Development and Regulation of Institutional Investors in Emerging Markets

EMERGING MARKETS COMMITTEE
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Contents

Executive Summary

The IOSCO Emerging Markets Committee (EMC) established a Project Team to review the development and regulation of institutional investors in Emerging Markets (EMs), to identify and analyze the issues and challenges for the development and regulation of institutional investors, and to make recommendations that EM regulators may consider as they supervise their respective markets. The Project Team[1] is chaired by China Securities Regulatory Commission (CSRC), its core members include the Securities Commission of Malaysia, the Conseil Déontologique des Valeurs Mobilières Morocco (CDVM), the Pakistan Securities and Exchange Commission, the South Africa Financial Services Board, the Financial Supervisory Commission of Chinese Taipei and the IOSCO EMC Team.

Institutional investors are playing an increasingly important role in the development of EMs. Markets with large numbers of institutional investors tend to be less volatile and allocate resources and capital more efficiently to companies requiring funding. Highly specialized and managing substantial capital, institutional investors are better positioned to put pressure on corporations and their management to improve corporate governance and transparency. By pooling assets, institutional investors can achieve economies of scale, employ high quality investment professionals, develop better investment strategies and build solid risk management systems, all of which result in higher and more stable returns for investors.

EM jurisdictions are at different levels of development when it comes to institutional investors. Some jurisdictions have all types of institutional investors present, while others are still dominated by retail investors. This calls for a better understanding of what underlying factors may have an impact on the development of institutional investors. To this end, an important objective of this study was to gather relevant data from EMs.

The Project Team has gathered data and information from EMs on their experiences regarding institutional investors. This report aims to present the data and information in a meaningful and concise manner, focusing on the wide range of developmental issues and challenges faced by the EMs. Some of these challenges include limited capital market size and liquidity, competition from substitute services, regulatory restrictions, overly powerful distribution channels and constraints on cross-border activities.

In light of the challenges ahead, the development of institutional investors in the EMs calls for concerted efforts by both regulators and the market. It requires a pragmatic and sequenced approach by regulators to ensure that such efforts do not destabilize the financial system, and that adequate safeguards are established at both market and regulatory levels.

This report makes recommendations to help EM regulators and policy makers develop and regulate institutional investors. The key recommendations are summarized below:

- **Capital Market Environment.** The foundation of a well-functioning capital market is the protection of property and ownership rights. In addition to a sound legal system, regulators need to promote proper corporate governance standards and other investor protection measures. A capital market that is favorable to institutional investors should have reasonable transaction costs (both explicit and implicit), a broad range of

[1] See Appendix A for list of Project Team members.

potentially high-quality investment products and flexible trading and hedging mechanisms.

- **Product Offering and Innovation.** The authorization process for new product issuance should be simple, fast and free of administrative obstacles. It should also be accompanied by strict post-issuance supervision and prompt regulatory actions when risks and violations occur. A multi-tier issuance regime could be used to lower issuance costs and broaden the product offering. Insofar as risks are manageable, regulators should support innovations that improve market efficiency or broaden investor-friendly product offerings.

- **Multi-pillar Pension System.** The aging population is a major concern in many jurisdictions because it burdens the national pension and social security system. This burden could be shared by private pensions and personal savings plans. The development of a multi-pillar pension system, however, requires an appropriate set of tax incentives. Given that the financial performance of pension plans affects future pensioners' standards of living, institutional investors in this market should be subject to higher prudential and professional standards.

- **Distribution Channels and Practices.** Regulators should broaden the product distribution channels by increasing the type and number of distributors institutional investors can use. Regulators should introduce detailed rules for distribution practices and encourage Self Regulatory Organizations (SROs) to establish best practice standards on suitability, disclosure, marketing and fees.

- **Market Openness.** Regulators should ensure a level playing field for foreign and domestic investors. Policy makers should gradually loosen or remove restrictions on fund repatriation and capital controls. Regulators should also break down barriers that prevent domestic investors from investing abroad.

- **Human Capital and Professional Integrity.** Regulators and SROs should seek to improve the quality and availability of human capital by training and developing local talent and attracting professionals from other industries or overseas. The incentive structure should align the interests of the professionals with those of the investors. Sound licensing, record keeping and supervision systems should be established for industry professionals.

- **Regulatory Framework and Financial Stability.** In accordance with the IOSCO Principles, regulators should prevent market abuse by building sound surveillance capacity and periodically reviewing their regulatory framework and coverage. Regulators should work together domestically and across jurisdictions, to monitor, mitigate and manage systemic risk.

Chapter 1 Introduction

There is no universally accepted definition among academics, government bodies and international organizations of what constitutes an "institutional investor". Given differences in market sophistication and regulatory systems, the active types of institutional investors in each market vary considerably. For the purpose of this study, institutional investors are professional investment institutions, including mutual funds, securities companies, insurance companies, commercial banks, pension funds, hedge funds, private equity funds, endowment funds and sovereign wealth funds.

1.1 Importance of Developing Institutional Investors

Institutional investors are playing an increasingly important role in the world's financial markets. Highly specialized and managing substantial capital, institutional investors can enhance market features in many ways, including increasing liquidity, influencing market psychology, improving disclosures and corporate governance. Institutional investors can also leverage their size to negotiate better services at lower cost. The importance of institutional investors can be seen from some of the benefits they provide:

- **Long-term investment philosophy.** Institutional investors provide the market with a professional investor base focused on the long term. Markets with numerous institutional investors tend to be less volatile and can allocate resources and capital to companies more effectively.

- **Enhanced corporate governance.** Compared to other investor types, institutional investors manage larger pools of assets, giving them more influence and control over their investment targets. They are better positioned to put pressure on corporations and management to improve corporate governance and transparency.

- **Professional service.** Institutional investors can exploit economies of scale to negotiate lower commissions, broaden research and employ high quality investment professionals. Furthermore, with comprehensive investment policies and procedures in place, institutional investors are likely to provide better risk management and achieve higher and more stable returns for their investors.

1.2 Purpose of this Study

In recent years, while the institutional investor base in some EMs has enjoyed healthy growth, other EM institutional investors still lack scale and influence. The IOSCO EMC Working Group 5 (WG5) believes that a study of the key issues and challenges for the development and regulation of EM institutional investors would benefit EMC members. To this end, during the EMC April 2011 plenary meeting, the EMC mandated the study of "Development and Regulation of Institutional Investors in Emerging Markets".

The purpose of this study is to provide EM regulators and policy makers with the following information:

- Overview of the underlying macro environments
- Current status of development and overview of regulations
- Cross border activities and regulatory restrictions
- Issues and challenges for development and regulation
- Key recommendations

1.3 Research Process

To gather the information needed, a survey questionnaire was drafted and circulated to EMC members in June 2011. The survey contains 5 sections:

1. General market data about institutional investors
2. Macroeconomic and stock market environment
3. Development status, regulation and policy incentives for each institutional investor type
4. Cross border activities and barriers impeding such activities
5. Outstanding issues about lessons and experiences from EMC members

By September 2011, 25 EMC members[2] (hereafter jointly referred to as the "Group", separately as "respondent(s)" or "jurisdiction(s)") responded to the survey. The Project Team analyzed these responses and sent several sets of follow-up questions based on the initial responses[3]. The Project Team also extensively reviewed previous IOSCO surveys and external research data to complement the survey and present a holistic and comprehensive perspective.

1.4 Scope and Structure of the Report

This report covers the following seven types of institutional investors: mutual funds, securities companies, insurance companies, commercial banks, pension funds, hedge funds and private equity funds.

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2 The 25 survey respondents were: Argentina, Bangladesh, Brazil, Chile, China, Colombia, Croatia, Czech Republic, Ecuador, Hungary, Korea, Macedonia, Malaysia, Morocco, Nigeria, Pakistan, Panama, Poland, Romania, Serbia, Slovenia, South Africa, Chinese Taipei, Turkey and The UAE.

3 Over 200 follow-up questions were sent to the Group, the majority of which concerned the accuracy of survey data. While a serious effort was made to tidy up the survey data used in this report, its integrity still depends very much on the respondent's interpretation of the questions and the quality of the data provided. Among other factors, differences in classification, accounting and currency conversion may also undermine the analysis made in this report.

The report is divided into four chapters: Chapter 2 provides a data summary and analysis of the current state of development and regulation of EM institutional investors; Chapter 3 discusses issues and challenges; Chapter 4 offers recommendations for policy makers and regulators looking to grow and better regulate institutional investors in their jurisdictions.

Additional discussions on relevant macro-economic and capital market conditions in EMs can be found in Appendix C, while analysis of cross border activities of institutional investors is in Appendix D.

Chapter 2 State of Play of Institutional Investors in the Emerging Markets

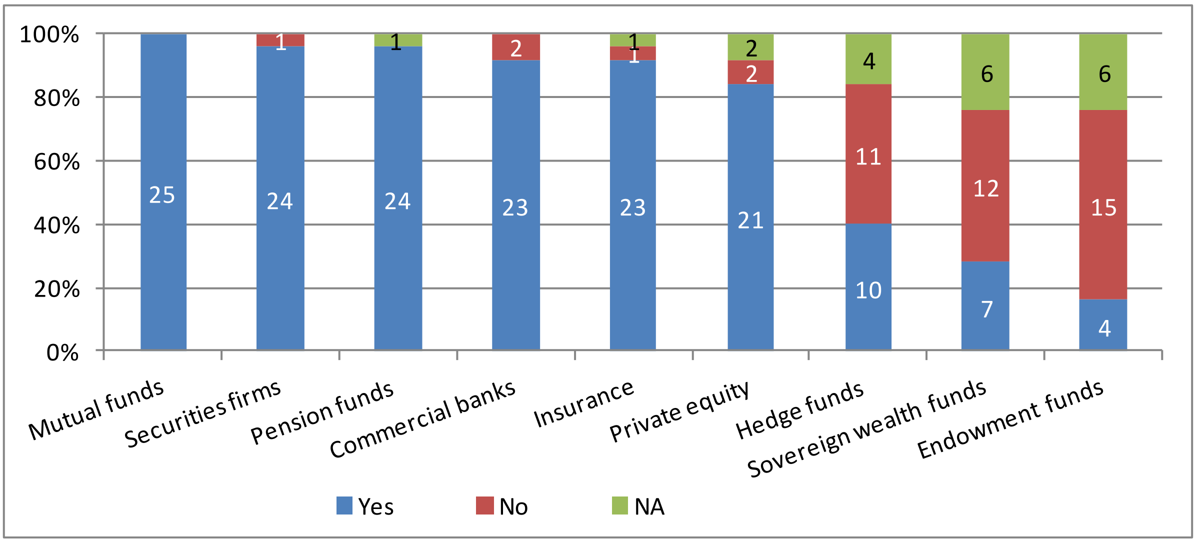
This chapter will provide an overview of the development status and regulatory environment for the seven types of institutional investors: mutual funds, securities companies, commercial banks, insurance companies, pension funds, hedge funds and private equity funds.

2.1 Landscape of Institutional Investors

2.1.1 Institutional Investors have Different Degrees of Presence

Survey results show that not all investor types are present to the same degree in the different jurisdictions. Chart 2.1 shows that among the institutional investors, mutual funds are ubiquitous in the Group. Securities companies, pension funds, commercial banks, insurance companies and private equity funds are also fairly common, while hedge funds, sovereign wealth funds and endowment funds have a smaller presence.

Chart 2.1: Presence of Institutional Investors in 25 Jurisdictions



Source: IOSCO survey data.

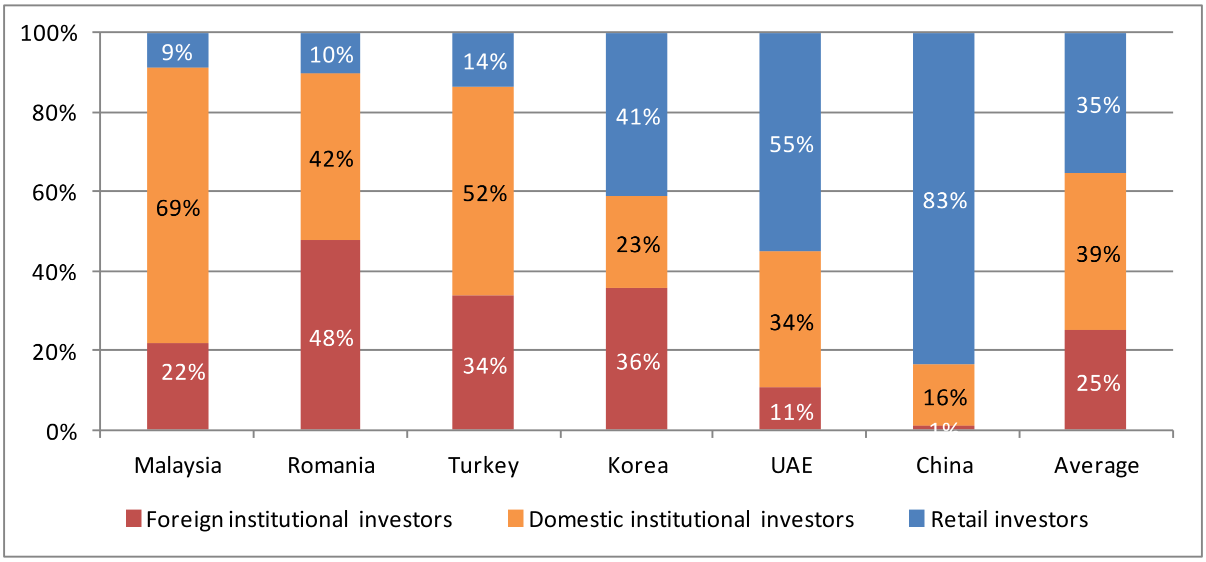
This report will not provide further information on sovereign wealth funds and endowment funds since they are less commercial in nature and fairly rare[4].

Institutional Investors are Already Influential in Some Jurisdictions

The survey also showed that in some jurisdictions institutional investors already hold a larger share of market capitalization compared to retail investors. As displayed in Chart 2.2, domestic institutional investors also tend to hold a larger proportion of market capitalization than foreign institutional investors. However, the latter are gradually gaining ground. In fact, foreign institutional investors already account for a larger share of market capitalization than domestic competitors in some of the jurisdictions.

[4] There is scarce data on sovereign wealth funds and endowment funds, or there is data gathering issues in relation to such types of funds.

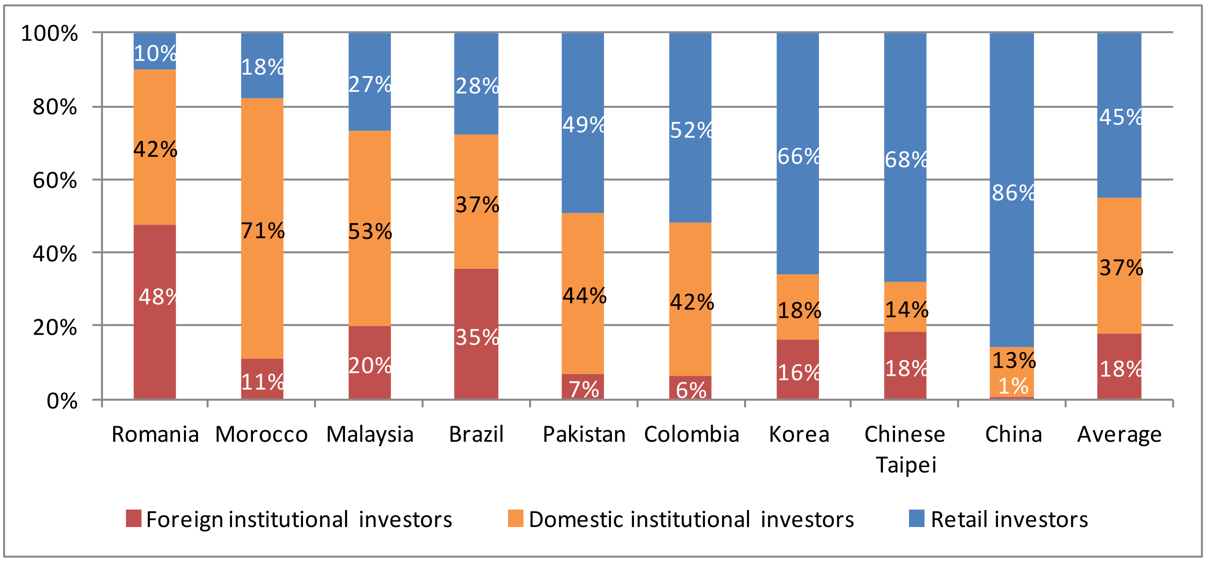
Chart 2.2: Share of Total Market Capitalization in 2010



Source: IOSCO survey data.

The share of trading volume was slanted more towards retail investors, as shown in Chart 2.3. While institutional investors still account for a larger share of trading volume in a number of jurisdictions, over 50% of the trading volume comes from retail investors in Colombia, Korea, Chinese Taipei and China.

Chart 2.3: Share of Annual Stock Trading Volume in 2010



Source: IOSCO survey data.

2.1.2 Total Number of Firms and Assets under Management

Large Number of Institutional Investors in EMs

There are a large number of institutional investors in EMs. Overall, private equity funds topped the aggregate number of firms in 2010 with 2,910 companies, followed by securities companies with 2,723. The number of hedge funds more than doubled from 2008 to 2010, while the number of private equity funds increased by 64% during the same period. Other types of institutional investor firms also increased, with the exception of securities companies, which stayed constant. As Table 2.1 shows, interestingly, some jurisdictions had a much larger number of certain types of institutional investor.

Table 2.1: Number of Firms by Investor Type

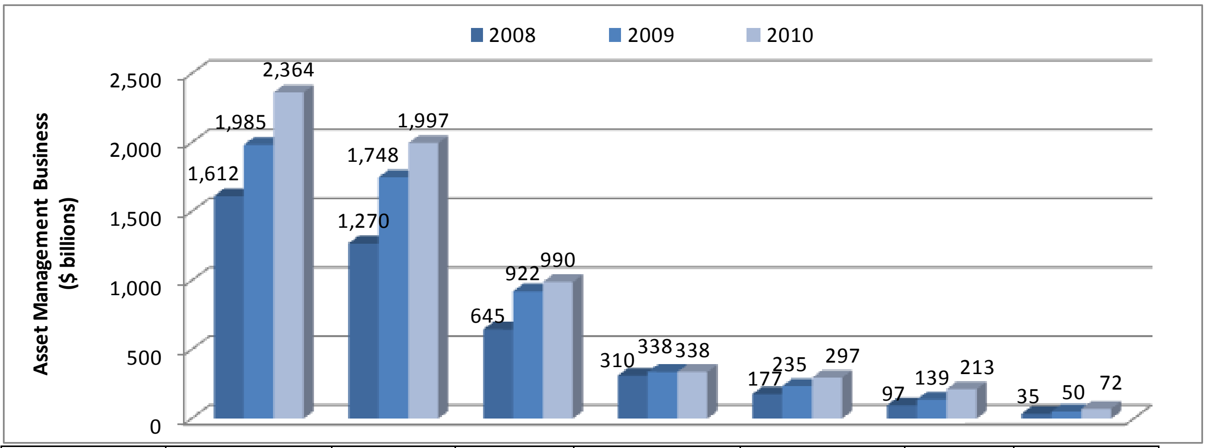
Year end 2010	Total Number	Jurisdiction with Max. Number	Max Number
Mutual funds	1578	Brazil	800
Securities companies	2723	South Africa*	537
Insurance companies	1169	South Africa	194
Hedge funds	892	China	459
Private equity funds	2910	China	1703
Commercial banks	957	China	164

** Includes brokers and asset managers.*
Source: IOSCO survey data.

Total Assets under Management (AUM) by Investor Type

Based on responses from the Group, insurance companies reported the highest total AUM, followed closely by mutual funds. As shown in Chart 2.4, the total AUM for all institutional investors grew between 2008 and 2010. The AUM of private equity funds and hedge funds approximately doubled, while the AUM of mutual funds, insurance companies, pension funds and commercial banks increased by approximately 50%[5].

