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Review of Governance of Collective Investment Funds in the New Member States of the European Union

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Contents

Abbreviations & Acroynms ii
Acknowledgments iii
Foreword iv
Executive Summary 1
Introduction 6
Methodology 8
Background 8
- Evaluations of Governance of Collective Investment Fund Sectors 9
- Mechanisms for Governance of Collective Investment Funds 10
- Legal Forms 11
- Common Entities for Management and Governance of UCITS Funds 13
- Supervisory Boards of Asset Managers and Self-Managed Investment Companies 14
- Depositaries 15
- Governmental & Industry Authorities 15

Key Issues 17
- Fund Disclosure 17
- Depositaries 18
- Oversight by Unit-Holders 21
- Supervision 24
- Liability 28

Conclusion 29
References 30
Annex 1: EU Directives related to Collective Investment Fund Governance 31
Annex 2: Regulation of Investment Fund Governance Abuses in EU Countries 33

Tables

Table 1: Key Issues, EU and National Measures, and Recommendations 5
Table 2: Net Assets of UCITS Funds 9
Table 3: Comparison of International Legal Forms of Collective Investment Funds 12
Table 4: Government & Industry Supervisory Structures 16
Table 5: Unit-holders' and Shareholders' Rights to Vote on Major Decisions 22
Table 6: Prohibition of Basic Abuses 25
Table 7: Recommended Measures of Regulation of Basic Abuses 27

Figures

Figure 1: UCITS Fund as a Contract-Based Investment Fund 13
Figure 2: UCITS Fund as an Investment Company 14

Boxes

Box 1: Governance of US versus European Funds 7

Abbreviations & Acroynms

CESR	Committee of European Securities Regulators
CIS	Collective Investment Schemes
CIU	Collective Investment Undertaking
EC	European Commission
EFAMA	European Fund and Asset Management Association
EU	European Union
EU11	Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia
GDP	Gross Domestic Product
IOE	Independent Oversight Entity
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive
NAV	Net Asset Value
N.A.	Not Available
OECD	Organisation for Economic Co-operation and Development
OTC	Over the Counter
SRO	Self-regulatory Organization
UCITS	Undertakings for Collective Investment in Transferable Securities
US	United States of America

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Foreword

We are pleased to present the Review of Governance of Collective Investment Funds in the New Member States of the European Union. Corporate governance is a critical issue for long-term stability of the financial sector.

The Review complements two other similar analyses looking at financial governance among the New Member States of the European Union—in the banking sector and the insurance sector. Much has already been accomplished with the transposition of the EU Directives into the laws of these countries. Taken together, the three Reviews highlight areas of progress to date and areas where further reform and additional measures would be helpful to bring governance practices to the higher levels seen in Western Europe and internationally.

Executive Summary

This review examines corporate governance practices in the investment fund sector of the ten new member states in the European Union, composed of the European countries that transitioned to market economies in the 1990s: the eight countries that joined the European Union (EU) in 2004 –Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia– plus Bulgaria and Romania which joined in 2007. Croatia, for which accession negotiations started in 2005, is also included in this Review. (For simplification, these countries will be referred to as the EU11.) The review draws on two sources for data. Over the last two years, in-depth diagnostic reviews of investment governance were conducted by the World Bank in two of the countries, the Czech Republic and Slovenia. The objectives of the reviews were to develop a set of "good practices" for investment fund governance and provide specific recommendations for the supervisory authorities in each country. The second source was the public websites of each of the supervisory authorities. The analysis in the review also draws on a number of recent studies done by international organizations such as IOSCO and the EU on governance in the investment fund sector. This review does not attempt to replicate these studies, but instead aims to identify selected areas where fund governance could be strengthened either by laws and regulations or by government policies.

The growth in investment funds in the EU11 countries over the last several years reflects increased public confidence in the securities markets. Having shaken off the negative after effects of the privatization funds in the 1990s, investment funds now provide a significant means for citizens to invest their savings. In order to maintain the trust and confidence of the new investors, the investment fund industry in the EU11 will need to maintain a high level of good governance practices.

The EU11 countries have spent the last several years adjusting their legislation and regulatory frameworks to meet a dynamic process for the development of the capital markets in the EU, which includes significant changes in the development of the investment fund industry. With the accession to the EU in 2004 and then in 2007, all ten member countries have transposed the key investment fund Directive, known as the UCITS Directive.[1] Croatia is in the process of adopting the EU directives to prepare for accession and expects to have all major financial directives transposed into national law in 2008. UCITS funds are the primary form of investment funds in the EU, representing over 90 percent of assets under management in most EU countries. As UCITS funds expand their reach in an integrated market and as new classes of assets become eligible for UCITS funds, a fresh look at governance issues is warranted. The EU began such a discussion in 2004 which has been ongoing in the EU and other organizations such as the International Organization of Securities Commissions (IOSCO).

The UCITS Directive provides a central basic framework for collective investment funds throughout the EU member states and incorporates a number of mechanisms which are internationally recognized as useful in establishing a robust governance environment for collective investment funds. These include the system of checks and balances among the institutions that influence a fund's actions and decisions, effective independent oversight of the fund, and strong enforcement of laws and fund rules.

[1] The UCITS Directive refers to the Directive on the Coordination of Laws, Regulations and Administrative Provisions related to Undertakings for Collective Investment in Transferable Securities (UCITS), 85/611/EEC, which was first introduced in 1985 and subsequently amended.

While the emphasis on a single market throughout the EU suggests the need for a common framework for financial services, including collective investment funds, the UCITS Directive allows some latitude for national implementation legislation to develop governance in light of local conditions. The relatively short history of dynamic capital markets in the EU11 countries—and in some cases, the small size of their economies—suggests that special attention should be paid to additional governance mechanisms, even if they go beyond the minimum requirements set under the UCITS Directive. To date, no major scandals or other problems have been seen since the EU11 countries transposed the UCITS Directive into national legislation. However the past three years have also witnessed stable global capital markets where risk, including for emerging markets, remains priced at low levels. Strong governance frameworks in the securities sector, and in particular in collective investment funds, will help the EU11 countries weather the next financial correction, when it arrives.

The report focuses on five issues that are important for investment fund governance in the EU11 countries: fund disclosure, depositaries, oversight by unit-holders, supervision, and liability. Most of the report's recommendations are suggested clarifications under the existing legislative framework of EU Directives, regulations and recommendations of the European Commission (EC). However in two areas, the report recommends consideration of approaches that are different from those currently used in Continental Europe. The first relates to the rights of unit-holders in contract-based investment funds to bring their rights to the same level as investors in investment companies. The second relates to the level of personal versus institutional liability. The report suggests that both areas would warrant further discussion in order to further strengthen governance of collective investment funds among the EU countries. Table 1 provides a summary of all the report's recommendations.

Fund Disclosure

Of critical importance for governance of investment funds are the requirements for disclosure to unit-holders. Regulations should prescribe certain minimum information, including the funds' risks (and risk management systems), expenses and performance. Historical investment returns should also be presented in a standardized fashion based on one, three and five-year histories. In addition funds should be obliged to publicly disclose their governance structures. Neither the UCITS Directive nor the regulations of many EU11 countries provide this level of detail.

Depositaries

The IOSCO review of governance of collective investment funds emphasized that the rationale for governance of collective investments is investor protection. The most critical element of a collective investment fund for providing the protection is an independent oversight entity (IOE), which monitors the activity of a fund to ensure that it is in compliance with the relevant laws and fund rules. This can be done through a separate entity or through other mechanisms such as independent members of the boards or directors. Under the UCITS Directive, the role of the IOE is given to the depositary. However the enumerated functions of the depositary may not be as extensive as needed in order for the depositary to carry out the full role of an IOE. National legislation should specify duties of the depositary to provide independent oversight.

Another issue relates to the effective independence of the depositary, especially on the issue of valuing illiquid securities, such as over-the-counter (OTC) derivatives. The UCITS Directive relies heavily on a structural division between the management company and the depositary to provide governance and investor protection for investment funds. The management company and the depositary cannot be the same entity and they must act independently of each other. However increasingly in the EU, the management company and the depositary for the same fund are owned by one financial conglomerate. To maintain a structural division between the two, internal "firewalls" are generally set between the

management company and the depositary. However the regulation of such firewalls varies widely among the EU11 countries. Most refer to firewalls only indirectly and in terms of rules on conflict of interest. There is no standard for the establishment and operation of such firewalls. A minimum set of standards for firewalls should be developed to avoid conflicts of interest and the relationship between the management company and the depositary should be disclosed.

At the same time, the responsibility of the depositary can be diluted. The UCITS Directive gives the responsibility of the verification of the net asset valuation to the depositary. However a new EC Directive on Eligible Assets allows management companies to use divisions within the companies or independent third parties to value assets such as OTC derivatives, which are illiquid securities and thus have no clearly defined market value. This creates a third entity to evaluate the assets. The depositary is responsible for the valuation of securities and conducts the final definitive analysis of the value of the OTC instruments. Therefore the use of the outside entity should be done in coordination with the depositary—and the entity should use a pricing model approved by the depositary.

Oversight by Unit-Holders

Another issue relates to the rights of unit-holders to participate in the governance of the collective investment funds. UCITS funds may be structured either as open-ended funds based on contracts, unit trusts or corporations (either self-managed or managed by a management company). Unit trusts and funds based on contract are referred to as "common funds" in UCITS.[2] In addition, non-UCITS funds may be structured as closed-end common funds or corporations. The investors' rights vary dramatically depending on the legal form. For example in many EU11 countries, shareholders in corporate funds and unit-holders in closed-end common funds have the right to approve changes in the depositary and the independent auditor and to make important decisions such as the liquidation of the fund. However unit-holders in open-ended common funds generally do not have such rights—although a few countries permit the creation of such rights in the fund's Bylaws. The rational justification for such disparity in unit-holder rights is difficult to find. There should be uniformity in shareholder/unit-holder rights regarding the basic decision-making process of the fund. The legal form of the investment should not determine the level of investor rights and investor protection for those who contribute their cash to collective investment funds. Unit-holders in open-ended common funds should have the right to elect investor committees and make basic decisions about the funds.

One of the basic governance mechanisms is the auditing of a business entity's accounts by an independent auditor. Concerns about the independence of auditors for public interest entities have led to mechanisms for reinforcing the independence of the auditors. However in most EU11 countries, the auditors for common funds are selected by the management company and not the unit-holders or some independent entity in the UCITS structure such as the depositary. Mechanisms should be developed for ensuring the independence of the auditors of common funds. Unit-holders should approve auditors for funds. Also auditors should not be tied to the management company and should have no conflicts of interest with the management company.

Supervision

In most EU11 countries, the powers of securities supervisory agencies to regulate collective investment funds should be extended. As part of the European single market for financial services, management companies can offer funds on a cross-border basis within the EU. The EC is currently

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[2] This paper will not deal with unit trusts since the countries in EU11 do not have a common law legal system. Those funds that are called "unit trusts" in the EU11 generally operate as funds based on contract i.e. common funds.

working to simplify the notification and passport procedures for such funds. However coordination of home and host supervisory agencies will need to be further strengthened. In addition, all supervisory authorities should have sufficient powers to bring actions against funds that are operating without the authorization required by the law, particularly when they are operating cross-border.

