EXAMINATION OF GOVERNANCE FOR COLLECTIVE INVESTMENT SCHEMES

PART II

Independence Criteria, Empowerment Conditions and Functions to be performed by the 'Independent Oversight Entities'

Responses to the Consultation Report

February 2007

Responses to the IOSCO Consultation Report

The Investment Trusts Association, Japan

0ctober 2, 2006

Mr. Philippe Richard
Secretary General
International Organization of Securities Commissions (IOSCO)
Oquendo 12, 28006 Madrid
Spain

Re: "Examination of Governance for Collective Investment Schemes" (Part II)

Dear Mr. Richard,

The investment fund management companies and the Investment Trust Association in Japan make the continuous effort to establish the robust governance regime suitable for the Japanese legal framework for the best interests of investors. We also believe a CIS governance based on the independent review and oversight is one of appropriate ways to assure that CIS are organized and operated for the best interest of their investors.

However, when examining the independence, powers and functions of Independent Oversight Entities, it is important to recognize that the CIS regulations and governance regimes vary from one country to another. Therefore, we believe that the principles for the independence, powers and functions of Independent Oversight Entities should be established in such a way that these principles could be broadly applied to various CIS regulations and governance regimes in different countries. Further, we consider that these principles should be flexible enough to make it possible to ensure that the CIS governance costs do not exceed the investor benefits.

Yours sincerely,

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(For your reference)
The Investment Trusts Association, Japan, is the self-regulatory organization whose membership includes 117 investment fund management companies and 11 securities firms.

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October 13, 2006

Ms. Pamela Vulpes
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Public Comment on Examination of Governance for Collective Investment Schemes – Part II

Dear Ms. Vulpes,

BVI[1] gladly takes the opportunity to comment on independence criteria, empowerment conditions and functions of "Independent Oversight Entities" proposed by IOSCO in part two of its report on governance for collective investment schemes.

General remarks

We are highly pleased that IOSCO has upheld its position accepting the variety of CIS governance structures existing in different legal environments, confirming that "there is no unique structural or optimal solution to the implementation aspects of governance in the case of CIS".

[1] BVI Bundesverband Investment und Asset Management e.V. represents the interest of the German investment fund and asset management industry. Its 83 members currently manage nearly 7,500 investment funds with assets under management close to € 1,200 bn. The units of these funds are held by some 15 million unit holders. Mandates for portfolio management services provided by our members comprise assets in excess of € 150 bn. For more information, please visit www.bvi.de.

This finding unequivocally rules out the possibility to install universal rules of CIS governance applicable in all jurisdictions. Consequently, the harmonisation efforts of IOSCO focus on development of general standards which might be put into effect within different governance models.

However, it is also important to bear in mind that the existing governance schemes have developed on grounds of national regulatory frameworks as well as differences in fund structures and financial environments. Hence, no model shall be considered intrinsically superior to others as each independent entity has certain advantages and disadvantages in the accomplishment of specific functions: independent directors might be considered less susceptible to conflicts of interests, but they are also less involved in the day-to-day business of the controlled CIS than its depositary or auditors, meaning that they have less direct access to information and as a result, might be less effective in their supervisory activity.

Therefore, personal independence of the overseeing entity might not always be the best solution, as it inevitably implies a lower level of involvement in the activity of CIS and its operator, reducing the potential for pro-active supervision. In our view, the pivotal point of independence is the ability of the oversight entity to perform its duties in an autonomous and impartial manner, without being affected by conflicts of interests. This so-called functional independence can be ensured by appropriate organisational measures and a clear assignment of legal responsibilities.

As an example, the supervisory board of a CIS operator in Germany is often comprised of members linked to the CIS operator or its corporate group and thus, does not meet the criteria for personal independence. Nevertheless, the functional separation from the administrative board and a legal obligation to safeguard the interests of investors are sufficient guarantees for a proper performance of supervisory tasks. In addition, any conflicts of interests arising in the course of supervisory activities must be duly managed by the affected board members.

Furthermore, the principle of functional independence has been proven and tested with regard to the depositary function in Germany. Even though the depositary may belong to the same group of companies as the CIS operator, there are appropriate legal mechanisms in place which warrant the absence of any interference in terms of the conduct of oversight. Most importantly, the depositary is required to act independently from the CIS operator and in the sole interest of investors when performing its supervisory duties, and is subject to civil liability for improper fulfilment of these obligations. Also, no inter-appointment of managers, signatories and agents is allowed between depositary and operator of the supervised CIS.

On balance, we are of the opinion that the lack of legal and economic ties to the CIS operator cannot be generally considered as appropriate means for achieving the necessary level of independence. As the oversight of various processes and activities within CIS operation requires different levels of specialisation and insight in its day-to-day functioning, the supervisory functions should not concentrate on one specific entity, but rather be assigned to several bodies regarded as competent for the performance of

particular tasks. These entities may differ in terms of their composition as well as their relationship to the fund manager.

In this context, we are deeply concerned by the fact that IOSCO does not fully acknowledge the prominent role played in many jurisdictions by external auditors when it comes to the oversight of CIS and its operator. In fact, the Report assigns to them only inferior functions in relation to independent oversight. However, in Germany as well as in other European countries, external auditors are not only in charge of reviewing annual reports of the fund and its operator, but also responsible for general examination of the CIS operation in terms of its compliance with legal and contractual requirements. Over and above, many fund managers tend to maintain close links to their auditors on continuous basis, relying on their judgement in sensible regulatory matters. Hence, we request IOSCO to reconsider its position on role and responsibilities of external auditors in relation to independent oversight and to accept their indisputable capability to perform supervisory functions on equal terms with other entities.

Specific Comments

Being in agreement with the most principles for independent oversight suggested by IOSCO, we would like to remark on the following points:

Principle II.1.: The Independent Oversight Entities should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interests with the CIS Operator and its related parties.

We consent to the general consideration that the functioning, appointment or dismissal of supervisory entities should not be affected by conflicts of interests.