Chart 2.4: Total Assets under Management by Institutional Investor Type



Jurisdictions Reported	**Insurance Companies***	**Mutual Funds**	**Pension Funds***	**Commercial Banks***	**Securities Companies***	**Private Equity**	**Hedge Fund**
2008	19	22	17	5	10	11	8
2009	19	22	17	5	12	11	8
2010	18	22	17	5	12	11	8

** Note: Insurance company AUM is the insurance companies' total assets, which somewhat overestimates the total AUM.*

5 The comparison of total AUM for institutional investor types is not "apples to apples". For one, the table below Chart 2.4 shows that institutional investors have very different levels of data reporting. Also, the data collected were subject to different interpretations of AUM as stated in the notes under the chart.

Pension fund AUM is the sum of national mandatory pension fund and corporate pension fund assets.
Securities company AUM is the AUM of the asset management business only.
Commercial bank AUM is the AUM refers to the asset management business only.
Source: IOSCO survey data.

2.1.3 Distribution Channels for Institutional Investors

The Group was asked to provide information about distribution channels for mutual funds as well as investment products offered by securities companies and commercial banks. The responses show that, overall, commercial banks are the top distribution channel by sales volume for all three types of institutional investors' asset management products.

Mutual funds are distributed through commercial banks, securities companies, independent financial advisors and direct sales. The commercial bank channel distributes mutual funds in most of the jurisdictions that responded, and is dominant in five jurisdictions. The Direct sales channel is dominant in Pakistan, Malaysia[6] and Chinese Taipei. The securities company channel is the main distribution channel for mutual funds in Korea[7] and Bangladesh[8]. South Africa is the only jurisdiction where independent financial advisors dominate mutual fund distribution[9].

Similarly, for securities companies' asset management business, commercial banks are dominant in distribution in Morocco (75%), China (51%) and Brazil. The commercial bank channel is also the second biggest distributor after direct sales in Korea (32%) and South Africa (10%).

Table 2.2: Distribution channels for mutual fund products

Distribution Channels	Number of Jurisdictions with each Channel	Number of Jurisdictions where Channel is dominant*
Commercial Banks	13	5
Securities Companies	10	2
Fund company Direct Sales	10	3
Independent Financial Advisors	3	1
Insurance Companies	4	0
Others	4	0

**Note: The dominant distribution channel is the one with the largest percentage of sales volume.*
Source: IOSCO survey data.

6 In Malaysia, fund companies became the primary distribution channel by using sales agents, similar to the insurance agent model.

7 In Korea, securities companies had a first mover advantage, since at the beginning only securities companies were approved to distribute mutual fund products. After commercial banks and insurance companies were permitted to sell mutual funds, commercial banks increased their market share; however they have not yet overtaken securities firms.

8 In Bangladesh, given that mutual funds are relatively new and are generally closed-end funds, most of the sales are through securities companies.

9 Commercial banks in South Africa are only allowed to market and distribute their own bank's mutual fund, whereas independent financial advisors are able to provide advice on a variety of mutual funds and other financial products.

2.1.4 Mutual Funds: Remarkable Recovery Post-Crisis

According to the Group's responses, mutual funds exist in all 25 jurisdictions. Despite the setbacks experienced by some during the financial crisis, the Group's mutual funds performed well, increasing in total number of firms, products and total AUM from 2008 to 2010, as shown in Table 2.3. In many jurisdictions, this quick recovery coincided with a rapid economic recovery and a rally in the capital markets. Higher inflows of funds boosted investor confidence and probably contributed to the growth.

Table 2.3: Mutual Funds growth

	2010	2009	2008	CAGR[10]
Number of Companies	1,578	1,446	1,336	8.7%
Number of Products	16,633	15,147	14,558	6.9%
Total Assets Under Management (USD billion)	1,997	1,748	1,270	25.4%

Source: IOSCO survey data.

Concentrated in a Few Jurisdictions

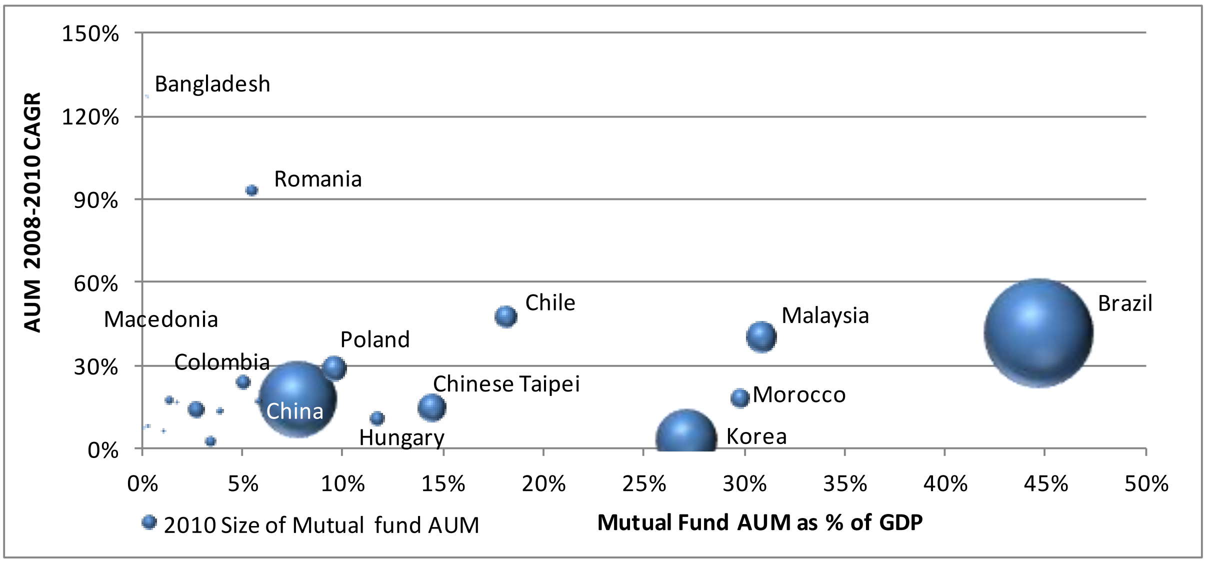
In 2010, the Group's average number of mutual fund companies per jurisdiction was 34, if Brazil is excluded; the latter being the outlier with an estimated 800 mutual fund companies. This highlights the growth potential for the other emerging jurisdictions. Similarly, Brazil and Korea together have over 10,700 mutual fund products, which is 64% of the Group's total. Finally, most of the mutual funds' $2.0 trillion AUM by mutual funds is concentrated in Brazil, China and Korea. Together, they hold 84% of the Group's mutual fund AUM.

Mutual Fund Influence is Strong and Growing

Mutual funds manage a significant proportion of assets in many jurisdictions. Mutual fund AUM is more than 10 percentage of GDP in seven of the 22 jurisdictions that reported data. From 2008 to 2010, all jurisdictions reported an increase in mutual fund AUM. Bangladesh and Romania experienced the fastest growth while Chile, Brazil, Malaysia and Macedonia's mutual fund AUM also grew a lot faster than average.

10 Compound annual growth rate from 2008 to 2010.

Chart 2.5: AUM as % of GDP vs. AUM Growth Rate



Source: IOSCO survey data.

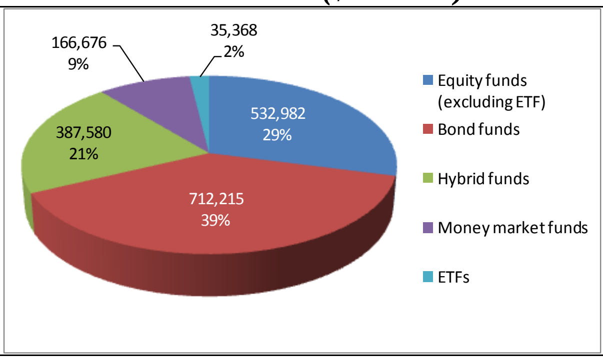
Mutual Fund Product Mix

Bond funds have attracted investor interest and have grown significantly compared to equity funds. In the Group, bond funds are the dominant product type in terms of AUM and number of products.

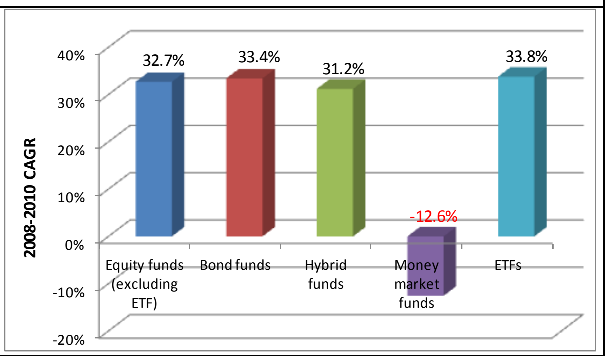
As illustrated in Chart 2.6, bond funds were the leading mutual fund product with nearly 40% of total AUM in 2010. Exchange traded funds (ETFs) is the newest product type. Many jurisdictions have yet to introduce ETFs, which is why only seven jurisdictions provided data. However, from 2008 to 2010, the CAGR for ETFs AUM was 34% and the CAGR for the number of products was 38%.

Chart 2.6: Mutual Funds by Product Types

Product AUM ($ billions)

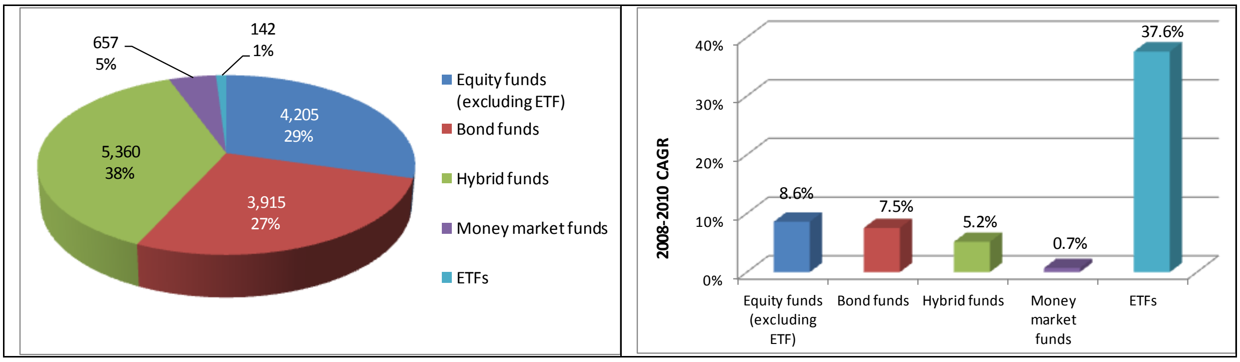


AUM Growth Rate



Number of Funds

Growth in Number of Funds



Source: IOSCO survey data.

Strong Growth for All But Money Market Funds

Defying the financial crisis, almost all types of mutual fund products enjoyed fast growth in AUM for the Group. Remarkably, the AUM for ETFs, equity funds excluding ETFs, bond funds and hybrid funds all grew at over 30% annually between 2008 and 2010. The high level of AUM growth for ETFs was accompanied by a similar level of growth in the number of products while the growth in AUM for equity, bond and hybrid funds was independent of expansion in the number of products. Importantly, the exception to the growth story was money market funds, which shrank by an annual average rate of 13%. This may be due to similar problems faced by money market funds world-wide. As interest rates were cut in most jurisdictions, yields for liquid and lower risk investments by money market funds dropped significantly, making it a less attractive product both for fund investors and for fund management companies.

2.1.5 Securities Companies: Constant Numbers but Growth in AUM

The aggregate number of securities companies reported by the Group was 2,723 as of 2010, about the same number as in 2008. Jurisdictions that suffered losses both in number of companies and asset under management were primarily in Europe, reflecting the difficulties in the Euro zone. South Africa is the jurisdiction with the most securities companies (537). The number of securities companies grew the fastest in Panama and Hungary, both at CAGR of 13%. The AUM of the asset management business of securities companies and the size of their proprietary trading operations both experienced growth from 2008 to 2010.

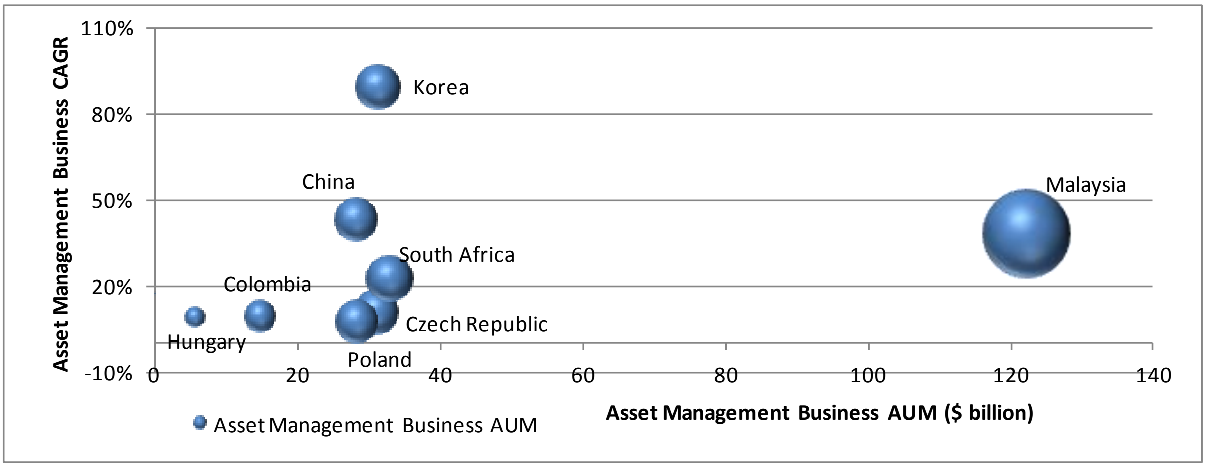
Table 2.4: Development of Securities Companies

	Number of Companies	Asset Management AUM (Million USD)	Prop. Trading* (Million USD)
2008	2,723	176,959	140,096
2009	2,714	234,668	164,136
2010	2,723	296,704	204,814
CAGR	0.0%	29.5%	20.9%
Number Reported	22	12	10

Note: Some jurisdictions reported having securities companies but did not provide number or AUM.
** Size of proprietary trading operation.*
Source: IOSCO survey data.

Malaysia had the largest asset management business, with a total AUM of $122 billion. Korea’s AUM grew the fastest, its AUM more than tripled from 2008 to 2010. In terms of the tt6size of proprietary trading operations, Korea was the largest with $106 billion. The fastest growing jurisdiction was Colombia, with a CAGR of 61% in the two-year period.

Chart 2.7: Asset Management Business AUM



Source: IOSCO survey data.

2.1.6 Insurance Companies: Major Players

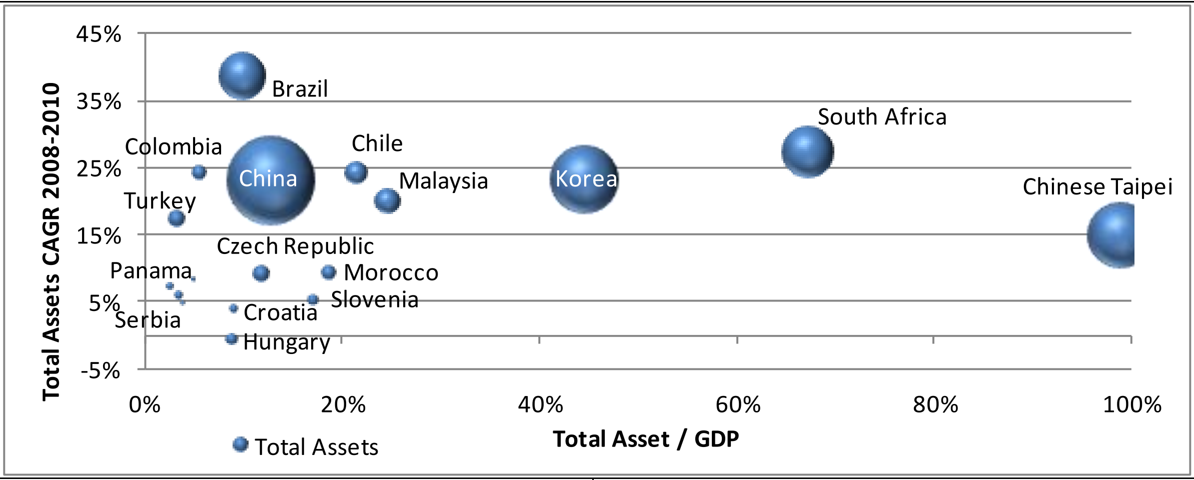
Insurance companies are present in 23 of the jurisdictions; the average number of insurance companies for 2010 was 56. South Africa had the largest number of insurance companies with 194, China and Brazil were the only two other jurisdictions with over 100 insurance companies.

In 2010, the total assets of insurance companies in the 18 respondent jurisdictions were $2.4 trillion, with average annual growth of 21% from 2008 to 2010. Total assets as a percentage of GDP vary greatly across jurisdictions. Chinese Taipei has the highest percentage with 99%, closely followed by South Africa with 67%.

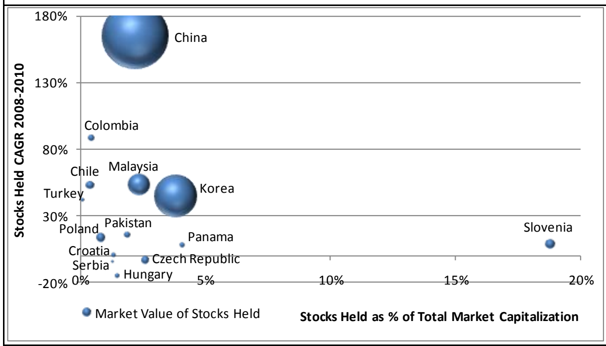
In 2010, 14 jurisdictions reported the market value of equities held by insurance companies, which together had a market value of $219 billion. This sum was approximately 9% of the total assets of the insurance companies, and it was about 3% of the total stock market capitalization for these 14 jurisdictions.

Chart 2.8: Insurance Companies

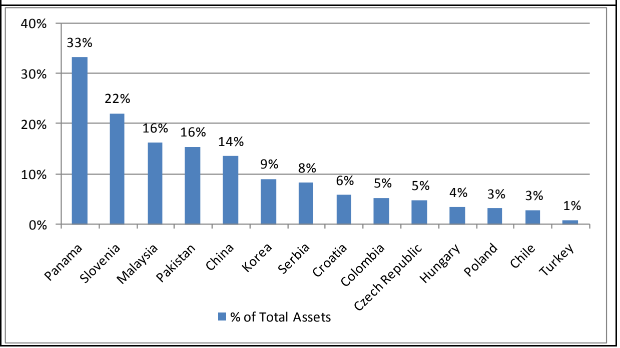
Total Assets of Insurance Companies



Market Value of Equities Held



Equities Held as % of Total Assets



Source: IOSCO survey data.

2.1.7 Commercial Banks: Concentrated Among a Small Number of Players

While the commercial bank is the primary financial service provider in most EM jurisdictions, the total number of commercial banks for the Group was 957 at the end of 2010, a low number compared to the 6,205 commercial banks in the United States. This shows that banking services in EM jurisdictions are concentrated among a few players. China had the highest number of commercial banks among the respondents with 164 commercial banks in 2010, followed closely by Brazil with 159.