The "fit and proper" provisions should also be strengthened. The UCITS Directive requires that the securities supervisors have the authority to establish entry requirements for collective investment funds and their shareholders, directors and officers. The EU11 countries have enacted laws and regulations setting up such "fit and proper" tests. However these tests vary from country to country and in some instances should be more comprehensive than they currently are. Home-host supervisors should increase co-ordination in supervision of management companies. The "fit and proper" provisions should be extended and harmonized across EU countries.

Furthermore, all basic abuses should be prohibited by law. Most countries prohibit abusive related-party transactions, but it is unclear if their laws adequately cover other classic abuses such as "front running."[3] In addition, most national legislation requires the disclosure of fees of management companies and depositaries, but does not regulate fees in detail such as the permissible limits of fees and the allocation of costs between the management company and the investment funds. This has been a source of abuse and should be regulated on a specific basis.

Allocation of trades to favored customers is another possible source of abuse. All management companies in the EU11 countries are allowed to manage multiple investment funds and securities portfolios of individual clients. Although the Markets in Financial Instruments Directive (MiFID) provides for improved procedures for obtaining the best execution of trades, neither it nor the UCITS Directive provide for procedures and rules for the allocation of trades among different clients to avoid assigning the better trades to favored clients. Some countries have legal provisions requiring that all investors be treated equally but EU11 countries don't have regulations setting forth detailed procedures for allocation of orders between the clients of a management company. Such regulations should be put into place. Rules on allocation of trades under block transactions (and other transactions in the same security) should be adopted and harmonized.

Liability

In addition, consideration should be given to strengthening the personal liability of individual officers and managers. Most abuses in the collective investment fund sector are committed by individuals, who take actions in the expectation of personal gain. While asset management companies and other institutions involved in collective investment fund governance have an important role to play in ensuring supervision of their officers and managers, individuals should also be personally responsible for their actions in managing investment funds under national laws.

Other provisions are also important. A number of countries in the EU11 use codes of conduct by industry associations to encourage good governance by fund managers. Voluntary codes are not determinative in providing for good governance, and mandatory requirements for transparency have a greater impact on governance practices. Nevertheless the codes are useful and those countries that do not have them should put them in place either in the rules of the regulatory authorities or in codes adopted by industry associations.

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[3] In front running, someone with access to a management company's investment decisions makes personal securities trades prior to the trades made by a management company on behalf of a fund. The "front runner" benefits from the price movement resulting from the trade.

Table 1: Key Issues, EU and National Measures, and Recommendations

Issue	EU Requirements	National Implementation	Recommendations
Fund Disclosure			
Fund Activity	Some requirements under Prospectus Directive.	Varies by country.	Disclosure documents should describe each fund's risks, risk management systems, performance and expenses.
Governance Structure	No requirements under Prospectus Directive.	Varies by country.	Disclosure documents should describe each fund's governance structure.
Depositaries			
Independent Oversight	IOSCO recommendation. Depositary under UCITS Directive partially fills the role.	Varies by country.	National legislation should specify duties of the depositary to provide independent oversight.
Functional Independence of Depositaries	UCITS Directive requires that management company and depositary are separate entities and operate independently.	Although separate legal entities, management company and depositary are often part of the same group, separated only by firewalls.	A minimum set of standards for firewalls should be developed to avoid conflicts of interest. The relationship between the management company and the depositary should be disclosed.
Valuation of Illiquid Securities (such as OTC derivatives)	Eligible Assets Directive says if no market price is available, OTC derivatives can be valued by independent entity.	Most national legislation has not yet adopted the Directive.	Valuation of illiquid securities should be done by the depositary. Any outside expert should work in coordination with the depositary.
Oversight by Unit-Holders			
Unit-holders' Decision Making Rights	UCITS Directive has no requirement, although IOSCO guidelines say unit-holders should have decision-making rights.	Unit-holders have different rights depending on the type of fund but no clear basis for distinction exists.	Unit-holders of open-ended common funds should have the right to elect investor committees and make basic decisions about the funds.
Independent Auditors	Annual reports and prospectuses must contain audited financial statements.	Audits required, but auditor chosen by management company.	Unit-holders should approve auditors for funds. Auditors should not be tied to management company.
Supervision			
Prohibition of Basic Abuses	UCITS Directive has general rules on conflicts of interest.	Varies by country.	National legislation should specifically prohibit all basic abuses.
Fraudulent Allocation of Transactions	UCITS Directive has no requirements re allocation of trades among different clients of a management company.	Varies by country.	Rules on allocation of trades of block transactions (and other transactions in the same security) should be adopted and harmonized.
Selected Supervisory Issues	1. Limited provisions set for home-host supervisory coordination. 2. UCITS Directive requires fit and proper tests for owners and directors. 3. No requirement for enforcement against funds that are operating without authorization required by the law.	1. Varies by country. 2. Varies by country, but all require securities regulator to set fit and proper test for management. 3. Varies by country.	1. Home-host supervisors should increase co-ordination in supervision of management companies. 2. Fit and proper provisions should be extended and harmonized across EU. 3. All supervisory authorities should have sufficient powers to bring actions against funds that are operating without authorization required by law.
Liability			
Personal vs. Institutional Liability	No requirement in UCITS Directive.	Varies by country.	National laws should establish strong individual liability for management personnel.
Codes of Conduct	No requirement.	Generally issued on a voluntary basis by an association of asset managers.	Industry associations should adopt codes of conduct, if they have not done so.

Introduction

All financial institutions have important fiduciary duties to the individuals and corporations who have entrusted their funds. However investment funds have particularly strong fiduciary obligations. Fund investors need to be able to focus on the issues of maximizing the return on their capital and are entitled to honest and industrious fiduciaries, who abide by fair and ethical principles. The investment sector is characterized by complex agency relationships, where a fund manager, usually known as a management company, could misrepresent the quality or value of an asset portfolio —or the nature of the risks involved— or a manager could manage assets in its own interest rather than in the best interests of investors. The asymmetry of market power and information available to a fund manager enables such abuses if the corporate governance framework for the collective investment fund sector does not preclude it.

Good investment fund governance benefits the collective investment fund sector (and parts of the pension sector) as well as investors. Good fund governance contributes to the integrity and credibility of the industry. This comes at a cost, since the implementation of good governance and the observance of corporate ethics are sometimes an expensive investment for an industry.[4] However such investments inevitably pay dividends to the extent that better governance improves investor confidence and increases contributions to investment funds and pension funds. In addition, a strong governance system may forestall the need for an even more expensive state regulatory and monitoring system.

As the capital markets develop in middle-income countries, collective investment funds[5] provide a vehicle for private citizens of all economic classes to participate in the capital market and the economic development of the country. In addition, investment funds provide for an additional means for savings for large expenses such as education and for retirement. In turn, the investment funds, as entities which aggregate large amounts of capital, are a source of financing for new and established companies in middle-income countries. Trust and continued growth of investment funds is important because they represent not only an alternative savings product for investors, but also a source of demand for new corporate and financial instruments, which can help develop local securities markets and expand access to finance.

In well-developed capital markets, collective investment funds provide a potentially attractive investment option for investors. Collective investment funds (also called collective investment undertakings or CIUs in the terminology of the UCITS Directive and mutual funds in the informal terminology of Wall Street) provide individual investors with access to a diversified investment portfolio, potentially benefiting from efficient sales and purchases of large blocks of securities. However collective investment funds also entail some risks. In many jurisdictions, individual investors lack direct information regarding the investment assets and are therefore obliged to trust the fund managers—and the sector's governance framework—to ensure that their interests are protected. It is

[4] Not all market participants agree on the cost of good governance arrangements. In the United States, some major mutual funds argue that the costs of ethics and codes and systematic reporting are relatively inexpensive.

[5] Various terms are used to describe entities which collect funds from the public for the purpose of investing the funds in a portfolio of securities, such as collective investment schemes, collective investment undertakings, investment companies, mutual funds and investment funds. For simplicity, this Report will use the term "collective investment funds" to generically refer to all types of such funds and, if appropriate, will specify the type of fund as well.

the role of the government to ensure that such trust is warranted and that investors can feel confident that their interests will be placed ahead of those of the investment managers.

As a starting point, investors need sufficient information to make well-informed decisions. The introduction of the revised international capital framework for banks worldwide, known as Basel II, and similar provisions for European insurance companies under Solvency II, highlight the need for strong transparency and disclosure as key governance provisions to strengthen the financial sector. The role of financial supervisory agencies is to ensure that financial institutions provide such information on a timely basis and in a format that permits clear understanding by investors and other participants in the financial markets.

The academic literature also supports the need for some government regulation and supervision of the securities markets. Over the last decade, policymakers in former transition economies have recognized that simply establishing an organization that allows formal trading of shares is not enough. In order for a market to function efficiently and attract investor interest, there needs to be effective enforcement of rules on transparency and disclosure. Equity market regulation is justified as a tool to guarantee investors a level-playing field (Levitt 1998). A cross-sectional study on the effect of securities market regulation on the cost of capital, finds that stricter regulation (in the form of high disclosure requirements set by the exchange or government) and strong enforcement is associated with lower cost of capital (Hail and Luez 2005). The study also found that as capital markets become more integrated, these effects become smaller. Further, strong disclosure requirements by stock exchanges increase liquidity (Frost et. al. 2001). Another study shows that different regulatory approaches taken by Poland and Czech Republic strongly affected development of the local stock market (Glaesser, Johnson and Shleifer 2001). The Czech Republic, which had a more hands-off approach to regulation of the capital markets, was associated with an inactive equity market, while Poland which had more strict enforcement of regulation and disclosure, witnessed strong growth in its capital market. The Polish example is a case of beneficial regulation, where regulators enforced credible and effective disclosure.

Key governance differences exist between collective investment funds in Europe versus the United States. Box 1 provides a brief summary.

Box 1: Governance of US versus European Funds

Recent changes in US legislation regarding investment companies highlight the differences between the governance structures of collective investment funds in the US compared to those in Europe. In the US, mutual funds are corporations or business trusts, overseen by boards of directors or trustees that are required by the Investment Company Act of 1940 to be organized and operated in the best interests of shareholders. Funds typically have no direct employees and hire registered investment advisors as asset managers and other service providers. For such funds, the key governance issues relate to conflicts of interest, particularly where officials of the investment advisor/asset management company are also the fund's directors and can set the management fees paid by the funds. Hence the focus of US regulatory reform is on having a large number of "independent" or unaffiliated directors or trustees.

In Europe, funds can also be organized using legal structures for corporations and trusts, but more often are structured as contract-based funds. In the contract approach, a fund is viewed as a product of the management company. The fees and other terms are spelled out in a governing agreement between the fund manager and investors. The fund has no legal status but is essentially a pool of assets with investors owning a specified number of units of the trust. For all types of collective investment funds, there is an outside entity that helps to ensure that the fund is indeed run by the fund's manager in accordance with governing documents, rules and regulations and fund investment guidelines. These independent oversight organizations, called "depositaries", are typically units of big banks and are responsible for safeguarding the assets of collective investment funds and for monitoring fund managers' actions. However, unlike the board of an investment company in the US, a depositary for a UCITS collective investment fund has no discretion to set investment policies for the fund.

Methodology

This report examines the governance structure for investment funds in the ten EU11 new member states, composed of the eight countries that joined the European Union (EU) in 2004 (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) plus Bulgaria and Romania which joined in 2007 plus Croatia, for which accession negotiations started in 2005.

