

CONSULTATION REPORT

EXAMINATION OF GOVERNANCE FOR COLLECTIVE INVESTMENT SCHEMES



OICU-IOSCO

**TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

FEBRUARY 2005

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- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc.) to create the attachment.
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Mr. Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

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I. INTRODUCTION

During its 31 January and 1 February 2005 meeting the Technical Committee approved the public release for consultation of this report (Consultation Report) prepared by its Standing Committee on Investment Management (SC5). The Consultation Report will be revised and finalized after consideration of all the comments received from the international financial community as a result of the present consultation process.

During its 17 May 2004 meeting, the IOSCO Technical Committee approved a mandate for its Standing Committee on Investment Management (SC5) regarding “Examination of Governance for Collective Investment Schemes.” The mandate directs SC5 to develop broad general principles for CIS governance based on a review of both its past work and the results of a survey concerning CIS governance in SC5 member jurisdictions.

SC5 has not previously examined CIS governance in a comprehensive manner. SC5 has, however, undertaken a number of projects that relate to CIS governance that may inform SC5’s development of the general principles of CIS governance.¹ In addition, IOSCO’s Principles of Securities Regulation 17-20, which relate to CIS (the “CIS Core Principles”), can inform the identification of the principles of CIS governance.²

The CIS Core Principles stem from IOSCO’s focus on the regulation of the world’s financial markets because IOSCO is an organization of securities regulators. In contrast, the general principles of CIS governance may focus on the role of other entities besides the regulator in CIS governance. The Core Principles and broad general principles of CIS governance are, however, complementary. They share the ultimate goal of investor protection.

The goal of investor protection relates to, among other things, the prevention of misleading, manipulative and fraudulent practices. It is also related to the prevention of loss due to malfeasance or negligence on the part of those that organize and operate the CIS. The general goal is not to protect investors from suffering any market-driven loss, but rather to enable investors to understand the risks that pertain to investments in specific CIS.³ We also note that our work focuses on retail investors in CIS, although we recognize that institutions also invest in CIS. The paper addresses principles of CIS governance for CIS that are marketed and sold to retail investors.

¹ See, e.g., Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators (May 2000).

² Principle 17 states that: “The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.” Principle 18 states that: “The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.” Principle 19 states that: “Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme.” Principle 20 states that: “Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.”

³ We note that, to some degree, the jurisdictions of SC5 members attempt, in different ways, to limit CIS investors’ exposures to excessive losses, for instance by limiting or prohibiting CIS investment in derivative instruments.

This paper defines CIS governance, and identifies one primary general principle concerning independent review that applies in all the jurisdictions of SC5 members, regardless of the structural form of the CIS. Additionally, it explains how the principle of independent review applies to, or is evidenced in, the different structural forms of CIS that exist in the jurisdictions of SC5 members. This work is based on the responses to the survey that SC5 sent to its members.

In addition, SC5 will later develop the principle of independence regarding the functions that should be entrusted to the entity responsible for reviewing the CIS Operator and CIS activities as well as other principles of CIS governance, namely those related with investors' rights and transparency. SC5 will also investigate how those principles relate to the various structures of CIS in the jurisdictions of SC5 members.

II. DEFINITION AND SCOPE OF CIS GOVERNANCE

Corporate Governance. The concept of corporate governance has been broadly developed. Corporate governance has been described in the following manner:

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which a company's objectives are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently. Good corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment.⁴

SC5 believes that the definition of CIS governance can be developed from the concept of corporate governance. A definition of CIS governance, however, must recognize the differences between the nature and purpose of CIS and the operating companies in which they invest. In addition, the definition must recognize the fact that CIS are structured and regulated differently among the jurisdictions of SC5 members.

CIS Governance. CIS governance can be defined as "*a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS investors⁵, and not in the interests of CIS insiders*".

⁴ OECD Principles of Corporate Governance (Jan. 2004).

⁵ Including both actual and potential investors.

A framework for CIS governance reflects the unique nature and purpose of CIS. CIS are a vehicle for pooling the investments of individuals in order to obtain professional management of the investors' pooled assets. The sole purpose of a CIS is to successfully invest the pooled assets for the primary benefit of CIS investors.⁶ As a consequence, a robust CIS governance framework should seek to protect the CIS assets from loss due to malfeasance or negligence on the part of those that organize or operate the CIS and should ensure that investors are adequately informed of the risks involved in their investment and the rewards they may obtain, and above all that the CIS is operated in the investors' best interests at all times. Accordingly, efficient disclosure requirements, accounting, valuation, reviewing and auditing standards should be in place in order to make sure that the risk-performance equation of the fund is adequately managed as the major role of CIS operators is primarily to execute investment strategies on behalf of well-informed investors while investors must be able to select the desired level of risks and potential rewards amid a reliable market environment.

The operation of CIS potentially entails conflicts between the interests of those who invest in CIS and those who organize and operate the CIS (“insiders”). In particular, CIS could be subject to the risk that those that organize or operate the CIS will use the CIS’s assets for their own gain to the detriment of CIS investors. There are many different ways in which this could occur.⁷ For instance, CIS Operators could rid themselves of unattractive securities that they own by dumping them into the CIS, or CIS Operators could obtain rebates from third parties in connection with transactions for the CIS or could evaluate their assets in order to avoid showing poor performances or non-well adequately managed risks. A robust CIS governance framework should, therefore, seek to minimize or otherwise address conflicts of interest and to ensure that the interests of well-informed investors in CIS are well protected and managed in the best conditions.