The total assets of the commercial banks for the 19 jurisdictions that reported this data was $22.4 trillion in 2010. China's commercial banks' total assets of $14.4 trillion were the largest in the Group. From 2008 to 2010, Brazil was the fastest growing jurisdiction with a growth rate of 36%, followed by China with 26%. The average ratio of commercial bank assets to equity market capitalization for the 19 jurisdictions in 2010 was 2.0 times, with the maximum in Slovenia at 7.1 times and the minimum in South Africa with 0.5 times.

Given most jurisdictions of the Group placed restrictions on commercial banks' direct engagement in the asset management business, there were only five jurisdictions with AUM data for commercial banks' asset management business. Among the respondents, Chinese Taipei had the largest AUM with $220 billion.

2.1.8 Pension Funds: Remarkable Growth but Still Underdeveloped

Having weathered the financial crisis, pension fund asset levels in most jurisdictions continue to show strong growth and are on the way to returning to pre-crisis levels. In 2010, aggregate assets in reported national mandatory pension funds of the reported jurisdictions were $851 billion, 55% higher than in 2008. The aggregate size of corporate pension funds reported was $88 billion in 2010, an increase of 4% compared to 2008. It is interesting to note that for the nine jurisdictions that reported these data, the total size of national mandatory pension funds was 8.9 times that of corporate pension funds. The former's asset growth was also significantly faster than corporate pension funds from 2008 to 2010.

The jurisdictions with the biggest mandatory pension funds in 2010 were Korea, China and Chile, with $305 billion, $232 billion and $148 billion, respectively. The jurisdictions with the highest growth in mandatory pension funds from 2008 to 2010 were Romania, Chile and Colombia, which soared by 361%, 100% and 99%, respectively, over the period.

For corporate pension funds, China had the largest market with $42 billion in 2010, South Africa had $37 billion in 2009 and Korea had $27 billion in 2010. Korea was the fastest growing jurisdiction as the value of corporate pension funds more than quadrupled from 2008 to 2010; Romania's funds also more than tripled during the same period.

More importantly, 2010 figures for pension assets as a percentage of GDP show signs of underdevelopment. The sum of national mandatory and corporate pension funds as a percentage of GDP stood at around 8% for the respondents. The jurisdiction with the highest percentage was Korea with 33%, followed by Morocco with 26% and Slovenia with 20%. Chile did not report the size of its corporate pension fund, but the AUM of its mandatory national pension scheme alone was an impressive 70% of GDP. The jurisdictions with the lowest ratios were Romania and China, with 1% and 5%, respectively. By contrast, the OECD[11] member with the highest total pension-to-GDP ratio was the Netherlands with 129%, while the U.K. and U.S. had 89% and 73%, respectively.

2.1.9 Hedge Funds: Still Some Room to Grow

The hedge fund industry in EMs is still underdeveloped**.** The survey results highlight this fact: within the Group, only 9 jurisdictions reported that hedge funds exist in their respective jurisdictions.

In 2010, Brazil and China had sizable hedge fund sectors compared to the rest of the Group, with 129 and 459 management companies managing $24.5 billion and $21.7 billion respectively. They are followed by Malaysia with $6.1 billion and the Czech Republic with $2.5 billion.

Although the AUM base is still small for hedge funds in the EMs, some of the jurisdictions that reported a hedge fund presence enjoyed a healthy growth rate for both the number of management companies and AUM. China's management companies increased from 178 in 2008 to 459 in 2010, the Czech Republic and Malaysia also doubled their management companies over the same period. Furthermore, the AUM in China and Turkey increased by over 300%, while the Czech Republic and Brazil grew by 101% and 75%, respectively.

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[11] OECD StatExtracts. Data available at: http://stats.oecd.org/Index.aspx?DatasetCode=PNNI_NEW

2.1.10 Private Equity Funds: Staggering Growth

Twenty-one jurisdictions confirmed that private equity funds existed in their jurisdictions. In 2010, the total number of private equity management companies reported by 14 jurisdictions was 2,910, up 64% compared to 1,771 in 2008. The number of management companies increased by 371% in Colombia and nearly doubled in Korea. Most of the increase came from China, where the number of management companies increased by 790 in the two-+ year period.

Out of the $213 billion of private equity AUM reported by 11 jurisdictions, China had the largest share with $154 billion, followed by Brazil with $37 billion. From 2008 to 2010, Colombia achieved the highest AUM growth, from a negligible market to $2.5 billion. During the same period, Brazil's AUM increased by 256%, while China's grew by 118%.

2.2 Regulation of Institutional Investors

Regulation plays a vital role in the development and growth of institutional investors. The survey collected information on the regulatory coverage, regulatory authority, company and product authorization, business scope, investment restrictions and more.

2.2.1 Regulatory Coverage

Most traditional forms of institutional investors, such as mutual funds, securities firms, insurance companies and commercial banks, are regulated in most of the EMs. For pension funds, hedge funds and private equity funds, the EM jurisdictions were asked if these sectors are under regulatory coverage.

Table 2.5: Regulatory Coverage

Industry Sector	Number of Jurisdiction Present	Number of Jurisdictions Regulated
Pension Funds	24	17[12]
Hedge Funds	10	9
Private Equity Funds	21	13

Source: IOSCO survey data.

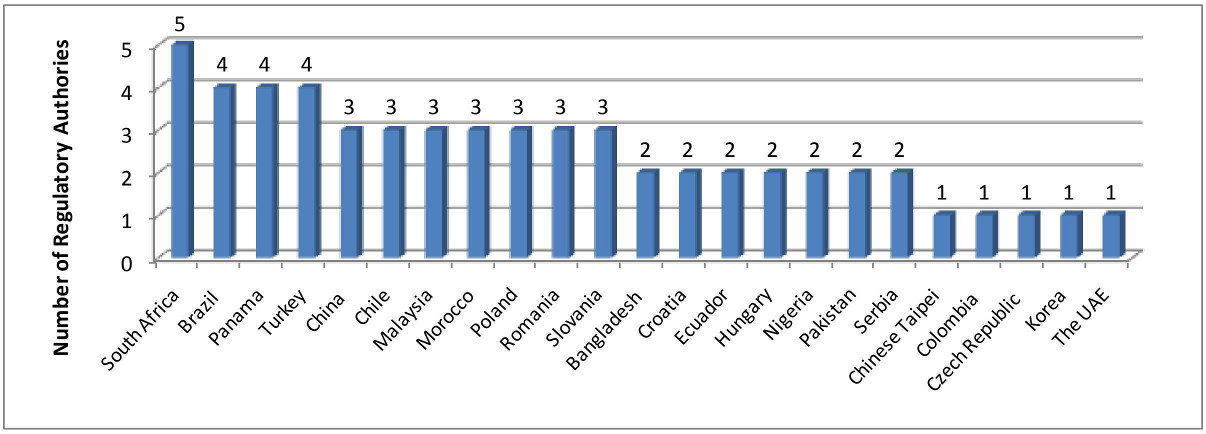
2.2.2 Regulatory Authorities

Single Unified Regulatory Authority is Rare

As the results have shown, few jurisdictions have one single uniform regulator responsible for all of the institutional investors in their jurisdiction. While independent regulatory bodies for different financial sectors could result in more focused regulation, a system of separate regulators for similar services provided by different financial institutions may create difficulties for uniform rule setting given the challenges of regulatory coordination.

12 17 jurisdictions regulate national mandatory pension funds, corporate pension funds or both.

Chart 2.9: Number of Regulators of Institutional Investors per Jurisdiction



Source: IOSCO survey data.

Regulatory Authorities by Institutional Investor Type

Commercial banks in EM jurisdictions are regulated and supervised mostly by central banks. In some jurisdictions, however, they are supervised either by a financial regulatory authority regulating all financial activities in the market or by an independent government agency dedicated to banks. Colombia and South Africa have their banks regulated by multiple regulators.

Out of the Group, 13 respondents have a regulatory authority for national mandatory pension funds. Some of the jurisdictions have a basic regulatory framework in place for private equity fund managers and products. For the majority of the respondents, regulation of private equity funds is the responsibility of the securities regulator.

Ten jurisdictions reported having regulations for hedge funds, while this investor type does not exist in over half of the jurisdictions. Macedonia, Poland, and Pakistan mentioned that they have the intention to introduce hedge fund regulations. The hedge fund regulatory authority in China is the Banking Regulatory Commission (CBRC). In Korea, the Financial Services Commission / Financial Supervisory Service (FSC/FSS) are the responsible authorities. Turkey's hedge fund regulator is the Capital Markets Board of Turkey. In Malaysia and Brazil, hedge funds are regulated by the securities regulators.

2.2.3 Management Company Authorization

Mutual fund companies require authorization from the market regulator in all of the jurisdictions. Private equity managers require regulatory approval in 10 of the 13 jurisdictions that provided data. Both regulatory approval and registration filing are required for private equity funds in Brazil, Nigeria and South Africa whereas Malaysia, Panama and Serbia only require registration filing. Hedge fund companies require regulatory approval in the Czech Republic, Korea, Turkey and South Africa. South Africa regulates only hedge fund managers and not hedge funds companies. In Czech Republic "Qualified Investors Funds" which cover both hedge funds and private equity funds should be registered with the Czech National Bank, although registration is not mandatory. Hedge fund managers are subject to both regulatory approval and registration filing in Malaysia and Brazil. In China, most of the hedge funds use the trust structure, where the trust company and the hedge fund managers are co-trustees. The trust companies are strictly regulated by the China Banking Regulatory Commission (CBRC). However, hedge fund managers are not regulated.

2.2.4 Product Authorization

Mutual fund products require regulatory approval in 24 of the jurisdictions in the Group. Slightly over half of the jurisdictions follow the disclosure-based principles for mutual fund product authorization, six jurisdictions follow merit-based principles and four jurisdictions adopt both principles. 15 jurisdictions require securities companies to obtain regulatory approval for offering of new asset management products, eight of which also require registration filing.

Thirteen jurisdictions responded to the regulatory requirement for commercial banks offering new asset management products, most of which require regulatory approval or a combination of regulatory approval and registration filing. China is the only jurisdiction which only requires registration filing for commercial bank asset management products. Half of the jurisdictions allow commercial banks to hold the same investment products as those of mutual funds.

Five jurisdictions require registration filing for private equity funds while six require regulatory approval only. Brazil and Nigeria require both registration filing and regulatory approval. Six jurisdictions, namely China, Macedonia, South Africa, Serbia, Pakistan and Nigeria, are considering introducing regulatory requirements for private equity funds.

Hedge fund products are subject to regulatory approval in Colombia, Czech Republic and China or registration filing in Turkey and Korea. Malaysia and Brazil require both regulatory approval and registration filing.

2.2.5 Business Scope

A large number of jurisdictions permit mutual fund companies to operate managed accounts, hedge funds and private equity funds. Wider business scopes are sometimes allowed for mutual fund management companies: in Hungary and Poland they can provide investment advice services; in Croatia, Colombia and Nigeria they can operate real estate funds; in Colombia they can participate in factoring and commodities businesses; in Nigeria they can raise venture capital funds; Poland's mutual fund companies can distribute other companies' mutual funds, including foreign funds; Brazil's can operate any collective investment scheme.

Half of the survey respondents permitted securities companies to operate in five different business categories: brokerage, corporate finance advisory, asset management, proprietary trading and private equity investment. In Brazil, securities companies cannot operate corporate finance advisory, asset management, and private equity investment without additional licenses from the CVM Brazil. In 17 out of 25 jurisdictions, securities companies are permitted to offer fund products to the general public.

Commercial banks are allowed to offer asset management products to the general public in the majority of the group, with the exceptions of Malaysia and Morocco. Slightly less than half of the Group permitted commercial banks to engage directly in asset management.

Investment linked products may be offered by insurance companies in most of the jurisdictions that responded to the survey.

2.2.6 Delegation

Most jurisdictions do not allow third party asset managers to manage national mandatory pension funds. For the five jurisdictions that permitted delegation of investment mandate, managers are required to pass strict regulatory approval or they must be a specialized entity in accordance with legislation. Insurance companies, on the other hand, are free to delegate investment functions to third party asset managers in most EM jurisdictions with the exception of Serbia.

2.2.7 Cross Border Activities

Despite allowing foreign ownership of mutual fund companies, with the exception of South Africa, several jurisdictions impose certain restrictions on foreign ownership. China, Malaysia and UAE have limitations on the percentage of foreign ownership a mutual fund company may have. Bangladesh also has a similar requirement, whereby joint venture is required for foreign ownership.

Nineteen respondents reported that insurance companies in their jurisdictions are permitted to invest in the domestic market as well as in overseas markets.

2.2.8 Pension Fund Contributions

For national mandatory pension funds, Slovenia has the highest employee contribution ratio, at 24.4%, and Poland has the lowest, at 2.3%. The highest employer contribution ratio is in China, at 20% of employee’s basic salary. The jurisdiction with the lowest ratio of contribution is Poland, at 2.3%. However, Poland plans to gradually increase the ratio annually, targeting to reach 3.5% in 2016.

There is no limit or minimum ratio imposed by law on contributions to corporate pension funds in most jurisdictions. Colombia stated a minimum of 4% contribution ratio; Panama sets a minimum of $50 per month although not legally binding; Poland technically sets the annual benchmark to 4.5 times average monthly salary; Romania allows up to 15% of the monthly gross earned income and South Africa permits from 7.5% to 22.5% of income.

2.2.9 Restrictions on Investments by Pension Funds and Insurance Companies

With regard to investment in financial instruments by pension funds, many jurisdictions set portfolio limits and investment concentration limits. Investments in equities, bonds, derivatives, mutual funds, private equity funds and other assets are either restricted or forbidden. China and Croatia also placed investment limits on bank deposits. Malaysia bans pension funds from investments involving gambling, alcohol or weapons. In Poland, the state pension fund may not hold more than 5% of their investments in foreign assets.

Similarly, insurance companies have a complex set of portfolio limits, concentration limits and investment restrictions in most of the jurisdictions. The portfolio and concentration limits are set up for risk management and diversification purposes. Investment restrictions are usually placed on high risk assets such as equities, investment funds, foreign investments and fixed income products below a certain rating.

2.3 Incentives for Institutional Investors

The survey asked respondents to provide information on tax incentives at the investment fund/company level, tax incentives on distribution and capital gains at the interest holder's level and other non-tax incentives. From the result of the survey, most of the incentives to develop the institutional investor base are tax related.

2.3.1 Tax Incentives for Funds

Most EMs Provide Incentives for Mutual Funds

In order to avoid double taxation and to encourage the development of the mutual fund industry, many EM jurisdictions provide tax incentives at the fund level that are mainly tax based incentives on capital gains (17 jurisdictions) and on dividend income (16 jurisdictions).

In Malaysia, there is an income tax exemption on management fees for securities companies managing approved Islamic funds for both local and foreign investors until 2016. Several jurisdictions provide other types of tax incentives at the fund level for mutual funds, such as lower corporate tax in the Czech Republic, and exemptions from company income tax altogether, as the case in Nigeria.

Incentives to Promote Pension Funds are Mainly Tax Based

Almost half of the jurisdictions confirmed having deferred tax policies for pension funds. Fourteen jurisdictions stated having other kinds of tax incentives for pension funds. The only jurisdiction that reported non-tax policy incentives is Hungary, where private pension funds are inheritable by a beneficiary in defined cases.

2.3.2 Tax Incentives for Investors

On the investor level, fewer jurisdictions provide tax incentives on capital gains, with only 10 out of 25 respondents providing some form of incentive. Even fewer (nine) provide dividend income tax incentives. Some of these incentives may carry conditions and requirements.

Some jurisdictions offer other types of tax incentives for mutual fund investors. In Malaysia, in order to avoid double taxation, the income distribution from the mutual funds will carry a tax credit.

Chapter 3 Issues and Challenges

3.1 Macroeconomic and Business Environment

3.1.1 Political Stability

Political stability is an important precondition for the development of institutional investors. Several jurisdictions pointed out that political stability and policy consistency are key factors for economic growth and development of institutional investors.

Domestic political instability may lead to inconsistencies in policy initiatives and weak protection for ownership rights. These uncertainties will make it very challenging for institutional investors to deploy resources and launch business initiatives.

The effects of foreign political troubles are less clear, in some cases foreign political turbulence may negatively affect the local economy. For example, Middle East conflicts and the Arab Spring helped trigger a sustained rise in crude oil prices, hurting the global economy, including the EMs. The political, economic and social turmoil caused by the European debt crisis also triggered broad credit concerns and widespread capital outflows from the EMs.

In other cases, political instability abroad may actually become a growth generator for the domestic economy. In the case of Panama, the political situation in a neighboring country actually brought unexpected opportunities for its securities industry. There has been a major migration of securities firms from a neighboring country to open branches or move their business altogether to Panama.

3.1.2 Economic Growth

Economic growth will boost market confidence and bring in capital for institutional investors. Economic growth will also lead to increases in corporate and labor force income, a robust growth generator for the development of the institutional investor base[13].

Conversely, during an economic slowdown, earnings expectations are lowered, business failures increase, unused product capacity depresses asset prices and the unemployment rate rises. Investors will have less money available for investment, and they will try to avoid risky assets by shifting money into safer places such as bank deposits. Retail investors’ risk aversion and dependency on traditional investment products have hindered development of the securities market in some EMs for a long time.

Unfavorable economic environments also present challenges for smaller institutional investors. Institutional investors' business models rely on economies of scale. During challenging times, larger firms with brand recognition, economies of scale and capital buffers will better withstand the down cycle, gaining even greater market share in the process. The

[13] Malaysia's institutional investor base experienced healthy growth due to several factors, including regulatory enhancements that facilitated product expansion and increased investor safeguards, favorable demographics in the form of an expanding labor force and high domestic savings. The investment management industry witnessed high double-digit growth over the last decade, assets under management (AUM) grew by 21.2% annually from US$18.4 billion in 2000 to US$125.8 billion in 2010.

survey indicates that after the financial crisis, some jurisdictions experienced a decrease in the number of fund management companies, especially in Europe.

3.1.3 Financial Crisis

The enormous task of de-leveraging after the financial crisis has a negative impact on financial markets and slows down the world economy. The European economy is still impeded by loss of investor confidence, falling asset values, instability of the banking system and deterioration of sovereign credit worthiness.

For some EMs, the sudden outflow of foreign capital during the financial crisis triggered local currency depreciation and lower market and asset valuation[14]. Lack of funding from abroad coupled with withdrawal of bank deposits severely strained their financial systems. Even after governments injected liquidity into banks and other financial institutions, they simply chose to "hoard the cash" and slow down their lending activities, causing further deterioration in asset values.

Export sectors in the EMs were also heavily hit by the fall in global demand. As economies in the developed regions slowed during the financial crisis, demand for goods and products decreased accordingly, causing a knock-on effect on EM exports[15].

3.1.4 Interest Rates and Inflation

Since the beginning of the crisis, developed economies and EMs alike have been using a combination of fiscal and monetary stimulus. This has eased the impact of the crisis in the short term, as indicated by accelerated GDP growth rates and increased corporate profits. However, such stimulus could create asset price bubbles and raise long-term inflationary expectations. Post crisis, some EMs are already struggling with inflation. In order to keep inflation in check, some central banks have tightened their monetary policies. Such tightening leads to a scarcity of credit and may further inhibit economic growth.

3.1.5 Savings Power (Culture and Demographics)

Savings culture will affect the amount of assets available for investment, hence the demand for the services of institutional investors. Based on the survey results, EMs have a range of savings ratios. Asian jurisdictions tend to have a higher savings ratio than South American jurisdictions[16]. This difference is partially due to differences in savings culture.

Demographics also play a very important role in savings. Aging populations tend to save, while younger populations tend to consume. The world's median age is around 29 and is

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14 When the crisis hit Serbia in October 2008 and foreign capital fled the country, there was strong depreciation pressure on the local currency. The Dinar weakened notably despite the National Bank's interventions in the forex market. This depreciation induced a further decline in confidence among savers, causing an outflow of deposits of 900 million EUR in October 2008, or 16% of total deposits.

