or property to: (a) the CIS; (b) another CIS with the same operator or holding itself out as related to the CIS; or (c) any account over which the CIS’s Operator has brokerage placement discretion or borrowing authority;
  - is declared not to be independent by order of the US SEC due to a material business or professional relationship with the CIS within the past two years.

An “affiliated person” of another person is:

- any person owning or holding 5% or more of the person’s outstanding voting securities;
- any company the outstanding voting securities of which the person owns 5% or more of the company’s voting securities;
- any person controlling, controlled by, or under common “control” with such other person;
- any officer, director, partner, copartner or employee of the person; and
- if a CIS, any CIS Operator or member of the CIS Advisory Board.

“Control” means the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of an official position with the company.

<sup>24</sup> Approximately 90% of CIS in the United States rely on at least one of the Exemptive Rules.

<sup>25</sup> If a CIS is not relying on one of the Exemptive Rules, it may be subject to a more stringent requirement than the 40% independent director requirement, if its operator has been recently sold or reorganized, e.g., for a period of three years after the change in control, at least 75% of the CIS’s directors must be independent of the predecessor or successor CIS Operator. .

<sup>26</sup> In the United States, CIS may divide directors into classes and prescribe the terms of tenure of the classes if permitted under the CIS’s corporate charter, certificate of incorporation or similar authorizing document, provided no class is elected for a shorter period than one year or for a longer period than 5 years and the term of office of at least one class expire each year.

In addition, under U.S. and Mexico laws, certain persons are disqualified from acting as a CIS's director (e.g., persons convicted of felonies or misdemeanors arising from the purchase or sale of securities within the past 10 years and persons permanently or temporarily enjoined from engaging in any conduct or practice in connection with the purchase or sale of any security, or persons with pending lawsuits against the CIS, bankrupt individuals, government officers that supervise or regulate CIS, the compliance officer of the management company). CIS directors may also be removed according to state law requirements or by explicit order of the regulator<sup>27</sup>.

**In Japan**, the Board of Directors is composed by executive directors and supervisory directors.

Executive Directors execute the daily businesses and represent the investment company.

The Supervisory Directors, which supervise the execution of duties of executive directors, must exceed the number of the latter at least by one.

The Supervisory Directors may require at any time from the executive directors, the management company or the custodian a report of the situation related to the business and the assets of the investment company and may conduct investigations that reveal to be necessary in order to perform their duties.

Those who can be appointed as supervisory Directors are subject to specific limitations that envisage ensuring their effective independence<sup>28</sup>.

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<sup>27</sup> In the United States, for example, persons who have been found to have engaged in certain unlawful conduct by a foreign financial regulatory authority, persons who have willfully made false or misleading statements in certain US SEC filings.

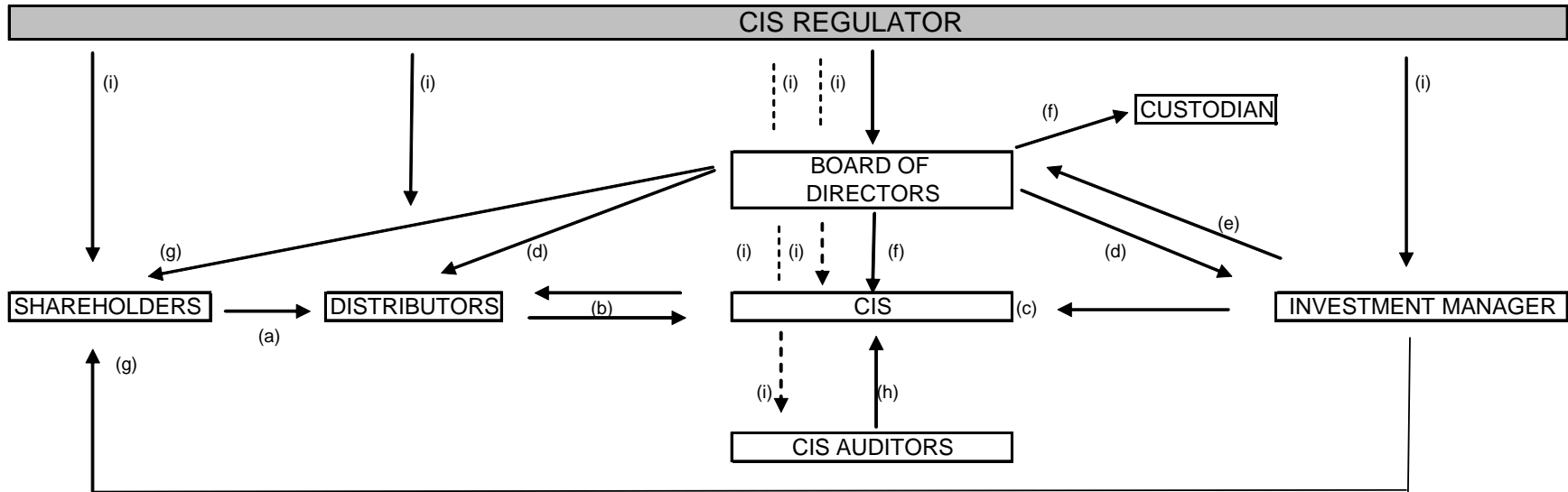
<sup>28</sup> Those who meet the following are not eligible as supervisory directors:

- An applicant is a bankrupt person who is irrevocable in that status or a person who has been imposed a penalty of imprisonment with labour and a period of five years has not elapsed yet from the day on which execution of such penalty was completed or nullified;
- The promoter of the investment company;

In case the promoter of the investment company is a juridical person, directors or employees of the promoter;

- The executive director of the investment company;
- Directors or employees of the securities company or its subsidiary which engage in the subscriptions and sales of investment certificates issued by the given investment company, or a sales agent in case that s/he is an individual; and
- Those that are prohibited under the Ordinance of the Cabinet Office to become a supervisory director because of conflict of interests with the promoter or executive directors.

**Flowchart 1**  
**CIS Governance Structure**  
*Corporate Model 1 - Board of Directors*



- (a) Placement of orders for purchase/redemption of CIS Shares.
- (b) Inflow/outflow of money and issue/amortization of Shares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS Investment Manager and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and subjection to approval of its contracts.
- (f) Oversight of CIS operations and safekeeping of assets (entrusted to a custodian).
- (g) Protection of CIS Shareholders best interests.
- (h) Audit of CIS financial statements.
- (i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Shareholders best interests.

## **APPENDIX 2**

### **Corporate Model 2 - Depositary**

The **United Kingdom** uses both this model and the Contractual Model 2 – Trustee.

Where this model is used, the Depositary, in first instance, provides oversight over the designated Authorized Corporate Director (ACD) since the CIS is not required to have a board of individual directors to operate the company, and oversee the interests of investors.

Under the legislative and regulatory framework the ACD is responsible for the daily management of the company and for ensuring compliance with investor protection rules. The ACD must be a company which is an authorized person in its own right and has permission to act as the sole director of a CIS under the legislative provisions.

The ACD is usually appointed by a written contract entered into by it and the CIS. When the ACD is the sole director, it will need to ensure that the terms are fair for the CIS and the investors. There will be no independent view taken as to the terms of the contract. The regulatory regime requires that the appointment of any ACD, other than the first ACD, must be ratified by a resolution of the shareholders at the following Annual General Meeting, otherwise the appointment will be terminated at the close of the Annual General Meeting following the appointment, or (whichever is later) 12 months from the date of appointment. If the CIS has no (other) directors, the Depositary may appoint an ACD. Alternatively, any remaining directors must take practical steps to find a competent replacement ACD as soon as possible.

The ACD must carry out the following tasks regarding the management of the CIS:

- making investment decisions in accordance with the investment objectives and policy of the CIS;
- ensuring that payments out of the scheme property are not unfair, relate to (i) remunerating the parties operating the CIS, (ii) the administration of the CIS, (iii) the investment or safekeeping of scheme property are appropriately disclosed to investors;
- making sure that customers have access to up-to-date information about the CIS before they buy unit shares, are able to participate in the decisions on key issues concerning the CIS, and are sent regular and relevant information about the CIS;
- ensuring that in retaining the services of anyone to assist it in the performance of its functions, the ACD ensures it can effectively monitor and supervise the delegate, give further instructions/withdraw the mandate when it is in the interests of investors, the mandate does not prevent the ACD from acting, or the scheme from being managed in the best interests of the shareholders;
- make certain that conflicts of interest resulting from certain transactions are properly managed (e.g transactions in CIS property and the lending of money to the CIS involving affected persons and their associates are precluded unless the

transaction can prove to be at least as favourable to the fund and would be comparable to a transaction effected on normal commercial terms negotiated at arms length between the affected person and an independent party);and

- compliance with published CIS policies and procedures.

