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## **IOSCO Publishes Report on Fund Governance**

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20158] July 7, 2006 TO: INTERNATIONAL INVESTING SUBCOMMITTEE No. 15-06 INTERNATIONAL MEMBERS No. 12-06 INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 17-06 INVESTMENT COMPANY DIRECTORS No. 13-06 RE: IOSCO PUBLISHES REPORT ON FUND GOVERNANCE The Technical Committee of the International Organization of Securities Commissions (IOSCO) has published a report in two parts on the governance of collective investment schemes (CIS) around the world.<sup>1</sup> Part I of the report contains an examination of the oversight functions in the various forms of CIS used around the world, and Part II provides a more specific analysis of “the one primary general principle of CIS governance that applied in all jurisdictions, regardless of the structural form of the CIS – independent review and oversight of the CIS operator’s fiduciary duties, including most notably the prevention of conflicts of interest.” The report, which is available on IOSCO’s web site, is summarized below. The report may be most noteworthy for its survey of fund governance structures. Although it also sets forth broad regulatory principles on fund governance, the principles are general enough to encompass the various approaches currently taken by IOSCO member regulators, making it unlikely that IOSCO members would need to change local laws or regulations to adhere to the principles. Background IOSCO is an organization that seeks to provide a cooperative forum for securities regulatory agencies from around the world and adopt regulatory standards and best practices that IOSCO members can implement in their own jurisdictions. The 108 current IOSCO members collectively 1 Examination of Governance for Collective Investment Schemes, Report of the Technical Committee of IOSCO (June 2006), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD219.pdf> (Part I) and <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD220.pdf> (Part II). The term “collective investment scheme” is used to refer generically to all types of mutual funds and similar collective investment pools. 2 regulate more than 90% of the world’s securities markets. The Technical Committee is the primary committee within IOSCO that deals with substantive regulatory issues. In May 2004, the Technical Committee approved a mandate to establish broad general principles for CIS governance based on a review of IOSCO’s past work and the results of a newly- authorized survey on CIS governance in the jurisdictions represented on its standing committee 5 (SC5), the committee devoted to asset management issues. The current report is a result of SC5’s two- year study on fund governance following the Technical Committee’s mandate. Part I of the Report Part I of the report provides the results of SC5’s survey on CIS governance. Part I identifies five structural models and provides, for each model, both a narrative and a flow-chart illustration describing the oversight mechanisms employed. The five models are: 1) a

corporate model with a board of directors or trustees (common in the US); 2) a corporate model with a depositary (common in European countries such as France, Germany, and Ireland); 3) a contractual model with a depositary (common in European countries such as Luxembourg); 4) a contractual model with a trustee (common in the UK and Japan); and 5) a model with an independent supervisory board or review committee (common in Australia and anticipated in Canada and the Netherlands). IOSCO does not conclude that any one structural form of CIS organization is better suited to governance or the prevention of conflicts of interest than any other, but rather that various governance tasks can be directly or indirectly fulfilled by a variety of mechanisms, including independent oversight entities, regulators, self-regulatory organizations, external auditors, depositaries, and trustees. The report does, however, present the following broad regulatory principles that have been agreed upon by SC5 members:

- CIS governance must provide for independent review and oversight of the organization and operation of the CIS;
- An independent entity's main purpose should be ensuring that when faced with a conflict, CIS operators respect the applicable rules, their contractual obligations and their duties;
- An independent entity should be empowered with sufficient conditions to exercise its functions in an effective and independent manner; and
- The delegation of the oversight responsibility entrusted to any independent oversight entity should not, as a general principle, be allowed, although some functions entrusted could be outsourced.

3 Part II of the Report Part II of the report seeks to further develop the concept of "independence" in CIS governance, the powers that independent oversight entities should have, and the precise functions and tasks that should be entrusted to independent oversight entities. Under each of these concepts, the report adopts the following broad principles:

The concept of independence

- Independent oversight entities should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interests with the CIS operator and its related parties;
- The organization and the practical functioning of the independent oversight entities should allow them to be out of the control or the influence of the management of the CIS operator or its related parties; and
- There should not be any confusion between responsibilities of the independent oversight entities when exercising their oversight function on the one side and the CIS operator in its asset management role over the CIS on the other side.

The powers of independent oversight entities

- Independent oversight entities should be entitled to receive all relevant information enabling them to perform their oversight function in a proper manner;
- Independent oversight entities should be given the necessary means to carry out their duties without relying exclusively on the CIS operator's assistance; and
- Independent oversight entities should be given the right to review the legal and operational conditions of the CIS management in relation with the CIS in a reasonable way.

The specific functions of independent oversight entities

- Independent oversight entities, collectively, should have the function of overseeing the CIS operator and CIS operator's activities;
- Independent oversight entities, collectively, should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investor's wealth and interests in the CIS; and
- 4 • Independent oversight entities should have a duty of reporting to the regulatory authorities or the CIS unit holders.

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