15 China, for example, is one of the largest export markets in the world; its exports accounted for 27% of its GDP in 2010, U.S., E.U. and Japan being China's top trading partners. Export business was negatively impacted by the decreasing demand from its top trading partners due to the global financial crisis.

16 Survey responses for household savings divided by GDP for Asian jurisdictions such as China (79%), Chinese Taipei (32%) and Malaysia (26%) are higher than those of South American jurisdictions such as Brazil (15%), Colombia (14%) and Ecuador (4%).

projected to exceed 37 by 2050. According to the U.S. Census Bureau, many EMs still have demographic dividend[17] benefits for many years to come[18]. Increase in income and a prosperous economic environment, together with demographic dividend in the EMs can provide great opportunities for institutional investors[19].

EMs often rely on private savings and family support for retirement instead of capital markets. Businesses that target the retirement age group, such as health and life insurance, individual retirement plans and corporate savings plans, remain under-developed. Compared to the developed countries, pension and retirement benefit programs in EMs are less-developed[20 21].

3.1.6 Competition and Substitute Services

Traditional capital market investments have faced widespread competition from substitute services such as bank-offered investment products, commodities, infrastructure and real estate investments.

Due to weak capital market performance, some EMs have witnessed fund outflow from institutional investors to substitute services that offer stable returns. For instance, commercial banks have developed deposit like products that promised fixed payouts[22]. If equity markets continue to post negative returns with no end in sight, there may be accelerated fund flows into other alternative investments, such as real estate or infrastructure projects[23].

In light of the competitive conditions and an ever-changing market environment, institutional investors seek to deliver innovative products to better meet the customer needs. However, regulatory restrictions on asset classes and stringent approval procedures for new products make it difficult for institutional investors in some jurisdictions to launch new products.

Favorable terms offered by public financial services such as public pension plans or government bond issues may crowd out the private pension plans and private institutional investors[24]. While public financial services are necessary, overzealous policies will increase

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[17] Demographic Dividend is the time when the working population is rising, while the share of the dependent young and old is falling. This period is always associated with rising tax revenues, savings, and incomes; in some nations this demographic dividend can last for several decades.

[18] Grindal, Alejandra, "Global macroeconomic drivers and risks", Euromoney, January 2012, Volume 43, 513.

[19] Based on survey feedback, the demographic dividend played an important role in the growth of Malaysia's asset management industry. Rapid growth was largely in Malaysia's mutual fund sector, where net asset value (NAV) grew by 18.0% annually from US$14.4 billion in 2000 to US$75.6 billion in 2010.

[20] According to OECD, only 9.1% of Indians and 20.5% of Chinese are covered by mandatory pension schemes. This compares with the developed world, where more than 90% of the population is covered.

[21] See footnote 18.

[22] The China A-share market has witnessed significant outflows to fixed coupon products offered by banks since late 2010.

[23] In Turkey, retail investor preferences have focused on bank deposits and other investment vehicles such as real estate because of capital market downturns.

[24] Hungary's private pension fund rules changed significantly, causing the majority of private pension members to shift to the national pension fund. Accordingly, portfolio management activity among investment fund managers decreased because the private pension funds were their major clients.

the burden on fiscal expenditure, draining funds away from the private sector, and threatening existing portfolio management activities. Similarly, large commercial banks and systemically important financial institutions can squeeze out other institutional investors, given advantages such as access to the discount window and the government's implicit guarantee.

3.1.7 Privatization and Ownership Rights

Privatization increases stock ownership, market capitalization and liquidity, bringing depth and width to the capital markets. Through privatization, state-owned enterprises can become more market-oriented, their operation more efficient and corporate governance more transparent and effective. An improved business environment would lift investor confidence, leading to faster development of capital markets. More investment opportunities would also expand the investor base for institutional investors. Nigeria reported that privatization was one of the main drivers of rapid growth for its institutional investors. Study has shown that local Nigerian institutional investors such as pension funds and insurance companies participated actively in the market once privatization took place[25].

Ownership rights are closely related to privatization as they represent one of the core values in privatized societies. The wealth effect from privatization encourages entrepreneurs and capital to actively seek investment opportunities, resulting in more demand for institutional investors to provide professional financial services.

3.2 Capital Market Efficiency and Transparency

3.2.1 Lack of Depth and Liquidity in the Markets

According to the survey, lack of market depth and liquidity is one of the major obstacles for institutional investors. Due to the specific investment guidelines they must comply with, institutional investors typically have much higher diversification and liquidity requirements than retail investors.

It was reported that 17 out of 24 jurisdictions had less than 500 publicly listed companies. In some EMs, finite market size and fewer securities to invest in tend to limit the ability of institutional investors to deploy capital[26]. In a less liquid market, any large volume transaction would have a significant market price impact.

Market efficiency can also be compromised due to restrictions on price movements, such as the price band on daily fluctuations imposed in some markets. It may take many trading days for institutional investors to add or trim their positions once the price band limit is reached.

A lack of liquidity in corporate bond markets is a prevalent issue in EMs[27]. This is mainly due to limited supply in the markets and the risk aversion to corporate bonds with a

25 Tanko, Dr. Muhammad, "The Impact of Privatization on Capital Market development and Individual Share Ownership", October 2004. Available at SSRN: http://ssrn.com/abstract=689702. The paper examined the impact of privatization on the Nigerian capital market, estimated that the Nigerian market capitalization increased 2,992 percent from N9.7 billion in 1988 (prior to the privatization exercise) to N472.9 billion in 2000.

26 IOSCO Emerging Markets Committee, "Development of Corporate Bond Markets in the Emerging Markets", November 2011. Available at IOSCO: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD360.pdf

27 ibid.

preference for safer securities such as government bonds. The buy and hold strategy of institutional investors reduces the amount of bonds available for trading. This will increase the price impact of large trades, thereby making transaction costs higher. Other factors such as poor market transparency and lack of timely information disclosure on corporate bonds also contribute to the problem.

3.2.2 Inadequate Trading and Hedging Mechanisms

The availability of trading and hedging mechanisms can make capital markets more efficient. However, due to concerns about the stability of the financial system, many regulatory authorities in EMs restrict certain trading and hedging activities. These restrictions bring potential problems for institutional investors.

- Price Fluctuation Band. Due to the developing nature of the EMs' capital markets, many investors in those markets have short-term investment objectives and speculative motivation. To prevent large swings in stock prices, regulatory authorities impose price fluctuation bands to ensure the stability of their capital markets[28]. However, price fluctuation bands could prevent stock prices from truly and promptly reflecting critical information. This is especially problematic for institutional investors given the large positions they typically hold, making it more difficult to quickly adjust portfolio holdings once new information is received.

- Market Making. Lack of a market making mechanism is another issue raised in the questionnaire. Market making is especially beneficial to less traded financial instruments because market makers provide extra liquidity by risking their own capital to warehouse the instruments, earning the bid/ask spread in the process. Nigeria has stated that they started implementing a market making mechanism to improve market liquidity after the financial crisis.

- Hedging Mechanisms. Another important issue is the lack of hedging mechanisms and restrictions on their use. According to the survey, even though 18 out of 25 respondents reported having some derivatives trading practices, many respondents also commented that the lack of hedging instruments was one of the major obstacles preventing the development of institutional investors. The reason behind the paradox is that although many EMs allow derivatives trading, the regulatory authorities usually impose stringent rules on institutional investors' participation in the derivatives markets[29]. For example, the restrictions on stock futures/options trading for institutional investors limit their abilities to hedge market exposures in their portfolios[30].

3.2.3 Transaction Costs

Explicit transaction costs consist of commissions, fees and tax (including stamp duty). Higher transaction costs could hurt market sentiment. For example, the application of a capital gains tax or stamp duty in China was considered a cooling down signal for the market from the investors' perspective. High transaction costs will also suppress investment strategies that

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[28] China imposes a 10% price fluctuation band on its stock trading, and Chinese Taipei's price fluctuation band is capped at 7%.

[29] For example, although short selling is carried out in China's financial market, institutional investors such as mutual funds are currently not able to sell stocks short due to regulatory restrictions.

[30] For instance, China's mutual funds are only allowed to have exposure of up to 20% of net assets value in stock index futures.

require frequent trading, making some of the product types such as quantitative investment strategies unfeasible. Complicated transaction cost structures could also discourage market activities.

3.3 Product Offering and Innovation

3.3.1 Lack of Underlying Investment Products

Well-functioning financial markets offer a wide variety of financial products to better meet investors' needs. In many EMs, however, investors' preference and stringent regulation prevent institutional investors from offering more diverse and innovative products.

Investors' preference has a huge impact on underlying product diversity. In Turkey for example, the investment preferences of retail investors had been mainly commercial banking products such as bank deposits and real estate investments. Retail investors’ risk aversion and dependency on traditional investment products have hindered the development of the securities market.

3.3.2 Regulation versus Innovation

There is a trade-off between financial regulation and innovation. To ensure financial market stability, many EMs heavily regulate new product offerings. Mutual fund products are subject to different forms of authorization in different EMs. Out of 25 jurisdictions, 6 use merit-based principles, 13 use disclosure-based principles, while 4 use a combination of both.

Authorization practices affect the amount of time and resources it takes to launch a new product. In China, partially due to the prudent regulations, product innovation is difficult. The issue of homogeneous products that lack differentiation comes up frequently for institutional investors such as mutual funds, insurance companies and securities companies.

By contrast, Brazil and Korea each have more than 5,000 mutual fund products, the most among surveyed EMs. It may not be coincidental that both jurisdictions use disclosure-based principles for product approval. Some jurisdictions also experienced high growth after the implementing of new regulations to promote financial innovation. For example, in Chile, a new bill allowed ETFs to be included as a new investment instrument for mutual funds, which boosted liquidity and lowered the cost of investing. As a result, the AUM of the ETFs increased 375% from 2008 to 2010.

3.3.3 Private Pension Fund Development

During the last decade, many EMs have experienced high growth in private pension funds due to government policy incentives and rapid growth in stock markets. By contrast, in some jurisdictions, the development of private pension funds is limited.

There are several issues and challenges associated with private pension fund development. The first one is a lack of supporting measures for private pension funds. For example, in China, the lack of tax incentives has been hindering the expansion of corporate annuities business for many years.

Another issue is limitations on investment in certain financial instruments by private pension funds. For example, according to the questionnaire, 12 jurisdictions either forbid or put up restrictions on derivatives investments; 11 jurisdictions did not allow private pensions to invest in mutual funds. The restrictions on financial instruments made it difficult to manage portfolio risks in private pension funds and limited their investment opportunities.

It is worth noting that changes in government pension policies also have a huge impact on institutional investors. For example, Hungary's private pension fund rules changed significantly, causing the majority of private pension members to shift to the national pension fund, hurting investment fund managers who have private pension funds as their major clients.

3.4 Product Distribution and Investor Culture

3.4.1 Distribution Channel and Cost

The distribution channel for financial products is very important for the development of institutional investors since it is the bridge between "manufacturers" and "consumers" of financial products. According to the survey, institutional investors such as commercial banks and insurance companies mainly sell through their own direct sales channels. On the contrary, some institutional investors such as mutual funds often sell through others' distribution channels[31]. When there is a high level of reliance on one particular type of distribution channel, and if this channel's industry structure is highly concentrated, institutional investors will have very low bargaining power[32]. This will give rise to high distribution costs, hindering the development of institutional investors. For instance, institutional investors in China usually pay commercial banks very high commissions to promote their products. This also raises conflict of interest issues within the distribution channel. To maximize commissions, sales people may promote financial products without considering the needs and risk preferences of customers, some may even mislead customers or practice churning. The resulting higher costs and less suitable products for customers will eventually hurt both the distribution channel and the institutional investors.

3.4.2 Investor Culture

Investment culture, which is not just limited to savings habits, plays an important role in the behaviour of institutional investors. Financial markets can be hampered by investor culture such as speculation and risk aversion.

Investors in certain EMs tend to be more speculative, especially in China and Korea, where trading turnover has been relatively high in recent years. Asset managers often have to deal with redemption pressure due to the speculative investment culture of retail investors, who make investment decisions based solely on short-term performance. As a result, institutional investors have to maintain a higher percentage of investment in liquid assets, inadvertently hurting the long-term performance.

Risk aversion is also a limiting factor for the development of institutional investors[33]. Investors' behaviour has changed substantially since the financial crisis. As such, long-term investors now tend to have shorter investment horizons in light of the sluggish performance

31 See section 2.1.3 of this report.

32 For example, China's mutual fund distribution is mainly through commercial banks. Furthermore, most of the sales volumes is in the hands of the five largest commercial banks.

33 Colombia cited investor fear of investing in securities not rated AAA as a major obstacle to the development of institutional investors.

and uncertainties seen during the past few years. IMF research[34] indicates that only about one-fifth of the pension funds surveyed expect higher risk exposure in their portfolios in the next three years.

Besides broad risk aversion, institutional investors are more comfortable investing in assets they are familiar with. For example, investors in some EMs would be inclined to invest in government bonds instead of corporate bonds. Such investment behavior will limit financing available to growth companies and reduce the supply of risk capital for the capital market.

3.5 Human Capital and Incentives

3.5.1 Human Capital and Professionalism

Human capital is essential for the success of institutional investors. Investment, trading, risk management, IT, sales and marketing all require trained and experienced professionals. Quality professionals will be able to enhance the products and services provided to its customers. Several jurisdictions mentioned the lack of qualified and trained professionals as an obstacle to the development of institutional investors[35].

Institutional investors are entrusted with significant amount of assets. Lack of ethics and professionalism could lead to anything from poor risk management to front running of fund assets, insider trading or outright fraud. For this reason, some of the EMs made continuous efforts to improve the industry culture[36].

3.5.2 Incentive Structures for Institutional Investors

Institutional investors often compete for high quality professionals. In order to attract and motivate the professional to perform at high standard, institutional investors need to use effective incentive schemes. The complexity of various incentive structures is beyond the scope of this report. What is evident is that incentive structures are often not designed to deal with the inherent conflicts of interest that exist throughout the financial services industry. More importantly, even if an individual firm has the intention of setting up the right incentive structure, it may still have to give in to the undesirable incentive structures within the financial system due to competitive pressure. Distorted incentives in the system can quickly lead to increased use of leverage, irresponsible risk taking and misleading of the customers, all with drastic consequences, damaging investor confidence and creating a setback for the industry.

3.6 Market Openness and Accessibility

3.6.1 Exchange Controls and Capital Account Restrictions

34 IMF, "Global Financial Stability Report - Grappling with Crisis Legacies", September 2011. Available at IMF: http://www.imf.org/External/Pubs/FT/GFSR/2011/02/index.htm

35 Chinese Taipei mentioned the need to recruit and train more traders who are familiar with the international market; Colombia thinks the capacities of its risk managers need to improve; China believes financial product sales staffs working for commercial banks need better training.

36 Malaysia revised Guidelines on the Compliance Function for Fund Managers in 2011, introducing 11 core principles aimed at promoting a culture of compliance, professionalism, ethical standards and responsible conduct for fund management companies and their representatives.

According to survey results, most EMs believe foreign institutional investors could add liquidity to their domestic market and bring best practices such as higher standards of corporate governance. The degree of market openness varies across jurisdictions. Some jurisdictions such as Brazil, Korea, Chinese Taipei, Morocco and Malaysia have a strong foreign institutional investor presence. Their foreign institutional investors hold 20-30% of the domestic equity market. However, in most of the other jurisdictions, foreign institutional investors hold less than 5% of the equity market.

Some EMs maintains remittance restrictions and exchange controls which limit foreign investments in domestic markets. These restrictions prevent foreign investors from having free access to the domestic market, a pre-requisite for their entry into an EM.

Besides approval requirements for capital flows, other types of capital controls range from limited quota schemes and minimum holding period requirements before fund repatriation, to restricted size of investments into certain local sectors in the market.

Although capital controls are targeted to regulate short-term irregular capital flows, long-term investors are also affected due to the complicated approval process for accessing markets and remitting funds.

3.6.2 Limitations on Foreign Investors and Investments Abroad

Apart from exchange controls and capital account restrictions, there are other factors that impede the entry of foreign institutional investors into the EMs. These factors include:

- Restrictions on accessibility to financial products or asset classes
- Lack of transparent and information disclosure in EMs. According to IMF research[37], international funds tend to avoid markets that lack transparency. This avoidance becomes more pronounced under volatile market conditions.
- Inequality in the treatment of foreign institutional investors and domestic investors. The most prevalent difference highlighted in the survey is tax treatment, according to 13 out of 20 jurisdictions[38]. Inequality in the treatment of fund repatriation and limitations on investment size also exist.
- Language and cultural barriers may be another issue, since foreign investors require clear, transparent, timely and complete information in order to make sound investment decisions.

Similarly, domestic investors investing offshore are limited by both regulatory and business factors. As specified in the survey, there are numerous regulatory barriers for domestic institutional investors investing abroad. Authorization is required for overseas investment in 7 out of 21 jurisdictions. Maximum investment limits and constraints on foreign assets have

37 International Mutual Funds, "Capital Flow Volatility, and Contagion - A Survey by Gaston Gelos", April 2011, WP/11/92. Available at IMF: http://www.imf.org/external/pubs/ft/wp/2011/wp1192.pdf

38 For example in Brazil, a special tax is applied to bond market investments made by foreign investors.

been posted for mutual funds, insurance companies or pension funds in 12 out of 20 jurisdictions[39].

Besides regulatory constraints, home bias also contributes to limited demand for overseas investment products. Country allocation remains an important strategy for portfolio diversification. However, domestic investors are quite cautious when dealing with overseas investment due to their limited knowledge and experience in overseas investing. Meanwhile, lack of confidence in the offshore investment capabilities of domestic institutional investors also diminishes demand.

3.6.3 Lack of Sound Legal Protection for Cross Border Investments

A fast and efficient legal system conferring adequate protection is particularly important for the involvement of foreign institutional investors in the domestic markets. This includes the rapid settlement of legal conflicts and a sound court and legal system in addition to the availability of arbitration procedures. Likewise, domestic law should respect ownership rights.

Equally important is adequate protection for domestic investors investing abroad. EM jurisdictions should enhance regulatory coordination with overseas counterparts to build conflict resolution procedures and to ensure that domestic investors' rights are properly protected. Through the signing of MOUs, regulators on both sides can cooperate with each other on information sharing and on detecting illegal cross border activities such as money laundering.

3.7 Taxation and Incentives

The imposition of excessive tax on institutional investors, whether in the primary or secondary markets, can impede and discourage their development. Tax is an important policy measure and it may come in many forms, such as corporate tax, transaction tax, stamp duties, as well as taxes on capital gains, dividend, interest, etc. The tax regime is often imposed by an arm of the government that is more focused and interested in maximizing government revenue. In many cases tax policies may not take into account important aspects and issues involving development. Given that tax revenue is a major income source, governments are unlikely to sacrifice it voluntarily. High levels of public debt that call for more tax revenue can be an obstacle to tax cuts, thereby hindering the development of institutional investors in the EMs.

Tax could affect the absolute development of a sector, perhaps just as importantly, it also impacts the relative development between sectors. Lack of neutrality in taxation between different types of financial instruments, such as government bonds, commercial loans, corporate bonds and deposits, may result in deviations in the allocation of investments in financial markets.

3.8 Regulation and Financial Stability

3.8.1 Quality of Regulation

[39] In Morocco, overseas assets are capped at 10% for mutual funds and 5% for insurance companies and banks. The Central Bank of Pakistan has allowed local mutual funds to invest abroad up to 30% of aggregated funds abroad, with a cap of US$ 15 million in total.

Due to the fast growing nature of the financial markets in EM jurisdictions, regulators are constantly facing the lack of rules and regulations for governing newly developed products and market activities. Existing regulations often lack clarity and transparency, which may also create confusion in the market. Finally, constant changes in regulation could create uncertainty and potentially increase the cost of conducting business for institutional investors.