Under the regulatory framework the ACD must not terminate the exercise of its functions voluntarily unless a replacement has been found.

The Depositary has the role of monitoring and overseeing the actions of the ACD to ensure the scheme is managed in accordance with its objectives and the regulations. It is also responsible for safekeeping of the assets of the company. It must also be an authorized person and so satisfy certain threshold conditions (relating, for example, to adequate resources) and must have permission under the legislation to act as the Depositary of a CIS.

The Depositary's supervisory role includes taking reasonable care to ensure that the CIS is operated by the ACD in accordance with the regulatory framework.

This includes namely the following specific duties:

- ensuring that investment by the ACD in assets that cannot be accurately valued and readily disposed of, is restricted;
- monitoring for and ensuring that if the scheme property is used contrary to the regulatory provisions, or any provision in the instrument prospectus , that action is reasonably taken by the ACD to restore compliance and to reimburse customers;
- ensuring the proper calculation of the NAV of unit shares by the ACD, and that the ACD maintains sufficient records to show compliance;
- ensuring that the price of unit shares is made public by the ACD in an appropriate manner;
- making sure dealings in shares are carried out by the ACD in accordance with the relevant regulatory provisions and any published fund policies and procedures;
- assuring the ACD treats the CIS fairly when arranging for the issue or cancellation of unit shares, and treats clients fairly when they purchase or sell unit shares;
- Ensuring the ACD properly accounts for, allocates and distributes on a timely and fair basis, any scheme income;
- Reporting to the regulator breaches by the ACD, unless the Depositary is of the view that the effects will not be materially significant; and
- Reporting annually to Shareholders whether, in any material respect, the investment and borrowing, valuation and pricing, dealing income and accounting provisions have not been complied with.

The Depositary also has a number of rights under the legislative provisions, including the right to convene a general meeting of the company when it sees fit, and to be heard at any general meeting it attends on any part of the business of the meeting which concerns it as Depositary.

In addition to the specific duties mentioned above under the legislative and regulatory framework, the Depositary has a fiduciary duty associated with the control it has over scheme property and as such it is liable to account for any losses.

The appointment of the first Depositary is made by the CIS in a written contract, often with the ACD as party. There are no legislative or regulatory provisions for terminating the appointment of a Depositary. This is usually dealt with in the Depositary agreement (e.g., by reasonable notice being given, or immediately in the event of liquidation, or the Depositary ceasing to be authorized). The legislative provisions provide a mechanism for the Depositary to alert Shareholders to any problems it is aware of and which have led to its resignation.

The Depositary must be independent<sup>29</sup> of the company and of the persons appointed as directors of the company. In the context of its role as such, it must act solely in the interests of the shareholders.

**In Spain**, the legal environment for CIS (both investment funds and companies) fits mainly within the contractual model, regardless of the functional aspects of the investment companies, essentially the right of vote of the shareholders.

CIS under the corporate form have their own Board of Directors which may alternatively appoint a management company to comply with duties of management<sup>30</sup>, representation and administration or be self-managed<sup>31</sup>.

As a consequence, Governance provisions to management companies that apply both to investment funds and investment companies are defined in the appendix 3 (Contractual Model 1).

In both cases though, CIS' s assets must be entrusted to a Depositary for safekeeping.

In the case of **Ireland**, the Board of Directors of corporate CIS is subject to the following:

- appointments to the office of director require the prior approval of IFSRA<sup>32</sup>. Departures from the office of director must be notified to IFSRA immediately;
- a minimum of two directors must be Irish residents;

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<sup>29</sup> The legislative framework requires independence between the Depositary, the CIS and the CIS's directors. The regulatory view is that independence is likely to be lost if by legal or operational means either relevant party could control the action of the other (by directors in common, cross shareholdings or contractual commitments).

<sup>30</sup> In this case, CIS really function as contractual funds since the role of the Board is merely instrumental.

<sup>31</sup> Which are the exception since they only represent 10 in a total of 3.000. As these companies have not appointed a management company, they must have enough organisational, material and human resources to accomplish their activity. They must comply with the same requirements applicable to CIS management companies.

<sup>32</sup> A completed questionnaire is required in respect of each candidate, which details experience, qualifications, reputation and character, and business interests (e.g., list of directorships).

- the Board of Directors shall not have any directors in common with the board of the directors of the Depositary of the CIS; and
- directors are required to disclose to their board any concurrent directorships, which they hold on boards of authorized CIS and/or related entities, which supply services to such CIS.

Initial directors are appointed by the promoter of the CIS, thereafter, appointments are subject to Irish Company Law requirements.

The board of directors has responsibility for its functions. While activities may be delegated the responsibility for activities cannot be delegated.

Differently from the United States model, there is no requirement for the board of the CIS to complete an annual evaluation of their performance and the performance of any of its committees regulatory requirement in Ireland, although the Depositary is required to enquire into the conduct of the CIS in each annual accounting period and report thereon to the Shareholders.

The Depositary's report shall state whether, in the Depositary's opinion the CIS has been managed in that period:

- in accordance with the limitations imposed on the investment and borrowing powers of the CIS memorandum and articles of association and the Regulations; and
- otherwise in accordance with relevant legislation.

If the CIS does not comply with the conditions above, the Depositary must state why this is the case and outline the steps taken to rectify the situation.

In what respects **Jersey**, the Board of Directors is responsible for appointing both the operator and depositary. The Board of Directors of the CIS has ultimate responsibility for seeing the proper operation of the fund in accordance with the constitutive documents of the fund and all regulatory requirements. However, the Board appoints an operator to undertake the day to day operation of the fund. This operator must be resident in Jersey. He can however delegate the investment management and or the administration functions to other entities either in the island or elsewhere. If such functions are outsourced, the operator remains responsible for the day to day supervision of the outsourced activities and must therefore retain sufficient resources both in number and caliber to be able to ensure that the work carried on its behalf by its delegates is done properly. The Board of the fund will also appoint a Depositary who, in addition to having responsibility for safe custody of the assets of the fund must also perform an oversight function of the operator. For example, he must take reasonable care to ensure that the investments made by the operator are:

- In accordance with the policy of the scheme and in compliance with any regulatory provisions;

- That NAV calculation is done properly and that dealings in shares are carried out in accordance with regulatory provisions.

The Depositary must report breaches by the CIS Operator to the Regulator. Also, the Depositary must report to shareholders, annually stating whether, in the depositaries opinion the fund has been properly managed in that period:

- In accordance with the limitations imposed on the investment and borrowing powers of the CIS Operator by the constitutional documents, by the prospectus and by the regulatory requirements; and
- Otherwise in accordance of the provisions of the constitutional documents and the rules;

And, if the operator has not done so, the respects in which he has or has not done so and the steps which the depositary has taken in respect thereof.