However, this does not necessarily imply a legal or economic dissociation of the oversight entity in question from CIS operator or its corporate group. Instead, appropriate organisational and procedural measures can be taken in order to prevent or manage conflicts of interests arising from the relationship with the fund manager.

This mechanism works particularly well with regard to depositary banks in the EU, where specific functional separation, organisational and control measures provided for by the UCITS Directive and national regulations have established a sound and effective system of CIS oversight working well since decades in many EU Member States. Similarly, members of supervisory boards at German CIS operators are required to dispense with potentially conflicting duties and to immediately disclose any conflicts of interests to the board.

Concerning the appointment or replacement of independent oversight entities, it is often not feasible for CIS unit holders to exercise direct control on these matters, especially in case of contractual-type funds. Hence, the respective control function should be conferrable to the CIS Regulator.

Principle III.3.: The Independent Oversight Entities should be given the right to review the legal and operational conditions of the CIS management in relation with the CIS in a reasonable way.

While generally supportive of this principle, we would like to point out that the implementation of proxy voting policies and procedures can also be adequately supervised by the CIS depositary. In fact, the depositary is ideally suited to perform this function as it is responsible for safekeeping of CIS assets and, therefore, deeply involved in the details of the voting process.

Principle IV.1.: The Independent Oversight Entities, collectively, should have the function of overseeing the CIS Operator and CIS Operator's activities.

We appreciate IOSCO's clear commitment to a system of CIS oversight comprising several entities with different supervisory tasks. The supervisory board of a CIS operator is duly considered capable of exercising some of these functions.

However, we miss the depositary in the list of suitable oversight entities. As some of the mentioned assignments (checking the compliance of the CIS portfolio with the applicable borrowing and investment limits, controlling the appropriateness of the valuation process of the CIS assets, the proper calculation and disclosure of the CIS NAV, and of the CIS unit price) are legally entrusted to the depositary in some jurisdictions, the depositary is undoubtedly best-placed to exercise these duties also in general terms. Moreover, the depositary has the necessary competence to oversee the application of principles and procedures for the exercise of shareholders' rights attached to the CIS securities portfolio.

Principle IV.3.: The Independent Oversight Entities should have a duty of reporting to the regulatory authorities or the CIS unit holders.

We do not share IOSCO's view that all types of independent oversight entities should be subject to reporting obligations either to regulatory authorities or CIS unit holders. Indeed, in some cases, the imposition of reporting duties might prove not feasible due to structural peculiarities of overseeing bodies and the tasks performed by them. For instance, when detecting any inefficiencies or failures in the functioning of CIS operator, the supervisory board in Germany is expected to make adequate arrangements in order to tackle the problem at an internal level. A duty to report the incident to an external authority might have a detrimental effect on the relationship with executive directors. On the other hand, members of the supervisory board are accountable to the management company's shareholders and under the obligation of reporting to them.

Therefore, it should be sufficient that at least one element of a collective Independent Oversight mechanism of a CIS, as acknowledged under Principle IV.1. above, has the duty of reporting to the regulator.

In the EU, the UCITS directive (Article 50a) stipulates that the auditor of a CIS has to report any facts or decisions which may constitute a material breach of relevant laws, regulations and administrative provisions to the competent authority. This mechanism, which is in place since 1995, has proved to be a very effective and reliable means to ensure

proper and timely information of the supervisor with respect to relevant irregularities and should be deemed to provide for sufficient reporting to external entities.

We hope that our remarks are helpful for IOSCO's work on finalizing the principles on independent oversight of CIS and remain at your disposal for further in-depth discussion.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

Signed:
Stefan Seip

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Investment Management Association
ima

Ms Pamela Vulpes

IOSCO General Secretariat
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Spain

12 October 2006

Dear Ms Vulpes,

Examination of Governance for Collective Investment Schemes. Part II

The Investment Management Association (IMA)[2] welcomes the opportunity to comment on the further work undertaken regarding your Consultation Report on Examination of Governance for Collective Investment Schemes Part II. We acknowledge and support the Committees objective to develop the primary general principle of independent review and oversight of CIS operators. In addition we support the desire to promote the establishment and the maintenance of consistently high regulatory standards. This objective is very much in line with IMA's own key objectives.

As indicated in our letter to Mr Philippe Richard in May 2005, the regulatory regime in the UK is super equivalent to the requirements of the European UCITS Directive in the area of independent oversight of CIS operators. The regulations in the UK prevent the depositary/trustee and the CIS operator from being members of the same economic group. This takes the UCITS requirement that no single company may act as both CIS operator and depositary a step further. We believe this is especially beneficial to CIS investors as it allows for clearer independence and separation of duties.

Having reviewed the detailed principles set out in the consultation document I can confirm we are in broad agreement with them. We also welcome your conclusion that each detailed example given may not be reflected in each and every jurisdiction and are dependent on the type of CIS used.

In our letter, mentioned above, we indicated that the IMA, in conjunction with the UK's Depositary and Trustee Association (DATA), had undertaken a review of CIS governance

[2] The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £3 trillion of funds based in the UK, Europe and elsewhere, including authorized investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorized collective investment schemes.

in the UK. Since the publication of the final report in February 2005 the UK Industry has continued to work towards implementing these recommendations.

The most recent example of this has seen the FSA set out an industry wide challenge to develop a standard of good practice to mitigate their concerns raised over the use of dealing commissions and bundled brokerage arrangements and the effect this has on UK retail CIS. This is testament to the governance framework that already exists in the UK and its ability to adapt to changes without recourse to additional regulation. The development of an industry standard of good practice in this area should satisfy the expectation expressed in section IV.2 of the report.

We would be more than willing to talk to you or any of your colleagues about any of the points we have made, or indeed regarding any of the ongoing work in the UK in relation to CIS governance.