The report focuses on collective investment funds which comply with the UCITS Directive by placing most of the assets of the fund in transferable and liquid securities. New developments in other asset types permitted for such funds, such as over-the-counter (OTC) derivatives, are examined in terms of the challenges that they bring to the governance structure of the funds. Other types of investment funds, such as "non-harmonized funds" for real estate, pension funds that function as collective investment funds, and insurance products that link their returns to the market performance of the premiums paid for the insurance are not covered in this report, but may be the subject of later studies.

This report uses and refers to a number of the governance guidelines that have been developed by international organizations and by the staff of the World Bank. The Organisation for Economic Co-operation and Development (OECD) *Discussion Draft Governance of Collective Investment Schemes (CIS) (2004)* and an earlier draft Guidelines for Governance of CIS provides a good source for issues related to such governance. In addition, IOSCO conducted an extensive study of investment fund governance and issued a report *Examination of Governance for Collective Investment Schemes, Part I (2006)* and *Consultation Report Part II (2006)*, which synthesized a number of characteristics of good governance for investment funds and key issues in such governance. The Committee of European Securities Regulators (CESR) conducted *Investigations of Mis-Practices in the European Investment Fund Industry (November 2004)*, which provided excellent insights into the governance of investment funds to prevent fraud and abuse. The European Fund and Asset Management Association (EFAMA) has also produced a draft *Code of Conduct for the European Investment Management Industry (January 2006)* for discussion purposes, which contains an excellent perspective on the elements of good governance for the investment fund industry. The *Code of Ethics and Standards of Professional Conduct* of the Institute of Chartered Financial Analysts also provides useful guidance. While the report is a desk review, it has benefited from pilot assessments of governance of investment funds conducted by the World Bank in the Czech Republic and Slovenia.[6] The two country-based assessments have provided helpful insights into the elements of good governance for investment funds throughout the EU11.

Background

Collective investment funds provide retail investors with a vehicle to use professional financial investment advice without the costs associated with an individual financial planner. Unfortunately, the effect of the failure of many privatization funds in the 1990s resulted in considerable skepticism on the part of investors in the EU11 towards the securities markets and investment funds. However the first five years of this decade saw a steady increase in the willingness of investors to invest in investment funds with a very strong increase after 2004, when the first eight countries under analysis formally joined the EU. Table 2 shows the net assets of UCITS funds steadily increasing until 2004 when they increased dramatically.

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[6] The review for the Czech Republic has been published and is available at www.worldbank.org/capitalmarkets

Table 2: Net Assets of UCITS Funds

Country	In million of Euros						As percentage of GDP		
	2001	2002	2003	2004	2005	2006	2001	2005	2006
Czech Republic	1,917	3,142	3,246	3,583	4,661	5,523	2.8	4.4	5.1
Bulgaria[7]	1.11	1.17	1.24	2.33	6.77	13.3	0.0	0.0	0.1
Croatia	N.A.	N.A.	398.61	614.9	1,201	2,184	N.A.	3.7	6.7
Estonia	192	279	461	695	1,155	1194	2.8	10.0	9.6
Hungary	2,794	3,856	3,167	3,629	6,149	7,420	4.7	6.6	8.7
Latvia	16*	29*	39	51	109	160	0.2	0.8	1.0
Lithuania	N.A.	N.A.	N.A.	46	174	241.1	N.A.	0.8	1.1
Poland	3,332	5,223	6,799	8,820	15,015	21,999	1.6	5.9	8.6
Romania	12.44	26.62	23.24	54.46	91.8	196	0.0	0.1	0.2
Slovakia	N.A.	N.A.	N.A.	1,816	3,264	3,002	N.A.	8.2	7.2
Slovenia	61	231	387	867	1,376	1,921	0.3	4.7	6.8

* Approximate values

Source: EFAMA Fact Book 2006, statistics from the Bulgarian, Croatian, Estonian, Latvian, Lithuanian, Romanian, Slovenian and Slovakian Securities Regulators and Investment Funds websites.

Some countries have seen increases of 10-fold or more in total assets under management in UCITS funds. UCITS funds represent more than 90 percent of total assets under management in most EU countries, although in 2006-2007 non-UCITS funds (such as private equity funds, hedge funds and real estate funds) have grown in size particularly outside the EU11.

In the EU11, the increase in assets under management in UCITS funds strongly indicates an increased confidence on the part of investors in the governance of the funds and the stability and attractiveness of the capital markets as a place to put their savings. As a result, increased attention is being given to the investment fund sector in terms of its governance and supervision to ensure that this confidence is warranted and continues for the benefit of the financial markets in the EU11.

Evaluations of Governance of Collective Investment Fund Sectors

Various international and EU institutions have evaluated the governance of collective investment funds in the EU over the last six years. Much of the analysis was motivated by the mutual fund scandals in the United States in 2002-03. In 2001, the OECD conducted a survey of investment fund governance among its members, including many members of the EU. In November 2003, the OECD released a set of draft principles of good governance for investment funds, along the lines of earlier principles which it had prepared for publicly traded corporations and pension funds. This effort resulted in a White Paper in March 2005. However the OECD did not issue a list of principles on good investment fund governance, deferring instead to ongoing work by IOSCO on investment fund investor protection.

Various national associations of investment funds have also issued codes of good practice. In the United States, the Investment Company Institute in June 1999 issued a *Report of the Advisory Group*

[7] Includes closed-end funds.

on Best Practices for Fund Directors which set out 15 best practice recommendations. In 2003, two additional recommendations were added, largely in response to the market timing scandals. In January 2006, the European Fund and Asset Management Association (EFAMA) also issued a discussion paper on a *Code of Conduct for the European Investment Management Industry* containing High Level Principles and Best Practice Recommendations.

In March 2004, the European Commission (EC) issued a Communication to the Council and European Parliament reviewing the regulation of UCITS depositaries in EU member states. The Communication voiced a number of concerns regarding the limitations of the UCITS Directive regarding the duties of the depositary and the lack of uniformity in national legislation implementing the Directive. The Communication set up a time-table for future work on the issue and intended to issue a more detailed statement in 2005. In November 2004, CESR issued a *Report on Mis-practices in the European Investment Fund Industry* which looked at the potential for the sort of misconduct, such as market timing, that had been prevalent in the United States. CESR's Report found that such practices did not seem to be a problem in Europe. In July 2005, the Commission issued the Green Paper on *The Enhancement of the EU Framework for Investment Funds*. The Paper did not deal with the issues of depositaries, stating that the Commission would await the outcome of the review being done by IOSCO related to investor protection in the investment fund area. A further White Paper on *Enhancing the Single Market Framework for Investment Funds* came out in November 2006, but it also did not deal with investor protection issues. The IOSCO study resulted in a two-part Report. Part I released in June 2006 set out a typology of different governance structures for investment funds throughout the world, and Part II in February 2007 set out a series of principles related to the concept of an "Independent Oversight Entity" (IOE) as the primary vehicle for governance and investor protection in investment funds.

The numerous studies highlight the need to revisit the governance structure for investment funds in the EU11. The 2004 EC Communication clearly shows a concern as to whether the governance structure for collective investment undertakings set forth in the UCITS Directive (i.e. the use of a management company to manage the assets plus a depositary to oversee the actions of the management company) is sufficiently effective in providing for governance and consumer protection. The IOSCO Report reinforces this concern by emphasizing the importance of the IOE, which can comprise several different institutions where each has a separate role. Thus the depositary is seen as a useful--but not comprehensive--tool in providing for good governance of collective investment funds.

Mechanisms for Governance of Collective Investment Funds

The laws regulating the funds provide for different legal approaches for corporate governance of the funds. Several different mechanisms have been used in different jurisdictions to provide for the good governance of investment funds. Different jurisdictions, with varying legal traditions, may opt for different means of obtaining maximum governance and investor protection within their jurisdiction. However, it is clear that there are several common themes that are widely used in the legislative frameworks which authorize the creation and operation of investment funds. Five methods are commonly used to ensure good governance of collective investment funds.

1) ***Legal Structure:*** Some legal regimes for investment funds attempt to ensure good governance by setting up a multiplicity of entities to carry out the various governance functions of the investment fund. One entity will provide for management of the fund. Another will act as the custodian of the assets of the fund. A third will represent the investors and their interests while a fourth will provide for an independent evaluation of the integrity of the investment fund.

Sometimes these functions are spread out among many entities and in other circumstances they are consolidated in only a few entities. In theory, the separate entities will provide for a system of checks and balances of a fund's activity in order to provide for good governance and investor protection.

2) ***Oversight***: Other legal structures look to an oversight body which constantly monitors the activity of the fund from the viewpoint of an independent, disinterested party whose sole perspective is the investor's interest. This function is sometimes carried out by the custodian (or in the case of UCITS funds, the "depositary") of the assets of the fund. In other instances, the role is played by one or more independent directors or supervisors of the investment fund.

3) ***Supervision***: Other legal structures look to the governmental supervisory agency of the securities markets and investment funds as the primary vehicle for investor protection. Through constant on-site and off-site supervision, inspection, and control, the supervisory agency is able to ensure that the investment fund is complying with the law, regulations, fund rules and investor interests.

4) ***Deterrence through Legal Sanctions***: Deterrence can be the key in other legal structures. In these regimes, heavy penalties are established and enforced against corporations and individuals who work for an investment fund for violations of the law and fund rules. These can be enforced by the regulatory authority or in private actions by the investors.

5) ***Deterrence through Disclosure, Market Forces and Reputational Damage***: Another vehicle for good governance is disclosure of a fund's policies, activity and performance. In this method, full disclosure will subject a fund to market forces. Bad governance leading to bad results will result in reduced demand and value for the fund to the detriment of the fund managers. In addition, failure to meet good governance standards can result in reputational damage to the fund managers which will also motivate investors to avoid funds under its control and thus reduce the value of the funds and the management company.

No jurisdiction relies on only one of these various mechanisms for good fund governance. Many jurisdictions use a hybrid of the above methods. Nonetheless, often a country will emphasize one or the other of the approaches as the primary approach.

Legal Forms

The European Union has promulgated a number of directives in the area of the financial markets to harmonize and improve the legal environment for the financial sector. A number of Directives have been issued related to investment funds (see Annex 1) Most notable is the 1985 UCITS Directive which has been amended on numerous occasions. The Directive along with others sets the framework for UCITS funds in the EU. Consequently, these Directives provide a large part of the governance framework for investment funds in the EU11.

The countries in the EU11 follow the UCITS Directive (Directive 2004/611/EEC, as amended) as to the types of funds and their basic structure. The UCITS Directive recognizes three legal forms for an investment fund: corporation, trust, and contract-based fund without juridical character. The types of funds and their characteristics are set out in Table 3, along with a summary comparison of fund structures in the United Kingdom and United States.