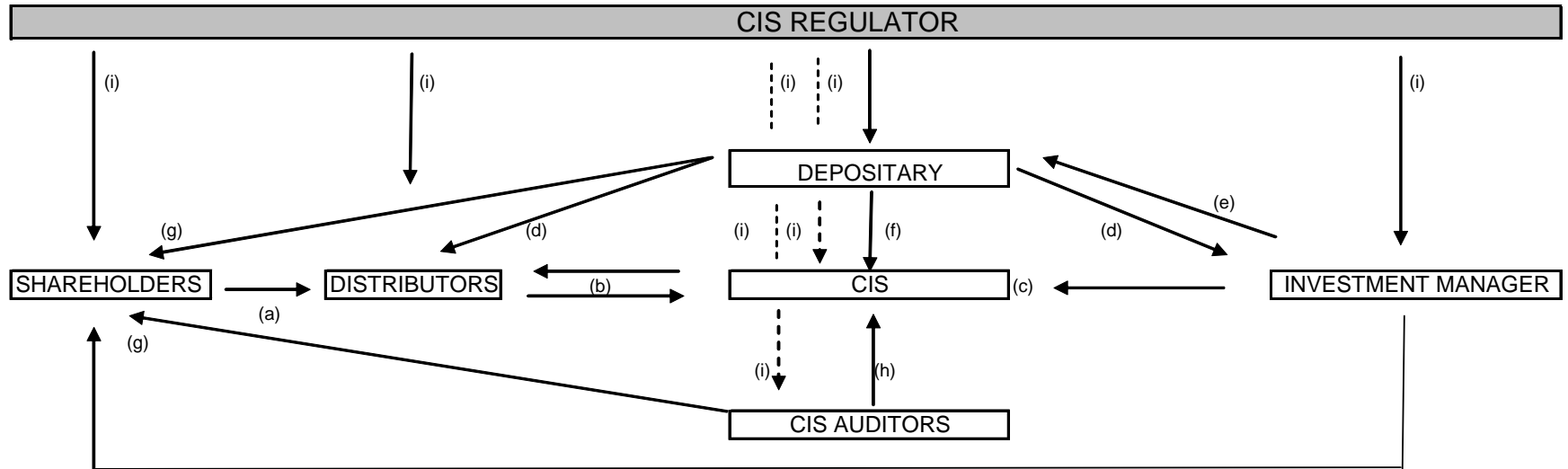
The CIS, CIS Operator and the Depositary must be authorized by the JFSC. Among the requirements for the purpose of CIS Governance the Commission requires;

- At least 2 Jersey resident directors on the boards of the operator depositary and fund company;
- While the Board of the Directors of the CIS and CIS operator can be the same, the board of directors of the Depositary must be completely independent of the operator and the fund;
- Also, the Depositary must be completely independent of the operator in all other respects. Thus, there can be no common ownership nor the Depositary must assume any management functions either directly from the board of the CIS or through delegation by the Operator.

All principal persons of the CIS Operator, Depositary and Board of the CIS must be authorized by the Commission; this includes the directors, senior managers, compliance officers, anti-money laundering officer and major shareholders.



**Flowchart 2**  
**CIS Governance Structure**  
*Corporate Model 2 - Depositary*



- (a) Placement of orders for subscription/redemption of CIS Shares.
- (b) Inflow/outflow of money and issue/amortization of Shares.
- (c) Day-to-day management of the CIS portfolio (may be conducted by the CIS Board of Directors in the special cases of self-managed CIS)..
- (d) Oversight of CIS Investment Manager and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and shared responsibility towards shareholders.
- (f) Oversight of CIS operations and safekeeping of assets.
- (g) Protection of CIS Shareholders best interests.
- (h) Independent review of CIS key elements.
- (i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Shareholders best interests.

## **APPENDIX 3**

### **Contractual Model 1 - Depositary**

In **Portugal**, in which CIS can only assume the contractual form, the Management Company is responsible for acting on account of the unitholders and on their exclusive interest, being their duty, in general, to carry out all acts and operations necessary or convenient to a proper CIS administration in accordance with criteria of both high diligence and professional competence.

The principal functions of the Management Company are:

- To buy and sell securities and to exercise the rights directly or indirectly connected with the CIS's assets;
- To issue, in coordination with the Depositary, the units of the CIS;
- To determine the NAV of the unit shares;
- To select the assets that are part of the CIS, in accordance with the investment policy contemplated in the CIS rules and to carry out, or to give instructions to the Depositary to carry out the proper operations to the execution of this policy;
- To maintain in order the CIS accounting;
- To ensure the accomplishment of disclosure duties according either with the law or the CIS rules.

Again, the same problems of agency relations and conflicts of interest are present in the contractual form and, consequently, it is fundamental that the CIS Operator and CIS activities are properly supervised to protect unitholders best interests.

Therefore, all Portuguese CIS must have a Depositary that is responsible not only for the custody of assets but as well as for overseeing the CIS Operator and CIS activities.

Specifically, the Depositary is namely responsible for:

- Buying and selling securities in accordance with Management Company instructions, receiving interests, dividends and other sort of income arising from the CIS's assets;
- Paying to unitholders their share in the CIS's profits when it is the case;
- keeping in order the chronological listing of all the performed operations and maintaining a monthly relation of the assets that are kept on his responsibility;
- Assuming a surveillance function and guarantying towards the unit-holders the compliance with the CIS rules, especially regarding the investments policy;
- Assuring that the sale, issue, repayment and amortization of units are carried out in accordance with the law and with the CIS rules;

- Assuring that the calculation of the participation units NAV is done in accordance with the law and with the CIS rules;
- Carrying out the instructions of the Management Company, except if they are either against the law or the CIS rules.

The Management Company and the Depositary, while exercising their functions, must act in an independent manner and in the exclusive interest of the unit-holders.

Even though there are no requirements of legal and economic independence between the Management Company and the Depositary<sup>33</sup> this last one has the ‘motivation’ for exercising its supervisory functions properly because otherwise it would have to respond with its own funds for misconducts or frauds committed by the CIS Operator.

This is a direct result of the principle stated in CIS Law that the management company and the depositary are jointly responsible upon unit holders for the accomplishment of the obligations acquired in the law and in the CIS rules.

The Depositary’s responsibility is not affected by the fact of confiding the guardianship of the CIS’s assets, in whole or partially, to a third party.

The replacement of the Depositary depends on an authorization of the Portuguese Regulator.

In **Switzerland, Italy, Germany, Spain, France and Luxemburg** contractual CIS are organized in a very similar way as in Portugal.

In **Switzerland** there is a statutory duty imposed on the Custodian Bank to review compliance of the Operator with all laws, regulations and the CIS Rules of each specific CIS and report serious wrongdoings immediately to the Regulator.

The concept of Independent Directors within the CIS Operator has not been considered relevant, because investors in Swiss contractual CIS have been protected by a different concept, which combines a mix of supervision by the Regulator, Fiduciary Duties of the Operator and Compliance Review by staff of the Custodian Bank independent from the Operator.

In **Italy**, the majority of CIS (about 98%) have a contractual type structure even though the corporate form is also a possible way of organizing a CIS.

In contractual type CIS the Board of Directors of the Management Company is responsible both for the management of the CIS Operator and for the management of the CIS.

The responsibility for overseeing the Board is imposed both on the Depositary and on the Audit Committee being this last one appointed by the Management Company shareholders.

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<sup>33</sup> Since the Management Company and the Depositary may belong to the same group.

The Depositary is mainly responsible for:

- checking the legitimacy of the operations of issuing and redeeming units;
- checking the correctness of the NAV calculation or, if appointed, making the calculations itself;
- carrying out the instructions of the management company unless they conflict with the law, the CIS rules or the prescriptions of the supervisory authorities.

The Depositary bank is liable to the Management Company and unit holders for any loss suffered by them as a result of its failure to perform its obligations.

The Audit Committee is responsible for checking:

- compliance with the law and the bylaws by the Board of Directors;
- the adequacy of the asset management company's organizational structure and of the procedures to supply its authorized activities;
- in particular, the adequacy of the internal control system.

The Audit Committee must notify the Regulator without delay about the violations of the Management Company's duties.

In what regards to the independence of the Board of Directors, Independent Directors represent, generally, a minority and they are responsible for overseeing the decisions of the Board before they are carried out, in order to assure that the CIS is operated in the best interests of Unitholders.

In this global context, CIS Governance in Italy is therefore based on:

- A general provision that states that members of the Board Directors and members of the Audit Committee must be independent;
- Statutory duties imposed on the asset management companies in order to avoid/minimize conflicts of interests; in particular, it is defined that the CIS Operator must act independently and refrain from any conduct that might benefit one mutual fund or individual portfolio at the expense of another;
- Self-discipline codes from asset management professional associations that have developed a "Protocol of Independence", containing rules that are recommended to be included in bylaws of CIS Operators.

As an example, the Code states that asset management companies shall ensure that Boards of Directors include at least one-third of Independent Directors with a minimum of two.

