

COMMENT LETTER

October 12, 2006

Institute Letter on IOSCO's Report on the Role of Independent Oversight in Fund Governance (pdf)

DRAFT 1401 H STREET, NW ■ WASHINGTON, DC 20005-2148 ■ 202/326-5815 ■ FAX 202/326-5841 October 12, 2006 VIA E-MAIL Ms. Pamela Vulpes IOSCO General Secretariat Oquendo 12 28006 Madrid Spain Re: Public Comment on Examination on Governance for Collective Investment Schemes, Part II Dear Ms. Vulpes: The Investment Company Institute¹ appreciates the opportunity to express its general support for the Technical Committee's recent consultation report on independent oversight for collective investment schemes (CIS).² The report clearly, and in our view correctly, recognizes both the importance of independent oversight and the need for significant flexibility to adapt regulatory requirements on independent oversight to different CIS models. We strongly support these objectives. Despite our general support, we have three concerns with the report. First, we are concerned with the final recommendation in the report that independent oversight entities (IOEs)³ should have a duty of reporting to the regulatory authorities or CIS shareholders. We believe that this recommendation should be revised in the final report to allow IOEs the flexibility to determine when and how to publicly disclose such breaches or irregularities. Second, we are concerned that the report in some respects may not fully recognize the important role played by internal CIS compliance mechanisms, such as the use of compliance officers and written compliance programs. Third, we are concerned that the report in certain respects sets forth unrealistic standards or is overly prescriptive. 1 The Investment Company Institute is the national association of the US investment company industry. More information about the Institute is attached to this letter. 2 Examination of Governance for Collective Investment Schemes, Part II, Consultation Report of the Technical Committee of IOSCO (June 2006). The report is available on the IOSCO web site at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD220.pdf>. 3 We note that the term "independent oversight entities" is not clearly defined in the report. IOSCO should consider inserting a concise definition of the term at the beginning of the report. IOSCO also should consider harmonizing the use of "independent oversight entities" and "independent entities," two terms that seem to be used interchangeably in the report. Ms. Pamela Vulpes IOSCO October 12, 2006 Page 2 of 5 We suggest certain revisions that might better retain the flexibility expressed in the report's introduction. These comments are explained in greater detail below. Duty to Report The report's final recommendation is that IOEs "should have a duty of reporting to the regulatory authorities or the CIS unit holders."⁴ IOSCO explains that this principle means that all IOEs should report "any material breaches or irregularities in terms of applicable rules or contractual obligations, detected in the course

of their controls” and “any material situation whereby the CIS operator has been considered as performing or operating in a way that would not meet the needs or the rights of the CIS unitholders.”⁵ We are concerned that this principle and the accompanying explanation suggests that an IOE’s duty to report material failures is mandatory, rather than discretionary. We strongly believe, for reasons explained below, that IOEs should have discretionary authority in this regard. An IOE’s decision whether to make a public statement to shareholders or a semi-public statement to regulators about a material failure is highly dependent on the many facts and circumstances involved. An IOE may decide to report a failure, for example, that it has been unable to completely address and resolve to its satisfaction. Even where a failure has been completely resolved to the IOE’s satisfaction, the IOE may still choose to report it to the regulator to demonstrate the IOE’s good faith in dealing with issues and the proper functioning of the CIS’s compliance program. There are times, however, when an IOE would appropriately choose not to report a failure to the regulator or make a public statement to shareholders, such as when the issue has been fully resolved and the report would likely confuse or alarm investors. Moreover, a mandatory reporting obligation on IOEs could lead to unintended consequences. For example, a mandatory reporting obligation could reduce the effectiveness of IOEs by creating a strong disincentive for CIS operators to alert the IOE to the existence of problems. As clearly recognized in IOSCO’s report, IOEs need to be empowered to detect and deal with issues that arise. A mandatory reporting obligation runs the risk of having precisely the opposite effect – making it harder for the IOE to detect precisely the problems that it ought to be addressing. For all of these reasons, we strongly believe that the IOE’s duty to report should be discretionary, rather than mandatory. We recommend that principle IV.3 be revised accordingly. ⁴ See Recommendation IV.3 of the report. ⁵ See page 15 of the report. Ms. Pamela Vulpes IOSCO October 12, 2006 Page 3 of 5 The Use of Internal Compliance Mechanisms We are concerned that in several places, the report places responsibility on IOEs for functions that are more appropriately handled by staff of the CIS operator. For example, the report suggests that IOEs should be monitoring expense ratio calculations (principle IV.1), ensuring that all fees, expenses, and other costs are being charged properly (principle IV.2), and verifying that income is timely and fairly reflected in the CIS’s net asset value (principle IV.2). In the US, these tasks are principally handled by fund accounting personnel employed by the CIS operator or external service providers, with periodic control checks and verifications by independent auditors⁶ and quarterly certifications by certain senior fund officers in accordance with requirements under the Sarbanes-Oxley Act. The report also suggests IOEs should be responsible for monitoring portfolio activity for compliance with investment policies and checking proxy voting policies and procedures (principle IV.1). In the US, fund boards may approve certain oversight policies and procedures, but Chief Compliance Officers (CCOs) are primarily responsible for ensuring day-to-day compliance with those procedures. We recommend that the examples under principles VI.1 and IV.2 be revised to reflect the role played by staff of the CIS operator and other service providers, particularly fund accounting staff and CIS CCOs. We also recommend that the part of the report that discusses the role of the IOE vis-à-vis the CCO be revised. In that part of the report, IOSCO states that IOEs should be informed of the hiring and firing of CCOs, in part to allow IOEs to “satisfy themselves of the independence of the compliance function and its effectiveness in meeting its obligations to investors.”⁷ In the US, CCOs for CIS typically are employed by the CIS operator, which may suggest that they are not technically “independent.” Nevertheless, US rules contain a number of provisions that ensure the CCO will be able to act independently. These provisions require the fund’s board to approve the designation and compensation of the CCO, provide the board sole power to authorize the CCO’s removal from his or her position, require the CCO to provide a written report to the board and meet with the independent directors in