The CIS governance framework in the jurisdictions of SC5 members, including how the framework addresses conflicts of interest, will reflect the legal structure of CIS in the jurisdictions. CIS typically are organized in the jurisdictions of SC5 members under two structures: (1) investment funds, as a trust or contract with individual investors (“contractual model”), and (2) investment companies, often structured as corporations (“corporate model”).⁸ Depending on the structural form, a number of different entities, such as CIS investors, CIS Operators, auditors, broker-dealers, CIS boards of directors and depositaries, can play a role in the CIS Governance framework.

SC5 members agree that⁹, regardless of the structural model for CIS, CIS Governance must provide for the independent review and oversight of the operations of the CIS. This is a primary principle of CIS Governance. The independent review and oversight should extend to the actions of a CIS Operator in managing the CIS’s assets.

⁶ We recognize that CIS Operators and others benefit from a CIS though compensation for the services that they render to the CIS.

⁷ See Conflicts of Interests of CIS Operators (May 2000).

⁸ Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators (May 2000) at 1.

⁹ Only the case of Brazil, as noted in Appendix 3, seems to be the exception.

Various entities in the jurisdictions of SC5 members can provide independent review and oversight. In the jurisdictions of each SC5 member, the regulator can itself provide occasional independent review and oversight of the operations of a CIS. In addition, in almost all the jurisdictions of SC5 members¹⁰, laws and regulations mandate that certain other private entities (collectively, “Independent Entities”) have a major role in independent review or oversight.¹¹ Our work regarding independent review and oversight will focus on the role of Independent Entities.

The responsibilities of Independent Entities with respect to a CIS and CIS Operator vary from jurisdiction to jurisdiction, depending in large part on the structural model for CIS in that jurisdiction. Regardless of the structural model, the goal of the Independent Entity is to oversee and address conflicts of interest, ensure compliance with obligations and protect the interests of CIS investors.

III. MODELS OF CIS GOVERNANCE IN THE JURISDICTION OF SC5 MEMBERS

The survey conducted among SC5 members allowed the identification of two main models from which a CIS Governance structure could be developed:

- Corporate Model;
- Contractual Model.

In both models, and as noted in IOSCO report ‘conflicts of interest of CIS Operators’¹² of May 2000, “*there is an overriding responsibility on CIS Operators to act in the best interests of investors*”.

However, the way such responsibility has to be accomplished, as well as the monitoring procedures to ensure that the associated fiduciary duties (and also regulatory obligations) are respected, varies among the jurisdictions of SC5 members even within the same model. Different solutions could also be adopted regarding the arrangements to ensure the safekeeping of CIS assets.

In fact, within each of these two models it is possible to identify different oversight structures that can be implemented to ensure the effective fulfillment of fiduciary and regulatory obligations by the CIS Operator.

For the Corporate Model, the oversight¹³ of fiduciary and regulatory obligations, as well as the safekeeping of CIS assets, can be ensured in some extent either by a:

¹⁰ Since the only exception is Brazil.

¹¹ Independent Auditors may also act as Independent Entities.

¹² This report together with another entitled ‘Delegation of Functions’ form the work undertaken by IOSCO with the objective of identifying the ‘Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators’.

¹³ This as first level of oversight since other entities like the CIS Regulator, the Auditor and the CIS shareholders/unit holders also play an important role in this field.

- Board of Directors;
- Depositary;

With regard to the Contractual Model, the above mentioned functions can in some extent be ensured by a:

- Depositary;
- Trustee,

complemented in certain jurisdictions by other types of independent oversight committees for certain governance functions.

A summary of the main characteristics of the above mentioned models, namely in what regards the role of independent entities, is presented subsequently.

IV. Corporate Models

A. Corporate Model 1 - Board of Directors

In CIS organized under the corporate form, investors become shareholders by acquiring shares of a company whose principal objective is to invest in a portfolio of securities. The acts of purchasing and redeeming CIS shares are generally processed through an authorized distributor that acts on behalf of the CIS.

The management of the CIS's securities portfolio is conducted by an Investment Adviser (CIS Operator) which is appointed through a contract approved by the Board of Directors of the CIS¹⁴. The Investment Adviser has a fiduciary duty to act in the best interests of CIS shareholders.

Nevertheless, as noted in IOSCO report 'Conflicts of interest of CIS Operators' "The separation of the ownership of the funds from its management, which is necessary in order to take advantage of the pooling of the funds, carries the potential for the interests of the CIS Operator and CIS investors to diverge".

Therefore, in this model the Board of Directors of the CIS plays a central role in the Governance structure. The Board of Directors is responsible for overseeing at a first level the CIS's operations and the CIS Operator and other service providers, such as CIS distributors, as well as for monitoring conflicts of interest. The action of the Board of Directors is therefore decisive to ensure the protection of CIS shareholders interests.

¹⁴ In certain situations it may so happen that CIS are directly managed by its Board ("self-managed" CIS).

A detailed description of the functions assumed by the Board of Directors in each of the jurisdictions of SC5 members allowing this form of CIS model is presented in **Appendix 1**.

Moreover, **Flowchart 1** describes schematically a possible global CIS Governance structure for the designated ‘Corporate Model – Board of Directors’. The scheme includes other entities such as the CIS Regulator and Auditor, as well as shareholders that jointly with the CIS Board of Directors form the set of key entities destined to ensure a proper CIS Governance structure¹⁵.

B. Corporate Model 2 - Depositary

In this model, the Depositary is responsible for the oversight of the CIS and CIS Operator activities as well as for the custody of the CIS assets. For the purpose of this mandate and in order to surround the "overview activity", the functions of the Depositary can be compared – but not stated as equivalent - with the activities exercised by the Board of Directors in the previous model.