Table 3: Comparison of International Legal Forms of Collective Investment Funds[8]

Type of Fund	Legal Form	Type	Manager	Depositary	Title to Assets	Investor Interest
Typical EU11 Structure						
Investment Fund (Based on Contract)	Fund has no legal personality	Open	Management Company	Assets must be "controlled" (i.e. supervised) by a depositary	Assets held in name of investment fund at depositary	Units of Participation
Investment Company	Corporation	Open Closed	Management Company	Assets must be controlled by a depositary	Investment company holds title	Shares
Investment Fund (non-UCITS)	Fund has no legal personality	Closed	Management Company	Assets are usually controlled by a depositary	Assets held in name of fund at depositary	Units of Participation
UCITS Recognized						
Investment Fund (Based on Contract)	Fund has no legal personality	Open	Asset Management Company	Assets must be entrusted to a depositary for safekeeping	Determined by national law	Unit Certificates
Investment Company (such as SICAV)	Corporation	Open	Asset Management Company or Self-managed	Assets must be entrusted to a depositary for safekeeping, with some exceptions	Determined by national law	Shares
Unit Trust	Trust form – based on UK model	Open	Asset Management Company	Assets must be entrusted to a depositary for safekeeping	Determined by national law	Units of Beneficial Shares
United Kingdom						
Unit Trust	Trust under law of England	Open	Corporate Asset Manager	Assets held by trustee	Trust Company as trustee has legal title	Beneficial Units in Trust
Unit Investment Company	Corporation	Closed	Fund Manager or Self-managed	None. An independent board of directors protects investor.	Unit Investment Company has title	Shares which can be in different classes
Open Investment Company (non-UCITS)	Corporation	Open	Fund Manager or Self-managed	Asset held by depositary	Depositary holds asset as trustee	Shares
United States						
Investment Company	Corporation	Open or Closed	Investment Advisor or Self-managed	Not obligatory, although assets can be held by custodian	Title held by investment company	Shares
Unit Investment Trust	Trust	Open	Same	Assets held by trustee	Title held by Trustee	Units of Interest

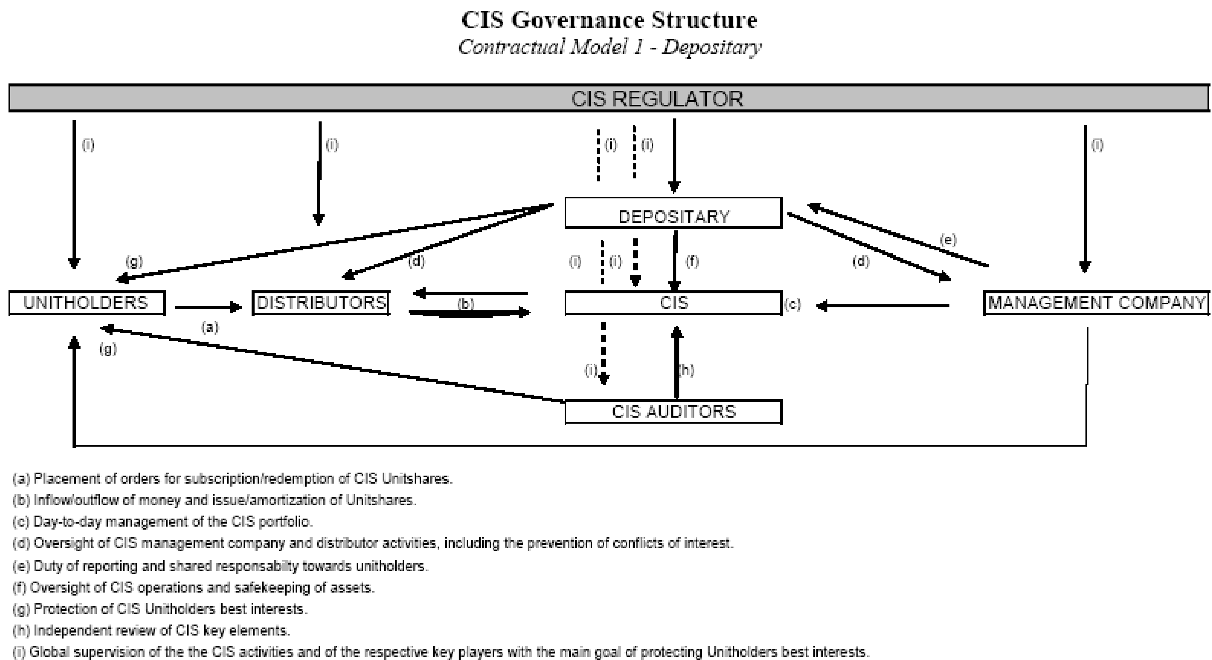
[8] For additional information on the governance of collective investment fund sectors in various OECD countries, see John K. Thompson and Sang-Mok Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*. OECD, Financial Affairs Division. April 2001. A copy can be found at http://www1.worldbank.org/finance/assets/images/Governance_Systems_for_Collectiveoccpap1.pdf

In the EU11, the most common forms of UCITS funds are the investment fund (based on contract) and the investment company (i.e. the corporate structure). Although many laws refer to trusts or unit trusts, the “trusts” typically function as funds based on contract and not as trusts under the general law of trusts that exists in common law jurisdictions such as the United Kingdom.

Common Entities for Management and Governance of UCITS Funds

The two primary entities for the operation and governance of a collective investment fund are the management company and the depositary of the fund. These entities will exist whether the fund is structured as a contract-based investment fund or as an investment company (i.e. a corporation). Figure 1 sets out the standard governance structure for a contract-based investment fund. For contract-based funds, governance is conducted primarily by the management company and the depositary. The investment fund is not a legal entity, except in Poland. The shareholders have an interest in the assets of the fund by operation of law. However the legal title to the assets may be held by the management company or depositary, except in Poland.

Figure 1: UCITS Fund as a Contract-Based Investment Fund



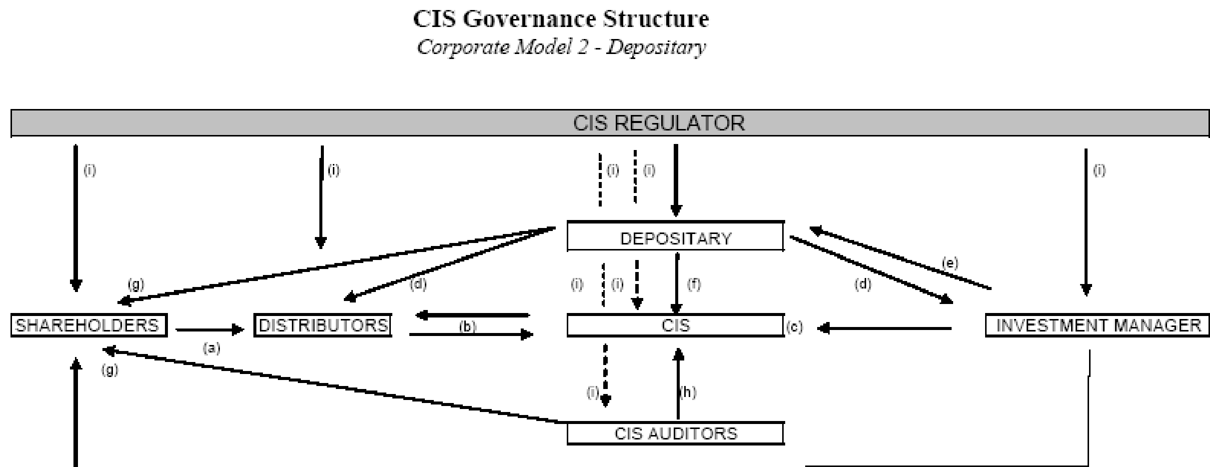
Source: IOSCO, *Examination of Governance for Collective Investment Schemes, Part I (2006)*

Figure 2 sets out the common structure for a fund which is organized as an investment company i.e. a corporation. When the fund is structured as a corporation, the management of the corporation can act as the board of the management company (a so-called “self-managed” investment company) or it can contract out the function to an external investment management company. Figure 2 uses an external investment management company. Some countries, such as Slovenia, allow investment companies to be self-managed.

In general, the governance for an investment company is the same governance that one would find in a public corporation. The supervisory board (or board of directors in a single-board corporate structure)

is responsible for the direction of the company and the shareholders decide on major corporate decisions at the annual and extraordinary shareholders' meetings. However wherever the fund is structured as a corporation, the fund's supervisory board has its usual responsibilities of overseeing the activity of the investment company. The assets of the corporation are held by the depositary, which reviews actions by the Management Company (or self-managed corporation) to determine compliance with relevant legislation, fund rules and the investment goals of the investment company. The role of the depositary is the same as for both the contract-based investment fund and the investment company.

Figure 2: UCITS Fund as an Investment Company



(a) Placement of orders for subscription/redemption of CIS Shares.
(b) Inflow/outflow of money and issue/amortization of Shares.
(c) Day-to-day management of the CIS portfolio (may be conducted by the CIS Board of Directors in the special cases of self-managed CIS)..
(d) Oversight of CIS Investment Manager and distributor activities, including the prevention of conflicts of interest.
(e) Duty of reporting and shared responsabilty towards shareholders.
(f) Oversight of CIS operations and safekeeping of assets.
(g) Protection of CIS Shareholders best interests.
(h) Independent review of CIS key elements.
(i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Shareholders best interests.

Source: IOSCO, *Examination of Governance for Collective Investment Schemes, Part I (2006)*

Supervisory Boards of Asset Managers and Self-Managed Investment Companies

The members of the supervisory board of a management company are generally required to be independent from the fund's depositary. Some countries, such as Poland, formalize this by stating that members of the depositary’s bodies and employees cannot be directors of the management company. It is not clear in many of the EU11 countries whether this prohibition also applies when a holding company of a management company is the depositary of a fund managed by the company or is the parent company of the depositary. For example, Lithuania allows the depositary's head of administration, employees, members of the management board and members of the supervisory board to be on the supervisory board of a management company whose activities are related to the depository, as long as they do not constitute over 25 percent of the members of the supervisory board. (On the other hand, the officers and directors of a management company cannot have any position with the management company’s depository.)

The liability of the officers and directors of asset managers and self-managed investment companies varies from country to country. In some countries, such as Latvia, there are no provisions for personal liability for individual directors or employees of the management company or depositary. In other countries, such as Poland, there are extensive personal liability provisions.

All jurisdictions require some form of qualifying ("fit and proper") criteria for the senior officers and managers of a management company and a self-managed investment company. The specific criteria and means for evaluating them differ. However they all rely largely on the discretion of the securities supervisory agency as to whether an individual officer or manager would act in the best interests of investors.

Depositaries

In the UCITS structure, the depositary is the primary entity protecting investors' interests. Under the UCITS Directive, depositaries have four distinct roles to: (1) hold the assets of a fund, (2) execute the sales and purchases of the fund's assets (or supervise execution by a securities broker), (3) control the sale and redemption of units of participation in the investment fund (or shares in the investment company), and (4) verify the calculation of the Net Asset Value (NAV) of the fund. The depositary in a UCITS fund plays a key role as a gatekeeper, protecting investors' interests. Investment decisions for the fund's portfolio are made by the asset management company but the depositary must ensure that all transactions are in compliance with applicable laws and regulations and the fund's own rules.[9] These are, however, just minimum requirements. Some EU11 countries give the depositary even more responsibilities. For example, Slovenia requires the depositary to ensure that the initial and secondary offerings are in compliance with the law and fund rules. Non-UCITS funds may also employ a depositary, depending on the national legislation.

All countries require that the assets of collective investment funds be segregated from those of the depositary and the management company. Some countries allow the depositary to hold title to the assets in the name of the fund. However in such cases, the bankruptcy laws stipulate that the assets of collective investment fund do not form part of the assets of the depositary or management company.

Although depositaries review the purchases and sales of securities in a fund's portfolio and can request documents and data from management companies, depositaries do not have the authority to conduct on-site examinations of a management company. On-site inspections are generally reserved for the governmental supervisory authority.