According to the said Code, Independent Directors must:

- check the adequacy and the compliance with the best interests of investors of the contracts having a significant impact on CIS portfolio (e.g. dealing, underwriting);
- express their judgement on the subjects submitted to them by at least two directors of the Board;

- address potential sources of conflicts of interest in order to submit them to the examination of the Board; their judgement is not binding and the Board can take decision against the assessment expressed by the Independent Directors, in this case, however, the Board must motivate such decision;
- express a separate opinion on the appropriate compensation of the Board of Directors, the general manager and the management team;
- verify that the assets of CIS are not burdened with otherwise avoidable costs or excluded from the enjoyment of otherwise accruable benefits;
- address the decision-making process followed in exercising the administrative rights attaching to financial instruments under management and submit proposals to the Board with regard to this point; invest in CIS on whose Boards they serve;
- Avoid, for at least two years since the end of the appointment, to act as employee or to undertake professional or income relationships with CIS Operator, its subsidiaries, the shareholder or group of shareholders who controls the company and the executive directors.

Additionally and in order to prevent conflicts of interests due to directors that serve on multiple companies Boards:

- the executive directors of a regular CIS’s broker-dealer, underwriter or company that provides the related activities may not be appointed to perform operational functions in the CIS;
- persons appointed to perform management functions (Independent Directors being in a position that let influence CIS’s investment choices) may not be members of the Board of directors of companies whose securities are among the CIS assets under management;
- persons appointed to perform management functions in the asset management company may not be Board chairman, CEO, general manager or manager responsible for the organization of the custodian bank.

This last requirement is imposed by the Bank of Italy which is responsible for the supervision of custodian banks.

As in Italy, in **Germany** the majority of CIS have a contractual type structure even though the corporate form is also possible according to the Investment Act.

A statutory duty to review compliance of the CIS operator with all laws, regulations and the CIS rules is imposed to the Depositary. Apart from a statutory controlling function of the Depositary, the Investment Act requires the consent of the Depositary for specific transactions of the CIS Operator. The Depositary does not have a duty of report to the regulator, but it may refuse to carry out the instructions of the CIS Operator, in case they contravene statutory provisions and the terms and conditions of the CIS. Furthermore, the Depositary is entitled and obliged to assert claims of investors against the CIS Operator in its own name for breaches of the Investment Act or of the CIS rules.

The CIS Operator and the Depositary can belong to the same group. In order to ensure independence and “Chinese Walls” the Investment Act requires that managers of the

Depository, its Shareholders and agents with powers of representation in the entire scope of its business may not, at the same time, be employees of the CIS Operator and vice versa.

The CIS Operator must be established in the legal form of a stock corporation or a company with limited liability with a Board of management directors (composed of at least 2 members). In both cases a Board of management directors (composed of at least 2 members) and a Supervisory Board (composed of at least 3 members) is obligatory. The Supervisory Board oversees all CIS under management. The appointment and retirement of members of the Board has to be notified without undue delay to Regulator to enable an appropriate check of their fitness and expertise. The regulator does not have the authority to order a dismissal of a member of the Supervisory Board, but it has the right to take part in the meetings of the Board and can take interim measures of investor protection.

Although the members of the supervisory board are not independent as defined in the corporate model for the case of the United States - since they act in most cases as management directors of the parent company - the supervisory board plays an important role in the practical supervision. The supervisory board is insofar an important function as it has the power to dismiss management directors of the CIS Operator. Before demanding dismissal of a management director of a CIS Operator by formal legal supervisory measures, the regulator, in most cases, may promote contacts with the chairman of the supervisory board to induce a dismissal of the management director who has violated his duties on their own initiative. The supervisory board is in most cases interested to avoid the publicity of a formal dismissal procedure conducted by regulator and dismiss management directors by their own initiative.

**In Spain,** CIS Governance provisions deals primarily with the following issues:

Authorization requirements for the Management Company:

- The Board of Directors must be composed of, at least, three members that must be professionally honorable and have enough experience with regard to financial matters.
- Internal control systems requirements:
  - The Management Company must have an administrative and accounting organization, computer security mechanisms and internal, management and risk control procedures appropriate for its activity. It must also have measures and procedures to avoid money laundering.
  - The Management Company must have a compliance function (control unit) comprising one or more persons who are not involved in any operational and business functions and which reports directly to the Board of Directors. The Board of Director of the Management Company assumes full responsibility for the implementation, development and on-going effectiveness of internal control.

## Conduct Rules:

- There are broad principles enshrined in the Spanish Securities Market Law regarding the general duty to act in the best interest of investors and guarantee the equal treatment of investors and the obligation for financial entities must be organized and structured in such a way as to minimize the risk of conflicts of interest, and in case of conflict, give priority to the clients interest (the Law requires Chinese walls for activities of “separated areas”).
- More detailed principles are developed in the “General Code of Conduct” for securities markets regarding conflicts of interest.
- “Internal Codes of Conduct” must be approved by every Management Company in order to avoid conflicts of interests. This must be subscribed by every person in the Board of directors, directors and all the employees with some responsibility related to the management activity.
- Finally, related party transactions are subject to a special regime, including the establishment of procedures to ensure that related party transactions have been made at market price or better, and the public disclosure of these transactions.

## Independent Review:

### By the Depositary:

- Securities and other financial assets of the CIS must be kept by its Depositary entity.
- Independence between the Management Company and Depositary is required.

Nevertheless, separation rules exist between the Management Company and the Depositary when they belong to the same group, namely:

- No existence of common board members or directors.
- The effective management of the CIS Operator must be independent to the Depositary entity.
- The CIS can not invest more than 1% of its assets in securities issued by the depositary entity.
- A physical separation must exist between the CIS Operator and the depositary entity.

If the CIS Management Company and the Depositary are part of the same group, additional procedures are required:

- To ensure independence and to avoid conflicts of interest.
- Disclosure to investors of the relationship between them.
- The periodic information to investors must include any purchase or sell of securities where the Depositary entity acted as counterparty.

- The supervisory role of the Depositary includes:
  - Valuation and pricing (Net Asset Value calculation methods).
  - It also has a role in the subscription and redemption process. The Depositary is the only entity authorized to order payments against the bank

accounts of the CIS, including redemption under the CIS Operator instructions.

- Compliance with diversification rules, and oversight of the management carried out by the management company.
- A duty of Communication to the regulator any non-fulfillment of those regulatory provisions.

**In France**, the framework for CIS Governance is based on three main principles:

- Transparency;
- Compliance functions under the regulator's supervision;
- External control by the Depositary and the Auditors.

The Management Company<sup>34</sup> must define appropriate procedures to monitor both their own activities and those of their intermediaries, depositaries and custodians. The implementation of a control structure of the asset management company, supervised by a person specifically appointed for this purpose by the company, is essential to the reliability of and compliance with control procedures, the prevention of operational risk and, ultimately, the security of the services provided to the investors.

In this sense, a compliance officer responsible for internal controls and compliance must be designated by the Management Company.

This control unit is responsible for compliance with the rules established by the regulator and the professional associations recognised by the regulator. For this purpose, it must conduct an ongoing review of the internal accounting control, risk monitoring and management procedures and systems. Its function is to evaluate compliance with all the established measures and limits, to verify their validity but also to propose any modifications it considers necessary. It is also responsible for notifying punctually the Board of Directors of any inadequacies observed in the system and for ensuring the separation of the functions of the CIS Operator and the Depositary.

The CIS assets are kept by a single Depositary, which is also responsible for ensuring that the decisions of the CIS comply with laws, regulations and the CIS prospectus (investment allocation rules, nature of the products constituting the assets).

In accordance with the French regulation, CIS Depositaries exercise two main functions:

- Control of compliance with rules and investors' interests;
- Custody of the CIS assets. This custodian activity may be delegated to other custodians under the responsibility of the Depositary.

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<sup>34</sup> Both in the corporate and in the contractual forms.



The Depositary must be independent from the Management Company (or not affiliated with the Investment Company - SICAV)<sup>35</sup> and they both must act in a independent manner.

Furthermore, the Management Company and the Depositary are as applicable, individually or jointly, liable toward third parties or shareholders for breach of the laws and regulations applicable to CIS, for breach of fund rules or errors.