As entity and product authorization procedures are expedited or simplified for the sake of development and innovation, post approval supervision should be strengthened. For example, it is commonly accepted that the hedge fund industry performs better under light touch regulation[40]. However exempting hedge funds from tighter regulation does not mean regulators should ignore potential systemic risks posed by hedge funds. Investor protection and disclosure should also be effectively monitored.

Lack of clear division of responsibilities and coordination among different regulatory agencies will either lead to overlapping supervision or a regulatory vacuum, creating opportunities for regulatory arbitrage. According to the survey responses, in some jurisdictions one type of institutional investor could have more than one regulatory authority and hence potentially conflicting laws and regulations, while other types of institutional investors could have no designated governing regulatory body.

According to the survey, most of the EM jurisdictions have separate regulatory bodies for different types of institutional investors, resulting in different regulatory standards for similar products. For example, in some jurisdictions securities companies and commercial banks have started to offer asset management products similar to mutual funds. In order to reduce the chance of regulatory arbitrage, some jurisdictions use a function-based regulatory framework, while others create overreaching committees to improve regulatory coordination.

3.8.2 Market Surveillance Capability for Enforcement and Investor Protection

Market abuse damages the integrity of markets and investor confidence, both of which are indispensable for market and economic growth. One of the major problems in EM securities markets is the lack of investor confidence due to widespread market abuses such as market manipulation and disguised profit transfers, etc. The lack of depth in the markets, poor corporate governance and ineffective minority shareholder protection are some of the factors that further exacerbate the problem. Loss of investor confidence has negative effects on market depth and liquidity, all of which calls for effective market surveillance.

New financial and technological developments enhance incentives, means and opportunities for market abuse. In particular technological developments in the IT area, such as high frequency trading (HFT), have turned out to be a big challenge for sound market surveillance in the EMs. Substantial investment in real time market surveillance tools is required to monitor and supervise large quantities of transactions. Without proper supervision, technological innovations and evolving trading strategies may exacerbate systemic risk and jeopardize the financial stability of the market[41].

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40 Regulating only hedge fund managers, as in the US and the EU, can provide hedge funds with operational flexibility since managers are the ones making critical decisions.

41 United States stock market flash crash on May 6, 2010: the Dow Jones Industrial Average plunged about nine percent—only to recover those losses within minutes. A large sell order triggered a move by high-frequency firms to quickly sell their positions, driving down the market substantially in just a

Finally, adequate human resources should be allocated to the enforcement of the rules and regulations. As institutional investors in EMs start to develop, many jurisdictions are facing a shortage of knowledgeable staff to properly enforce market behavior. If market abuses are not detected and punished in a timely fashion, investor confidence will erode.

3.8.3 Monitor, Mitigate and Manage Systemic Risk

While developing the institutional investor base, regulators should be mindful of the systemic risk institutional investors may pose for the financial system, particularly given the fragility of the system in the aftermath of the global financial crisis.

The recent financial crisis has led regulators to put greater emphasis on systemic risk and financial stability. A number of lessons can be learned from the recent crisis which has helped to define the regulators' role in maintaining financial stability. Regulators should be aware of the channels through which the effects of a systemic crisis can be transmitted across the financial system and the real economy. To this end, it is important that EM regulators cooperate with each other to recognize, monitor, mitigate and manage systemic risk and combat financial instability.

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couple of minutes due to the lack of liquidity and negative sentiment in the market just before the crash.

Chapter 4 Recommendations

Developing an institutional investor base should be given top priority by the EMs because of the growth in capital markets and increasing demand for professional asset management services. However, certain preconditions have to be fulfilled before the institutional investor base can be further developed. Regulators and policy makers need to decide what roles capital markets and institutional investors should play in their jurisdictions, taking into consideration economic, political, social, legal and market factors.

Each market is different in size and has its own set of characteristics, therefore there is no "one size fits all" solution. Regulation should maintain a balance between innovation and financial stability concerns and provide an appropriate environment for the development of institutional investors.

While a long term development plan should be prepared, implementation should be in phases. Given that policy changes often have broad and unpredictable consequences, the plan should be constantly monitored and revised. Regulators should be mindful that frequent policy changes may create confusion and increase compliance costs for industry participants. Therefore, regulators and policy makers should consider starting with smaller scale experimentation of policies, observing their impact, modifying and fine-tuning the policies, before full scale implementation. Finally, policy development plans should be accessible to all market participants. Involving the financial industry, private sectors and other stakeholders in the policy design process can provide awareness, transparency and a sense of direction.

The following recommendations are developed based on the findings from the survey responses, independent industry studies and empirical academic research. These recommendations cover a wide range of areas, including: Macroeconomic Environment and Market Efficiency, Product Offering and Financial Innovation, Distribution Channels and Investor Education, Market Openness and Accessibility, Human Capital and Professional Integrity and Regulatory Framework and Financial Stability.

4.1 Macroeconomic Environment and Market Efficiency

- **Take action depending on the political and economic environment.** A favorable political and economic environment is vital for the development of institutional investors, and it is also naturally desirable for any government. However, governments are seldom in full control of these factors. Regulators should be fully aware of current conditions and outlook. A favorable political and economic environment with positive outlook would be a good time for regulators to drive forward development plans for institutional investors. Conversely, an unstable political and economic environment could create difficulties for attracting and growing institutional investors. Regulators should adjust their agenda accordingly and be more prudent in launching major initiatives. Brute force may only use up time and resources with limited results.

- **Ensure legal protection of ownership rights.** A well-functioning capital market is founded on legal protection for property and ownership rights. There should be clear rules and regulations, transparent and fair legal proceedings and adequate enforcement. Private property rights should be respected.

- **Promote proper corporate governance standards**. Corporate governance focuses on the rights and equitable treatment of the shareholders, information disclosure and the duties of board members and management team. Companies that have accessed capital markets to fulfill their financing needs should have clear, transparent, timely and complete disclosure of material information. Proper corporate governance will promote a transparent and efficient market and increase investors' confidence.

- **Introduce market making mechanisms.** Financial instruments that are less followed by analysts and investors are thinly traded. It is very difficult for institutional investors to buy and sell such instruments with meaningful size. Introducing market making mechanisms would narrow the bid/ask spread and make large volume transactions possible for institutional investors.

- **Broaden the price fluctuation band.** The price fluctuation band can dampen the volatility of the market through temporary suspension of trading activities. But it sacrifices the timeliness and accuracy of market price and also limits institutional investors' ability to react to critical market information promptly. Therefore, as the market matures, price fluctuation band could be gradually broadened or removed.

- **Lower transaction costs to improve market liquidity**. Regulators could lower explicit transaction costs such as bid/ask spreads, transaction commissions, taxes and fees. If done correctly, this will increase market participation and increase liquidity, which will then lower the implicit transaction costs by adding market depth. More investment strategies, such as market neutral strategy, will become feasible with lowered transaction costs.

- **Encourage the use of derivatives to reduce market volatility.** Derivative products offer institutional investors the ability to hedge their exposure in a timely fashion without affecting the underlying holdings. They can also improve cash and liquidity management. Used properly, derivative products can decrease market volatility and enhance returns for investors. Regulators should devise more effective policies and measures to encourage the use of derivative products by institutional investors. In the meantime, effective risk management parameters should be set and comprehensive monitoring and reporting systems should be put in place to deter any abuse of derivative products.

4.2 Product Offering and Financial Innovation

- **Simplify product offering procedures and broaden offering methods.** To further develop the equity and bond markets and broaden the institutional investor base, EM jurisdictions need to speed up the approval or registration procedures for primary issues, streamline the offering documentation requirements and remove undue administrative impediments. Broadening the offering methods beyond stand-alone public offers would help invigorate the development of institutional investors in the EMs. Advanced markets have already developed methods to make securities offerings expeditious and cost-effective for institutional investors. This can be achieved by the use of a variety of offering regimes such as traditional private placements, institutional offerings, shelf registration and hybrid regimes facilitated by integrated disclosure. Introducing different offering and disclosure standards for smaller companies could also help increase the supply of investment products. Foreign issuers, particularly multinational companies that have significant operations in the jurisdiction, should be allowed to raise capital by issuing corporate bonds in the domestic market to create more high credit quality instruments in the domestic corporate bond market.

- **Develop pension and insurance products to counteract the aging population problem.** Businesses that target the retirement age group, such as health and life insurance, individual retirement plans and corporate savings plans remain under-developed in the EMs. Aging population could create a heavy burden on the governments' social security and pension system, particularly for jurisdictions with low savings rates. Governments need to facilitate the development of a multi-pillar pension system with emphasis on supplementary occupational pensions and individual savings plans.

  In order for such programs to succeed, proper infrastructure and sufficient publicity are critical. Since these programs are likely voluntary in nature, appropriate tax incentives are needed to attract participants. For example, at the product level, policy makers could waive or deduct taxes levied on dividend, interest income and capital gains. At the investor level, partial income and capital gains tax deductions or deferral could be applied to private pension or other long term savings plans. While these tax incentives may decrease tax revenues in the short term, it could lead to behavioral changes, attracting private entities and individuals to share some of the burden that would otherwise fall fully on the shoulders of the government.

  Institutional investors could also become a part of the solution by designing appropriate products and providing professional asset management services. Development of pension and insurance systems will provide the capital markets with lasting risk capital that will further benefit economic development. Finally, given that returns on these pension and insurance plans will affect the quality of life of future pensioners, institutional investors participating in this market should be held to higher prudential and professional standards.

- **Promote innovative financial products.** Regulators could encourage institutional investors to develop innovative products that better fit investors' needs. For example, during period of high inflation, Real Estate Investment Trusts (REITs) and commodities funds are good defensive products against inflation. Feeder funds, fund-of-funds, wholesale funds and listed collective schemes such as Exchange Traded Funds (ETFs) are other examples of well-designed products. Regulators should also promote the development of professional financial advisors. Because of their close relationship with the investors, professional financial advisors could foster product innovation by providing feedbacks on investors' needs. They could also customize investment strategies to meet investors' needs.

- **Monitor financial stability issues arising from financial innovation.** Innovation should be encouraged and facilitated where it has the potential to improve market efficiency or satisfy unmet demand. Innovation which involves opacity and improper risk management problems should be carefully monitored. Regulators need adequate resources, proper training and statutory authority to be able to keep close supervision of innovative financial products.

4.3 Distribution Channels and Investor Education

- **Diversify distribution channels and encourage competition.** Distribution channels in many EM jurisdictions are highly concentrated, particularly in the mutual fund industry. According to the survey results, commercial banks typically dominate mutual fund distribution. High concentration leads to higher bargaining power for certain distribution channels, which makes it very difficult to negotiate lower fees for institutional investors. Regulators should implement policy incentives with an aim to encourage more participation in the distribution channels. Diversified channels that include commercial banks, securities firms, independent financial advisers, insurance companies and direct sales could bring in healthy competition. This will translate into higher service standards and lower fees for institutional investors.

- **Establish best practice standards for product distribution.** Due to a lack of product knowledge and the misalignment of financial incentives, distribution channels might promote products that offer high sales commissions without fully disclosing the risks involved or fully considering the suitability issues. Regulators should introduce detailed rulings on the activities of distribution channels and encourage self-regulatory organizations to establish best practice standards on product suitability, disclosure requirements, marketing and advertising standards and distribution fee structures.

- **Promote investor education and guidance.** The relationship between institutional investors and its customers are fragile if the customers do not understand the services provided and the risks involved. It is important for investors to be educated, informed and aware of the risks. Therefore, regulators and SROs should provide help and resources to investors who are interested in improving their financial literacy. Tax and other incentives could also help guide investors in changing their behavior. For example, investment horizon could be lengthened if tax deductions or deferrals are provided for long term capital gains or dividend reinvestment. Meanwhile, lower or zero service fees could also be applied to transactions with longer holding periods.

- **Improve transparency**. Beyond standard disclosure requirements, regulators should develop ways to encourage investors to make rational decisions. For example, standardized product categorization and performance measure, along with fair and consistent quality evaluation practices could improve transparency and help financial advisors and investors in selecting the right financial products and services.

4.4 Market Openness and Accessibility

- **Level the playing field for foreign institutional investors.** Even though EM assets are being recognized as a standard class for portfolio diversification, EMs continued to be largely under-weighted in well-accepted benchmarks. China and Brazil account for only 2.39% and 2.05% of the MSCI world index, respectively. EMs will be more attractive when there is a level playing field for foreign investors. Equal economic and voting rights and investor protection are still top concerns for foreign investors in the EMs. Quota systems, differences in ownership policies, investment restrictions on certain domestic industries and restriction on fund repatriation including the imposition of capital controls should be gradually removed. EMs jurisdictions should simplify the qualification requirements and speed up the approval procedures for foreign institutional to access the domestic markets.

- **Develop the road map for a stable transition to an open market.** In order to encourage the greater presence and participation of foreign institutional investors, regulators need to be mindful of the openness of the market. Policy makers should adopt a pragmatic and sequenced approach to guard against destabilization of the financial system, with adequate safeguards at both the market and regulatory level. The immense diversity of regimes in different jurisdictions suggests that regulations and policies need to be individually tailored, taking into consideration the particular political, economic, social, market and overall regulatory context of a given jurisdiction. In determining the type of policies to adopt, policy makers and regulators will first need to review the intended objectives, assess the impact of foreign institutional investors in their markets. Where appropriate, they should address impediments or structural issues to improve conditions for this group of investors. It would also be helpful to engage foreign institutional investors to better understand their practices and needs.

- **Encourage domestic investors to invest aboard.** Investing overseas will offer domestic investors the benefits of diversification. Due to home bias and lack of familiarity with overseas markets, domestic investors are reluctant to invest overseas. Investor education about asset allocation and diversification is needed to encourage investments abroad. Delegating investment mandates to overseas managers or investment advisors will help to ease the lack of confidence in the local asset manager's ability to invest overseas.

4.5 Human Capital and Professional Integrity

- **Promote human capital and design proper incentive structures.** A professional institutional manager requires skills, knowledge and ethics which are developed through education, training and experience. As EM jurisdictions develop their institutional investor base, the need for human capital will grow. Regulators and self-regulatory organizations need to have policies in place to develop and train local talents, as well as attracting talents from other industries and overseas. Incentive structures need to be designed and implemented to ensure that the interests of institutional managers and the investors are properly aligned.

- **Maintain high standard of professional integrity.** Regulators should be effective in their supervision of business conduct and ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed pursuant to IOSCO Principles. Likewise, regulators should have sound licensing and renewal procedures for authorizing of the staff working in the financial sector, in order to keep track of compliance records, professional knowledge and experience.

4.6 Regulatory Framework and Financial Stability

- **Prevent market abuse by building sound surveillance capacity**. Market abuse undermines market integrity and investor confidence. As envisaged by IOSCO Principles 10 and 36, regulators should have comprehensive inspection, investigation and surveillance powers designed to detect and deter manipulation and other unfair trading practices.

- **Review the regulatory framework and coverage constantly.** EM regulators should have or contribute to a regular reviewing process to ensure its current regulatory framework adequately addresses the issues related to investor protection, market transparency and the reduction of systemic risk. Consistent with the new IOSCO Principle 7, securities regulators should also periodically review the regulatory coverage of financing activities to ensure that none are escaping appropriate regulation. Examples might include: the rapid growth of new and unregulated financing activities; the rapid growth of financing activities that have previously been lightly regulated, or exempted from supervision; banks' extended business activities in the securities markets; and the transfer of activities from the banking or insurance sectors to unregulated entities or to entities within the securities sector, as prudential regulatory requirements increase.

- ◆ **Balance development with attention on financial stability and systemic risk.** While developing institutional investors, regulators should be mindful of the systemic risk they may pose. Promoting financial stability and reduction of systemic risk should be the shared responsibility of the regulatory community and the relevant national/international organizations. Securities regulators, prudential regulators and central banks all have an important role to play and each come equipped with different tools. The global and interconnected nature of modern financial markets makes it very important that regulators, along with IOSCO, play a key role in addressing systemic risk and financial stability issues. Regulators should seek to develop key risk measurements relevant to systemic risks arising within securities markets, and improve their understanding and application of tangible steps to mitigate such risks. It is important to develop risk indicators through the use of qualitative and quantitative data.

  As a consequence of its review of the recent financial crisis, IOSCO has added to its existing Principles in 2010 a new principle on systemic risk; IOSCO Principle 6 prescribes that "The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate". Under the new principle, the Regulator should have, or contribute to, regulatory processes to monitor, mitigate and appropriately manage such risks. Regulators should have particular regard to investor protection, market integrity, transparency and the proper rules for business conduct within markets as contributing factors to reducing systemic risk. The tools securities regulators could consider using to reduce the probability and impact of systemic risk include measures to increase transparency, business conduct rules, organizational, prudential and governance requirements and emergency powers. In particular, strong investor protection standards, vigorous enforcement, the transparency offered by extensive disclosure requirements, robust resolution regimes and other factors are all important elements of how the regulator can mitigate and manage risks against a gradual erosion of market trust.

  In some cases, regulators will have to collaborate with other regulators and raise risk awareness. The aim of these measures is to promote conditions under which market participants are better able and incentivized to manage and appropriately price risk. To better address questions of systemic risk and the role that securities regulators play in promoting financial stability, the IOSCO Technical Committee published a report in 2011. The report provides guidance for all regulators on the tools that can be used to identify, monitor, mitigate and manage systemic risk[42].

[42] IOSCO Technical Committee, "Mitigating Systemic Risk - A Role for Securities Regulators", February 2011. Available at IOSCO: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf

Appendix A - List of Project Team Members

Pen-holders

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Zhong Li
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Securities Commission, Malaysia
Su Ee Juen
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Ahmed El Attari
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Khalida Habib
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Financial Services Board, South Africa
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Nobambo Mlandu

Financial Supervisory Commission, Chinese Taipei
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Other Project Team members

Ecuador	**Superintendencia de Compañías**
Panama	**Superintendencia del Mercado de Valores**

IOSCO EMC Team
Isabel Pastor
Alp Eroglu
Youngki Kim

Appendix B - List of Survey Respondents

List of Survey Respondents

Argentina	Comisión Nacional de Valores
Bangladesh	Securities and Exchange Commission
Brazil	Comissão de Valores Mobiliários
Chile	Superintendencia de Valores y Seguros
China	China Securities Regulatory Commission
Colombia	Superintendencia Financiera de Colombia
Croatia	Financial Servcies Supervisory Agency
Czech Republic	Czech National Bank
Ecuador	Superintendencia de Conpanias
Hungary	Financial Supervisory Authority
Korea	Financial Supervisory Services
Macedonia	Securities and Exchange Commission
Malaysia	Securities Commission
Morocco	Conseil Deontologique des Valeurs Mobilieres
Nigeria	Securities and Exchange Commission
Pakistan	Securities and Exchange Commission
Panama	National Securities Commission
Poland	Polish Financial Supervision Authority
Romania	Romanian National Securities Commission
Serbia	Securities Commission
Slovenia	Securities Market Agency
South Africa	Financial Services Board
Chinese Taipei	Financial Supervisory Commission
Turkey	Capital Markets Board
UAE	Emirates Securities & Commodities Authority

Appendix C - Macroeconomic and Capital Market Environment

When looking at the development of institutional investors in an EM jurisdiction, it is important to shed light on the macroeconomic and capital market environment of that jurisdiction. The macroeconomic and capital market environment will affect the landscape and growth potential of a jurisdiction's domestic institutional investors, and also attract or repel foreign institutional investors.

Macroeconomic growth, per capita income and savings, interest rate and inflation all have an impact on the development of institutional investors. Similarly, the size, depth, product range, performance, investor structure and trading mechanisms of the capital market also facilitate or hinder the growth of institutional investors.