Governmental & Industry Authorities

All the EU countries have governmental authorities charged with licensing and supervising collective investment funds in their jurisdictions. This usually resides with the securities supervisory agency but is increasingly handled by unified supervisory agencies for the entire financial sector. As a result of compliance with EU Directives, supervisory agencies generally have sufficient authority to set entry criteria for investment funds, management companies and depositaries, as well as other participants such as auditors. They also have qualification requirements in terms of experience and education, as

[9] By contrast, in the United States "depositories" play a far more limited and passive role. In the US, depositories are responsible only for custody and safekeeping of the funds' assets and they do not control the activities of the management companies.

well as fit and proper tests for the promoters, employees and directors of the companies. The primary issue facing the supervisory agencies is their capacity and willingness to enforce rules that have been put in place. Industry associations also have a valuable role to play in governance of collective investment funds through their preparation and adoption of a Code of Conduct for their member companies. See Table 4 summarizing government and industry authorities for the EU11 countries.

Table 4: Government & Industry Supervisory Structures

Country	Supervisory Agency	SRO or Industry Association	Code of Conduct
Bulgaria	Financial Supervision Commission	None	None
Croatia	HANFA – Croatian Financial Services Supervisory Agency	Fund Association within Chamber of the Economy	Approved
Czech Republic	Czech National Bank	Association of Funds and Asset Management	Approved
Estonia	Financial Supervisory Authority	Informal Association that represents most management companies	None in place
Hungary	State Financial Institutions Commission	Association of Investment Fund and Asset Management Companies	Not available on website
Latvia	Financial and Capital Markets Commission	Only Latvian Venture Capital Association	None in place
Lithuania	Securities Commission	Investment Management Companies Association	Not clear if in place
Poland	Securities Commission	Chamber of Fund and Asset Managers	Approved
Romania	CNVM – National Securities Commission	UNOPC - National Union of Collective Investment Organizations	Approved
Slovakia	National Bank of Slovakia	Association of Fund Management Companies	Approved
Slovenia	Securities Market Authority	ZDU-GIZ - Slovenian Investment Fund Association	Approved

Source: National Laws; websites of Securities Authorities and SROs.

All national laws, in conformity with the UCITS Directive, have supervisory authority over the investment managers and investment funds, including the power to conduct off-site and on-site compliance inspections, gather documents and statements and bring enforcement actions. However the laws in the various members of the EU11 vary as to the extent to which they cover the common abuses found in investment funds. The enforcement aspects of the legal regime for investment funds will need to be continually reviewed to see that they are up-to-date and comprehensive.

Key Issues

The collective investment fund industry in the countries that comprise the EU11 has been evolving to meet the increased demand for such investment vehicles by its citizens and the changes in relevant EU Directives. Notwithstanding the extensive development of the industry, there are still some issues that need to be addressed by the countries in the EU11. Table 1 (on Page 5) summarizes the recommendations in the report which are made for improvements in the governance structure. Not all recommendations apply to every country in the EU11. Different recommendations will be appropriate for different countries depending on the status of local legislation and regulatory procedures.

Fund Disclosure

Fund Activity

The general requirements of accurate disclosure of fund performance and activity act as a prime motivation for good governance. Disclosure documents should describe each fund's risks, performance and expenses. The accurate description of the results of the management company's decisions regarding the disposition of fund assets is one of strongest pressures that can be placed on a management company. The disclosure requirements in the EU11 are generally good and in line with the UCITS requirements. However regulations should be put into place requiring that fund performance be disclosed on a standardized basis, for example at the end of one, three, and five years.

Due to extensive disclosure requirements and the difficulty in describing the complexity of an investment fund, fund prospectuses (as defined in the UCITS Directive) were and are viewed by many market participants and investors as too long and difficult for the average investor to use as a means of obtaining information. The result was the creation of the simplified prospectus which was added to the UCITS Directive and the contents of which were set out in Schedule A to the UCITS Directive. However this document in turn is now being criticized as opaque and inadequate in describing a fund to a retail customer. A new call for evidence has now been sent out by CESR in an attempt to determine what information is necessary for retail investors in an attempt to find a new document that will be more useful.

Fund Governance

The disclosures required in the UCITS Directive and national laws do not include a disclosure of the governance structure of common funds and the rights of investors in the funds. The simplified prospectus and prospectus should cover the characteristics of the goals of the investment fund, management skills and fees to be charged. In particular, when unit-holder committees are permitted, the rights of the unit-holders (which may not be laid out in the law, but only in the fund rules) should be clearly disclosed to the investors. However, currently they do not give sufficient detail on the governance structure of the investment funds, the duties and liabilities of the asset manager and depositary, or the rights of investors vis-à-vis the two entities. As a result, investors do not have a clear vision of the respective governance responsibilities and liabilities of the management company and depositary.

In addition, the identities of the managers of a fund are critical to evaluating a fund and the effectiveness of its governance. Disclosure documents should also include the names and professional backgrounds of the senior officers and managers, including the portfolio manager of the management company for each fund. In addition, investors should receive notification of client personnel changes

in each of the key governance entities, including the fund's management company, depositary or external auditor. This would enable them to engage in an on-going evaluation of a fund's governance over time.

Depositaries

Independent Oversight

The safekeeping of customer assets and their proper use by fund managers is a cornerstone of the governance of investment funds. One of the key mechanisms for investor protection and for ensuring the safekeeping and proper use of the assets is an Independent Oversight Entity (IOE) for the investment fund. Different countries use different institutions to carry out this function. Some countries use independent directors, some use depositaries, some use committees of the boards of directors and some use the regulatory or supervisory agency. Most of the countries in the EU11 use the depositary and the securities regulator to conduct this activity of independent oversight. The depositary has the day-to-day responsibility for the oversight of the investment fund, while the securities regulator's responsibility is spread out over the period of the examination cycle on a periodic basis due to reporting requirements. IOSCO conducted an extensive study of the governance of investment funds, *Examination of Governance of Collective Investment Schemes, Part I and II (2006 and 2007*). This study emphasized the role of the IOE and explained the variety of ways in which this function is carried out in its member countries throughout the world. The IOSCO study developed a series of characteristics of an IOE, which would strengthen the governance of collective investment funds. All of the recommended characteristics of the IOE are applicable to UCITS funds, regardless of the legal structures used for the IOE.

IOSCO takes the position that the IOE should be established in such a manner that the decision making process in not tainted with conflicts of interest with the manager of the investment fund. In all of the countries of the EU11, the management company in setting up an investment fund enters into a contract with the depositary, which conducts many of the activities of the IOE. In the application process, the depositary is submitted to the securities regulator for approval. The fact that the depositary is usually a supervised financial entity such as a bank gives it the independence needed to avoid conflicts of interest—the banking supervisors oversee the independent establishment, and closure, of the depositary. However the appointment of the depositary is done by the management company as the operator of the fund. This raises some doubt as to the true independence of the depositary.

IOSCO notes that the depositary and securities regulator should collectively be able to act as the independent oversight authority for investment funds. In all of the EU11 countries, the general authority to oversee the asset manager is given to the governmental body supervising the investment funds. In this regard, the securities regulator acts as an IOE for the investment funds. The power to obtain information is lodged with the securities regulator in its inspection powers and not with the depositary. In addition, the securities regulator has the right to review the legal and operational conditions of the management company. None of the countries in the EU11 give this broad supervisory authority to the depositary.

IOSCO states that the oversight should have appropriate mechanisms in place to detect, prevent or avoid the misappropriation or dissipation of fund assets. The depositary should view the accuracy of the transactions of the fund and their compliance with the fund rules and relevant law, but it does not act as fraud investigator. Related-party transactions would not necessary fall within its review unless

the transactions were on a list of related persons to a manager at the management company. The general oversight for fraud would be the securities regulator. It should establish reporting requirements for the management company and conduct on-site and off-site inspections that it considers necessary.

Nonetheless, the depositary oversees the day-to-day operations of the investment funds. It holds the assets, executes the orders of the asset manager, reviews the transactions of the funds, reviews the NAV of the fund and transfers the money of the funds for which it is the depositary. The IOSCO report indicates that the IOE should be entitled to receive all information necessary to perform its oversight role and to review the legal and operational relationship of the management company and the fund without assistance from the management company. Therefore, as part of the IOE function, depositaries should have the right to request any additional information that they do not already have from the management companies. However under the system established by the UCITS Directive and the manner in which it has been implemented in the countries in the EU11, the depositary has limited powers for overseeing the asset manager. In most countries in the EU11, they do not have the right to inspect the management companies or obtain information at other sources. The depositary's duties are limited to seeing that the transactions are in compliance with the law and the rules of the fund. In order to fulfill its role as part of the IOE function, the depositaries should be given as much authority as needed to allow it to carry out their day-to-day oversight quickly and efficiently. In order to provide for more extensive oversight, most of the countries of the EU11 should consider expanding the authority of the depositary. The laws should provide for some sanction in the event that the depositary does not receive all relevant information. This would be a red flag for the securities regulator that there may be problems in the collective investment fund.

Nevertheless a division of authority between the securities regulator and the depositary will continue. However, if communication between the securities regulator and the depositary were weak, it is possible that the depositary would not have all necessary documents (or access to documents) to fulfill its responsibility of overseeing the fund. The regulatory structures must require and enforce a close working relationship between the depositary and regulator. For example, the IOSCO study states that the oversight entities should have a duty to report to the securities regulator or unit-holders. All of the EU11 countries impose a reporting obligation on the depositary if it uncovers actions by the management company that are in violation of the fund rules or relevant laws. In addition, it should report to the unit-holders, although most national laws do not require this. The regulatory authorities should also notify the depositary in the event that their inspections indicate that there are problems with the fund or asset manager.

Functional Independence of Depositaries

In order to provide protection to investors in investment funds, the UCITS Directive establishes a three-part structure for a common fund: (1) the management company; (2) the depositary; and (3) the fund which is comprised of the assets of the entity and which, in most countries, does not have a legal personality. The investors are unit-holders which have undivided interests in the fund but do not have the rights of shareholders in a corporation. The officers and directors of the management company have an obligation to place the interests of the unit-holders above their own. However the framers of the contract-based UCITS structure did not see this duty as sufficient to protect the unit-holders of the fund and required the use of an independent depositary. Thus, the structure of UCITS funds in the countries of the EU11 attempts to create a system of checks and balances between: (1) the managers who make the decisions regarding the disposition of fund assets, and (2) the depositary which holds and safeguards the funds and checks whether the management company's actions are in accordance with the law and fund rules. This structure places the investor protection responsibility on the depositary, which is required to act independently of the management company and to act solely in the

interest of the investor/unit-holders. This entire structure is dependent on the separation of the management company or self-managed corporation and the depositary. One company cannot act as both—and the UCITS Directive requires that the two act independently of each other and in the shareholders' best interest.

A fund established as an investment company (i.e. a corporation) also effectively has three parts: (1) the management of the corporation, (2) the shareholders and (3) the depositary. Once again the depositary acts as the primary investor protection entity with the same responsibilities as for a fund based on contract. It appears that the drafters of the Directive determined that a UCITS fund using a corporate structure also required the protection of a depositary to hold the fund's assets fund, even though the shareholders in an investment company have the full rights and remedies given to them under the company law.

The specific characteristics of the depositary are not set out in the UCITS Directive, but the Directive requires that the depositary be subject to public control. In fact, most countries in the EU11 require that the depositary be a credit institution licensed by the banking authorities, most often the central bank. This adds an additional level of regulation and oversight as a result of the supervision of the credit institution by the banking authorities.

However in practice, it is not clear if the depositary is as distanced from the management company as one would expect in a fully effective system of checks and balances. The requirements do not take into account the European practice of universal banking or the recent development of financial conglomerates. Neither the UCITS Directive nor national laws in the EU11 forbid the management company or self-managed investment company and the depositary from belonging to the same financial conglomerate. In fact, the bank/depositary may hold the management company as a subsidiary, as seen for example in Lithuania.