A detailed description of the functions assumed by the Depositary in each SC5 jurisdiction that allows this form of CIS model is presented in **Appendix 2**.

Additionally, **Flowchart 2** describes schematically a possible CIS Governance structure for the designated ‘Corporate Model – Depositary’. As in flowchart 1, the scheme also includes other key entities which should ensure an adequate CIS Governance structure.

V. Contractual Models

A. Contractual Model 1 - Depositary

Differently from the case of CIS under the corporate form, in the contractual type investors buy unit shares that provide them interest in a portfolio of diversified securities that does not have legal existence for itself.

Because of this, CIS does not have the legal capacity to contract on its own and therefore the management of its portfolio has to be entrusted to a Management Company.

Similarly to the corporate model cases in which the CIS Operator functions are assumed by an Investment Adviser, the Management Company becomes committed with the fiduciary duty of acting exclusively on behalf of CIS unit holders best interests.

¹⁵ Mechanisms such as the prohibition/restriction of transactions with affiliated parties or shareholder voting requirements could also be seen as an integral part of a CIS Governance structure.

For the purpose of this mandate, the functions of the Depositary can be nonetheless compared with to the ones described in the previous model.

Again, a detailed description of the functions assumed by the Depositary under the contractual type in the jurisdictions allowing this form of CIS model is presented in **Appendix 3**.

Flowchart 3 describes schematically a possible CIS Governance structure for the designated ‘Contractual Model – Depositary. The scheme includes again other key entities which should ensure a proper CIS Governance structure.

B. Contractual Model 2 - Trustee

CIS under this type of contractual form are denominated Unit trusts (UT) and are established and governed by a trust deed.

A UT is a CIS under which the property is held in trust for the beneficiaries of that trust. Subscriptions from investors are pooled together and then used to purchase a portfolio of assets managed by the Manager (CIS Operator). Investors receive units in proportion to the amount of money invested.

Nevertheless, this model can be compared with the one previously presented since the functions performed by the Depositary are exercised by an entity designated Trustee, which is responsible for both the oversight of the CIS Operator and also the safekeeping of the CIS assets.

The key entities of CIS governance for UT are therefore the Manager and the Trustee.

A detailed description of the functions assumed by the Trustee in each jurisdiction that allows this form of CIS model is presented in **Appendix 4**.

Flowchart 4 describes schematically a possible CIS Governance structure for the designated ‘Contractual Model – Trustee.

In some jurisdictions these two possible players can be complemented by additional independent oversight entities that represent the interests of shareholders and are in charge of certain reviewing aspects of the governance function.

Chart 1, presented in next page, provides a global view of the existing models and respective sub-models in each jurisdiction and identifies also the independent entities that ensure the review of the CIS Operator and CIS activities.

Chart 1
Models of CIS Governance
in the Jurisdictions of SC5 Members

	Corporate Model 1 <i>Board of Directors</i>	Corporate Model 2 <i>Depositary</i>	Contractual Model1 <i>Depositary</i>	Contractual Model2 <i>Trustee</i>
AUSTRALIA				
BRAZIL				
CANADA				
FRANCE				
GERMANY				
HONG KONG				
IRELAND				
ITALY				
JAPAN				
JERSEY	-	-	-	-
LUXEMBURG				
MEXICO				
NETHERLANDS	-	-	-	-
PORTUGAL				
SPAIN				
SWITZERLAND				
UNITED KINGDOM				
UNITED STATES				

VI. BROAD GENERAL PRINCIPLES OF CIS GOVERNANCE

CIS governance is defined in this document as a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated in the interests of CIS investors, and not in the interests of CIS insiders.

Within this scope, it should be reminded that it was the purpose of this mandate to articulate broad general principles for CIS Governance focusing particularly in the field of the independent oversight of the CIS Operator’s duties and on the structure implemented for the prevention of conflicts of interest.

As discussed below, SC5 member jurisdictions agree that as a primary principle, CIS Governance must provide for independent review and oversight of the organization and operation of the CIS. In the jurisdictions of each SC5 members, Independent Entities are the primary source of independent oversight.

The Independent Entity’s main objective should be ensuring that CIS Operators respect the applicable rules, their contractual obligations and their duties, from “an outside perspective”, and therefore protect CIS investors from divergent behaviors of the CIS Operator.

Many jurisdictions of SC5 members impose a fiduciary duty on CIS Operators to act in the CIS investors' best interests. Independently of the form or model under which a CIS is organized, CIS Operators should always be subject to the fiduciary duty of acting for CIS investors in the best possible way. The respect for this duty constitutes a basilar principle of CIS management.

Nevertheless, as noted in this paper, CIS often entail a separation of the ownership of the CIS from its management which carries the potential for the interests of the CIS Operator and CIS investors to diverge. Therefore, in order to ensure that the CIS Operators do not deviate from their duties it is fundamental that their activity be properly monitored.

In addition, in many jurisdictions of SC5 members, CIS Operators must maintain appropriate controls and implement an internal structure of compliance responsible for monitoring compliance with their contractual obligations and the rules that are applicable to the CIS management activity. Many CIS Operators employ a compliance officer to help assure compliance with the rules and allow proper information to be passed to the entity responsible for enforcing fiduciary duties.