The main aspects of the preservation of good CIS Governance are therefore:

- Rules governing the custodian's independence and oversight;
- Control over persons in authority;
- Control over regulatory ratios, the specific investment rules set out in the prospectus and the rules on capital ratio for the CIS;
- Annual control of custodial functions by the statutory Auditors of the Custodian, including checks of the accounts opened in the books of the custodian on behalf of the CIS

The French *Fonds Communs de Placement d'entreprise (FCPE)* scheme can also be exhibited as it presents an interesting specificity. This scheme is organized in the form of a mutual fund whose shares can be exclusively subscribed by employees of a given company. As other mutual funds, French FCPEs are managed by a management company. However, the activity of management companies of such funds has to be monitored by a specific Supervisory Board and 50% of the members of this Supervisory Board are, at least, employees representatives. This Board fulfills the role of a sort of an "independent review committee".

**In Luxembourg** the local Law requires that each CIS appoints a Depositary. The Depositary is primarily responsible for the safekeeping of the assets of the CIS and, in addition, has various monitoring and supervisory functions, the extent of which depends upon the corporate or contractual form chosen. For both forms of CIS, the Depositary must ensure that:

- the sale, issue, redemption and cancellation of units/shares effected /by the Management Company/by or on behalf of the CIS is carried out in accordance with the law or the management regulations/articles of incorporation;
- in transactions involving the assets of the CIS, the consideration is remitted to it within the customary time limits; and
- the income of the fund is applied in accordance with its management regulations/articles of incorporation.

Moreover, for contractual CIS, the Depositary has to ensure that the value of CIS unitshares is calculated in accordance with the law and the management regulations and to carry out the instructions of the Management Company, unless they are in conflict with the law or the management regulations.

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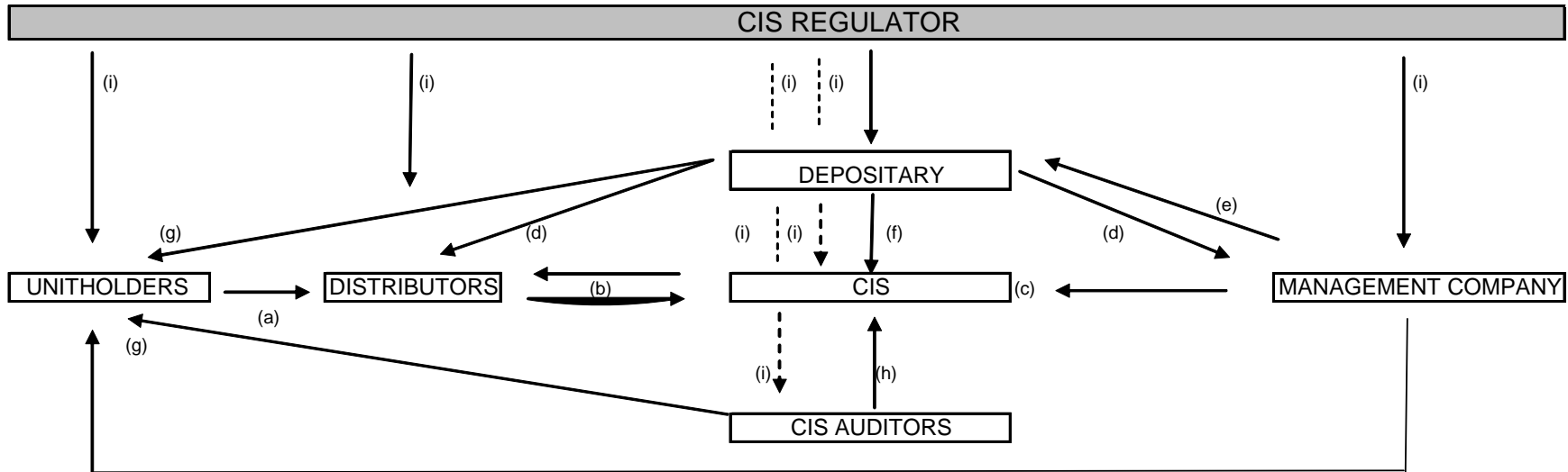
<sup>35</sup> No single company can act both as Management Company and Depositary.

The Luxembourg law expressly provides that the Management Company and the Depositary must act independently and solely in the interest of the unitholders with regard to their respective roles.

In the case of **Brazil**, the Depositary is required to supervise the activities of the CIS Operator. Notwithstanding, there is no requirement of legal and economic independence between the CIS Operator and Depositary. The last has to conduct its business separately from the CIS Operator and must appoint a Director responsible for both custodian and supervisory activities, who cannot exercise any functions at the CIS Operator. Furthermore, the governance structure in Brazil entails that the CIS Operator itself must have both an administrator and a manager. In the majority of cases the administrator and the manager are distinct companies. The administrator has supervisory powers and responsibility over the managing activities (that consist mainly in managing the CIS assets). In this sense, the role of the administrator and of the manager resemble, respectively, the ones assumed by a supervisory board and executive committee in a Management Company of a CIS that has such a governance structure. In the few cases where the administrator and the manager are not separate, the depositary gets entrusted with supervising the manager's activities.

Notwithstanding the fact that the majority of CIS have a contractual type structure, the corporate form is also a possible way of organizing a CIS in Brazil.

**Flowchart 3**  
**CIS Governance Structure**  
*Contractual Model 1 - Depositary*



- (a) Placement of orders for subscription/redemption of CIS Unitshares.
- (b) Inflow/outflow of money and issue/amortization of Unitshares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and shared responsibility towards unitholders.
- (f) Oversight of CIS operations and safekeeping of assets.
- (g) Protection of CIS Unitholders best interests.
- (h) Independent review of CIS key elements.
- (i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Unitholders best interests.

## APPENDIX 4

### Contractual model 2 - Trustee

In the **United Kingdom**<sup>36</sup> and Jersey, The functions of the CIS Operator and the Trustee are somehow equivalent to the ones performed by the ACD and the Depositary in the UK corporate model for CIS.

The CIS Operator is appointed under the deed to carry out the daily management and promotion of the UT. In addition to the duties imposed on the manager under the trust deed there are additional requirements, rights and duties imposed on the manager under the legislative and regulatory framework, including trust law and ensuring compliance with investor protection rules. The manager must be a company which is an authorized person in its own right and has appropriate permission to act under the legislative provisions.

Under the regulatory framework the CIS Operator must not retire voluntarily unless an eligible replacement has been found, is agreed by the trustee and becomes a party to the trust deed.

Under the legislative and regulatory framework the Trustee is responsible for monitoring and overseeing the manager's activities to ensure the scheme meets its objectives and the requirements of the regulations. It is also responsible for holding the assets of the trust on trust for unitholders who are beneficially entitled to them. It has a direct relationship with, and must act only in the interests of, the unitholders. Like a Depositary, the Trustee must be an authorized person and must have the appropriate permission under the legislation to act. The Trustee must also be independent<sup>37</sup> of the UT CIS Operator.

Under the regulatory provisions the Trustee may only retire voluntarily (e.g if a Trustee ceases to offer trustee services) if a new Trustee has been appointed. If the trustee ceases to be an authorized person, the UT manager may appoint another eligible person.

The Trustee also has a right to convene a general meeting of the fund when it sees fit, and to be heard at any general meeting it attends on any part of the business of the meeting which concerns it as trustee.

In addition to the specific duties mentioned above under the legislative and regulatory framework, the Trustee has a fiduciary duty associated with the control it has over scheme property and as such it may be liable to account for any losses if it is negligent in carrying out its duties. The Trustee will receive all details of any corporate actions and may exercise all rights relating to the ownership of scheme property (as registered holder of

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<sup>36</sup> In the UK Unit Trusts are known as AUT (Authorized Unit Trust).

<sup>37</sup> The legislative framework requires independence between the Trustee and the Manager. The regulatory view is that independence is likely to be lost if by legal or operational means either relevant party could control the action of the other (by directors in common, cross shareholdings or contractual commitments.)

investments and because the trust cannot act on its on behalf), but may only vote in accordance with the instructions of the CIS Operator. It is therefore obliged to pass all details of any corporate actions to the manager without undue delay.