The solution for this weakness in the structure of the collective investment funds is not stated in the UCITS Directive or in the national investment laws, but in regulations. Some regulations simply require the management company and depositary to have internal structures to avoid conflicts. Some conglomerates use internal "firewalls" (i.e. corporate policies that forbid the communication of client information among different parts of the financial group) as the primary method of separating the activities of the depositary, the management company and the securities broker where they are part of the same conglomerate. However the laws or regulations requiring that conflicts of interest be avoided do not provide for specific standards or mechanisms for "firewalls" that would give direction to the management company, depositary and securities broker. Only Poland has a specific requirement for the creation of the firewalls. The system of firewalls that are supposed to separate the activity of these two entities are not explicitly set out in EU Directives, nor are they standardized throughout the EU11. Standards should be set for firewalls to avoid conflicts of interest within the same financial group or conglomerate. Criteria should set by which the effectiveness of firewalls can be evaluated and procedures established to ensure that such firewalls can tolerate the stress of potential high profits from internal sharing of information. This is an area of increasing importance and requires a standardization of procedures for reinforcing the structure of the UCITS funds. It may also be helpful to give unit-holders the authority to approve any change of depositary. In addition, consideration could be given to encouraging funds to use depositaries that are not affiliated with management companies in their financial groups. At a minimum, the relationship between the management company and the depositary should be publicly disclosed.

A further independence problem is that, in order to carry out its responsibilities, the depositary may be required to review both the buy and sell orders given by the management company and the execution of those orders by the securities broker. However this is not specified under the UCITS Directive. In

addition, there are no requirements for independence of the securities intermediary from the management company and the depositary—and all three may be part of the same financial group. Furthermore in some countries, such as Estonia, the depositary is required to execute the orders itself. The UCITS Directive does not even require that the depositary verify the "best-execution" of fund orders. This could lead to considerable conflicts of interest in that the securities intermediary could act in its own self-interest and that of the group, but not in the interest of the investment fund.

Finally, the IOSCO report states that the roles and responsibilities of the management company and depositary should be clearly defined. As a result of the UCITS Directive, the roles of the depositary and the management company are fairly well defined in the legal structure. However, as stated in the EU Commission's 2004 review of the regulation of depositaries, management companies in a number of EU countries delegate some of their activities to the depositaries or their related entities. This is prohibited in the legislation of a number of EU11 countries and should be prohibited in those that allow it.

Valuation of Illiquid Securities (such as OTC Derivatives)

The valuation of non-exchange traded assets (such as OTC derivatives) poses some issues since such assets are not traded on an exchange and are frequently illiquid. For securities that are traded outside of an organized securities exchange, the European Commission's Directive on Eligible Assets[10] permits an independent third party, independent unit in the management fund, or a self-managed investment company to calculate the value of the assets of the fund and the NAV. However this approach reduces the responsibility of the management company and depositary. It gives the responsibility to evaluate OTC derivative contracts to an outside entity not under the control of the depositary or management company. Also it does not establish the procedure that the depositary should use to check the valuation of the OTC derivatives.

The Directive requires only that a pricing model using an adequately recognized methodology be used. However the role of the depositary is to verify the NAV of the fund which would presumably be done by valuing such assets. There are a number of issues that are not resolved by the Directive. Should the depositary use a similar or different pricing model in order to double check the management company or the outside valuation expert? What if the depositary disagrees with the model used by the independent unit of the UCITS or the outside expert? Which entity should prevail in such a valuation dispute? When should the depositary conduct such a valuation? Nonetheless, one thing is clear. The depositary should be responsible for verifying the value of assets, both liquid and illiquid, in a fund. If an independent expert is used by the management company, the work of the expert should be done in coordination with the depositary.

Oversight by Unit-Holders

Unit-holders' Decision-Making Rights

Another governance issue is that the decision-making rights of investors may vary, depending on the legal structure of the collective investment fund. The shareholders' meeting is an important governance entity for corporations. However it is not usual for common funds to hold shareholder meetings. A fund which is based on a contract established by a management company, does not have a

[10] Directive 2007/16/EC of 19 March 2007 implementing Directive 85/611/EEC.

juridical personality in any of the countries in the EU11, except Poland[11]. Consequently the unit-holders in such a fund do not have the same shareholder rights that exist in a UCITS fund organized in the form of a company. Even in Poland, they do not have the same rights as corporate shareholders. This gives unit-holders little influence on the management company and they rely primarily on the depositary or the regulatory authority to assert their interests before the management company. As a result, in many countries, unit-holders in investment funds based on contract do not have a voice in many basic decisions regarding the fund, such as a change in depositary, the liquidation of the fund or a change in the management company itself. A comparison of the various voting rights in investment funds in the EU11 with different legal forms is described in Table 5.

Table 5: Unit-holders' and Shareholders' Rights to Vote on Major Decisions

Country	For Open-ended Funds	For Investment Companies	For Closed-end Funds
Bulgaria	No provision	Yes – Company Law	N.A.
Croatia	No provision	Yes – Investment Funds Law	N.A.
Czech Republic	Optional	Yes - Company Law	Optional
Estonia	Optional	Yes - Company Law	Mandatory
Hungary	No provision	Yes - Company Law	No provision
Latvia	No provision	Yes - Company Law	Yes
Lithuania	No provision	Yes - Company Law	No provision
Poland	No. Management company is governing body	N.A. Poland's funds are a hybrid legal entity. They have legal personality, but are not corporations. There are different rules for investor participation in open-ended and closed-end funds	Yes - The Board of Investors
Romania	No provision	Yes – for open and closed end investment companies - Company Law and Law on Securities Markets	No provision
Slovakia	No provision	N.A. Investment Funds are not organized as companies	No provision
Slovenia	No provision	Yes - Company Law	No provision

Source: National legislation

However, laws in some jurisdictions, for example Estonia, require the creation of a unit-holders' committee for closed-end funds based on contract (i.e. non-UCITS funds). In the Czech Republic, the law allows the fund rules to provide for such a committee for open-ended common funds. This committee represents the rights of the unit-holders before the management company and, in some countries, even has the right to approve basic decisions regarding the fund, such as a change in investment goals or conversion to another legal format. This right is usually given only to the common funds which are closed-end in character, such as in Latvia, and or the hybrid fund used in Poland which allows for a board of investors for a closed-end fund. Some countries such as Slovenia and Slovakia do not have a provision for such a meeting.

As seen from Table 5, the rights of unit-holders in common funds vary considerably from country to country based on whether the fund is closed or open-ended. The result of these various rules is a

[11] Funds in Poland have a legal personality, but are not corporations or other legal forms. They are generally referred to as a hybrid structure between a fund based on contract and a fund with a legal personality such as a corporation, trust, limited partnership, etc.

patchwork of rights for unit-holders in investment funds within each country and within the EU11 as a whole. There does not appear to be any justification for different treatment of the unit-holders in investment funds with different legal structures. The argument is sometimes made that contract-based investment funds are intended to be more flexible in dealing with the market and the fund's investments—consequently unit-holders in those funds have fewer rights that shareholders in an investment company which as a corporation has more cumbersome procedures and is less nimble. Even if one were to accept this argument, it does not explain why unit-holders in a closed-end common fund have more rights than those in an open-ended common fund. It is not tenable to say that the major remedy for unit-holders in open-ended funds is to sell and move to another fund. There may be negative tax consequences from such a move. In addition, the unit-holder may incur considerable expenses in moving to another fund which may not even meet the unit-holders' risk/return expectations in the first fund.

Independent Auditors

Article 27 of the UCITS Directive requires that each management company produce an annual report for each fund it manages. Article 31 provides that this annual report is to be audited by an authorized statutory auditor. However it is silent on the issue of the manner of the appointment of auditors for an investment fund. Article 41 of the Directive on Statutory Audits[12] permits member states to exempt collective investment undertakings from the creation of audit committees for public interest entities. Nonetheless, many countries provide that funds established as corporations generally have the protections provided by the company law, in which the annual general meeting of shareholders appoints the statutory auditor. However such rights do not exist for unit-holders of a fund based on contract. The shareholders of the management decide on the auditor of the management company and by extension, the auditor of the investment fund.

None of the investment fund laws of the EU11 provide for any other manner for selection of the external auditor. For example, in Latvia the law specifically provides that the auditor is appointed by management. In other countries, such as Poland[13] or Slovakia, an auditor is required for the annual statements of a fund, but no specific procedure is provided for. Thus, one of the critical structural safeguards for the investors is not in effect. Even in the Czech Republic, where a unit-holder's meeting can be created, the selection of the auditor is specifically excluded from the items that the meeting can vote on.

The current EU regime for auditors clearly relies on the depositary to act as the investor protection entity and (to save expenses for contract-based funds) does not require an audit committee. No country among the EU11 has created a requirement for such an entity. Even given the assumption that the depositary is sufficiently independent so that no other entity is necessary to act as an investor protection entity, all countries recognize the need to have the fund's annual financials audited by a certified auditor. In that event, the need for an independent auditor could be met by having the depositary select the auditor and oversee the auditor's activity. In addition, the auditor should be subject to independence criteria, although the only country to put such criteria in the law is Hungary. Auditors should be approved by shareholders and unit-holders and should not be tied to the fund's management company. Auditors should also be accountable to the supervisory agency, both to report any violations of law that they witness and be prepared to share their working papers with the supervisory agency. Periodic rotation of audit partners should also be considered.

[12] Directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.

[13] In Poland, the semi-annual report is also audited by an external auditor.

Supervision

Prohibition of Basic Abuses

One of the mechanisms for ensuring good governance in investment funds is the deterrence of bad conduct through the use of various types of sanctions against improper behavior. A typology of the different governance abuses and their treatment in the EU11 countries is summarized in Table 6 and described in detail in Annex 2. Some of these abuses are dealt with in laws other than the collective investment law, such as the securities law. For example, front running is frequently viewed as a form of insider trading.[14] Although the forms of fund governance abuses are widely recognized, many of the laws of the EU11 countries do not fully prohibit all of the violations. The overall coverage of these abuses needs to be improved.

Front Running

"Front running" involves the use of information about fund transactions for the benefit of the person with knowledge of the pending transaction. Since most large transactions will result in price pressure in the direction of the transaction, a person aware of the transaction can purchase or buy securities ahead of the transaction and benefit from the movement in the stock price. The Market Abuse Directive explicitly states that "front running" is a form of market abuse covered by the Directive.[15] Some countries, such as Slovenia, do not cover this transaction in their prohibitions. Latvia requires the fund to have internal rules to eliminate front running (as a conflict of interest), but there are no penalties in the law for such a violation.

Related-Party Transactions

One of the areas that has a variety of approaches is the abuse of related-party transactions, with some jurisdictions providing far less rigorous regulation than others. This is surprising since, along with front running, this is one of the basic frauds that promoters and owners of management funds can perpetrate against an investment fund. Related-party transactions can take a number of different forms. First, by selling badly performing assets to the fund or buying valuable assets from the fund at non-market prices, the insiders, either directly or through affiliated entities, are able take advantage of their position for personal gain. Frequently, this prohibition only goes to the corporate entities and senior officers but does not cover entities or persons lower in the organization.