The concept of independence assumes different forms among the various CIS Governance structures, although the aim is to provide an “outside perspective” to protect CIS investors. For example, in some jurisdictions with a “corporate model – Board of Directors,” independence refers to the status of certain directors as unrelated to the CIS or other significant entities such as the CIS Operator and also refers to the percentage of directors on the CIS Board of Directors that are independent. In other jurisdictions, independence is derived from requirements that seek to ensure that the trustee and CIS Operator are functionally, or economically, separate entities ("Chinese walls"), such as by requiring that there be no common board members or directors among the two entities or by prohibiting entities that are subsidiaries of one another. Other requirements impose restrictions that eliminate or reduce conflicts of interest such as restrictions on investments by the CIS in securities issued by the Independent Entity. All the jurisdictions of SC5 members seek to promote an environment in which the Independent Entity is separated or insulated from the conflicts inherent in the operation of the CIS so the Independent Entity can fulfill its oversight and review responsibilities. (See Appendices for additional detail concerning independence).

Independent Entities should be empowered with sufficient conditions to exercise its functions in an effective independent manner. The Independent Entity also should have sufficient powers to authorize or issue guidance to the CIS Operator regarding operations that may conflict with CIS investors' interests and to interfere with the designation of the entity responsible for an additional check of the CIS activities and accounts (e.g., CIS Auditor). Independently of the nature of the entity primarily responsible for overseeing the CIS Operator (Board of Directors, Depository, Trustee or any other type of independent oversight committee), the Independent Entity should be able to establish and to report to relevant bodies (board of director of the asset management company, regulatory authorities, external auditor) policies for the prevention and resolution of conflicts of interest, namely those that may arise between the

CIS Operator or its related parties and investors. The Independent Entity also should have sufficient economic or financial resources to enable it to exercise its functions. The full responsibility endorsed by these entities and the possibility for each of them (depositories for instance) to compensate unitholders when damages happen is a key condition for the efficiency of the working of this model.

The nature of the Independent Entity depends upon the structural model for CIS in the jurisdiction of an SC5 member. In the context of the “corporate model – Board of Directors,” the Board of Directors and the independent directors, in particular, serve as the Independent Entity. Independent directors are intended to serve as “watchdogs” who provide independent oversight of CIS management, and who have primary responsibility for overseeing at a first level the CIS’s operations and the CIS Operator’s activities and other service providers, such as CIS distributors, as well as overseeing conflicts of interest, with the ultimate objective of protecting the interests of CIS shareholders. In the contractual models, as well as in the “corporate model – Depository”, the above mentioned functions can be exercised either by the Depository, the Trustee or any other independent oversight entity. The Depository, Trustee or other entity should, desirably, be legally and economically independent from the CIS operator.

When the Depository, Trustee or another independent oversight entity are not legally and economically independent from the CIS Operator, it should have sufficient conditions to act independently from the CIS Operator’s interests, for example by imposing a requirement of different directors between the CIS Operator and Depository or a requirement for a separate review committee and by making the Depository jointly responsible for possible misconduct or fraud of the CIS Operator.

In any case, and whatever the model and the role played by the various independent entities, the regulators should insist on having all relevant functions properly covered and monitored by one or the other entity, based on the governance principles and procedures in place.

The delegation of the oversight functions entrusted to either the Board of Directors, Depository, Trustee or any other independent oversight entity should not, as a principle, be allowed. The effective and permanent control of the CIS and CIS Operator activities should be directly exercised by the entity responsible for those functions (Board of Directors, Depository, Trustee or any other oversight entity) in order to ensure proper investor protection.

As mentioned in the introductory part of this paper, SC5 will develop in a subsequent report the precise functions and tasks that should be entrusted to Independent Entities.

APPENDIX 1

Corporate Model 1 - Board of Directors

Under the **United States and Mexico** laws, CIS board of directors, which are subject to fiduciary duties established under the law that applies to directors of others businesses, such as the duties of loyalty and care¹⁶, are namely responsible for exercising the following specific tasks:

- CIS Operator’s Contract. The CIS Operator’s contract, and the annual continuance of the contract, must be approved by the board and by a majority of the CIS’s independent directors;
- CIS Accountant. Generally, the CIS accountant must be selected by a majority of the CIS’s independent directors which must be subsequently ratified by the CIS shareholders at the forthcoming annual meeting of CIS shareholders. The selection of the accountant does not need to be submitted for ratification by the CIS shareholders if the CIS’s board has established an audit committee composed entirely of independent directors that is responsible for overseeing the CIS’s auditing and accounting processes;
- Audit Committee. The CIS board must annually determine and disclose whether there is an Audit Committee financial expert. When there is no separate Audit Committee, then the Board of Directors itself is the Audit Committee. The Audit Committee also must pre-approve certain engagements with the CIS’s independent auditor;
- Code of Ethics. The CIS’s Board of Directors, including a majority of the CIS’s independent directors, must approve the CIS’s code of ethics, the code of ethics of each CIS Operator and the principal underwriter and any material changes to these codes;
- Proxy Voting Policies. The CIS’s Board of Directors approves the policies and procedures relating to the voting of proxies in connection with portfolio securities;
- Compliance Procedures and Compliance Officer. The CIS’s Board of Directors, including a majority of the CIS’s independent directors, must approve the written compliance procedures and policies of the CIS and each service provider. The approval must be based on a finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws. The CIS board, including a majority of the CIS’s independent directors, must approve the designation of the CIS’s chief compliance officer and such person may be removed by action of, and only

¹⁶ In the United States, the duty of loyalty generally mandates that CIS directors perform their duties in good faith and in a manner reasonably believed to be in the CIS’s best interests. Fundamental to the duty of loyalty is the avoidance of self-dealing. The duty of care generally requires directors to perform their functions with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances.