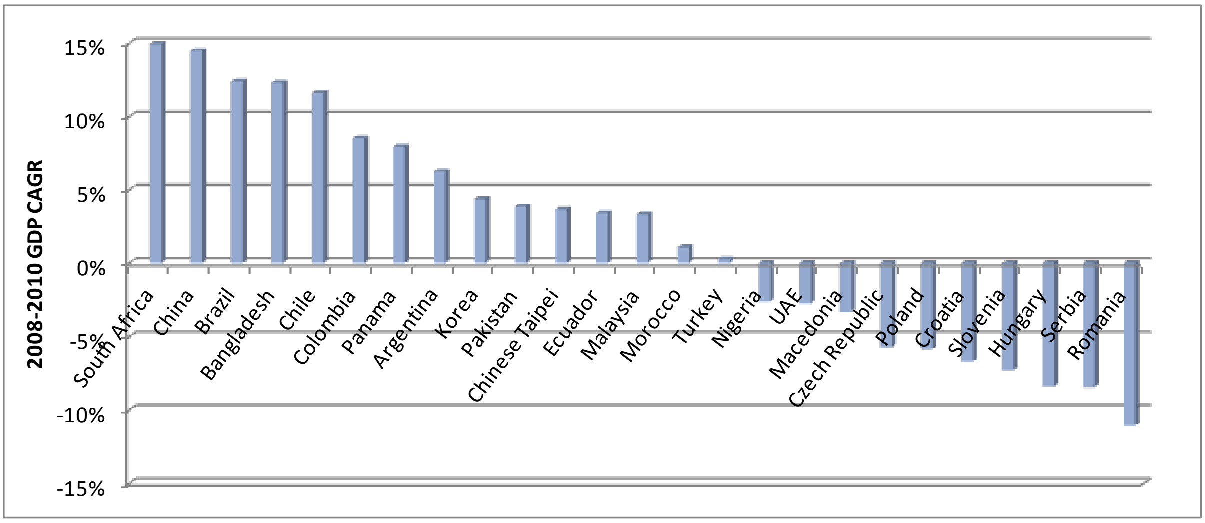
This chapter will discuss and analyze some of these factors. It is important to keep these factors in mind when looking at the current state of development of institutional investors in the EMs.

1 Macroeconomic Environment

1.1 Polarized Gross Domestic Product Growth

GDP is an indicator of the size and growth trend of the economy. Jurisdictions with sizable domestic economies and high GDP growth rates are better positioned to develop institutional investors.

Chart C.1: 2008-2010 GDP Compound Average Growth Rate[43]



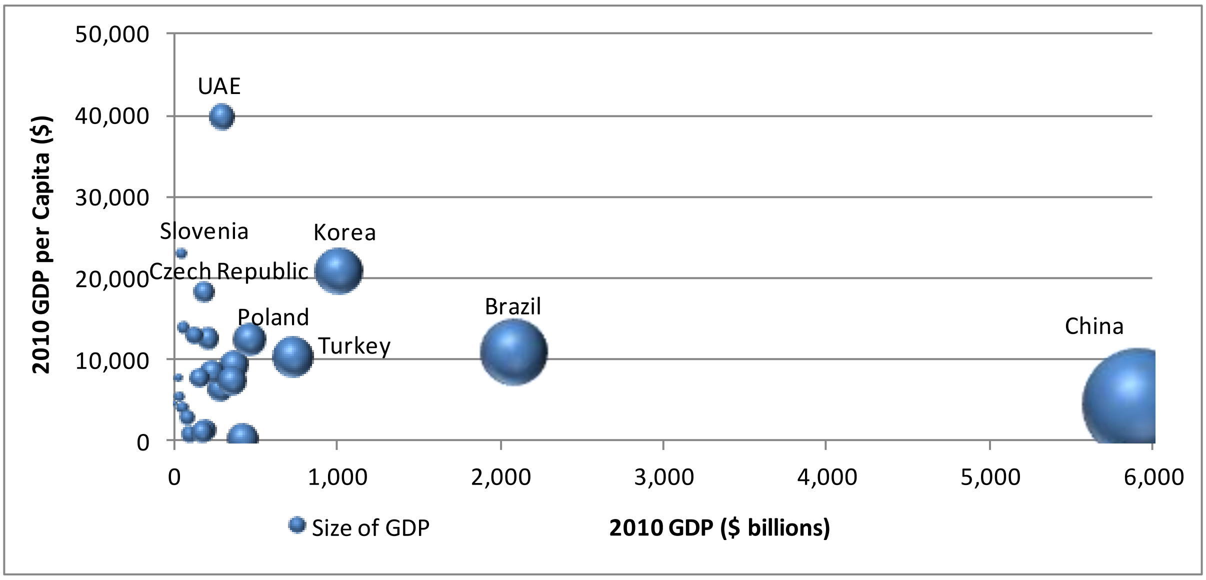
Source: World Bank, IOSCO Survey data.

The total GDP of the Group was over $13 trillion in 2010, representing close to 22% of the global economy. From 2008 to 2010, the aggregate GDP for the Group increased by an average of 8.3% annually, compared to 1.5% for the World and negative 1.2% for high income OECD countries. The strong growth was led by South Africa, China, Brazil and Bangladesh, which grew at an annual rate of 14.9%, 14.5%, 12.4% and 12.3% respectively.

43 This data shows the average growth rates between 2008-2010. However, some jurisdiction's economic environment had improved since 2010. For example, Turkey's growth rate is 9% in 2010 and 8.5% in 2011.

On the other hand, many jurisdictions experienced significant economic contraction after the financial crisis.

Chart C.2: GDP & GDP per Capita



Source: World Bank, IOSCO Survey and IMF.

1.2 Broad Range of GDP per Capita

GDP per capita is an indicator of economic development and income level, and it supplements GDP data. Its relevance to institutional investors' development rests on the assumption that, all else being equal, an individual will demand more financial services as income level goes up.

In 2010, the average GDP per capita[44] for the Group was $10,151, higher than the World average of $9,228, but significantly lower than that of high income OECD countries' average of $39,521. The GDP per capita for the Group varies substantially, with 5 jurisdictions well above $15,000 and 7 jurisdictions below $5,000. Like GDP, from 2008 to 2010, GDP per capita for the Group grew by 7.4% annually, significantly greater than the world's average growth of 0.3% and high income OECD countries' -1.7%.

2 Savings

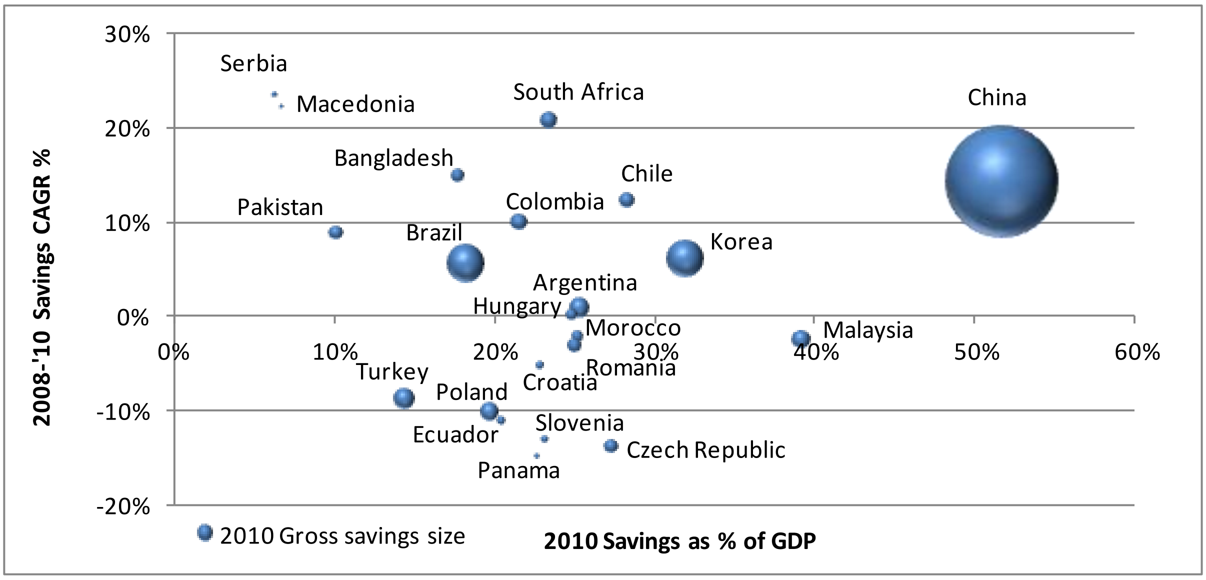
GDP per capita is only an income indicator. For institutional investors, the remaining amount for savings and investment after deducting basic and discretionary consumption is of greater importance.

2.1 Gross Savings in Most EMs is Limited in Scale

[44] Data from World Bank, IMF and IOSCO survey data. GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars.

Gross savings is GDP less total consumption expenditure. Average gross savings for the Group was $207 billion in 2010, highly skewed by China's gross savings of $3,137 billion. Taking China out of the equation, the average slips to $68 billion. This is a lot smaller compared to developed countries such as the US and UK, which have $1,592 billion and $263 billion gross savings respectively.

Chart C.3: Gross Savings



Note: Gross savings are calculated as gross national income less total consumption, plus net transfers. Data are in current U.S. dollars.
Source: World Bank, IOSCO survey data.

2.2 Healthy Gross Savings Rate

Gross savings to GDP ratio shows the amount of GDP that is being saved for late consumption. The Group's average savings to GDP ratio was 24%, higher than 20% for the World, and 17% for high income OECD countries. Jurisdictions with the highest savings ratios were China with 52%, Malaysia with 39% and UAE with 34%. On the other hand, some jurisdictions registered single digit ratios of gross savings to GDP.

3 Interest Rates and Inflation

The prevalent interest rates in any jurisdiction significantly affect institutional investors since interest rates impact the balance between consuming today versus consuming later.

3.1 Deposit Interest Rates Were Cut Dramatically

The prevalent deposit interest rate affects the decision to deposit savings in a bank as opposed to investing in high risk assets. A lower deposit interest rate would encourage consumers to invest in other instruments to obtain higher returns while a higher rate on deposits would discourage investment and spending.

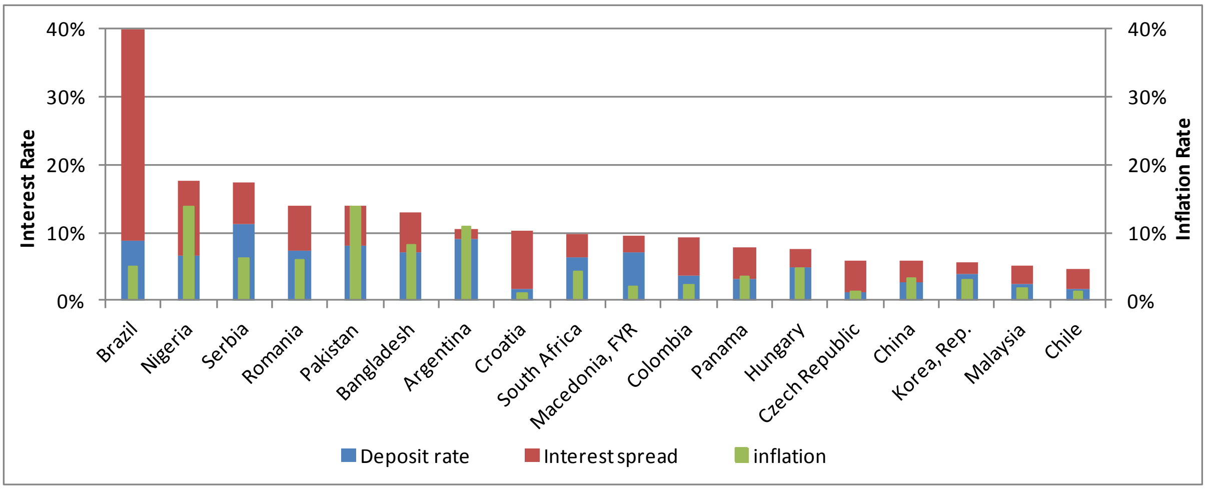
In order to combat the economic slowdown brought by the global financial crisis, central banks in EMs lowered interest rates across the board. From 2008 to 2010, the Group's average deposit interest rate decreased from 7.4% to 5.4%, with Turkey's decrease of 7.6%

being the largest in the Group. Only China, Macedonia, Pakistan and Serbia increased deposit rates during the period.

3.2 Lending Rates Decreased but Interest Rate Spread Changes Varied

From 2008 to 2010, the Group's average lending rate decreased from 13.6% to 11.3%, Argentina experienced the largest drop, where its rate decreased by 8.9%. In the meantime, the average spread between lending rate and deposit rate only decreased by 0.3%. However, individual change in spread varied within the group. For example, Argentina's spread shrank by 7.0%, while Nigeria's spread increased by 7.6%.

Chart C.4: Deposit and Lending Rates relative to Inflation



Source: World Bank and IOSCO survey data.

3.3 Inflation

The inflation rate affects consumers' purchasing power and impacts the way consumers manage their finances. Together with deposit rates, inflation will influence what proportion of financial resources will be used now versus later. Furthermore, inflation also affects asset allocation, hence impacting the flow of assets in/out of deposit, equity, debt, commodities, real estate, etc.

The average inflation rate for the Group in 2010 is 5.0%, with Pakistan and Nigeria having the highest rates of inflation at 13.9% and 13.7% respectively, whereas Morocco had an inflation rate of less than 1%. It is also important to look at the change in inflation, as it has a more significant effect on portfolio performance. Institutional investors are more likely to invest where there is a decelerating trend in inflation. Almost all the jurisdictions surveyed experienced a decreasing trend for inflation between 2008 and 2010. Only Argentina and Nigeria registered an increase in the rate of inflation throughout this period. The decreasing trend of inflation is usually followed by lower deposit and lending rates, which is an especially attractive situation for institutional investors.

4 Capital Markets

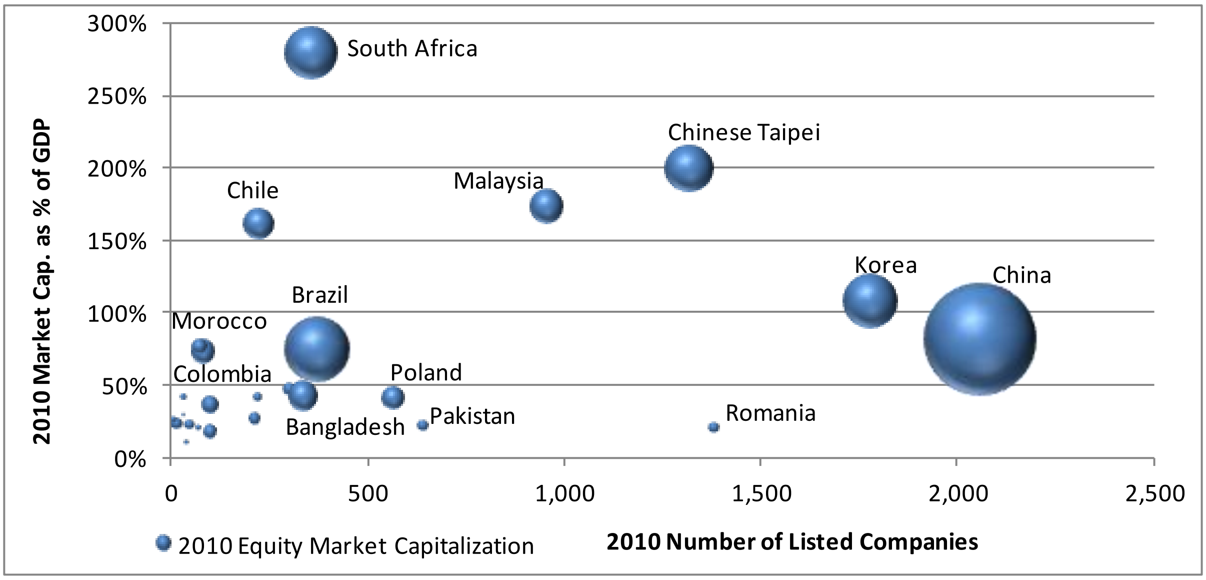
4.1 Capital Markets Size and Market Share Increased

The Group's total market capitalization is $11.3 trillion, compared to the $38.1 trillion market size for high income OECD countries and $56.1 trillion overall global market. Many EM jurisdictions' capital markets experienced a strong rebound from 2008 to 2010. As a result, the Group's total market capitalization as a percentage of the World total increased from 16.6% to 20.0% during that period.

4.2 Market Still Under-Developed

Market capitalization divided by GDP is an indicator for how well the equities market is developed. The market capitalization to GDP ratio for the Group is 82%, lower than the World average of 90% and the high income OECD countries level of 92%. The group's ratio had a wide range. South Africa was the highest with 278%, while Ecuador had the lowest with 9%.

Chart C.5: Market Capitalization



Source: IOSCO survey data and World Bank.

4.3 Flat Growth in Number of Listed Companies

The number of listed companies is another indicator of the level of market development. A large number of listed companies indicates broad investment options. The Group had a total of 11,363 publicly traded companies, significantly lower than that of the high income OECD countries, which had a total of over 25,000 listed companies. Within the Group, China, Chinese Taipei, Korea and Romania all had over a 1000 listed companies while Colombia, Czech Republic, Ecuador, Hungary, Macedonia, Morocco, Panama, Serbia and Slovenia had fewer than 100 listed companies. There has not been a dramatic change in the number of listed companies of any jurisdiction during the 2008-2010 period.

Initial Public Offerings (IPOs) is another indicator for the growth of the market in terms of new investment targets. IPOs signal the strength of the market and provide institutional investors with new opportunities and investment options. Overall, very few IPOs took place throughout 2008-2010. Most jurisdictions raised little capital through IPOs. The only exception is China, which raised $117.7 billion during the period.

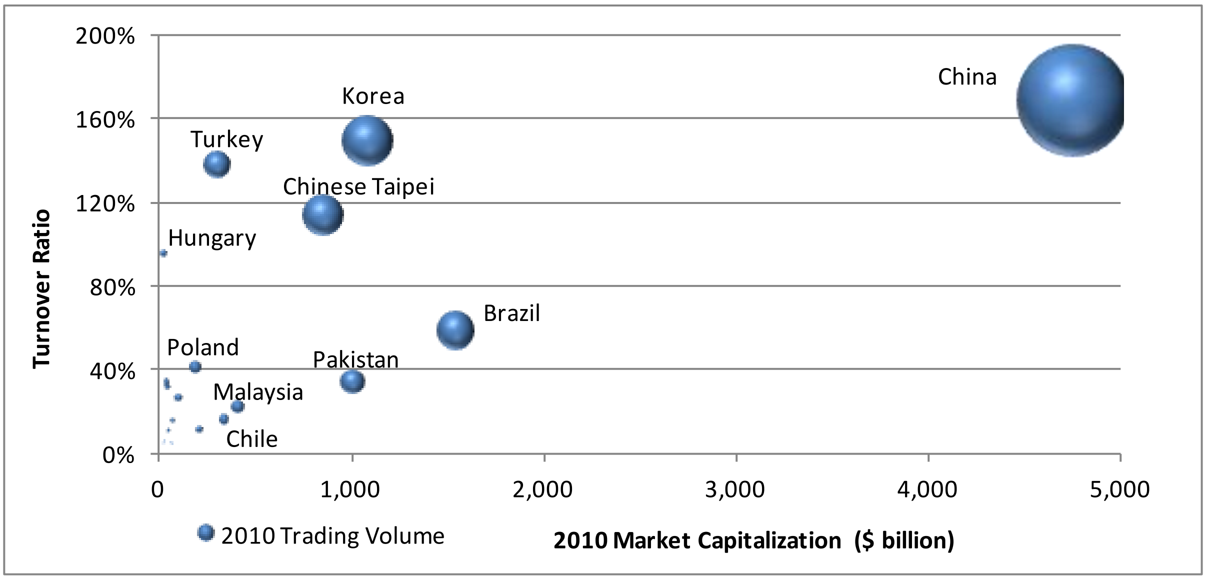
4.4 Smaller Markets are Lacking Market Depth

It is also important to look at the trading volume of the capital markets to have a better sense of the depth and activeness of the market. This is particularly important for institutional investors, who prefer liquid and active markets.