Yours sincerely

David Grocott
Technical Adviser

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Re: Public Comment on Examination on Governance for Collective Investment Schemes, Part II

Dear Ms. Vulpes:

The Investment Company Institute[3] appreciates the opportunity to express its general support for the Technical Committee's recent consultation report on independent oversight for collective investment schemes (CIS).[4] The report clearly, and in our view correctly, recognizes both the importance of independent oversight and the need for significant flexibility to adapt regulatory requirements on independent oversight to different CIS models. We strongly support these objectives.

Despite our general support, we have three concerns with the report. First, we are concerned with the final recommendation in the report that independent oversight entities (IOEs)[5] should have a duty of reporting to the regulatory authorities or CIS shareholders. We believe that this recommendation should be revised in the final report to allow IOEs the flexibility to determine when and how to publicly disclose such breaches or irregularities. Second, we are concerned that the report in some respects may not fully recognize the important role played by internal CIS compliance mechanisms, such as the use of compliance officers and written compliance programs. Third, we are concerned that the report in certain respects sets forth unrealistic standards or is overly prescriptive. We suggest certain revisions that might better retain the flexibility expressed in the report's introduction. These comments are explained in greater detail below.

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[3] The Investment Company Institute is the national association of the US investment company industry. More information about the Institute is attached to this letter.

[4] Examination of Governance for Collective Investment Schemes, Part II, Consultation Report of the Technical Committee of IOSCO (June 2006). The report is available on the IOSCO web site at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD220.pdf.

[5] We note that the term "independent oversight entities" is not clearly defined in the report. IOSCO should consider inserting a concise definition of the term at the beginning of the report. IOSCO also should consider harmonizing the use of "independent oversight entities" and "independent entities," two terms that seem to be used interchangeably in the report.

Duty to Report

The report's final recommendation is that IOEs "should have a duty of reporting to the regulatory authorities or the CIS unit holders."[6] IOSCO explains that this principle means that all IOEs should report "any material breaches or irregularities in terms of applicable rules or contractual obligations, detected in the course of their controls" and "any material situation whereby the CIS operator has been considered as performing or operating in a way that would not meet the needs or the rights of the CIS unitholders."[7]

We are concerned that this principle and the accompanying explanation suggests that an IOE's duty to report material failures is mandatory, rather than discretionary. We strongly believe, for reasons explained below, that IOEs should have discretionary authority in this regard.

An IOE's decision whether to make a public statement to shareholders or a semi-public statement to regulators about a material failure is highly dependent on the many facts and circumstances involved. An IOE may decide to report a failure, for example, that it has been unable to completely address and resolve to its satisfaction. Even where a failure has been completely resolved to the IOE's satisfaction, the IOE may still choose to report it to the regulator to demonstrate the IOE's good faith in dealing with issues and the proper functioning of the CIS's compliance program. There are times, however, when an IOE would appropriately choose not to report a failure to the regulator or make a public statement to shareholders, such as when the issue has been fully resolved and the report would likely confuse or alarm investors.

Moreover, a mandatory reporting obligation on IOEs could lead to unintended consequences. For example, a mandatory reporting obligation could reduce the effectiveness of IOEs by creating a strong disincentive for CIS operators to alert the IOE to the existence of problems. As clearly recognized in IOSCO's report, IOEs need to be empowered to detect and deal with issues that arise. A mandatory reporting obligation runs the risk of having precisely the opposite effect – making it harder for the IOE to detect precisely the problems that it ought to be addressing.

For all of these reasons, we strongly believe that the IOE's duty to report should be discretionary, rather than mandatory. We recommend that principle IV.3 be revised accordingly.

[6] *See* Recommendation IV.3 of the report.
[7] *See* page 15 of the report.

The Use of Internal Compliance Mechanisms

We are concerned that in several places, the report places responsibility on IOEs for functions that are more appropriately handled by staff of the CIS operator. For example, the report suggests that IOEs should be monitoring expense ratio calculations (principle IV.1), ensuring that all fees, expenses, and other costs are being charged properly (principle IV.2), and verifying that income is timely and fairly reflected in the CIS's net asset value (principle IV.2). In the US, these tasks are principally handled by fund accounting personnel employed by the CIS operator or external service providers, with periodic control checks and verifications by independent auditors[8] and quarterly certifications by certain senior fund officers in accordance with requirements under the Sarbanes-Oxley Act.

The report also suggests IOEs should be responsible for monitoring portfolio activity for compliance with investment policies and checking proxy voting policies and procedures (principle IV.1). In the US, fund boards may approve certain oversight policies and procedures, but Chief Compliance Officers (CCOs) are primarily responsible for ensuring day-to-day compliance with those procedures. We recommend that the examples under principles VI.1 and IV.2 be revised to reflect the role played by staff of the CIS operator and other service providers, particularly fund accounting staff and CIS CCOs.

We also recommend that the part of the report that discusses the role of the IOE vis-à-vis the CCO be revised. In that part of the report, IOSCO states that IOEs should be informed of the hiring and firing of CCOs, in part to allow IOEs to "satisfy themselves of the independence of the compliance function and its effectiveness in meeting its obligations to investors."[9] In the US, CCOs for CIS typically are employed by the CIS operator, which may suggest that they are not technically "independent." Nevertheless, US rules contain a number of provisions that ensure the CCO will be able to act independently. These provisions require the fund's board to approve the designation and compensation of the CCO, provide the board sole power to authorize the CCO's removal from his or her position, require the CCO to provide a written report to the board and meet with the independent directors in executive session at least annually, and prohibit persons from coercing or fraudulently influencing the CCO in the course of his or her responsibilities.[10] Accordingly, we recommend that the reference to independence in the sentence quoted above be deleted. This change would reflect the fact that IOEs should remain focused on whether compliance professionals (such as CCOs) and other internal compliance mechanisms are effective in protecting CIS shareholders.

[8] While the report states that certain functions can be "managed" (principle IV.1) or "exercised" (principle IV.2) by the CIS auditor, fund auditors in the US do not assume a comprehensive oversight role that would alone appear to satisfy the concepts in principles IV.1 and IV.2.
[9] *See* page 11 of the report, in the second bullet point under recommendation III.1.
[10] *See* Rule 38a-1 under the Investment Company Act.