Like a Depositary the trustee of an UT is prevented from delegating oversight and custody to the AUT manager and oversight but not custody and control of scheme property to any associate of the AUT manager as this could lead to compromise of investor protection.

**In Hong Kong**, CIS can only be established in the form of a unit trust.

The centerpieces for CIS Governance are:

- the CIS Operator;
- an Independent Trustee;
- an Independent Auditor.

Hong Kong laws require segregation and protection of assets of a CIS through the appointment of a trustee independent from the CIS Operator. Additionally, the regulator places certain supervisory responsibilities on the trustee of an authorized CIS. For instance, the trustee is responsible for ensuring that the operation of the CIS is in accordance with the provisions of the constitutive documents.

The Trustee plays also an important role in a possible CIS Operator removal since that is mandatory if the Trustee state in writing that a change in Management Company is desirable in the interests of the unitholders<sup>38</sup>.

**In Japan**, the contractual model of CIS is more widely used than the corporate model. In the contractual model, a CIS Operator (Investment Trust Company) concludes an investment trust contract with a trust company, which manages and keeps in custody the trust properties as a trustee.

To protect investors (beneficiaries), a CIS Operator must comply with several obligations, including fiduciary duty and duty of care with a good manager. In addition, certain restrictions apply to the activities which may give rise to conflicts of interest. In particular, the law prohibits a CIS Operator to be involved in the following transactions which may be abused to benefit its own, third parties' and/or interested parties' interests.

- Transactions between a CIS Operator (or its directors) and trust properties;
- Transactions among funds managed by the same CIS Operator; and
- Transactions with conditions which differ from the ones for ordinary transactions, and harm investors' interest.

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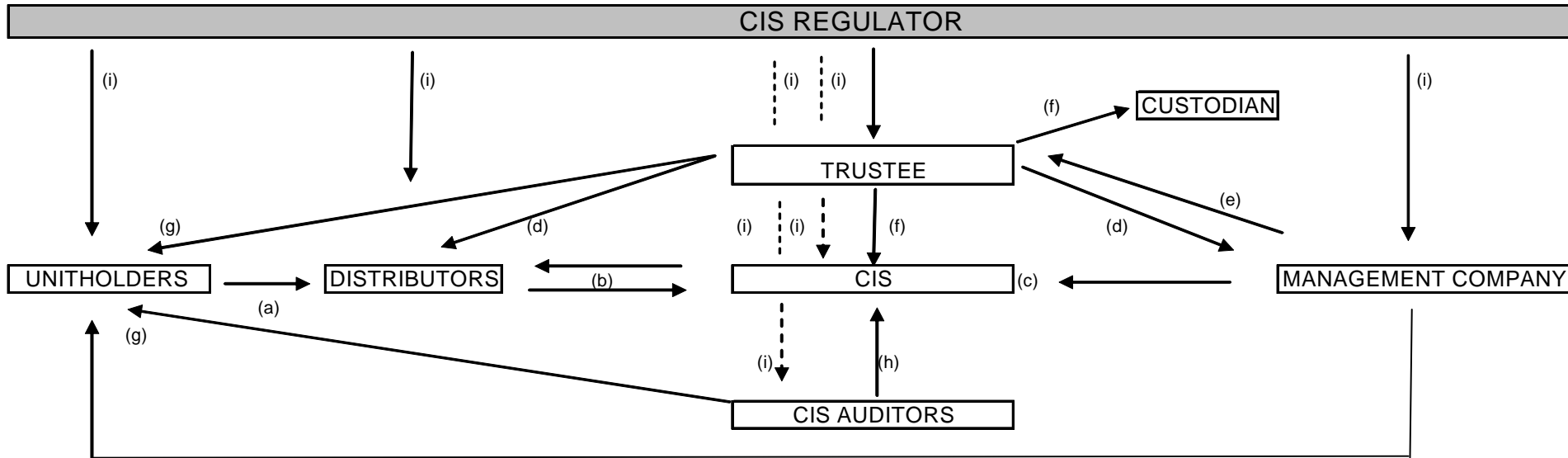
<sup>38</sup> Removal of the CIS Operator in the case of a unit trust, if holders representing at least 50% in value of the units outstanding deliver to the Trustee a written request to dismiss the operator.

The law also requires the trustee to be independent from the CIS Operator.

The regulatory authority monitors whether a CIS Operator complies with the laws and regulations, including aforementioned obligations, through on-site inspection and off-site monitoring to protect the interest of CIS investors. In this sense, the regulatory authority's role is critical in enhancing the CIS governance in the contractual model.

In addition, investors play an important role in the CIS governance scheme. A CIS Operator shall, in concluding an investment trust contract, notify the trust contract to the regulatory authority and provide a copy to the investors. The trust contract shall include information on a trustee, business conducted by a trustee, and matters concerning valuation of assets. The CIS Operator shall, when changing the trust contract, also notify it to the regulatory authority in advance, if the change is important to the investors, and the CIS Operator shall disclose it publicly and provide a copy to investors. Investors may, in cases where they have objections to the change, express their views to the CIS Operator. If the majority of the investors disagree to the proposed change, the CIS Operator cannot make such change. Investors may also request the CIS Operator to disclose the documents related to their trust properties.

**Flowchart 4**  
**CIS Governance Structure**  
*Contractual Model 2 – Trustee*



- (a) Placement of orders for subscription/redemption of CIS Unitshares.
- (b) Inflow/outflow of money and issue/amortization of Unitshares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and submission to approval/ratification of contracts and certain restricted transactions.
- (f) Oversight of CIS operations and fiduciary property of CIS assets, although its safekeeping is entrusted to a custodian.
- (g) Protection of CIS Unitholders best interests.
- (h) Independent review of CIS key elements.
- (i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Unitholders best interests.

## APPENDIX 5

In **Australia**, even though CIS are organized as unit trusts their regulation is similar to the Corporate Model, because there is no separation of the roles of the CIS Operator and the Trustee. The sole responsibility for oversight and operation of the scheme rests with the single responsible entity and its directors and employees, who all stand in a fiduciary relationship to the investors. The responsible entity is able to appoint agents, such as a custodian or investment manager, but remains responsible for the actions of the agent.

The board of directors of the CIS plays a central role in the governance structure. This oversight role is supplemented by the monitoring role of a Compliance Committee. If at least half of the directors are not independent, then at least half of the Compliance Committee members must be independent.

The role of the Compliance Committee is to monitor to what extent the responsible entity complies with the scheme's compliance plan and to report breaches to the responsible entity. The Compliance Committee is required to assess compliance at regular intervals and may commission independent legal, accounting or other professional advice or assistance at the expense of the responsible entity.

In **Canada**, even though CIS can be organized as either corporations or trusts, the majority of open-ended CIS are organized as trusts. In practice, there is no separation of the roles of the CIS Operator and the Trustee. It is the CIS Operator who has the day to day responsibility for the oversight of CIS operations, including the prevention of conflicts of interest.<sup>39</sup> In this way, the Canadian model has many similarities to the Contractual Model 1 – Depositary.

Typically, CIS operators will provide the services required to operate the CIS, or will organize other service providers to do so. The main service providers required are: the custodian, who holds the securities; the trustee (in the case of trust CIS) which is the legal owner of the investments for the benefit of the Unitholders; the investment adviser, who provides expertise in the investment of the capital; the registrar and transfer agent; and the distributor.

CIS Governance in Canada relies on the fiduciary obligations of CIS Operators (as well as Trustees and Investment Advisers), on statutory prohibitions, on regulatory oversight and on the remedies available upon abuse.<sup>40</sup> The CIS Operator is in a fiduciary role to the CIS

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<sup>39</sup> In most corporate-CIS in Canada, the investors have few of the rights of public corporation shareholders. Similarly, in trust-CIS in Canada, the trustee provides the (absolutely essential) service of separating ownership into legal title (the trustee's formal title) and equitable or beneficial title (the securityholder's economic interest).

<sup>40</sup> Current remedies include the power of the regulatory authorities to investigate alleged problems and to issue orders, to levy fines or not to issue receipts for prospectuses, and the power of unit holders to commence litigation (including class actions in some jurisdictions).



and the CIS Investors. This fiduciary duty arises at common law and civil law, and is reinforced in statutory standard of care provisions for CIS Operators set out in most jurisdictions in Canada. For the trust-CIS Operator acting as Trustee (which is often the case), a fiduciary role additionally arises at trust law.