In response to the scandals regarding market timing and preferential sales of fund units to insiders in the United States, CESR conducted a study and issued a report on "mis-conduct" in the investment fund industry.[16] The report found that there was little evidence of market misconduct by investment funds in much of the EU regarding the abuse of market timing. (The report only covered four of the eleven countries.) Nevertheless it would be useful to do additional studies particularly in areas, such as fraudulent misallocation of orders from block trades, not well covered in the existing law.

[14] In front running, a person at a management company (or someone with access to the management company's trading decisions) buys or sells securities which he or she knows will be purchased or sold by a fund operated by the management company. The "front runner" thus benefits from the price movement resulting from the purchase or sale.

[15] Market Abuse Directive, 2004/72/EC, paragraph (19) of the Preamble.

[16] Committee of European Securities Regulators, *Investigations of Mis-Practices in the European Investment Fund Industry*. November 2004

Table 6: Prohibition of Basic Abuses

Country	Front running	Preferential Sales to Insiders or Favored Customers	Transactions with Insiders at Non-market Prices	Transactions with Insiders	Market Timing	Dealings with Affiliated Entities	Preferential Allocation	Excessive Fees
Bulgaria	Prohibited	Not prohibited	Prohibited	Prohibited	Not prohibited	Not prohibited	Not prohibited	Not prohibited
Croatia	Not prohibited	Not prohibited	Prohibited	Prohibited	No specific provision	No specific provision	No specific provision	Not prohibited
Czech Republic	Prohibited	Prohibited	Not prohibited	Not prohibited	Not prohibited	No specific provision	Not prohibited	Not prohibited but fees must be disclosed
Estonia	Not prohibited	Not prohibited	Prohibited	Prohibited	Not prohibited	Limitations on dealing with affiliates	Not prohibited	Not prohibited, but fees must be disclosed
Hungary	Not prohibited	Prohibited	Prohibited	Prohibited	Not prohibited	Management company must use broker/dealer to sell units	Prohibited	Not prohibited but fees must be disclosed
Latvia	Not prohibited	Not prohibited	Prohibited	Prohibited	Not prohibited	Not prohibited	Not prohibited	Not prohibited
Lithuania	General conflicts prohibition	General conflicts prohibition	Prohibited	Prohibited	General conflicts prohibition	Not prohibited	Not prohibited	Not prohibited
Poland	Not prohibited	Prohibited	Prohibited	Prohibited	Not prohibited	Not prohibited	Not prohibited	Not prohibited but fees must be disclosed
Romania	Not prohibited	Not prohibited	Not prohibited	Not prohibited	Not prohibited	Prohibited	Prohibited	Not prohibited but fees must be disclosed
Slovakia	Not Prohibited	Prohibited	Prohibited	Prohibited	Prohibited	No specific provision	No specific provision	Fees must be disclosed
Slovenia	Not prohibited	Not prohibited	Prohibited	Prohibited	Not prohibited	Not prohibited	Not prohibited	Not prohibited

Source: National Laws

Fraudulent Allocation of Transactions

The national laws and regulations and UCITS Directive are silent on the handling of block orders and the allocation of trades that are made based on the order. Management companies can manage multiple investment funds of different types such as special funds and UCITS funds, as well as individual accounts. If the management company wished to buy the same financial instrument for several of these clients, it would be inefficient and costly to place a separate order and pay a separate commission for each client. It would be more efficient if the different fund orders were placed as a single order, sometimes called a "block order", and then the "fills" for that order were allocated between the clients. The question is how these "fills" are allocated between the clients. In a block order on the exchange, the order will be filled with a number of smaller transactions to make up the whole order. Some of these transactions will be more advantageous than others. One way to deal with fraudulent allocation of transactions is to aggregate all the fills into one block for purposes of allocation. An average price can be calculated and all clients pay that one price. If on a particular day, only a portion of the total order for clients is executed, then all clients received the same portion of their order. That is, if the management company executed 50 percent of the total order, each client would receive 50 percent of their order. Another method would be to assign the trades in accordance with a pre-arranged assignment plan.

Fund pricing should also be reviewed. Purchases and sales of fund shares should be based on the NAV on the day of the transaction. Pricing for stock splits (social capital increases) can also create distortions in the NAV valuation. Foreign exchange rates should also be set based on the date of the transaction. Where different dates are used, sophisticated market players may take advantage of these opportunities to the detriment of fund investors.

In general, there should be a rule in place which sets the procedure for allocating such orders fairly and objectively without favoritism to a preferred client. It does not appear that any of the EU11 countries have such a procedure set out in the law or regulations for handling such block orders and they adopt a standardized procedure for handling the orders. It would be best if a set of harmonized rules regarding the allocation of the trades of block transactions and other transactions in the same security were adopted.

Excessive Fees

Traditionally fees have been left up to the negotiations between the various parties to an investment fund. The main mechanism for protection for investors continues to be disclosure of the fees involved. However, many fees and expenses of funds remain hidden and more robust disclosure rules are needed. In addition, the fiduciary duty of asset managers to obtain the best fees for services to the funds it manages is not clearly set forth in most laws. The fees should be approved subject to the supervisory board's fiduciary responsibilities to the unit-holders. In addition, outer limits on fee arrangements should be established by the regulatory authorities as an element of consumer protection for investors in an investment fund.

Regulation of Abuses

The regulatory regime should have explicit rules in place to deal with the basic abuses. General exhortations in the law or regulations that funds should consider the investors interests are not enough. Specific prohibitions rules related to such conduct should be in place. Table 7 sets forth some of the recommended measures that can be taken for the basic abuses found in the operation of investment funds.

Table 7: Recommended Measures of Regulation of Basic Abuses

Abuse	Recommended Measure
Front Running	The law should prohibit front running.
Preferential Sales to Insiders or Favored Customers	The law should prohibit preferential sales to insiders and favored customers.
Preferential Allocation	A regulation should establish the permitted means of allocation of trades among clients.
Transactions with Insiders	The law should prohibit sales to, and purchases from, insiders and affiliated entities. Some jurisdictions allow insider transactions if the law and regulations require: (1) full disclosure and approval by supervisory board of the management company; (2) an arms-length transaction and independent appraisal; and (3) for large transactions, approval by shareholders or unit-holders for the transaction.
Transactions with Insiders at Non-market Prices	The law should prohibit sales to affiliated entities at non-market prices.
Market Timing	The law should require: (1) disclosure of risks of frequent purchases and redemptions and fund rules regarding such activity, including exit fees for short-term holders; and (2) disclosure of use of fair value pricing for illiquid securities and effects of such pricing.
Dealings with Affiliated Entities	The law or regulations should provide for a review of brokerage transactions to ensure that they provide "best execution of trades" and that they act in best interests of investors.
Excessive Fees	The law should require: (1) disclosure of fees and other compensation such as "soft commissions"[17], (2) approval by supervisory board of the management company, and (3) prohibition of excessive fees.

Selected Supervisory Issues

In general, the supervisory powers of the regulatory agencies for investments are sufficient to carry out their responsibilities. However three issues continue to face members of the EU11. The first is cooperation with foreign supervisory agencies. Substantial increases in cross-border offerings of funds and the establishment of foreign-owned asset management companies have highlighted the need for strong cooperation among home and host supervisory agencies across national borders. Although the formal mechanisms have been put in place for such cooperation through IOSCO and EU memoranda of understanding, it appears the efficient operation of such cooperation has yet to be fully realized. As the EU moves towards a more integrated market, this cooperation will, of necessity, need to improve.

The second issue relates to fit and proper criteria for the senior officers and managers of a management company or a self-managed investment company. All jurisdictions require some form of qualifying criteria, although the specific criteria and means for evaluating them differ. However they all rely largely on the discretion of the securities supervisory agency as to whether the individual officer or manager would act in the best interests of investors. Due to the ease by which passported funds can be sold cross-border, there is a critical need for the harmonization of these fit and proper criteria so that the host country authorities can have confidence that the foreign funds sold in their jurisdictions are managed by qualified managers of integrity.

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[17] The Financial Services Authority of the United Kingdom refers to soft commissions or "softing" as the practice by which a broker agrees to pay for the supply of services from a third party to a fund manager in return for an agreed volume of business at an agreed commission rate. See Consultation Paper 176. *Bundled brokerage and Soft Commission Arrangements*. April 2003. Available at http://www.fsa.gov.uk/pubs/cp/cp176.pdf

The third issue is the enforcement of prohibitions against entities acting as investment managers or funds without obtaining authorization required by law. Although many members of the EU11 have prohibitions against such activity, it is common for unregistered activity to be viewed as criminal conduct and outside the scope of activity of civilian regulatory authorities. However, this leads to ineffective oversight of the securities markets since, as the expert agencies, the civil regulatory authorities are the government agencies which have the most knowledge of the types of securities markets activities carried out by the unregistered entities. The civil regulators should be given responsibility for preventing and stopping such unregistered activity. In addition, they would need to be given the enforcement tools, such as injunctions and receiverships, which would enable them to fully utilize their expertise in the prevention of such activity and the protection of investors.

Liability

Personal vs. Institutional Liability

The UCITS Directive is silent as to how liability should be apportioned in the event of violations of the law. Some of the EU11 countries, such as Latvia and Estonia, provide for sanctions for violations of the law which are levied only against institutions such as the management company and depositary but not against the directors, officers and employees of them who have taken the action resulting in the violation and have benefited from the violation. As long as individuals can benefit from misconduct and not be sanctioned, there will be only a medium level of deterrence against the misconduct resulting from reputational damage and possible loss of a job.

The issue is also one of private versus public liability. In some countries, the threat of a civil lawsuit for damages is an important deterrent as a governmental enforcement action, particularly when the defendant is an individual officer or manager. However, most countries in the EU11 allow investors to recoup losses from the management company and depositary, but not from individuals working for them. Consequently the threat of personal loss is not a significant deterrent in the EU11. Although it is not a standard approach in EU member states, increased personal liability of officers, directors and employees would have a significant deterrent effect. Strong individual liability should be placed in national laws.

Codes of Conduct

The associations of asset managers in a number of the countries of the EU11, such as the Czech Republic, have issued Codes of Conduct for their members which are enforced by associations. (See Table 4.) EFAMA has also issued a Code of Conduct for discussion. The Codes are generally referred to as soft law, but sanctions by the association would carry reputational damage that few managers would want to deal with. While a welcome addition to the panoply of governance methods, the voluntary codes have generally not been seen as a substitute for governmental enforcement. However they provide a useful standard of acceptable industry practices. Industry associations should adopt codes of conduct, if they have not done so.

Conclusion

The EU11 countries have spent the last several years adjusting their legislation and regulatory frameworks to meet the requirements of the EU accession. With the accession to the European Union in 2004 and then in 2007, all ten member countries have transposed the UCITS Directive. Croatia is in the process of adopting the EU directives to prepare for accession and expects to have all major financial directives transposed into national law in 2008.

A number of areas remain to be completed in the establishment of a governance regime for UCITS funds. The final form of an independent oversight entity for the funds needs to be put in place. This will vary from country to country, but will in all likelihood consist of a combination of the governmental supervisor and the internal independent oversight structure in the corporate funds or fund managers. The depository will play the most important role for this in the UCITS structure. However, the enumerated functions of the depositary may not be as extensive as needed in order for the depositary to carry out the full role of an IOE. National legislation should specify duties of the depositary to provide more independent oversight.

Additional areas will need to be improved. In general, the "fit and proper" provisions for the officers, directors and managers of the funds should generally be strengthened. Furthermore all basic abuses that are specific to collective investment undertakings should be prohibited by law. This would include front running and transactions with affiliated persons.