The Need for Regulatory Flexibility

We are pleased that the report clearly recognizes the fact that there is "no unique structural or optimal solution to the implementation aspects of governance in the case of CIS," and generally supports the need for regulatory flexibility with respect to fund governance.[11] Despite that general statement, however, a few of the report's recommendations appear overly rigid, suggesting that IOEs should act as guarantors of their functions and responsibilities. Instead of achieving IOSCO's goal of promoting the establishment and maintenance of high standards for governance, unreasonably strict standards instead may have a reverse effect, making it nearly impossible to comply with regulatory mandates and thus making it difficult to attract high quality candidates to serve in oversight positions.

To allow for the reasonable implementation of its principles, we suggest that IOSCO make clear reference in the report to the fiduciary duties applicable to many IOEs, including fund directors in the US, and the appropriate application of the business judgment rule.[12] We also suggest that IOSCO consider clarifications or less prescriptive language in the following sections of the report:

- **Principle II.1** states that IOEs "should be set up, composed, appointed or dismissed under conditions that prevent the decision making process *from being tainted by any type of conflicts of interest* with the CIS operator and its related parties." IOSCO's explanation of the principle states that this "*ensures*" that the IOE does not have "*any potential conflict of interests* with the CIS operator." This principle is overly broad and unrealistic, given that IOEs cannot *ensure* that they will not face *any* potential conflicts. Instead, the focus should be on the establishment of appropriate safeguards to deal with any conflicts of interest that arise and avoiding conflicts that regulators specifically prohibit.

- **Principle II.2** states that the "organization and the practical functioning" of IOEs "should allow them to be out of the control *or the influence* of the management of the CIS operator or its related parties." The complete absence of any influence is unrealistic, given that IOEs such as fund directors look to the CIS operator for, among other things, its views and recommendations on investment and operational matters.

- The explanation of **Principle III.3** states that the CIS operator's contract is subject to review by the IOEs, "with the aim of checking the fairness and the adequacy of its terms and subsequently *controlling* the correct implementation of the contract by the CIS operator." IOEs do not and

[11] *See* page 4 of the report.

[12] Part I of the report recognizes that under US law, CIS boards of directors are subject to fiduciary duties including the duties of loyalty and care. *See* Part I of the report at page 14. There is no indication in Part II of the report, however, of how these fiduciary duties or the application of the business judgment rule affect the principles and commentary in Part II.

cannot *control* the implementation of contracts, but rather can and should monitor the CIS operator's performance of its contractual obligations and take action as appropriate when such performance is substandard, as discussed above.

- Certain examples under **Principle IV.1** are too detailed for an oversight function of an IOE such as a fund board, but rather, as discussed above, are better handled by compliance professionals, such as CCOs, or staff of the CIS operator or other service provider.

- **Principle IV.2** states that IOEs "should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the *erosion* or expropriation of CIS investor's wealth and interests in the CIS." While we agree that the IOE should take steps to safeguard fund assets (*e.g.*, by ensuring the use of independent and financially sound custodians), we recommend that IOSCO clarify that "erosion" does not include losses due to the performance of a CIS's portfolio or the payment of fund expenses.

* * * *

The Institute appreciates the opportunity to support IOSCO's work on CIS governance and to share our concerns. If you have any questions concerning our views or would like additional information, please contact me at (202) 371-5430 or Glen Guymon at (202) 326-5837.

Sincerely,

Robert C. Grohowski
Senior Counsel – International Affairs

About the Investment Company Institute

The Investment Company Institute is the national association of the U.S. investment company industry. Its membership includes 8,821 open-end investment companies (mutual funds), 654 closed-end investment companies, 234 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.468 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households.

European Fund and Asset Management Association

Reply to IOSCO's Report

"Examination of Governance for Collective Investment Schemes"

EFAMA[13] congratulates IOSCO for its report "Examination of Governance for Collective Investment Schemes", providing a thorough overview of various models of fund governance in use in the jurisdictions of the members of IOSCO's SC5. We shall limit ourselves to commenting on the general parts of the report, leaving specific comments on the descriptions of national models to our members.

It is EFAMA's long-standing position that Independent Oversight is crucial for the good functioning of a robust CIS Governance framework, and we fully agree once again[14] with IOSCO's conclusion that "there is no unique structural or optimal solution to the implementation aspects of governance in the case of CIS".

As demonstrated by the successful development of Europe's CIS industry, no model is intrinsically superior to others, but all represent solutions to different regulatory environments, fund structures (corporate vs. contractual) and financial environments that have been proven to be effective in practice for many years.

As we stated in our reply to IOSCO's first report on CIS governance, each independent oversight entity has certain slight advantages and disadvantages in the accomplishment of specific functions: the Board of Directors might be considered by some as more independent (depending on its composition), but in EFAMA's view it is less involved in the day-to-day business vs. the Depositary and Auditors, therefore has less direct access to crucial information and as a result might be less effective in its supervisory activity.

Since conflicts of interest may arise within different processes and at different levels, in EFAMA's opinion a concentration of the oversight functions in one specific entity is not an effective and efficient way forward. Such concentration would require extensive staff support for the Independent Oversight Entity, creating unnecessary costs and functional

[13] EFAMA is the representative association for the European investment management industry. Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, as well as its 40 corporate members, EFAMA represents at mid-2006 about EUR 14 trillion in assets under management, of which EUR 7 trillion through about 43,000 investment funds. For more information, please visit www.efama.org.

[14] EFAMA's reply of 13 May 2005 to IOSCO's Report "Examination of Governance for Collective Investment Schemes"

duplications. On the other hand, the lack of such support would impair the effectiveness and reach of the Independent Oversight Entity to the detriment of CIS investors.