- with approval of, the CIS's board, including a majority of the CIS's independent directors. The CIS's chief compliance officer must meet separately, at least once a year, with the CIS's independent directors;
- Custody and Service Contracts. General fiduciary principles or a CIS's corporate charter require board review and approval of custody and service provider arrangements;
 - Valuation and NAV Calculation. The CIS's directors must determine the fair value of the CIS's portfolio securities (and other assets) for which market quotations are not readily available. The CIS's directors must initially set the time or times of day when the CIS calculates its net asset value and make and approve any changes as necessary.

As noted above, the issue of independence of CIS directors assumes particular importance in the case of the United States as a key principle to ensure that the Board of Directors fulfills its mission properly.

Independent directors are intended to serve as “watchdogs” who provide an independent verification on CIS management, and who have, as already referred primary responsibility for protecting the interests of CIS shareholders.

In the **United States**, at least 40%¹⁷ of the CIS's directors must be “independent.”¹⁸ Most U.S. CIS, however, rely on certain exemptive rules (“Exemptive Rules”)¹⁹ that effectively require that at least 75% of the CIS's directors be independent.²⁰

¹⁷ In the case of Mexico the equivalent requirement of independence is established in one third.

¹⁸ A director is not “independent” if he or she:

- is an “affiliated person” of the CIS;
- is an immediate family member of an affiliated person of the CIS;
- acted as the CIS's legal counsel within the past two years (and any partner or employee of such a person);
- is an affiliated person of a registered broker or dealer;
- is not independent of the CIS's operator or principal underwriter;
- is declared not to be independent by order of the US SEC due to a material business or professional relationship with the CIS within the past two years.

An “affiliated person” of another person is:

- any person owning or holding 5% or more of the person's outstanding voting securities;
- any company the outstanding voting securities of which the person owns 5% or more of the company's voting securities;
- any person controlling, controlled by, or under common “control” with such other person;
- any officer, director, partner, copartner or employee of the person; and
- if a CIS, any CIS Operator or member of the CIS advisory board.

“Control” means the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of an official position with the company.

¹⁹ Approximately 90% of CIS in the United States rely on at least one of the Exemptive Rules.

²⁰ If a CIS is not relying on one of the Exemptive Rules, it may be subject to a more stringent requirement than the 40% independent director requirement, if its operator has been recently sold or reorganized, e.g., for a period of three years after the change in control, at least 75% of the CIS's directors must be independent of the predecessor or successor CIS Operator.

Any U.S. CIS that relies upon any one of the Exemptive Rules must comply with the following Governance Conditions:²¹

- at least 75% of the CIS’s directors must be independent;
- an independent director must serve as chairman of the CIS’s board;
- independent directors must have the authority to hire advisers and experts necessary to carry out their duties so that they do not have to rely on the CIS Operator for assistance and expertise;
- the CIS’s board of directors must evaluate, at least once a year, the performance of the board and its committees, including the effectiveness of the CIS board’s committee structure and the number of CIS on whose boards each director serves;
- the CIS’s independent directors must meet together in separate sessions each quarter, without any director who is an interested person of the CIS.
- the CIS’s independent directors must select and nominate the CIS’s other independent directors; and
- any legal counsel to the CIS’s independent directors must be an “independent legal counsel.”²²

The issue of how directors can be elected or removed is also a matter that is expressly addressed in the United States. In this field, U.S. law foresees that CIS directors must be elected by CIS shareholders, except for the case of vacancies that can be filled in any manner as long as two-thirds of the board at any time is composed of directors who were elected by the CIS shareholders.²³

If a U.S. CIS’s regular broker-dealer, principal underwriter or investment banker is a director, officer or employee of the CIS or is a person of which the director, officer or employee is an affiliated person, then at least a majority of the CIS’s directors must not be affiliated with such broker-dealer, principal underwriter or investment banker. In addition, a majority of the CIS’s directors may not be officers, directors or employees of any one bank or bank holding company, together with their affiliates and subsidiaries.

²¹ The US SEC recently amended the Governance Conditions, to add or change conditions. As a result of the amendments, the first condition raises the percentage of independent directors from a majority of the CIS’s directors to 75% of the CIS’s directors. The second, third and fourth conditions are new conditions. The last two conditions, concerning the nomination of independent directors and independent legal counsel, are currently effective and remain unchanged by the amendments.

²² A person is an “independent legal counsel” if a majority of the CIS’s independent directors determine, in the exercise of their business judgment, based on information obtained from the person, that any legal representation of the CIS’s operator, principal underwriter, administrator or any of their control persons, from the beginning of the CIS’s last two completed fiscal years, is unlikely to adversely affect the professional judgment of the person providing legal representation to the independent directors.

²³ CIS may divide directors into classes and prescribe the terms of tenure of the classes if permitted under the CIS’s corporate charter, certificate of incorporation or similar authorizing document, provided no class is elected for a shorter period than one year or for a longer period than 5 years and the term of office of at least one class expire each year.

In addition, under U.S. law, certain persons are disqualified from acting as a CIS's director (e.g., persons convicted of felonies or misdemeanors arising from the purchase or sale of securities within the past 10 years and persons permanently or temporarily enjoined from engaging in any conduct or practice in connection with the purchase or sale of any security). CIS directors also may be removed according to state law requirements or by explicit order of the regulator²⁴.

In Japan, the Board of Directors is composed by executive directors and supervisory directors.

Executive Directors execute the daily businesses and represent the investment company.

The Supervisory Directors, which supervise the execution of duties of executive directors, must exceed the number of the latter at least by one.

The Supervisory Directors may require at any time from the executive directors, the management company or the custodian a report of the situation related to the business and the assets of the investment company and may conduct investigations that reveal to be necessary in order to perform their duties.