On the horizon is a proposed national rule by the Canadian securities regulatory authorities<sup>41</sup> which will introduce independent review and oversight of conflicts of interest faced by the CIS Operator by an independent body, referred to as an Independent Review Committee (“IRC”). It is expected this ‘independent oversight’ by the IRC will have similarities to the role of independent directors in the Corporate Model 1 – Board of Directors.

The proposed Rule introduces the requirement for every publicly offered CIS to establish an IRC. The IRC must be composed of at least three members, and all members are required to be “independent”. “Independence” is defined to mean “no direct or indirect material relationship with the manager (CIS Operator), the mutual fund (CIS) or an entity related to the manager (a defined term in the instrument).” “Material relationship” is defined to mean “a relationship which could, in the view of a reasonable person, interfere with the exercise of the member’s independent judgement regarding conflicts of interest facing the manager.”.

The CIS Operator must refer to the IRC proposed actions where there is an inherent conflict of interest, or perceived conflict of interest, between the interests of CIS Investors and the CIS Operator of the CIS.<sup>42</sup>

The proposed role of the IRC has similarities to the role of independent directors in the Corporate Model 1 – Board of Directors. It is contemplated that the IRC’s role will be as follows:

- to provide an independent check/perspective on CIS Operators in conflict of interest situations.
- to permit CIS to engage in certain transactions (which are otherwise prohibited under securities rules) with affiliated or related persons, if the CIS Operator refers the issue to the IRC, receives the IRC’s approval, and otherwise complies with the proposed rule.
- to act in the best interests of the CIS, and by extension, in the best interests of the CIS Investors. The proposed rule contemplates the CIS Operator appointing the

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<sup>41</sup> Proposed National Instrument 81-107 *Independent Review Committee for Investment Funds* (2005) 28 OSCB (Supp-2).

<sup>42</sup>The proposed Rule recognizes CIS Operators, and those who work for CIS Operators, can find themselves in situations where their pecuniary interests conflict with their fiduciary duty or in situations where they have a diminished interest in pursuing the best interests of securityholders. Some of these conflicts are addressed by existing conflict rules while others are not.

first members of the IRC, with the members independently appointing replacement. The IRC will also be able to engage independent legal counsel and other advisors it determines necessary (or useful) to carry out its duties.

- To review and approve certain changes and thereby relieve CIS from seeking investor approval in certain circumstances. This would include a change in the CIS's Auditor and in the case of a CIS merger or reorganization with another CIS with the same CIS Operator. Changes to the 'commercial bargain' would continue to require investor approval.

In the new proposed **Dutch** corporate and contractual model, CIS Governance can be organized at the level of the individual CIS by stipulating that each CIS should have a (sufficiently independent) supervisory board that is responsible for the oversight of the CIS or at the level of the Management Company by stipulating that each Management Company should have a (sufficiently independent) supervisory board.<sup>43</sup>

Such a supervisory board could specifically ensure that (i) the potential conflicts of interest between the CIS (and the Management Company) and its affiliated parties are dealt with in a responsible manner, (ii) meticulous account is rendered for the functioning of the CIS, and (iii) the CIS is managed in accordance with its objectives and the conditions set out in the prospectus.

In order to properly fulfil its function as an Independent Entity, the supervisory board (of the Management Company) should have sufficient independence from (its Management Company and) the parties affiliated (with the management company) in terms of their composition and operation. This can be ensured by stipulation that either the majority of the board members must be independent (from the Management Company and its affiliated parties), or the supervisory board must appoint a compliance committee consisting entirely of independent board members, of which there must be at least two. To prepare the decisions to be made by the supervisory board as a whole, Compliance Committees should consult with the executive board about compliance issues, and explicitly report on those consultations to the full supervisory board.

A supervisory board at the level of the individual CIS has the advantage that the position of Independent Entity is filled as close as possible to the investors in the individual CIS. A large disadvantage however is that it creates substantial costs for CIS and requires a large number of independent and sufficiently knowledgeable board members to be recruited outside the management company or the group of enterprises to which the Management Company belongs. The less complicated alternative is to organize CIS governance at the level of the Management Company by requiring that each Management Company should have a sufficiently independent Supervisory Board. (This also complies with the new Dutch regulations according to which the Management Company, rather than the individual CIS, is required to obtain a licence).

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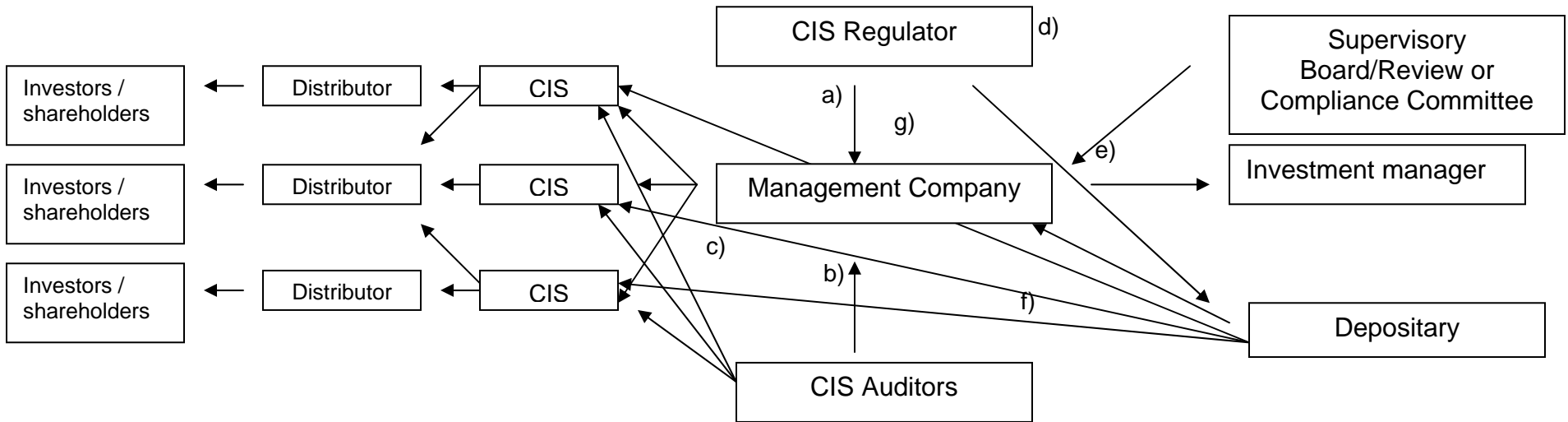
<sup>43</sup> In the Netherlands a supervisory board either on the individual CIS level or management company level is not yet obligatory.

A possible area of tension lies in the fact that is precisely the Management Company itself whose interests may conflict with those of the shareholders/investors, and that it could be argued that a supervisory board at the level of the Management Company should be responsible for ensuring that the interests of the Management Company are sufficiently protected. However, the Management Company is required by law to act in the interests of the investors of each separate CIS. The responsibilities of the supervisory board of a CIS Management Company might certainly include ensuring that that Management Company conducts its activities in accordance with its statutory obligations, and in particular that the Management Company acts in the interests of the investors in each separate CIS that the Management Company manages. The decision-making process for dealing with conflicts of interest between the management company and the CIS and between the various CIS managed by the management company is one of the duties of the management company's Supervisory Board.

The role of the depositary in this model is limited to protecting the assets that are held for investors in CIS, particularly against arbitrary actions on the part of the Management Company and against the consequences of financial collapse of the Management Company or the CIS. Custodians, as they are currently organized, are generally not equipped to perform a more general supervisory function, since they function not independently from the Management Company and the group of enterprises of which the Management Company is a part.

An external auditor who audits the annual accounts shall state in the annual management letter the extent to which he has assessed the system of administrative organisation and internal control measures (AO/IC) as part of his audit activities. He shall also state the most important findings from his audit activities. The external auditor has to inform the Dutch regulator of any irregularities that his audit has uncovered.