EFAMA strongly believes that a sound compliance mentality and effective control functions embedded in the CIS Operator's systems and processes are much more likely to guarantee that investors' best interests are upheld than any supervision from outside the CIS Operator (or by independent members of the Board of Directors).

The internal compliance function must ensure that internal policies, structures and procedures are properly designed to deal with them, that they are well documented, that positions are adequately staffed and the staff is well informed of its duties. An Independent Oversight Entity would in this case exercise an indirect oversight, reviewing such organizational structures and processes and approving their soundness in principle, carrying out spot checks on a regular and/or on an ad hoc basis to verify their correct implementation in practice, but leaving the daily supervision to the compliance department. The Board of Directors, external Auditors, the Trustee and the CIS Regulator can all fulfil this function, and the Depositary could carry it out as well with regard to a number of CIS activities (e.g. related to the processing of fund transactions).

As an equally – or more – effective alternative to the Board of Directors model, comprehensive oversight can be achieved through:

1) the direct supervision of specific CIS Operator activities by the Depositary and/or the Auditors, and
2) an effective internal compliance structure, in turn subject to controls by an Independent Oversight Entity (external Auditors, CIS Regulator).

Finally, we regret the fact that the Report is ambiguous regarding the role played by Auditors: it mostly assigns to them only a secondary role among the entities that can ensure independent oversight[15], although certain statements point out (correctly) that Auditors may have a major role[16]. EFAMA wants to underline once more the critical function Auditors fulfil in several countries (Austria, Germany, Luxemburg and Switzerland among others) and wishes to see them clearly included by IOSCO among the independent oversight entities.

IOSCO has also entirely forgotten the role that the Supervisory Board of the CIS Operator can play (where it exists, for example in Germany), in view of its legal obligation to protect the investors' best interests.

EFAMA also believes that the report should have given more prominence to the role of self-regulation, which is also a very effective way of dealing with CIS Governance.

[15] For example on page 6, 7, 9, 11 and 14 of Part I, page 5 of Part II of the Report
[16] Page 5 (Footnote 11) of Part I and page 15 of Part II.

Specific Comments regarding the specific Principles in Part II of the Report

Principle II.1

The Independent Oversight Entities should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interests with the CIS Operator and its related parties.

EFAMA fully agrees with the Principle, and shares the opinion that dismissal and replacement of Independent Oversight Entities should be subject to certain safeguards and disclosed to the CIS Regulator. In the interest of investor protection, Art. 11 of the UCITS Directive stipulate that "The law or the fund rules shall lay down the conditions for the replacement of the management company and the depositary and rules to ensure the protection of unit-holders in the event of such replacement." (Art. 18 stipulates the equivalent in reference to investment companies). Furthermore, in a number of countries (e.g. France, Luxemburg and Ireland) the appointment of the Depositary and of the Auditor is subject to approval by the CIS Regulator.

Regarding the independence of the Depositary and Trustee, EFAMA believes that the fact that they belong to the same economic group as the CIS Operator (and the Depositary is in many cases is an integral part of the mother company) is not by itself detrimental to an effective oversight, but special attention is required. Specific functional separation, organizational and control measures have been built into the EU regulatory framework by the UCITS Directive and by national regulators, taking into account the prevalence in Continental Europe of "universal banking" structures. [17] For example, Article 10 (2) of the UCITS Directive requires that "in the context of their respective roles the management company and the depositary must act independently and solely in the interest of the unit-holders", whereas Art. 17 sets similar independence requirements for the investment company and the Depositary.

Decade-long experience in many EU Member States confirms that such measures are effective, and no problem was reported by the European Commission in its Communication on the Regulation of UCITS Depositaries[18]. Depositaries carry out their oversight function without conflicts of interest or interference from the CIS Operator, and the independence of the CIS Operator – a fundamental investor protection principle in the EU – is thus ensured.

[17] See FEFSI's Position Paper "The Regulation of UCITS Depositaries" (6 November 2002) at http://www.efama.org/55PositionPapers/2002/Regultion_of_UCITS_depositaries/documentfile

[18] COM(2004) 207 final of 30/3/2004

The joint liability mechanism mentioned on page 9 of Part II of the Report is unnecessary in our opinion, but the respective liability of CIS Operator and Depositary must be clearly defined in national legislation in any case (whether they belong to the same group or not).

Principle II.2

The organization and the practical functioning of the Independent Oversight Entities should allow them to be out of the control or the influence of the management of the CIS Operator or its related parties.

EFAMA fully agrees with this principle, but wishes to point out that contractual commitments are clearly unavoidable between the CIS Operator and the Depositary or the CIS Auditors. They are not, however, sufficient to threaten their independence from the CIS Operator in view of their fiduciary duties and legal liability. Chinese Walls and safeguards mechanisms (as discussed above) further guarantee their independence.

Principle II.3

There should not be any confusion between responsibilities of the Independent Oversight Entities when exercising their oversight function on the one side and the CIS Operator in its asset management role over the CIS on the other side.

EFAMA is in full agreement with the principle of separation of responsibilities between the Independent Oversight Entity and the CIS Operator.

However, the Report states that "…Independent Oversight Entities could not receive any remuneration or incentives from the CIS Operator which may bias the independence of its assessment in such a way that it could be detrimental to the interests of CIS Investors". We welcome the fact that IOSCO recognizes (albeit only in footnote 10) that "…compensation from the CIS Operator to the members of the Independent Oversight Entity generally would not bias the independence function when the terms of the compensation are determined by the Independent Oversight Entity and are disclosed to unitholders (e.g custodians or Depositary fees)." The amount of the Depositary fees is already disclosed to investors in the annual reports, as it represents a cost to the fund. Due to the commercial sensitivity of the terms of the compensation, we do not believe that they can be subject to further disclosure without causing harm to CIS Operator and investors.

Furthermore, compensation paid to some Independent Oversight Entities (Depositary, Auditors) cannot be entirely determined by the Entity itself, but should be left to commercial negotiation, in order to protect investors from excessive compensation requests and as it also represents compensation for commercial services.