Those who can be appointed as supervisory Directors are subject to specific limitations that envisage ensuring their effective independence²⁵.

In Australia, even though CIS are organized as unit trusts their regulation is similar to the Corporate Model, because there is no separation of the roles of the CIS operator and the Trustee. The sole responsibility for oversight and operation of the scheme rests with the single responsible entity and its directors and employees, who all stand in a fiduciary relationship to the investors. The responsible entity is able to appoint agents, such as a custodian or investment manager, but remains responsible for the actions of the agent.

²⁴ For example, persons who have been found to have engaged in certain unlawful conduct by a foreign financial regulatory authority, persons who have willfully made false or misleading statements in certain US SEC filings.

²⁵ Those who meet the following are not eligible as supervisory directors:

- An applicant is a bankrupt person who is irrevocable in that status or a person who has been imposed a penalty of imprisonment with labour and a period of five years has not elapsed yet from the day on which execution of such penalty was completed or nullified;
- The promoter of the investment company;

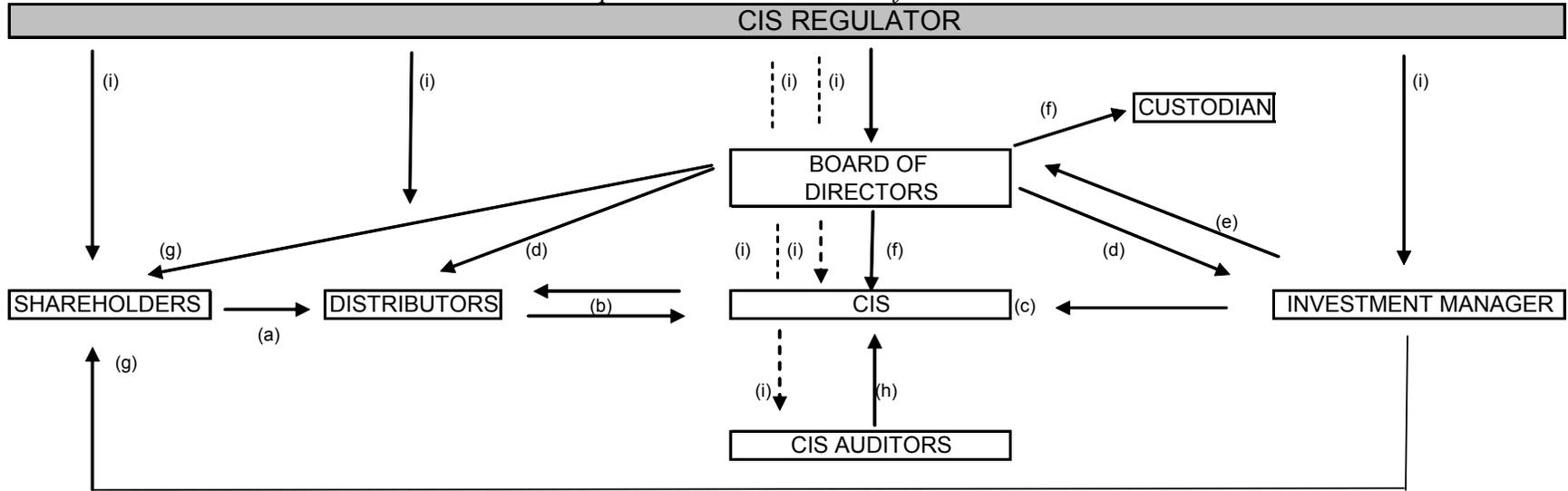
In case the promoter of the investment company is a juridical person, directors or employees of the promoter;

- The executive director of the investment company;
- Directors or employees of the securities company or its subsidiary which engage in the subscriptions and sales of investment certificates issued by the given investment company, or a sales agent in case that s/he is an individual; and
- Those that are prohibited under the Ordinance of the Cabinet Office to become a supervisory director because of conflict of interests with the promoter or executive directors.

The board of directors plays a central role in the governance structure. This oversight role is supplemented by the monitoring role of a compliance committee. If at least half of the directors are not independent, then at least half of the compliance committee members must be independent.

The role of the compliance committee is to monitor to what extent the responsible entity complies with the scheme's compliance plan and to report breaches to the responsible entity. The compliance committee is required to assess compliance at regular intervals and may commission independent legal, accounting or other professional advice or assistance at the expense of the responsible entity.

Flowchart 1
CIS Governance Structure
Corporate Model 1 - Board of directors



- (a) Placement of orders for purchase/redemption of CIS Shares.
- (b) Inflow/outflow of money and issue/amortization of Shares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS Investment Manager and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and subjection to approval of its contracts.
- (f) Oversight of CIS operations and safekeeping of assets (entrusted to a custodian).
- (g) Protection of CIS Shareholders best interests.
- (h) Audit of CIS financial statements.
- (i) Global supervision of the the CIS activities and of the respective key players with the main goal of protecting Shareholders best interests.

APPENDIX 2

Corporate Model 2 - Depositary

In the **United Kingdom** the centerpieces of CIS governance for corporate CIS²⁶ are the Depositary and the designated Authorized Corporate Director (ACD) since the CIS is not required to have a board of individual directors to operate the company, and oversee the interests of investors.

Under the legislative and regulatory framework the ACD is responsible for the daily management of the company and for ensuring compliance with investor protection rules. The ACD must be a company which is an authorized person in its own right and has permission to act as the sole director of a CIS under the legislative provisions.