executive session at least annually, and prohibit persons from coercing or fraudulently influencing the CCO in the course of his or her responsibilities.⁸ Accordingly, we recommend that the reference to independence in the sentence quoted above be deleted. This change would reflect the fact that IOEs should remain focused on whether compliance professionals (such as CCOs) and other internal compliance mechanisms are effective in protecting CIS shareholders. ⁶ While the report states that certain functions can be "managed" (principle IV.1) or "exercised" (principle IV.2) by the CIS auditor, fund auditors in the US do not assume a comprehensive oversight role that would alone appear to satisfy the concepts in principles IV.1 and IV.2. ⁷ See page 11 of the report, in the second bullet point under recommendation III.1. ⁸ See Rule 38a-1 under the Investment Company Act. Ms. Pamela Vulpes IOSCO October 12, 2006 Page 4 of 5 The Need for Regulatory Flexibility We are pleased that the report clearly recognizes the fact that there is "no unique structural or optimal solution to the implementation aspects of governance in the case of CIS," and generally supports the need for regulatory flexibility with respect to fund governance.⁹ Despite that general statement, however, a few of the report's recommendations appear overly rigid, suggesting that IOEs should act as guarantors of their functions and responsibilities. Instead of achieving IOSCO's goal of promoting the establishment and maintenance of high standards for governance, unreasonably strict standards instead may have a reverse effect, making it nearly impossible to comply with regulatory mandates and thus making it difficult to attract high quality candidates to serve in oversight positions. To allow for the reasonable implementation of its principles, we suggest that IOSCO make clear reference in the report to the fiduciary duties applicable to many IOEs, including fund directors in the US, and the appropriate application of the business judgment rule.¹⁰ We also suggest that IOSCO consider clarifications or less prescriptive language in the following sections of the report:

- Principle II.1 states that IOEs "should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interest with the CIS operator and its related parties." IOSCO's explanation of the principle states that this "ensures" that the IOE does not have "any potential conflict of interests with the CIS operator." This principle is overly broad and unrealistic, given that IOEs cannot ensure that they will not face any potential conflicts. Instead, the focus should be on the establishment of appropriate safeguards to deal with any conflicts of interest that arise and avoiding conflicts that regulators specifically prohibit.
- Principle II.2 states that the "organization and the practical functioning" of IOEs "should allow them to be out of the control or the influence of the management of the CIS operator or its related parties." The complete absence of any influence is unrealistic, given that IOEs such as fund directors look to the CIS operator for, among other things, its views and recommendations on investment and operational matters.
- The explanation of Principle III.3 states that the CIS operator's contract is subject to review by the IOEs, "with the aim of checking the fairness and the adequacy of its terms and subsequently controlling the correct implementation of the contract by the CIS"

⁹ See page 4 of the report. ¹⁰ Part I of the report recognizes that under US law, CIS boards of directors are subject to fiduciary duties including the duties of loyalty and care. See Part I of the report at page 14. There is no indication in Part II of the report, however, of how these fiduciary duties or the application of the business judgment rule affect the principles and commentary in Part II. Ms. Pamela Vulpes IOSCO October 12, 2006 Page 5 of 5 operator." IOEs do not and cannot control the implementation of contracts, but rather can and should monitor the CIS operator's performance of its contractual obligations and take action as appropriate when such performance is substandard, as discussed above.

- Certain examples under Principle IV.1 are too detailed for an oversight function of an IOE such as a fund board, but rather, as discussed above, are better handled by compliance professionals, such as CCOs, or staff of the CIS operator or other service provider.
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Principle IV.2 states that IOEs “should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investor’s wealth and interests in the CIS.” While we agree that the IOE should take steps to safeguard fund assets (e.g., by ensuring the use of independent and financially sound custodians), we recommend that IOSCO clarify that “erosion” does not include losses due to the performance of a CIS’s portfolio or the payment of fund expenses. * * * * The Institute appreciates the opportunity to support IOSCO’s work on CIS governance and to share our concerns. If you have any questions concerning our views or would like additional information, please contact me at (202) 371-5430 or Glen Guymon at (202) 326-5837.

Sincerely, /s/Robert C. Grohowski Robert C. Grohowski Senior Counsel – International Affairs

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