Principle III.1

The Independent Oversight Entities should be entitled to receive all relevant information enabling them to perform their oversight function in a proper manner.

EFAMA agrees that Independent Oversight Entities should be entitled to receive the information necessary to exercise their functions. As described above, when their function requires indirect oversight they should be entitled to receive information from the internal compliance function to check on the correct functioning of compliance mechanisms.

Principle III.2

The Independent Oversight Entities should be given the necessary means to carry out their duties without relying exclusively on the CIS Operator's assistance.

EFAMA agrees with this principle.

Principle III.3

The Independent Oversight Entities should be given the right to review the legal and operational conditions of the CIS management in relation with the CIS in a reasonable way.

EFAMA agrees with the principle, and supports IOSCO's statement that the CIS Operator's contract and its subsequent amendments are subject to review by the Independent Oversight Entity only when relevant.

However, we would like to underline that the Depositary can oversee the implementation of proxy voting policies and procedures just as adequately as other Independent Oversight Entities. As a matter of fact, the Depositary is best placed to oversee such function, as it is charged with the safekeeping of the CIS assets and is therefore deeply involved in the voting process.

Principle IV.1

The Independent Oversight Entities, collectively, should have the function of overseeing the CIS Operator and CIS Operator's activities.

EFAMA agrees with this principle, and welcomes the specific recognition by IOSCO of a collective supervision responsibility by different Independent Oversight Entities**.**

However, we disagree with IOSCO's assessment that "…these functions would be best fulfilled by the board of the CIS in the case of the corporate model, or by the Independent Directors sitting at the board of the CIS Operator, or by a Supervisory Board or an Independent Review or Compliance Committee in the case of the hybrid corporate and contractual model." We welcome the fact that CIS Auditors are specifically mentioned here as capable of exercising some of the functions mentioned, although we disagree on which ones they are best suited to manage.

There is no explanation of why specifically these functions should best be fulfilled only by the CIS Board or the Independent Directors on the Board of the CIS Operator, when the Depositary is ideally suited to oversee at many of them (e.g. checking the compliance of the CIS portfolio with the applicable borrowing and investment limits and restrictions; controlling the appropriateness of the valuation process of the CIS assets and the proper calculation and disclosure of the CIS NAV and of the CIS unit price; and checking the correct application of the principles and procedures for the exercise of shareholder's rights attached to the securities portfolio) and the CIS Auditors could effectively oversee the other functions, as well as some of those above.

Principle IV.2

The Independent Oversight Entities, collectively, should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investor's wealth and interests in the CIS

EFAMA agrees with this principle, and welcomes the specific mention of the CIS Auditor and Self-Regulatory Organizations among the entities that can exercise some of the Independent Oversight functions. The role of Self-Regulatory Organizations should indeed be given more prominence overall. We wish to underline, however, that some of the functions mentioned under this Principle are already performed very effectively by the Depositary.

Principle IV.3

The Independent Oversight Entities should have a duty of reporting to the regulatory authorities or the CIS unit holders.

EFAMA agrees, although the definition of materiality should be chosen carefully.

It should be sufficient for one of the Independent Oversight Entities to report material breaches. In any case, the Auditors'duty to report to competent authorities any material breach of law is already extensively regulated in the EU both at national level and by the UCITS Directive (Art. 50a, introduced through the post-BCCI Directive 95/26/EC).

SJ - n° 2167/Div.

Mr Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Espagne

Paris, 15 October 2006

AFG RESPONSE TO IOSCO CONSULTATION ON EXAMINATION OF GOVERNANCE FOR COLLECTIVE INVESTMENT SCHEMES (PART II)

Dear Mr Richard,

The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 365 management companies. Some are entrepreneurial ones; others belong to French or foreign banking, insurance or asset management groups. AFG members are responsible for the management of over 2200 billion euros in the field of investment management. In terms of financial management of collective investment schemes domiciled wherever in Europe (i.e. in France, Luxemburg or elsewhere), the French industry is the leader in the EU (with more than 20% of EU investment funds assets under management) and the second one at global level. Our collective investment industry includes – beside UCITS – a significant part of products such as hedge funds, real estate funds and private equity funds. Globally, the French asset management industry manages more than 800 investment companies and 6000 mutual funds. We are a member of European Fund and Asset Management Association

(FEFSI/EFAMA) and of the International Investment Fund Association (IIFA) and contribute actively to the work carried out by these two trade associations.

Therefore, we hope that AFG (through the size and diversity of its membership) can provide with a helpful contribution to IOSCO, based on our members' experience.

We appreciate the opportunity to comment on IOSCO's consultation report on "*Examination of Governance for Collective Investment Schemes – Part II*".

In addition to supporting the remarks expressed by EFAMA, to which we contributed actively, we would like to express some general comments complemented by some more specific ones.

I. General comments

The work carried out by IOSCO SC5 and its members can be lauded as delivering a global mapping of the way the governance of funds is currently carried out among various jurisdictions. Such a general overview of the topic had never been done before and is very useful for getting a wider view of the CIS industry and its organisation depending of the countries concerned.

a) How to tackle the concept of governance when applied to CIS?

As already expressed in answering your previous consultation document last year, *we agree with IOSCO that, although the definition of CIS" governance" can make some use of the concept of corporate governance, a definition of CIS governance must recognize the differences between the nature and purposes of CIS and the operating companies in which they invest.* Following the first consultation paper issued by IOSCO last year, some public events like the "*Entretiens de l'AMF*" on 29 November 2005 made clear that such a difference had to be kept, in particular because the collective management industry has already to comply with a very comprehensive set of rules as compared to those applied by competitor products. At the end of the day, CIS are efficient saving vehicles, not corporations; therefore, the notion of "oversight" seems more appropriate than the one of "governance".