The total stock trading volume for the Group in 2010 was $12.7 trillion, about a quarter of the amount traded by high income OECD countries. However, trading volume varied greatly within the group. China witnessed the highest trading volume while Macedonia had the lowest. Market turnover is a key indicator of liquidity since it provides the value of shares traded against the total market capitalization. While the Group's market turnover of 112% is comparable to high income OECD countries' 135%, the simple average for market turnover of the jurisdictions in the Group was only 41% in 2010. This is mainly due to the smaller markets in the Group, which were characterized by low market turnover. The situation was better in 2008 when the simple average for market turnover of the Group was 89%. Market liquidity has gradually decreased since then.

As Chart C.6 shows, low turnover is common for smaller stock markets. Low turnover is especially problematic for institutional investors since market depth and liquidity are important factors for them. Foreign investors who are already hesitant to enter these markets may decide not to because of the liquidity concern.

Chart C.6: Stock Trading Volume and Turnover

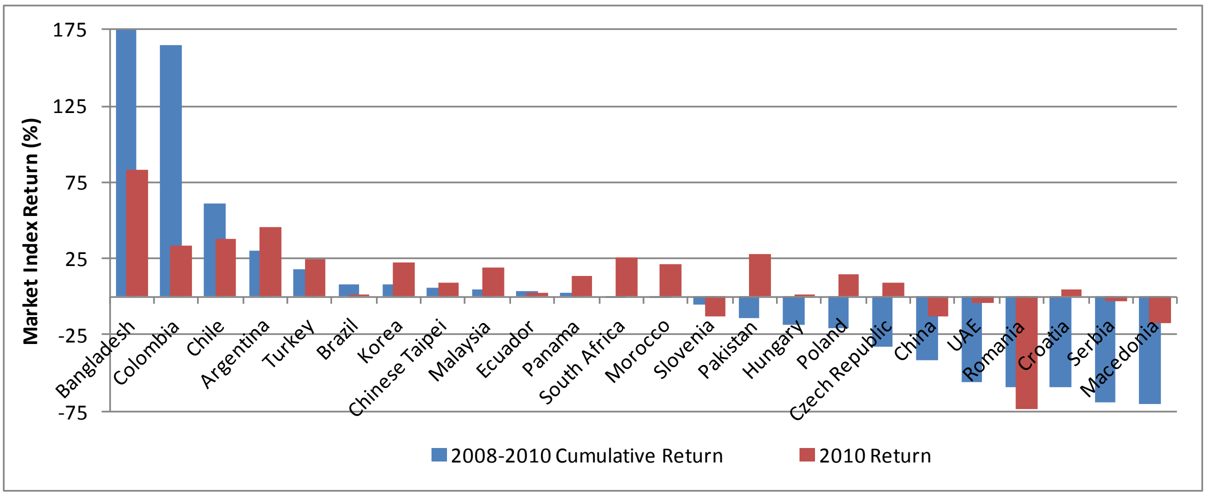


Source: IOSCO survey data and World Bank.

4.5 Market Performance

Market performance measured by the returns of stock market indices is relevant for the development of institutional investors since good performance will not only increase asset valuations due to the appreciation of the underlying holdings, but also attract more capital flows. Furthermore, strong market returns boost investor confidence, provide a positive outlook for the economy and a healthy investment environment. All of which are essential for building a sound institutional investor base. The stock market performance has been mixed among the respondents; Chart C.7 shows the main stock market index return for the jurisdictions.

Chart C.7: Main Stock Market Index Return



Source: IOSCO survey data.

In 2008 most of the Group's market indices dropped. The average return for the jurisdictions was -36%. The markets bounced back significantly in 2009 with an average return of 43%, and it grew steadily at 11% in 2010. Again each jurisdiction's experience was different. Bangladesh and Colombia's stock market indices experienced cumulative returns of over 100% from 2008 to 2010, while Croatia, Macedonia, Romania, Serbia, and the UAE all lost over half of the value of their indices during the same period.

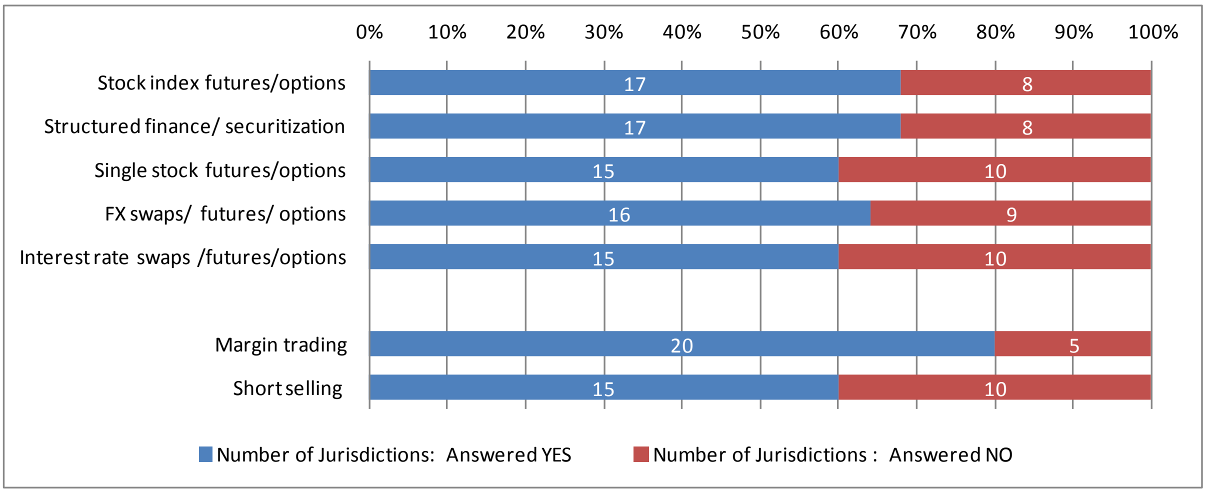
5 Availability of Trading Avenues and Derivative Products

Various trading avenues such as short selling, margin trading and different types of derivative products bring depth and liquidity to the market, providing institutional investors with more diverse and complex investment strategies. Based on the responses, all but 6 jurisdictions namely Brazil, Chinese Taipei, Colombia, Korea, Malaysia and South Africa have room for more instruments and trading avenues. About one third of the jurisdictions have 3 or less of the 7 trading and hedging methods available.

As illustrated by Chart C.8, margin trading is available in 80% of the jurisdictions, while short selling is available in 60%. For derivative products and hedging instruments, stock index futures/options and structured finance/securitization are the most ubiquitous, followed closely by single stock futures/options, FX swaps/futures/options and interest rate swaps/futures/options.

However, it is important to note that while these products may be available in the EM jurisdictions, they may not be commonly used. Lack of depth and liquidity may make them ineffective options for institutional investors.

Chart C.8: Availability of Trading Avenues and Derivative Products



Source: IOSCO survey data.

Appendix D - Cross Border Activities of Institutional Investors

Institutional investors are growing in size and number to become major players in the global markets. As they expand in significance and influence, institutional investors show a growing tendency to reach beyond their local markets to invest internationally.

Institutional investors from developed markets also invest in the EMs for the purpose of diversification, growth and better returns. For the EMs, foreign capital bridges the gap between domestic savings and investment, facilitating economic growth. Other benefits range from indirect productivity gains and diversified investor profiles to increased competition in the local market.

This section will explore the regulatory policies, development status and jurisdictional experiences and feedback related to these cross-border activities of institutional investors.

1 Foreign Institutional Investors Entering EM Jurisdictions

1.1 Regulation of Foreign Institutional Investors

Based on the survey responses, 24 out of 25 jurisdictions permitted foreign institutional investors access to their domestic securities markets[45]. This may indicate that EMs are liberalizing and opening their markets to foreign investors. Of the 24 jurisdictions that permitted access to foreign institutional investors, Brazil, China, Czech Republic, Ecuador and Serbia require advanced approval for entry. China and UAE also reported that they imposed restrictions on the size of the investments.

It is further observed that 6 out of the 24 jurisdictions place restrictions on product accessibility, a large majority of them from the Asia Pacific region. For example, in China, Qualified Financial Institutional Investors (QFIIs) are only allowed to invest in equities, bonds, securities investment funds, listed warrants and other financial instruments approved by CSRC. In Chinese Taipei, foreign institutional investors are only allowed to invest in offshore beneficial interest certificates, domestic securities, overseas corporate bonds, overseas depositary receipts, or overseas equities. Offshore foreign investors in money market instruments have an investment cap of 30%. Further, foreign investors may have a percentage limit on equity holdings in certain industries. In Korea, there are limitations on acquisitions of equity of certain public interest corporations.

Less than 20% of the jurisdictions have restrictions in place for the repatriation of funds. For example in Chile, capital repatriation can only be carried out after 5 years in the case of Foreign Capital Funds and 3 years in the case of Risk Capital Funds from the date of entry[46]. In China, the lock-up period for investment principal is 3 months for pension funds, insurance funds, mutual funds, charity funds, endowment funds, government and monetary authorities and Open-Ended China Funds launched by QFIIs, while for others it is one year.

45 Bangladesh did not respond to this question.

46 More specifically, this restriction for the repatriation of funds works only for those foreign investors who have entered the Chilean market using the special tax benefits established by law only for Foreign Capital Funds and Risk Capital Funds. Notwithstanding the above, the foreign investor can choose whether to use or not this special investment vehicle to invest in Chile, or to prefer direct investment without special restrictions. The remainder of foreign institutional or non-institutional investors in Chile do not have such restrictions.

Some of the jurisdictions surveyed have additional prudential regulations that hinder foreign institutional investors. For example, in one jurisdiction, foreign investors are required to designate a custodian bank and an agent, apply to the exchange for registration and open a currency account in the jurisdiction's currency. In another jurisdiction, foreign institutional investors are required to comply with foreign exchange administrative requirements set by the Central Bank.

1.2 Development Status of Foreign Institutional Investors

Only a few jurisdictions were able to confirm the amount of investments by foreign institutional investors. Brazil had the highest amount of foreign investments, at $389 billion. Table D.1 displays the data on total investment by foreign institutional investors.

Foreign institutional investors' investments in the secondary market are generally short term as it is relatively easy to enter and exit the market. Foreign direct investment (FDI) indicates a long term commitment in terms of equity investment in a particular company. For the jurisdictions that provided this survey data, half have more FDI than foreign institutional investments. Notwithstanding, FDI is the preferred investment for recipient economies.

The figures for China indicate substantial amount of FDI compared to the amount of secondary market investment by foreign institutional investors, as the jurisdiction has introduced measures to create an open market to attract FDI. The Chinese government had released Foreign Direct Investment Industry Guidelines to open more sectors to FDI and increase foreign investment into the country. The sectors include energy-saving and environment-friendly technologies, new-generation information technology and biotechnology.

Table D.1: Foreign Institutional Investor Investment versus FDI

Jurisdiction 2010 (USD Million)	**Total Foreign Institutional Investor Investment**	**Market capitalization**	**As % of Market capitalization**	**FDI[47]**
Korea	335,017	1,089,217	31%	-150
Malaysia	127,313	410,534	31%	9,509
Morocco	20,181	69,153	29%	1,241
Brazil	388,539	1,545,566	25%	48,438
Chinese Taipei	266,566	854,698	31%	N/A
Colombia	7,805	208,502	4%	6,765
China	44,866	4,762,837	1%	185,081
Turkey	13,661	306,662	4%	9,278
Ecuador	19	5,263	0%	167

Source: IOSCO survey data, World Bank.

By comparing the total investment by foreign institutional investors with the corresponding domestic market capitalization, Table D.1 shows that foreign institutional investors have

[47] Data source: World Bank. Foreign direct investment is the net inflow of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors. Data are in current U.S. dollars.

between 20% and 30% of the market capitalization in jurisdictions such as Brazil, Korea, Chinese Taipei, Morocco and Malaysia, a fairly strong presence. The remaining jurisdictions have a much smaller presence of foreign institutional investors.

1.3 Perceived Impact of Foreign Institutional Investors

The survey found that most of the jurisdictions believed foreign institutional investors had a positive impact on domestic market liquidity, corporate governance and investment philosophies. Foreign institutional investors, in complying with their own investment criteria, demand higher standards of corporate governance in listed companies. The positive impact on corporate governance was mentioned the most among the different areas that were studied. A smaller number of jurisdictions reported that there was a positive impact on financial innovation and the structure of domestic market investors. It is also interesting to note that very few jurisdictions believed that foreign institutional investors had any negative impact. The relevant statistics are listed in Table D.2.

Table D.2: Foreign Institutional Investors' Impact

Impact Areas	Positive*	Neutral*	Negative*	NA*	% Positive
Corporate governance of listed companies	15	5	0	5	**75%**
Domestic market liquidity	15	5	1	4	**71%**
Investment philosophies	13	6	1	5	**65%**
Financial innovations	9	11	0	5	**45%**
Structure of domestic market investors	5	15	0	5	**25%**

** Number of jurisdictions that perceived the impact of foreign institutional investors to be positive, neutral, negative, NA for each area.*
Source: IOSCO survey data.

2 EM Institutional Investors Investing Abroad

2.1 Regulation of Domestic Institutional Investors Investing Offshore

Most jurisdictions allow domestic institutional investors to invest offshore, with some boundaries prescribed. Based on the Table D.3, 7 out of the 25 jurisdictions, including China, Argentina, Chile, Nigeria, Pakistan, Poland and Chinese Taipei responded that institutional investors are required to seek relevant approvals prior to investing offshore. Furthermore, in 12 jurisdictions including Brazil, Korea, Malaysia and Pakistan, there are limits on the size of offshore investments domestic institutional investors could make. For example, Pakistan's Central Bank permits locally established mutual funds to invest up to 30% of its aggregate fund assets offshore, with a notional ceiling of USD 15 million.

Another way to invest offshore is through direct distribution of offshore funds domestically. Out of the 25 jurisdictions, 14 allow distribution of offshore funds.

Table D.3: Regulation of Offshore Investments

Parameters	Yes	No	NA
Permitted to invest in overseas securities markets	21	1	3

Need approval to invest in overseas market	7	15	3
Restrictions on the size of offshore investments	12	8	5
Distribution of offshore funds permitted	14	9	2

Source: IOSCO survey data.

2.2 Development of Domestic Institutional Investors Investing Offshore

For a balanced assessment of market accessibility, Table D.4 sets out the total offshore investments by domestic institutional investors.

Table D.4: Offshore Investments

Jurisdiction 2010 (million USD)	**Total Offshore Investment by Domestic Institutional Investors**	**Market Capitalization**	**Offshore Investment as % of market Capitalization**	**Total Foreign Institutional Investor Investment (% of market capitalization)**
South Africa	123,000	1,012,538	12.1%	NA
Korea	80,180	1,089,217	7.4%	31%
Colombia	7,114	208,502	3.4%	4%
Poland	6,199	190,235	3.3%	NA
Malaysia	6,659	410,534	1.6%	31%
China	24,878	4,762,837	0.5%	1%
Brazil	2,611	1,545,566	0.2%	25%

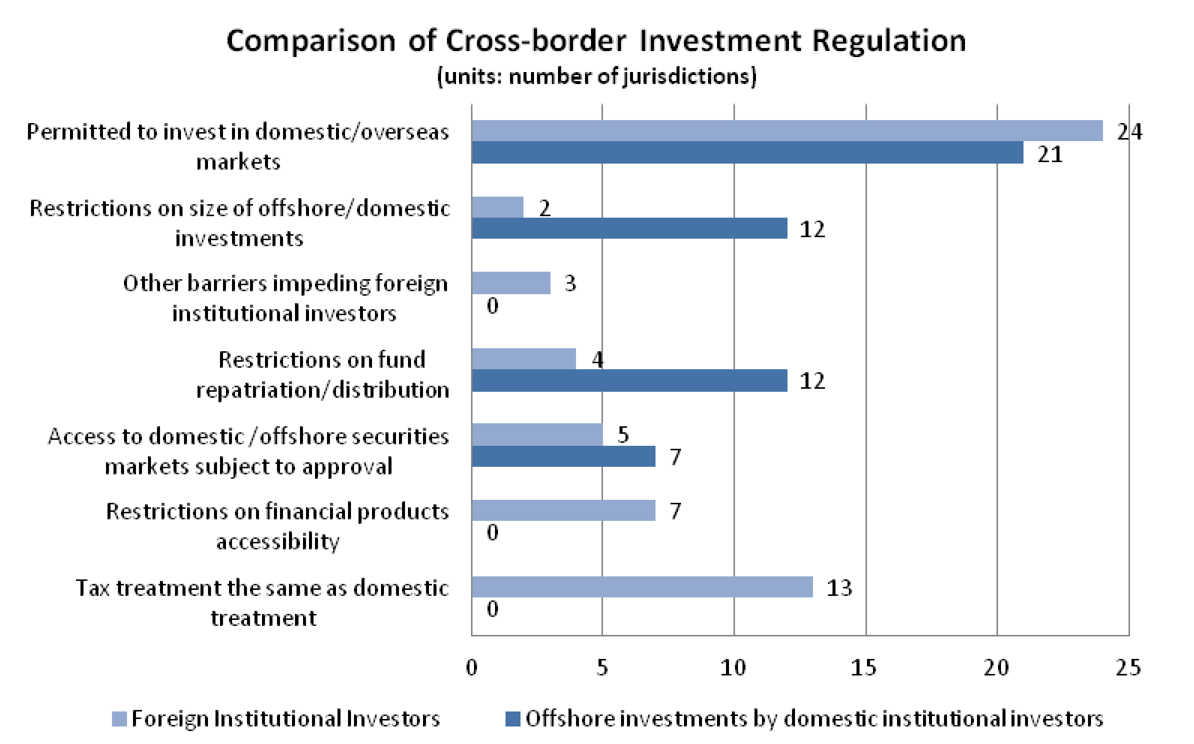
Source: IOSCO survey data, World Bank.

In almost all jurisdictions, the survey reveals that the percentage of foreign institutional investment in the domestic market is larger than offshore investments by domestic institutional investors. It is believed that in order to minimize the outflow of funds, more restrictions might be placed on domestic institutional investors. Foreign institutional investors, primarily from developed markets, have more assets to allocate to offshore investments compared to those of EMs. Also, foreign institutional investors started to invest into EMs earlier than EM institutional investors started to invest abroad, providing foreign institutional investors with more opportunity to acquire local investment knowledge. In EM jurisdictions, the lack of professional investment managers who are familiar with the offshore markets and home based bias may also contribute to the lack of offshore investment. Other factors such as risk appetite, investment strategies of domestic institutional investors as well as the availability of information and costs of foreign investment products may also influence the willingness to invest abroad.

3 Comparison of Cross-border Investment Regulations

A comparison of the treatment of foreign and domestic offshore institutional investors is highlighted in Chart D.1.

Chart D.1: Regulation Comparison



The barriers against foreign institutional investors investing onshore are less restrictive than those of domestic institutional investors wishing to invest offshore. In comparison, 23 jurisdictions permit foreign institutional investors to invest in the domestic market, while 20 jurisdictions permit domestic institutional investors to invest in the overseas market. When answering the market accessibility question, 4 out of 22 jurisdictions require approval for foreign investors to access the domestic market while 7 out of 21 jurisdictions require approval for domestic institutional investors to invest overseas.