**Flowchart 5**  
**CIS Governance Structure**  
*Hybrid Corporate and Contractual Model*  
*Supervisory Board/Review or Compliance Committee*



- a) Licence held by Management Company, offering range of CIS (UCITS, non-UCITS).
- b) Auditors review only Management Company financial reporting, report irregularities to the Regulator.
- c) Auditors review separate financial reporting by CIS, report irregularities to the Regulator.
- d) Requirement of sufficiently independent Supervisory Board at the CIS or Management Company level or an Independent Review or Compliance Committee.
- e) Outsourcing and monitoring of investment management.
- f) Legal ownership of assets separate from CIS and Management Company, limited monitoring of asset management.
- g) Licensed Depository, not independent of Management Company.

## APPENDIX

### Feedback Statement on the Public Comments Received by the Technical Committee Consultation Report – Examination of CIS Governance, part 1

#### Introduction

1. The IOSCO Technical Committee publicly released a first consultation report entitled *Examination of Collective Investment Schemes (CIS) Governance* in February 2005 with a comment period running until May 2005.
2. In this first document, CIS Governance is defined as "*a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS investors, and not in the interests of CIS insiders*". The document examines Governance for Collective Investment Schemes, including a detailed description of each SC5 jurisdiction approach to this issue.
3. This statement summarizes the main issues raised in the responses received and explains how the Technical Committee and its SC5 addressed those issues in the final report.

#### Responses (General)

4. Comments from thirteen (13) organizations were received on this consultation paper and SC5 met in Sintra, Portugal, on the 7 and 8 of June to consider them.
5. Broadly speaking, the majority of comments received expressed support for IOSCO's work in defining CIS Governance and a primary general principle of independent review and oversight of CIS Operators (done by 'Independent Entities') to be applied in all SC5 jurisdictions, regardless of the structural form of the CIS.
6. Several respondents mentioned that CIS Governance principles should be sufficiently broad to allow for difference in structure and legal frameworks amongst national industries and sufficiently firm to guarantee investors protection. In this sense, no optimal or universal should be available to reach this goal.
7. Some respondents stressed that importance that Auditors and CIS Operators' Compliance Officers may have, either by acting or complementing Independent Entities' work.

#### Responses (Specific)

8. The following chart tries to explain how IOSCO analyzed and addressed each particular response.

Organization	Main issues	How the issues have been addressed by IOSCO
Investment Trust Association - Japan	“Believes that each country should be able to determine whether it adopts the independent review or not after due consideration in the light of its own system.	Not adopted since the comment contradicts one of the main statements of the report, precisely the one which advocates that independent review of CIS and CIS operator’s activities should be seen as necessary namely to prevent conflicts of interest. However, the report ensures that jurisdictions are given the flexibility to define the exact terms and entities through which this principle could be implemented.
Association of Deontology (“ <i>Club des Deontologues</i> ”) - France	The objectives of governance are the same both in corporate and contractual CIS. Each CIS should have a compliance officer (“ <i>déontologue</i> ”) and its role should not be ignored in the process of CIS governance as one of the most important in what regards protecting investors’ interests.	Appropriate references already included in the report, namely in its point VII.
The Investment Funds Institute of Canada (IFIC)	1) It is necessary to move towards better than increased regulation, in the sense that the costs imposed by any CIS governance structure should not outweigh the benefits to investors. <u>2) The roles of independent entities and the CIS operator are different – “The right and privilege of the CIS operator to continue to act on behalf of investors is earned and subject to reaffirmation on a continual basis, as nothing bars an investor from moving to a more appealing product/manager combination, therefore Independent entities should not</u>	Partially adopted. Comments marked as 2) and 3) were respectively included in new footnotes 18 and 8.

	<p><u>be empowered to an extent that would potentially give them the ability to undermine or impair the choices made by individual investors. 3) Competitive Market Forces Discipline Mutual Fund Manager Conduct and Should Not be Discounted - The adoption of a fund governance regime, in any form, must recognize the commercial mechanisms of strenuous competition and the need to preserve and enhance firm reputation and how these factors continually ensure the alignment of fund manager and investor interests.</u></p>	
Fidelity International	<p>1) <u>The independent entity exists to protect certain investors' interests, not all – It would be beneficial to identify those areas which should remain outside the independent entities' competence (e.g investment discretion within the CIS rules versus investments outside those rules).</u></p> <p>2) Investors should be involved and encouraged namely by regulators and industry operators to “behave actively” in what respects the perception of how their investments in CIS evolve.</p> <p>3) <u>More than having an “outside perspective”, independent entities should have an objective and informed perspective – Independence for its own it is not a “magic wand”.</u> 4) Strongly against any form of box-ticking approach to defining the concept of independence – Independence is a state of mind. 5) <u>Thinks that is unnecessary or even incompatible to certain CIS structures to prevent Independent</u></p>	Partially adopted. Comments marked as 1), 3) and 5) were respectively included in new footnote 18 and in point VII.

	<u>entities to outsource their oversight functions.</u>	
Italian Association of Fund and Asset Managers (Assogestioni)	CIS Governance principles should be sufficiently broad to allow for difference in structure and legal frameworks amongst national industries and sufficiently firm to guarantee investors protection.	Remark which is already within the structure and spirit of the report.
Association of the Luxembourg Fund Industry (ALFI)	There should be independent oversight in a CIS but different solutions should be available to reach this goal.	Remark which is already within the structure and spirit of the report.
German Investment Fund and Asset Management Association - BVI	1) Structural divergences between CIS rule out the possibility to install universal rules of CIS governance. 2) The definition of independence should not lie only on the legal or economic independence of the oversight entity, but on the ability of the independent entity to perform its duties in an autonomous manner (functional independence). 3) The absence of legal or economic ties between fund manager and supervising entity marks only one way of achieving the necessary level of independence.	The principles stated in the report, as they have some flexibility, do not deny the remarks and suggestions put forward.
The Directors' Office - Luxembourg	<u>1) The report refers that the functions of the Depositary and of the Board of Directors are not equivalent, but its overall structure and the contents do not convey that idea (e.g. corporate model 2 places the Depositary as the "independent entity". 2) The report should outstand that investor's rights are different accordingly to the structure of the CIS (corporate or contractual). 3) The report should not imply that all four CIS governance structures are as efficient in</u>	Adopted. Comments marked as 1), 2) and 4) were respectively included in point VII, in new footnote 12 and in point III. Comment 3) is within the spirit of the report.



	<p>providing value and protection.</p> <p><u>4) Draw the attention to the fact that the role of the CIS operator and its fiduciary responsibilities of acting on behalf exclusively of CIS investors seems to be absent of the report.</u></p>	
Investment Management Association (IMA) - UK	Stresses that in the UK it is mandatory for CIS manager and depositary not to belong to the same group of companies and that this fact is a fundamental element of investor protection.	Although not imposing it as a mandatory solution, the report stresses precisely the importance of independence between the CIS operator and the entity that is responsible for overseeing this last.
European Fund and Asset Management Association (EFAMA)	<p><u>1) Refers that CIS Auditors can also act as independent entities, provided that their obligations and reporting lines are organized accordingly.</u> 2) Stresses the importance of a compliance structure and mentality within the CIS operator as a fundamental tool to the independent entities' mission.</p>	Adopted. Comment 1) was inserted as new footnote 19. Comment 2) is already reflected in the report, namely in its point VII.
Investment Company Institute (ICI) - USA	Shows its concern regarding the fact that independent entities could be affiliated to the operators, mainly because “as a member of the same corporate group as the fund operator, an affiliated depositary or trustee has an economic interest in the success of the corporate enterprise that could impair its ability to provide independent oversight of the fund operator”.	Although not imposing it as a mandatory solution, the report stresses precisely the importance of independence between the CIS operator and the entity that is responsible for overseeing this last.
French Association of Financial Management (AFG)	Agrees in not adopting a ‘one size fits all’ approach which might harm many regional industries and suggests a clear definition of what should be the responsibilities of independent entities.	Already within the context of the report.
Portuguese Fund Association	1) Is in favor of a self-regulated definition of CIS governance	The report does not deny the possibility mentioned in

(APFIPP)	standards. 2) Stress the importance of the role of compliance officer within the CIS operator.	comment 1) and comment 2) is included in point VII.
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