We agree that CIS must be organized and operated efficiently and exclusively in the interests of CIS investors, and not in the interest of CIS insiders. We consider that in the EU, thanks to the UCITS Directive and the MiFID, such a condition is already met. For UCITS, the two decades following the adoption of the 1985 Directive did not bring any significant market failure. The French regulator is even stricter. For instance, the role and responsibilities of depositaries is wider and much more detailed than they are in the directives.

Thus, we fully share IOSCO's approach which makes clear that CIS are structured and regulated differently among the jurisdictions of SC5 members. For instance, the way in which potential conflicts of interest in the operation of funds are addressed reflects differences in law, policy, and business structures.

Therefore, we are ready to help regulators to find improvements in the way the CIS are managed in the best interest of the investors – as it is already a requirement for the whole EU thanks to both the UCITS and MiFID Directives. Considering that regulation has already reached a very deep level of requirements, we consider that the remaining space for taking action, if any, must be left to industry or cross-industry *self-regulation*.

Between the different types of IOEs identified in the Report, we know that some outsiders would like to favour the approach of independent Boards of Directors. However, it appears that Boards of Directors, in practice, are too far from the day-to-day activities of CIS and CIS Operators. Our members consider that in addition to the proper organisation of the CIS management company, depositaries, auditors and an effective supervision by the CIS Regulator are more able to fulfil the functions dedicated to IOEs.

b) The work already carried out by EFAMA and AFG

EFAMA already made public a comprehensive set of conduct of business rules last year (with the contribution of AFG in particular), to be applied by the European industry.

On its own, *AFG* itself released (and updated) codes of ethics to be complied with by the French management companies. Those AFG codes were approved by the French regulator and are used by AMF staff when investigating French management companies:

- AFG professional code of conduct for managers of UCITS (1st one issued in 1990);
- AFG professional code of conduct for specially-tailored, individual management mandates (1997);
- AFG specific provisions for the manager of employee saving funds (in addition to the code of conduct for UCITS managers) (1999);
- AFG specific code of conduct for venture capital management companies (2001).

For your convenience, *you will find attached an English version of the compendium of codes of ethics which were issued by AFG* during the last decade. Some parts have been updated and the English version will be available soon.

c) What should be tackled beyond the topics already dealt by regulation and self-regulation today?

AFG has not concluded yet what should be deepened in the field of oversight of funds. The extreme variety of situations (remarkably reflected through IOSCO's work) prevents from following very detailed and cumbersome routes.

We suggest regulators, in the context of IOSCO or in other contexts, to apply therefore cost-benefit analysis in order to identify the areas in which fund oversight improvements should be brought.

In the meantime, the main improvement could be, based on existing legislations, to reinforce in practice the disclosure of the rules to be applied by CIS and CIS operators: already today, management companies have to comply with the rules of funds and must act in the best interests of their clients. For instance, management companies have to tackle any conflict of interest which might harm investors' interests: the policy and procedures

related to conflicts of interest should be identified, disclosed and enforced/controlled afterwards.

Regarding the existing French system, in addition to the codes of conduct to be applied by them, our members consider that this system has worked well until now thanks to the crucial roles of depositaries and auditors as external Independent Oversight entities. However, the responsibilities of those two external entities could be clarified (as well as their respective roles). In any case, the fact for a depositary to be a 'related party' to the CIS or to the CIS Operator should not be considered as harming investors' protection, as what is crucial are the duties to be fulfilled by the depositary (which are defined for UCITS through the UCITS Directive).

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II. Specific comments

a)The concept of independence: definition and key features

We agree with the various forms presented in page 6. We also agree with the definition of the concept of independence – as it is in any case required both by the French law and by the UCITS Directive - though we have some doubts around the specific notion of 'related parties' which might be clarified.

We agree with Principle II.1 and the fact that this Principle can be reached by various means, in particular the fact that Independent Oversight Entities (IOEs) could be designated in such a *transparent* way as to help ensure that the IOEs or their members do not face any conflicts of interests with the CIS Operator.

We do share IOSCO's view that entities such as trustees or depositaries can be considered, among others, as *Independent Entities* for the purpose of independent review – as long as (as stated by IOSCO) these entities are "*legally and economically independent from the CIS operator*". Instead of adopting a 'one size fits all' approach which might harm many regional industries, IOSCO is right when accepting that such various independent entities can ensure CIS are operated exclusively in the interest of CIS investors.

We agree that in the case of depositaries or trustees, the organization and the functioning of the Oversight Entities should be clearly segregated from any CIS Operator activity through contractual arrangements. However, *we think that prohibiting direct or cross shareholdings would be very costly to be set up in the jurisdictions which do not have such a requirement today - without harm for investors - and should therefore be strictly limited to the jurisdictions which have it in place already*.

In addition, we agree that the prohibition for IOEs to be entities (or to be composed of a majority of individuals) that have direct or indirect relationships with the CIS

Operator or an entity related to the CIS Operator is *limited to the cases* where it creates conflicts of interest or situations impeding the independence of their assessment. *However, we strongly disagree on the fact that having directors shared with or affiliated to the CIS Operator automatically implies a conflict of interest.*

Regarding Principle II. 2, we agree that if independence is likely to be endangered, the IOEs can be controlled by the management of the CIS Operator. Until now in France, the CIS Operator has to put in place the means and procedures in order to monitor not only its own activities but also those of its depositaries and intermediaries. *However, as mentioned above, we disagree on the two stances given for endangering the independence, i.e. common directors and cross shareholdings.*

Regarding Principle II. 3, we support in particular the prohibition for the IOEs to receive any remuneration or incentives from the CIS Operator which may bias the independence of its assessment in such a way that it could be detrimental to the interests of CIS investors, and that this prohibition is compatible with the exception where compensation from the CIS Operator to the members of the IOE is done in terms determined by the IOE and disclosed to unitholders.

b) The powers of the IOEs

We support Principles III. 1, III.2 and III.3. However, we consider that the examples of rules which are given can also be provided through industry or cross-industry self-regulation.