The ACD is usually appointed by a written contract entered into by it and the CIS. When the ACD is the sole director, it will need to ensure that the terms are fair for the CIS and the investors. There will be no independent view taken as to the terms of the contract. The regulatory regime requires that the appointment of any ACD, except the first ACD, must be ratified by a resolution of the shareholders at the following Annual General Meeting, otherwise the appointment will be terminated at the close of the Annual General Meeting following the appointment, or (whichever is later) 12 months from the date of appointment. If the CIS has no (other) directors, the depositary may appoint an ACD. Alternatively, any remaining directors must take practical steps to find a competent replacement ACD as soon as possible.

The ACD must carry out the following tasks regarding the management of the CIS:

- making investment decisions in accordance with the investment objectives and policy of the CIS;
- ensuring that payments out of the scheme property are not unfair, relate to (i) remunerating the parties operating the CIS, (ii) the administration of the CIS (iii) the investment or safekeeping of scheme property are appropriately disclosed to investors;
- making sure that customers have access to up-to-date information about the CIS before they buy unit shares, are able to participate in the decisions on key issues concerning the CIS, and are sent regular and relevant information about the CIS;
- ensuring that in retaining the services of anyone to assist it in the performance of its functions, the ACD ensures it can effectively monitor and supervise the delegate, give further instructions/withdraw the mandate

²⁶ Which are called Investment Companies of Variable Capital (ICVC's).

when it is in the interests of investors, the mandate does not prevent the ACD from acting, or the scheme from being managed in the best interests of the shareholders;

- make certain that conflicts of interest resulting from certain transactions are properly managed (e.g transactions in CIS property and the lending of money to the CIS involving affected persons and their associates are precluded unless the transaction can prove to be at least as favourable to the fund and would be comparable to a transaction effected on normal commercial terms negotiated at arms length between the affected person and an independent party).
- Compliance with published CIS policies and procedures.

Under the regulatory framework the ACD must not terminate the exercise of its functions voluntarily unless a replacement has been found.

The Depositary has the role of monitoring and overseeing the actions of the ACD and is responsible also for safekeeping of the assets of the company. It must also be an authorized person and so satisfy certain threshold conditions (relating for example to adequate resources) and must have permission under the legislation to act as the Depositary of a CIS.

The Depositary's supervisory role includes taking reasonable care to ensure that the CIS is operated by the ACD in accordance with the regulatory framework.

This includes namely the following specific duties:

- ensuring that investment by the ACD in assets that cannot be accurately valued and readily disposed of, is restricted;
- monitoring for and ensuring that if the scheme property is used contrary to the regulatory provisions, or any provision in the instrument prospectus, that action is reasonably taken by the ACD to restore compliance and to reimburse customers;
- ensuring the proper calculation of the NAV of unit shares by the ACD, and that the ACD maintains sufficient records to show compliance;
- ensuring that the price of unit shares is made public by the ACD in an appropriate manner;
- making sure dealings in shares are carried out by the ACD in accordance with the relevant regulatory provisions and any published fund policies and procedures;
- assuring the ACD treats the CIS fairly when arranging for the issue or cancellation of units, and treats clients fairly when they purchase or sell unit shares;
- Ensuring the ACD properly accounts for, allocates and distributes on a timely and fair basis, any scheme income;
- Reporting to the regulator breaches by the ACD to the FSA, unless the depositary is of the view that the effects will not be materially significant;

- Reporting annually to unitholders whether, in any material respect, the investment and borrowing, valuation and pricing, dealing income and accounting provisions have not been complied with.

The Depositary also has a number of rights under the legislative provisions, including the right to convene a general meeting of the company when it sees fit, and to be heard at any general meeting it attends on any part of the business of the meeting which concerns it as Depositary.

In addition to the specific duties mentioned above under the legislative and regulatory framework, the Depositary has a fiduciary duty associated with the control it has over scheme property and as such it is liable to account for any losses.

The appointment of the first Depositary is made by the CIS in a written contract, often with the ACD as party. There are no legislative or regulatory provisions for terminating the appointment of a Depositary. This is usually dealt with in the depositary agreement (e.g., by reasonable notice being given, or immediately in the event of liquidation, or the depositary ceasing to be authorized). The legislative provisions provide a mechanism for the Depositary to alert shareholders to any problems it is aware of and which have led to its resignation.

The Depositary must be independent²⁷ of the company and of the persons appointed as directors of the company. In the context of its role as such, it must act solely in the interests of the shareholders.

In Spain, the legal environment for CIS (both investment funds and companies) fits mainly within the contractual model, regardless of the functional aspects of the investment companies, essentially the right of vote of the shareholders.

CIS under the corporate form have their own Board of Directors which may alternatively appoint a management company to comply with duties of management²⁸, representation and administration or be self-managed²⁹.

As a consequence, Governance provisions to management companies that apply both to investment funds and investment companies are defined in the appendix 3 (Contractual Model 1).

²⁷ The legislative framework requires independence between the Depositary, the CIS and the CIS's directors. The regulatory view is that independence is likely to be lost if by legal or operational means either relevant party could control the action of the other (by directors in common, cross shareholdings or contractual commitments).

²⁸ In this case, CIS really function as contractual funds since the role of the Board is merely instrumental.

²⁹ Which are the exception since they only represent 10 in a total of 3.000. As these companies have not appointed a management company, they must have enough organisational, material and human resources to accomplish their activity. They must comply with the same requirements applicable to CIS management companies.

In both cases though, CIS' s assets must be entrusted to a Depositary for safekeeping.