Another outstanding issue relates to the rights of unit-holders to participate in the governance of the collective investment funds. Although day-to-day operations should remain in the hands of the managers, fundamental changes in the fund's goals or structure should be approved by the unit-holders. Most laws do not provide for this which lessens the degree of governance in the funds.

Finally, most laws in the EU11 are weak in regards to the liability of the fund's managers, officers and directors. Consideration should be given to strengthening the personal liability of individual officers and managers. Due to the high fiduciary responsibility of the funds towards the unit holders, the law should provide for liability for the managers and directors if they breach this duty. Otherwise, there will be no incentive for managers to act in the best interests of the unit holders or recourse for the unit holders against the managers.

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Annex 1: EU Directives related to Collective Investment Fund Governance

UCITS Directive 85/611/EEC, as amended provides the framework for the establishment and operation of collective investment undertakings in tradable securities. It requires the use of a custodian for each undertaking as the primary investor/ consumer protection vehicle. The custodian holds the customer assets and monitors the activity of the asset manager for the undertaking, or investment company for self-managed undertakings, to verify that actions taken are in compliance with the undertaking rules and in the best interests of investor/consumers. The EU has issued a Green Paper on the Enhancement of the EU Framework for Investment Funds to improve the EU regulatory structure in the industry. COM(2005) 314, 12-7-2005. It has also produced a White Paper in November 2006 regarding the main issues faces investment funds in EU. The simplified prospectus provided for in the UCITS Directive has been widely considered as unhelpful and an alternative is being debated.

Financial Market Abuse Directive 2004/72/EC provides for the basic framework for regulating fraudulent market practices, the establishment of rules against insider trading and market manipulation and the authority for the use of specific investigative tools to determine the existence of, and to uncover admissible evidence of, violations of such rules.

The Transparency Directive 2004/109/EC establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operated within a Member State[18]. Greater disclosure in the financial accounts is a part of the Financial Services Action Plan. The issuer has to make public its annual financial report at the latest four months after the end of each financial year and has to ensure that it remains publicly available for at least five years, together with the audit report. The issuer has to disclose the total number of voting rights and capital at the end of each calendar month during which an increase or decrease has occurred. Moreover, the issuer must make public without delay any changes in the rights attaching to the various classes of shares and derivatives.

Directive on Distance Marketing for Consumers of Financial Services 2002/65/EC. This Directive adopted in 2002 lays down common rules for selling contracts for credit cards, investment funds, pension plans, etc. to consumers by phone, fax or internet. The Directive fills the "legal gap" in existing consumer protection legislation, left by the exclusion of financial services from the 1997 Directive on distance selling. Its main features are:

- the prohibition of abusive marketing practices seeking to oblige consumers to buy a service they have not solicited ("inertia selling");
- rules to restrict other practices such as unsolicited phone calls and e-mails ("cold calling" and "spamming");
- an obligation to provide consumers with comprehensive information before a contract is concluded; and
- a consumer right to withdraw from the contract during a cool-off period--except in cases where there is a risk of price fluctuations in the financial market.

[18] This Directive does not apply to units issued by collective investment undertakings other than the closed-end type.

"Distance marketing" means selling by telephone, fax, proprietary computer networks and the internet. A Directive regulating the distance selling of (all other) goods and services was adopted in 1997 and entered into force in 2000 (Directive 97/7/EC). Financial services were excluded from its scope since they were considered to require a separate set of rules.

Based on the Directive, sellers of financial services and products are obliged to provide consumers with a comprehensive package of information before a contract is concluded. This package should include the identity, contact details etc. of the supplier, the price and payment arrangements, contractual rights and obligations as well as information about the performance of the service offered. Information on the technical quality and nature of the financial service must be also provided in accordance with the rules of the "vertical" Directives on credit, insurance and investment services or with relevant national rules for services not currently subject to EU legislation.

Directive on Markets in Financial Instruments 2004/39/EC (MiFID). This Directive is a central component of the Financial Services Action Plan, and confines itself to setting out the general high-level obligations which Member State authorities should enforce. It aims to allow investment firms, banks and exchanges to provide their services across borders on the basis of their home country authorization, and seeks to bring closer into line national rules on the provision of investment services and the operation of exchanges, with the ultimate aim of creating a single European "securities rule book". The Directive is designed to enhance investor protection, including by setting minimum standards for the mandate and the powers national competent authorities must have at their disposal and establishing effective mechanisms for real-time cooperation in investigating and pursuing breaches of the Directive. The Directive maintains the principle of a pre-trade transparency obligation whereby "internalisers" (i.e. firms trading outside regulated markets) would be obliged to disclose the prices at which they will be willing to buy from and/or to sell to their clients. However it limits this disclosure obligation to transactions up to "standard market size," defined as the "average size" for the orders executed in the market. The Directive also includes a set of protective measures for "internalisers" when they are obliged to quote, so that they can provide this essential service to their customers without incurring undesirable risks. More detailed implementing measures will be set down by the Commission, following consultations with market participants and Member States, and taking into account advice from the Committee of European Securities Regulators (CESR)[19].

Directive on Eligible Assets 2007/16/EC (Commission Directive) provides guidance to management companies on new types of asset classes which UCITS funds can invest in, for example OTC derivatives transactions, for which it explains acceptable procedures for valuations.

Directive on Statutory Audits 2006/43/EC provides guidance as to the regulation of the audit profession and the requirements for the independence of auditors. It provides that a country can exempt UCITS funds from the requirement for an audit committee to oversee the activity of the statutory auditor.

[19] For more information please visit http://eur-lex.europa.eu/LexUriServ/site/en/consleg/2004/L/02004L0039-20060428-en.pdf

Annex 2: Regulation of Investment Fund Governance Abuses in EU Countries

Country	Front running	Preferential sale of fund units to insiders or favored customers	Transactions with insiders at non-market based prices	Transactions with insiders	Market timing	Dealings with affiliated entities such as securities brokers	Preferential allocation	Excessive fees
Bulgaria	Ord. 25 Art.2 prohibits disclosing or taking advantage of trade secrets	Ord. 25 Art. 3 requires all transactions of insiders to be made pursuant to internal rules	Ord. 25 Art.3 prohibits all transactions except as unit holder	Ord. 25 Art.3 prohibits all transactions except as unit holder	No provisions as to clients of fund. Insiders prohibited by Ord. 25 Art. 2	No provision	Art. 202(9) of Law on POS requires that management company act in interest of share-holders, but no specific provision	No provision
Croatia	No provision	Art. 47 of Investment Funds Act prohibits sales to management company	Art. 47 provides that all sales of assets must be at market prices	Prohibited by Art. 47(1) 2.	No provision	No provision	No provision	Art. 94 states out types of fees permitted and Art. 97 requires disclosure of fees
Czech Republic	S74 and 75 of Collective Investment Law provides that internal rules should avoid conflicts and misuse of inside information.	S74 and 75 of Collective Investment Law provides that internal rules should avoid conflicts and misuse of inside information.	S74 and 75 of Collective Investment Law provides that internal rules should avoid conflicts and misuse of inside information. Penalties only against MC, corporate investment fund & senior officers.	No provision	No provision	No provision	No provision	Disclosure but no limits
Estonia	Section 70 Management Company to avoid conflicts and if one exists, to act in interest of fund. No provision on front running Section 312 Fine on MC	No provision	S281 of IFA prohibits such transactions	S281 of IFA prohibits such transactions	No provision	Depositary acts as broker Section 95 S280 of IFA prohibits a fund from investing in a management company and subsidiaries. .	No provision	No rule as to excessive fees, determined by contract Section 205; Fees must be submitted to Authority under Section 15, but are no grounds for refusal under S18

Country	Front running	Preferential sale of fund units to insiders or favored customers	Transactions with insiders at non-market based prices	Transactions with insiders	Market timing	Dealings with affiliated entities such as securities brokers	Preferential allocation	Excessive fees
Estonia (cont.)	Section 313-314 Fine against manager for not protecting interests of fund unit-holders Section 55 Fund Manager liable					But fund can purchase securities of other members of managers' group if purchase is done on a regulated market		
Hungary	Section 201.7(b) or 201A.1 Definition of insider trading does not appear to apply to officers and employees of MC	Art.236 Act in client's best interest Art.270/A.3 Prohibition (Regs. on client-MC relationship are not in English)	Art.236 Act in client's best interest Art.270/A.3 Prohibition	Art236 Act in client's best interest Art270/A.3 Prohibition	No provision	Art.246 MC must use broker/dealer to sell units	Art.236 Duty for Equal Treatment	Art.237 can charge fees, no limit, only disclosure
Latvia	S14 Internal rules should prohibit. No penalties. No personal liability in act, only MC, but S13(8) MC not liable for acts of officers and directors S13(5) MC must act in interest of investors	S14 Internal rules should prohibit. No penalties. No personal liability in act, only MC. S13(5) MC must act in interest of investors	S33(5) prohibits such transactions. S14 Internal rules should prohibit. No penalties. No personal liability in act, only MC. S13(5) MC must act in interest of investors.	S33(5) Prohibited	S13(5) MC must act in the interest of investors	No provision	No provision	No provision
Lithuania	Art.3(40) of Law on Markets does not cover front running, but it may a violation of general conflict provisions in Art. 9	Art.9 MC and investment company should avoid conflicts and treat investors fairly	Art.15 Prohibited	Art.15 Prohibited	No provision although it may a violation of general conflict provisions in Art. 9	Art.11 No delegation to depositary	No provision except Art9	Art.25 Fund rules set forth fees; Res 17 requires disclosure of fees

Country	Front running	Preferential sale of fund units to insiders or favored customers	Transactions with insiders at non-market based prices	Transactions with insiders	Market timing	Dealings with affiliated entities such as securities brokers	Preferential allocation	Excessive fees
Poland	Article 48 Officers and employees should refrain from trading if it creates a conflict (Regulation may set out specifics but not on website in English)	Art.107 Prohibited	Art.107Prohibited	Art.107 Prohibited	Art.10 Act in best interest of investors	No provisions	Art.10 Act in best interest of investors	Art.1 Articles of Association of fund set forth fees. Only disclosure, no approval guidelines
Romania	No provision for individual employees and officers; Art. 68 of Law on Securities Markets says management firms should avoid conflicts of interest but no prohibition	No specific provision – generally Art. 68 of law says management company must act in best interests of all investors	No specific provision – Art. 45 says management company should generally obtain most favorable price under circumstances	No specific provision – generally Art. 68 of law says management company must act in best interests of all investors	No specific provision – generally Art. 68 of law says management company must act in best interests of all investors	Art. 47 of Reg. 15/2004 recognizes this as a conflict of interest and Art. 48 says should be prevented	Art. 48 of Reg. 15/2004 says acts by management companies must benefit all investors in all funds	No limits on fees; all fees must be disclosed under Art. 46 of Reg. 15/2004; some special fees regulated such as for fund of funds in Art. 101 of Law on Securities Markets
Slovakia	Prohibited as misuse of information	Prohibited	Prohibited	Prohibited	Prohibited as misuse of information	No provisions	No provisions	Disclosure required
Slovenia	The Investment Funds Act does not cover "front running." Sections related to fraud do not apply to fund officers or employees	No provision	Prohibited	Prohibited	No provisions	No provisions	No provisions	No provisions

Note: IFA= Investment Funds Act; MC= Management company; POS= Public Offering of Securities.
Source: National Legislation