In addition, we have some doubt on the need to debate about proxy voting in the context of this paper strictly dedicated to the oversight of funds.

c) Functions to be performed by the IOEs

We agree with Principle IV.1. Depending on the functions quoted, the most appropriate IOEs might be either the CIS auditor (functions 2 to 5) and/or the CIS depositary (functions 3 to 6).

On Principle IV.2, we support as well as it is required for depositaries through the EU UCITS Directive. Regarding the list of functions, the first one should probably be introduced in the national law; the 2nd, 3rd, 4th and 5th would be best fulfilled by auditors and depositaries. The last one is already done today by the depositary regarding subscriptions and redemptions.

Regarding Principle IV.3, we agree on it.

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We are now looking forward to reading your next paper on the subject and ready to share our experience with IOSCO if you find it helpful.

If you would like to discuss the contents of this letter with us, please contact myself on 00 33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), our Head of International Affairs Division Stéphane Janin on 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or his deputy Catherine Jasserand on 00 33 1 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Stéphane Janin Pierre Bollon

Depositary And Trustee Association

Ms Pamela Vulpes
IOSCO General Secretariat
Oquendo 12
28006 Madrid
Spain

12th October 2006

Dear Ms Vulpes,

Examination of Governance for Collective Investment Schemes. Part II

The Depositary and Trustee Association (DATA) represents all depositaries and trustees of UK-based authorised unit trusts and open-ended investment companies (OEICs). At the end of August 2006, the members of DATA were responsible for safeguarding £378.3 billion of funds under management.

We welcome the opportunity to comment on the further work undertaken regarding your Consultation Report on Examination of Governance for Collective Investment Schemes Part II. We acknowledge and support the Committees objective to develop the primary general principle of independent review and oversight of CIS operators. In addition we support the desire to promote the establishment and the maintenance of consistently high regulatory standards. This objective is very much in line with DATA's own key objectives.

As indicated in the Investment Management Association's (IMA) response to the initial IOSCO paper on CIS Governance, submitted to Mr Philippe Richard in May 2005, the regulatory regime in the UK is super equivalent to the requirements of the European UCITS Directive in the area of independent oversight of CIS operators. The regulations in the UK prevent the depositary/trustee and the CIS operator from being members of the same economic group. This takes the UCITS requirement that no single company may act as both CIS operator and depositary a step further. We believe this is especially beneficial to CIS investors as it allows for clearer independence and separation of duties.

Having reviewed the detailed principles set out in the consultation document I can confirm we are in broad agreement with them. We also welcome your conclusion that each detailed example given may not be reflected in each and every jurisdiction and are dependent on the type of CIS used.

The IMA's letter also refers to the joint review of the CIS governance arrangements in place in the UK, conducted by IMA and DATA. Since the publication of the final report in February 2005 the UK Industry has continued to work towards implementing these recommendations.

The most recent example of this has seen the FSA set out an industry wide challenge to develop a standard of good practice to mitigate their concerns raised over the use of dealing commissions and bundled brokerage arrangements and the effect this has on UK retail CIS. This is testament to the governance framework that already exists in the UK and its ability to adapt to changes without recourse to additional regulation. The development of an industry standard of good practice in this area should satisfy the expectation expressed in section IV.2 of the report.

We would be more than willing to talk to you or any of your colleagues about any of the points we have made, or indeed regarding any of the ongoing work in the UK in relation to CIS governance.

Yours sincerely,

David England
Chairman of DATA

APFIPP
Portuguese Association of Investment Funds, Pension Funds and Asset Management

From: Joana Silva [joanasilva@apfipp.pt]
Sent: Friday, November 24, 2006 4:51 PM
To: Pamela Vulpes
Subject: Public Comment on Examination on Governance for Collective Investment Schemes. Part II

Importance: High

Dear Ms. Pamela Vulpes,

Following the same procedure taken in the consultation of Part I of the Report "Examination of Governance for Collective Investment Schemes", which resulted in our letter of 10th May 2005, APFIPP disclosed Part II of the Report to its Members and it was also analysed by its Technical Committee on Mutual Funds.

APFIPP considers the Governance for CIS a very important topic since it is on the interest of the Industry to stress the transparency of this activity and its commitment of acting in the interest of the investors. In relation to part II of the Report, we did not receive any specific comment from our Members and do not have any more suggestions to add to the Report.

We thank you for your attention to this issue and we apologize for the delay of our response.

Yours Sincerely

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IFSA

Investment & Financial Services Association Ltd
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VIA E-MAIL

13 October 2006

Ms. Pamela Vulpes
IOSCO General Secretariat
Oquendo 12
28006 Madrid
Spain

Dear Ms. Vulpes

Re: Public Comment on Examination on Governance for Collective Investment Schemes, Part II

We refer to the request for comment on the Technical Committee's recent consultation report on independent oversight for collective investment schemes (**CIS**). We have read the submission of the Investment Company Institute to the Committee and endorse its comments.

IFSA represents the retail and wholesale superannuation, funds management and life insurance industries. IFSA has over 135 members who are responsible for investing over $950 billion on behalf of more than 10 million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

The Australian statutory regime under the *Corporations Act 2001*, for the operation of collective investment vehicles, has a multi-faceted approach to compliance and investor protection.

Our law places responsibility for the operation of a CIS on a single responsible entity which must be licensed; must satisfy certain capital, operational, disclosure, reporting and integrity requirements; must have a majority of independent directors or a compliance committee with a majority of independent members; and which requires an independent annual compliance audit. Our industry is compliance oriented and the operators of schemes are very aware of their fiduciary and statutory responsibilities to scheme members.

While the legislative requirements for the operation of Australian CISs have been very effective, the Australian Government has been in recent times particularly concerned with regulatory measures that significantly increase operational cost with little, if any, additional benefit to scheme members.

We, therefore, strongly recommend that the Committee guard against recommendations that promote over-regulation and consequently damage both economic efficiency and the financial interests of scheme members.

Yours sincerely

David O'Reilly
Policy Director

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