

**Reply to IOSCO's Report  
"Examination of Governance for Collective Investment Schemes"**

EFAMA<sup>1</sup> congratulates IOSCO for its report "Examination of Governance for Collective Investment Schemes", providing a thorough overview of various models of fund governance in use in the jurisdictions of the members of IOSCO's SC5. We shall limit ourselves to commenting on the general parts of the report, leaving specific comments on the descriptions of national models to our members.

It is EFAMA's long-standing position that Independent Oversight is crucial for the good functioning of a robust CIS Governance framework, and we fully agree once again<sup>2</sup> with IOSCO's conclusion that "there is no unique structural or optimal solution to the implementation aspects of governance in the case of CIS".

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

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

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

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<sup>1</sup> EFAMA is the representative association for the European investment management industry. Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, as well as its 40 corporate members, EFAMA represents at mid-2006 about EUR 14 trillion in assets under management, of which EUR 7 trillion through about 43,000 investment funds. For more information, please visit [www.efama.org](http://www.efama.org).

<sup>2</sup> EFAMA's reply of 13 May 2005 to IOSCO's Report "Examination of Governance for Collective Investment Schemes"

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

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

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

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

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

Finally, we regret the fact that the Report is ambiguous regarding the role played by Auditors: it mostly assigns to them only a secondary role among the entities that can ensure independent oversight<sup>3</sup>, although certain statements point out (correctly) that Auditors may have a major role<sup>4</sup>. EFAMA wants to underline once more the critical function Auditors fulfil in several countries (Austria, Germany, Luxemburg and Switzerland among others) and wishes to see them clearly included by IOSCO among the independent oversight entities.

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

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

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<sup>3</sup> For example on page 6, 7, 9, 11 and 14 of Part I, page 5 of Part II of the Report

<sup>4</sup> Page 5 (Footnote 11) of Part I and page 15 of Part II.

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

### **Principle II.1**

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

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

Regarding the independence of the Depositary and Trustee, EFAMA believes that the fact that they belong to the same economic group as the CIS Operator (and the Depositary is in many cases is an integral part of the mother company) is not by itself detrimental to an effective oversight, but special attention is required. Specific functional separation, organizational and control measures have been built into the EU regulatory framework by the UCITS Directive and by national regulators, taking into account the prevalence in Continental Europe of “universal banking” structures.<sup>5</sup> For example, Article 10 (2) of the UCITS Directive requires that “in the context of their respective roles the management company and the depositary must act independently and solely in the interest of the unit-holders”, whereas Art. 17 sets similar independence requirements for the investment company and the Depositary.

Decade-long experience in many EU Member States confirms that such measures are effective, and no problem was reported by the European Commission in its Communication on the Regulation of UCITS Depositaries<sup>6</sup>. Depositaries carry out their oversight function without conflicts of interest or interference from the CIS Operator, and the independence of the CIS Operator – a fundamental investor protection principle in the EU – is thus ensured.

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

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<sup>5</sup> See FEFSI’s Position Paper “The Regulation of UCITS Depositaries” (6 November 2002) at [http://www.efama.org/55PositionPapers/2002/Regultion\\_of\\_UCITS\\_depositaries/documentfile](http://www.efama.org/55PositionPapers/2002/Regultion_of_UCITS_depositaries/documentfile)

<sup>6</sup> COM(2004) 207 final of 30/3/2004

### **Principle II.2**

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

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

### **Principle II.3**

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

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

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

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

### **Principle III.1**

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

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

**Principle III.2**

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

EFAMA agrees with this principle.

**Principle III.3**

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

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

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

**Principle IV.1**

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

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

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

There is no explanation of why specifically these functions should best be fulfilled only by the CIS Board or the Independent Directors on the Board of the CIS Operator, when the Depositary is ideally suited to oversee at many of them (e.g. checking the compliance of the CIS portfolio with the applicable borrowing and investment limits and restrictions; controlling the appropriateness of the valuation process of the CIS assets and the proper calculation and disclosure of the CIS NAV and of the CIS unit price; and checking the correct application of

the principles and procedures for the exercise of shareholder's rights attached to the securities portfolio) and the CIS Auditors could effectively oversee the other functions, as well as some of those above.

**Principle IV.2**

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

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

**Principle IV.3**

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

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

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

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