There is however an unequal treatment of foreign and domestic institutional investors. The most prevalent difference highlighted in the survey is tax treatment, 7 out of 20 jurisdictions reported that there were different tax treatments for foreign and domestic institutional investors. Restrictions on foreign institutional investors accessing financial products were reported by 7 out of 23 jurisdictions; 4 jurisdictions reported having restrictions put in place on fund repatriation, ranging from the lock-up period to restrictions on foreign exchange remittance for investment capital and earnings. Finally 12 out of 20 jurisdictions reported restrictions on the size of investment by domestic institutional investors.

Appendix E - Survey Questionnaire

QUESTIONNAIRE

ON THE DEVELOPMENT AND REGULATION OF INSTITUTIONAL INVESTORS IN EMERGING MARKETS

Institutional investors are playing an increasingly important role in financial markets around the globe. Highly specialized and having substantial capital, institutional investors could influence market psychology as well as corporate governance. Given the importance of institutional investors and the fact that many emerging markets suffer from the lack of an (or inadequate) institutional investor base, the WG5 believes that it would be beneficial to explore the key issues in the development and regulation of institutional investors in emerging markets, and a mandate on such a topic was commissioned by IOSCO EMC Plenary Meeting in April 2011.

The goal of our study is to provide an overview of institutional investors in the emerging markets and to provide guiding recommendations for the EMC jurisdictions that are contemplating regulatory policies to develop the institutional investor base. We will collect data on the landscape of the institutional investors, identify the key regulatory policies and best practices to promote the growth of the major institutional investors and offer an opportunity for each participant to share their experience and lessons in regulating the institutional investors. We hope to develop a tool-kit of actionable items that could be used by regulators to facilitate the sustainable growth of institutional investors in their markets.

For purposes of this survey, the frequently used terms and abbreviations are described as following:

Institutional Investors--organizations that trade large volumes of securities. Some examples are mutual funds, banks, insurance companies, pension funds, endowment funds and sovereign wealth funds.

Retail investors--persons who do not fall within the definition of institutional or professional investor (individuals or entities that meet certain net wealth or asset levels) are generally treated as a retail investor.

Mutual funds--publicly offered collective investment schemes that are managed by regulated fund management companies.

Securities companies--financial intermediaries that have been authorized by the regulator to engage in securities businesses, such as brokerage, corporate finance advisory, asset management, proprietary trading and private equity investment, etc.

Pensions funds--funds established by the government or employers to facilitate and manage the investment of employees' retirement funds contributed by the employer and employees.

Hedge funds--investment schemes displaying a combination of the following characteristics: using high levels of leverage; significant performance fee; permitting periodical (e.g. quarterly, semi-annually, annually) redemption of interests by investors; offered only to accredited investors; using derivatives for speculative purposes; and more diverse risks and underlying products are involved.

Private equity funds--collective investment schemes used for investing in equity securities in operating companies that are not publicly traded on a stock exchange. Private equity funds often take the form of limited partnership controlled by a private equity firm that acts as the general partner and that gets specific dollar commitments from qualified institutional investors and individual accredited investors. *Endowments*--A financial asset donation made to a non-profit group or institution in the form of investment funds or other property that has a stated purpose at the bequest of the donor. Most endowments are designed to keep the principal amount intact while using the investment income from dividends for charitable efforts.

Sovereign wealth funds--Pools of money derived from a country's reserves, which are set aside for investment purposes. The funding for a sovereign wealth fund (SWF) comes from central bank reserves that accumulate as a result of budget and trade surpluses, and even from revenue generated from the exports of natural resources.

AUM--Assets Under Management.

ETF--Exchange Traded Funds.

IMPORTANT NOTE:

PLEASE NOTE THAT THE DEADLINE FOR RESPONDING TO THE QUESTIONNAIRE IS SEPT. 15, 2011

- WHILE RESPONDING TO THE QUESTIONS PLEASE PROVIDE VERY CLEAR ANSWERS. PLEASE AVOID PARTIAL AND UNCLEAR ANSWERS. IF YOU ARE NOT SURE OF YOUR ANSWER OR IF THE QUESTION DOES NOT APPLY, PLEASE ANSWER AS N/A (NON APPLICABLE).
- PLEASE ANSWER ONLY “YES”, “NO” or “N/A” TO YES/NO QUESTIONS.
- PLEASE DO NOT LEAVE BLANK OR GIVE PARTIAL STATISTICAL DATA. ONLY MENTION AS “N/A” IF YOU DO NOT HAVE ANY NUMERIC FIGURES FOR ANY PARTICULAR QUESTION or A PART OF A PARTICULAR QUESTION.
- FOR NARRATIVE QUESTIONS, PLEASE DO NOT LEAVE BLANK. IT WILL BE REGARDED AS N/A IN CASE YOU LEAVE SUCH QUESTIONS BLANK. PLEASE RESPOND AS N/A IN CASE YOU DO NOT HAVE ANY APPLICATION FOR NARRATIVE QUESTIONS.

THANK YOU FOR CONTRIBUTING TO THIS SURVEY. YOUR INPUT IS VERY IMPORTANT TO US.

Part I Current Status of Institutional Investors in Your Jurisdiction

1.1. Overview of Institutional Investors

Do the following types of institutional investors exist in your jurisdiction? If so, what is the market value of all publicly traded domestic stocks they held by the end of 2010 ?		
Mutual funds	Yes: ☐ No: ☐	million USD
Securities companies	Yes: ☐ No: ☐	million USD
Commercial banks	Yes: ☐ No: ☐	million USD
Insurance companies	Yes: ☐ No: ☐	million USD
Pension funds	Yes: ☐ No: ☐	million USD
Hedge funds	Yes: ☐ No: ☐	million USD
Private equity funds	Yes: ☐ No: ☐	million USD
Endowment funds	Yes: ☐ No: ☐	million USD
Sovereign wealth funds	Yes: ☐ No: ☐	million USD
Other institutional investors, if any, and the market value of their domestic stock holding		

1.2. Structure of Stock Market Investors

Type of investors	2010	2009	2008
Retail investors:			
Share of total market capitalization at year end (%)			
Share of annual stock trading volume (%)			
Institutional investors in total:			
Share of total market capitalization at year end (%)			
Share of annual stock trading volume (%)			
Domestic institutional investors:			
Share of total market capitalization at year end (%)			
Share of annual stock trading volume (%)			

Foreign institutional investors:			
Share of total market capitalization at year end (%)			
Share of annual stock trading volume (%)			

Part II Macroeconomic Environment and the Capital Markets

2.1. Macroeconomic Situation

Macroeconomic indicators	**2010**	**2009**	**2008**
GDP (million USD)			
Year-end household savings (million USD)			
One-year deposit rate (%)			

Note: For the purpose of comparability. please give the IMF or the World Bank figures of GDP.

2.2. Stock Market Profile

Stock market indicators	**2010**	**2009**	**2008**
Total market capitalization (million USD)			
Market capitalization of tradable shares (million USD)			
Annual stock trading volume (million USD)			
Annual return of the main index of the stock market (%)			
Number of publicly traded companies			
Money raised through IPOs (million USD)			
Do the following types of financial derivatives exist in your jurisdiction?			
Stock index futures/options	Yes: ☐ No: ☐		
Single stock futures/options	Yes: ☐ No: ☐		
Interest rate swaps/futures/options	Yes: ☐ No: ☐		
Foreign exchange swaps/futures/options	Yes: ☐ No: ☐		

Do the following types of trading activities/markets exist in your jurisdiction?	
Structured finance/securitization markets	Yes: ☐ No: ☐
Margin trading	Yes: ☐ No: ☐
Short selling	Yes: ☐ No: ☐

Part III Development and Regulation of Major Institutional Investors

3.1. Development and Regulation of Mutual Funds

3.1.1 Development of mutual funds	**2010**	**2009**	**2008**
Number of fund management companies			
Total assets under management (million USD)			
Equity funds (excluding ETF)			
Bond funds			
Hybrid funds			
Money market funds			
ETFs			
Number of mutual funds			
Equity funds (excluding ETF)			
Bond funds			
Hybrid funds			
Money market funds			
ETFs			

3.1.2. Regulation of mutual funds	
3.1.2.1. Regulation of mutual fund management companies	
Are mutual fund management companies subject to authorization by the regulator?	Yes: ☐ No: ☐
Legal structure of fund management companies	Corporation: ☐ Partnership: ☐ Other, please specify:

Is foreign ownership permitted in mutual fund management companies? If so, is there any limit on foreign ownership?	Yes: ☐ No: ☐ Ownership Limit:
Business scope permitted	Mutual funds: ☐ Managed accounts: ☐ Hedge funds: ☐ Private equity funds: ☐ Others, please specify:__________
3.1.2.2. Regulation of mutual fund products	
Are mutual fund products subject to authorization by the regulator?	Yes: ☐ No: ☐
Authorization principles	Disclosure-based: ☐ Merit-based: ☐
Main distribution channels and their respective market shares	Commercial Banks: %; Securities companies: %; Direct sales: % Independent financial advisers: %; Insurance companies: %; Others: %

3.1.3. Main policies to promote the development of mutual funds	
3.1.3.1. Tax incentives on mutual funds	
Any tax incentives on capital gains?	Yes: ☐ No: ☐
Any tax incentives on dividend income?	Yes: ☐ No: ☐
Please specify other tax incentives on mutual funds, if any.	
3.1.3.2. Tax incentives on mutual fund investors	
Any tax incentives on capital gains?	Yes: ☐ No: ☐
Any tax incentives on dividend income?	Yes: ☐ No: ☐
Please specify other tax incentives on mutual fund investors, if any.	
3.1.3.3. Please specify other non-tax incentives to promote mutual fund development, if any.	

3.2. Development and Regulation of Securities Companies

3.2.1. Asset management business and proprietary trading	2010	2009	2008
Number of securities companies			
AUM of their asset management business (million USD)			
Size of proprietary trading operation (million USD)			

3.2.2. Regulation of Securities Companies	
3.2.2.1. Business scope of securities companies	Brokerage: ☐ Corporate finance advisory: ☐ Asset management: ☐ Proprietary trading: ☐ Private Equity investment: ☐
3.2.2.2. Regulation of asset management business of securities companies	
Regulatory requirements on product offering	Regulatory approval: ☐ Registration filing: ☐
Are they permitted to offer fund products to the general public?	Yes: ☐ No: ☐
Are they permitted to hold the same investment products as that of mutual funds?	Yes: ☐ No: ☐
Main distribution channels and their respective market shares	Commercial Banks: %; Securities companies: %; Direct sales: % Independent financial advisers: %; Insurance companies: %; Others: %

3.2.3. Main policies to promote the development of securities companies	
Are there any tax or other policy incentives to promote the growth of asset management business or proprietary trading by securities companies? If yes, please provide a brief description.	Yes: ☐ No: ☐

3.3. Development and Regulation of Insurance Companies

3.3.1. Development of insurance companies	2010	2009	2008
Total number of insurance companies			
Total assets (million USD)			
Market value of stocks held (million USD)			

3.3.2. Regulation of insurance companies	
3.3.2.1. Regulatory authority of insurance companies	
3.3.2.2. Are insurance companies permitted to invest in stock markets and when were they first authorized to do so?	Domestic market: ________ Overseas market: ________
3.3.2.3. Are there any restrictions on insurance assets to invest in stocks or funds? If yes, please specify.	
3.3.2.4. May insurance companies delegate third-party asset managers to manage their assets?	Yes: ☐ No: ☐
3.3.2.5. Do insurance companies offer investment-linked products? What is the regulatory authority for such products?	
3.3.2.6. Do insurance companies own asset management subsidiaries? If so, who is the regulatory authority?	
3.3.2.7. Business scope of such asset management subsidiaries	Managing the assets of its parent company: ☐ Managing the assets of other insurance companies: ☐ Managing the assets of other third parties: ☐ Launching mutual funds: ☐

3.3.3. Main policies to promote the development of insurance companies	
Are there any tax or other policy incentives to promote securities investments by insurance companies ? If yes, please provide a brief description.	Yes: ☐ No: ☐

3.4. Development and Regulation of Commercial Banks

3.4.1. Developments of Commercial banks	2010	2009	2008
Number of commercial banks			
Total assets (Million USD)			
AUM of their asset management Business (Million USD)			

3.4.2. Regulation of the asset management business of commercial banks	
3.4.2.1. Regulatory authority of commercial banks	
3.4.2.2. Are commercial banks permitted to engage in asset management business directly in your jurisdiction?	Yes: ☐ No: ☐
3.4.2.3. If yes, are they permitted to offer asset management products to the general public?	Yes: ☐ No: ☐
3.4.2.4. Regulatory requirements of asset management products offered by commercial banks	Regulatory approval: ☐ Registration filing: ☐
3.4.2.5. Are they permitted to hold the same investment products as that of mutual funds?	Yes: ☐ No: ☐
3.4.2.6. Distribution channels of such asset management products	In-house bank channels: % Other channels, please specify: %

3.4.3. Main policies to promote the development of commercial banks	
Are there any tax or other policy incentives to	Yes: ☐ No: ☐

promote securities investments by commercial banks? If yes, please provide a brief description.	

3.5. Development and Regulation of Pension Funds

3.5.1. Development of pension funds	**2010**	**2009**	**2008**
Size of national mandatory pension funds (million USD)			
Size of corporate pension funds (million USD)			

3.5.2. Regulation of pension funds	
3.5.2.1. National mandatory pension funds	
Are they regulated? If yes, who is the regulatory authority?	
Ratio of contribution from worker's compensation to the mandatory pension funds	
Are there any restrictions to invest in the following financial instruments? If yes, please specify.	Bonds: ☐ ___ Stocks: ☐ ___ Mutual funds: ☐ ___ Private Equity: ☐ ___ Derivatives: ☐ ___ Others: ☐ ___
Are third-party asset managers permitted to manage national mandatory pension funds? If yes, please specify the types of third party managers.	
3.5.2.2. Corporate pension funds	
Are they regulated? If yes, who is the regulatory authority?	
Ratio of contribution from worker's compensation to corporate pension funds	
Are there any restrictions to invest in	Bonds: ☐ ___

the following financial instruments? **If yes, please specify.**	Stocks: ☐ ___ Mutual funds: ☐ ___ Private Equity: ☐ ___ Derivatives: ☐ ___ Others: ☐ ___
Are third-party asset managers permitted to manage corporate pension funds? If yes, please specify the types of third party managers.	

3.5.3. Main policies to promote the development of pension funds	
Are there any deferred tax policies for pension funds?	Yes: ☐ No: ☐
Are there any other tax incentives for pension funds? If yes, please provide a brief description.	Yes: ☐ No: ☐
Are there any other non-tax policy incentives? **If yes, please provide a brief description.**	Yes: ☐ No: ☐

3.6. Development and Regulation of Hedge Funds

3.6.1. Development of hedge funds	**2010**	**2009**	**2008**
Number of hedge fund management companies			
Total AUM of hedge funds (million USD)			

3.6.2. Regulation of hedge funds	
Are hedge funds regulated in your jurisdiction? If yes, please specify the regulatory authority.	Yes: ☐ No: ☐
If regulated, what is the regulatory requirement for hedge fund management companies?	Regulatory approval: ☐ Registration filing: ☐
If regulated, what is the regulatory requirement for hedge fund products?	Regulatory approval: ☐ Registration filing: ☐

If not regulated, is your jurisdiction considering introducing regulatory requirements in this area?	Yes: ☐	No: ☐

3.7. Development and Regulation of Private Equity Funds

3.7.1. Development of private equity funds	**2010**	**2009**	**2008**
Number of private equity fund managers			
Total AUM of private equity funds (million USD)			

3.7.2. Regulation of private equity funds		
Are private equity funds regulated in your jurisdiction? If yes, please specify the regulatory authority.	Yes: ☐	No: ☐
If regulated, what is the regulatory requirement for private equity fund managers?	Regulatory approval: ☐ Registration filing: ☐	
If regulated, what is the regulatory requirement for private equity fund products?	Regulatory approval: ☐ Registration filing: ☐	
If not regulated, is your jurisdiction considering introducing regulatory requirements in this area?	Yes: ☐	No: ☐

Part IV Securities Market Accessibilities

4.1. Regulation of Foreign Institutional Investors

4.1.1. Market accessibilities of foreign institutional investors		
4.1.1.1. Are foreign institutional investors permitted to invest in domestic securities markets?	Yes: ☐	No: ☐
4.1.1.2. Total size of investment by foreign institutional investors at the end of 2010	______________________million USD	
41.1.3. Barriers impeding the access of foreign institutional investors		

Is the access of foreign institutional investors to domestic securities markets subject to approval?	Yes: ☐ No: ☐
Are there any restrictions on the total amount of investments made by foreign institutional investors?	Yes: ☐ No: ☐
Are there any restrictions on the financial products accessible to foreign institutional investors? If yes, please describe.	Yes: ☐ No: ☐
Are there any restrictions on fund repatriation by foreign institutional investors? If yes, please describe.	Yes: ☐ No: ☐
Are the tax policies for foreign institutional investors the same as that of domestic institutional investors?	Yes: ☐ No: ☐
Are there any other barriers impeding the access of foreign institutional investors? If yes, please describe.	Yes: ☐ No: ☐

4.1.2. Impacts of foreign institutional investors on domestic securities market			
Domestic market liquidity	Positive: ☐	Neutral: ☐	Negative: ☐
Structure of domestic market investors	Positive: ☐	Neutral: ☐	Negative: ☐
Corporate governance of listed companies	Positive: ☐	Neutral: ☐	Negative: ☐
Investment philosophies	Positive: ☐	Neutral: ☐	Negative: ☐
Financial innovations	Positive: ☐	Neutral: ☐	Negative: ☐

4.2. Regulation of Offshore Investments by Domestic Institutional Investors

Regulation of offshore investments	
Are domestic institutional investors permitted to invest in overseas securities markets?	Yes: ☐ No: ☐
Total size of offshore investments by domestic institutional investors	______________________million USD
Restrictions on the offshore investments by domestic institutional investors	
Do domestic institutional investors need approval to invest in overseas markets?	Yes: ☐ No: ☐

Are there any restrictions on the size of offshore investments made by domestic institutional investors?	Yes: ☐ No: ☐
Are distribution of offshore funds permitted in your jurisdiction?	Yes: ☐ No: ☐

Part V: Experiences and Lessons in Developing Institutional Investor Base

5.1. Main Driving Forces for the Development of Institutional Investors

Major Factors	**Ranking of importance (from 1 to 8, and 1 denotes the most influence)**
Political Stability	1 2 3 4 5 6 7 8
Sound legal system	1 2 3 4 5 6 7 8
Removal of regulatory constraints	1 2 3 4 5 6 7 8
Tax and other policy incentives	1 2 3 4 5 6 7 8
Rapid economic growth	1 2 3 4 5 6 7 8
Matured securities market	1 2 3 4 5 6 7 8
Matured pension security system	1 2 3 4 5 6 7 8
Technology progress and financial innovation	1 2 3 4 5 6 7 8
If there are any other factors, please specify .	

2. Please describe the circumstances/occasions during which institutional investors in your jurisdiction have undergone rapid growth. What are the driving factors and what types of institutional investors have experienced the most significant growth in recent years?

3. Please summarize the major obstacles to the development of institutional investors in your jurisdiction.

4. What are the regulatory changes that have been introduced with regard to institutional investors in your jurisdiction after the financial crisis?

5. What are the key lessons learned in the development and regulation of institutional investors in your jurisdiction? Do you have any suggestions or advice to other emerging market regulators who are contemplating regulatory policies to expand the institutional investor base? Please describe.

6. In jurisdictions where some institutional investors are regulated by multiple regulators, e.g., commercial banks are regulated by both the banking and securities regulators, does the regulatory framework encourage cooperation between the regulators to ensure the growth and development of institutional investors? If yes/no, please explain.