In the case of **Ireland**, the Board of Directors of corporate CIS is subject to the following:

- Appointments to the office of director require the prior approval of IFSRA³⁰. Departures from the office of director must be notified to IFSRA immediately;
- A minimum of two directors must be Irish residents;
- The Board of Directors shall not have any directors in common with the board of the directors of the Depositary of the CIS; and
- Directors are required to disclose to their board any concurrent directorships, which they hold on boards of authorized CIS and/or related entities, which supply services to such CIS.

Initial directors are appointed by the promoter of the CIS; thereafter, appointments are subject to Irish Company Law requirements.

The board of directors has responsibility for its functions. While activities may be delegated the responsibility for activities cannot be delegated.

Differently from the United States model, there is no requirement for the board of the CIS to complete an annual evaluation of their performance and the performance of any of its committees regulatory requirement in Ireland, although the Depositary is required to enquire into the conduct of the CIS in each annual accounting period and report thereon to the unit holders.

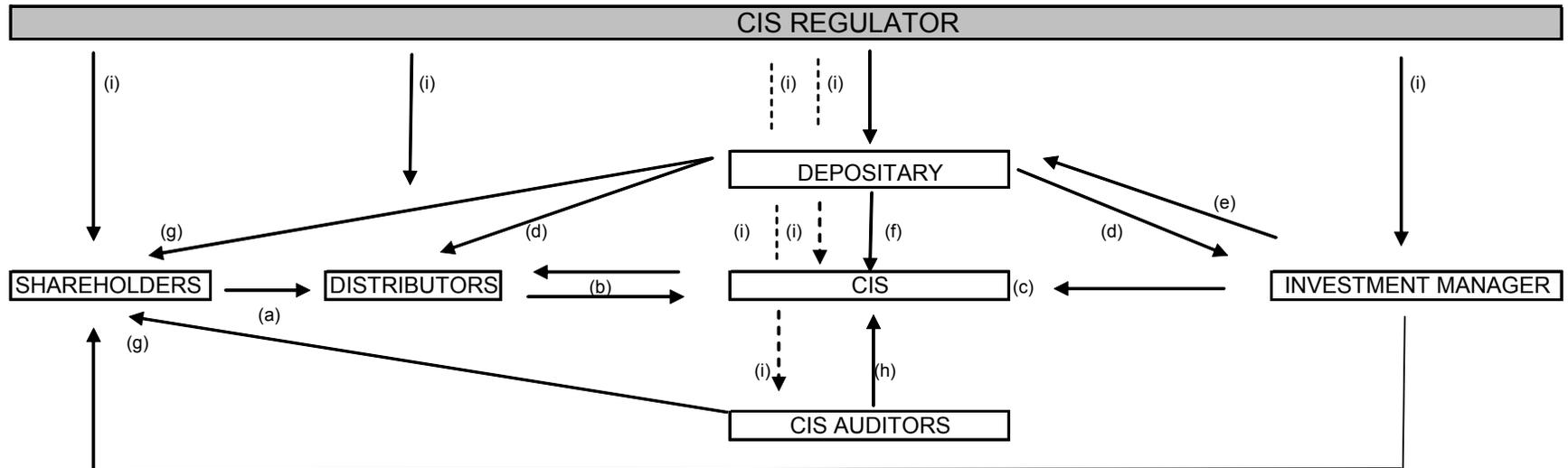
The Depositary's report shall state whether, in the Depositary's opinion the CIS has been managed in that period:

- in accordance with the limitations imposed on the investment and borrowing powers of the CIS memorandum and articles of association and the Regulations;
- and otherwise in accordance with relevant legislation.

If the CIS does not comply with the conditions above, the Depositary must state why this is the case and outline the steps taken to rectify the situation.

³⁰ A completed questionnaire is required in respect of each candidate, which details experience, qualifications, reputation and character, and business interests (e.g., list of directorships).

Flowchart 2
CIS Governance Structure
Corporate Model 2 - Depositary



- (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 responsibility 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.

APPENDIX 3

Contractual Model 1 - Depositary

In **Portugal**, in which CIS can only assume the contractual form, the Management Company is responsible for acting on account of the unit-holders and on their exclusive interest, being their duty, in general, to carry out all acts and operations necessary or convenient to a proper CIS administration in accordance with criteria of both high diligence and professional competence.

The principal functions of the Management Company are:

- To Buy and sell securities and to exercise the rights directly or indirectly connected with the CIS's assets;
- To issue, in coordination with the depositary, the unit shares;
- To determine the NAV of the unit shares;
- To select the assets that are part of the CIS, in accordance with the investment policy contemplated in the CIS rules and to carry out, or to give instructions to the Depositary to carry out the proper operations to the execution of this policy;
- To maintain in order the CIS accounting;
- To ensure the accomplishment of disclosure duties according either with the law or the CIS rules.

Again, the same problems of agency relations and conflicts of interest are present in the contractual form and consequently it is fundamental that the CIS Operator and CIS activities are properly supervised to protect unitholders best interests.

Therefore, all Portuguese CIS must have a depositary that is responsible not only for the custody of assets but as well as for overseeing the CIS Operator and CIS activities.

Specifically, the Depositary is namely responsible for:

- Buying and selling securities in accordance with Management Company instructions, receiving interests, dividends and other sort of income arising from the CIS's assets;
- Paying to unit-holders their share in the CIS's profits when it is the case;
- keeping in order the chronological listing of all the performed operations and maintaining a monthly relation of the assets that are kept on his responsibility;
- Assuming a surveillance function and guarantying towards the unit-holders the compliance with the CIS rules, especially regarding the investments policy;

- Assuring that the sale, issue, repayment and amortization of unit shares are carried out in accordance with the law and with the CIS rules;
- Assuring that the calculation of the participation units NAV is done in accordance with the law and with the CIS rules;
- Carrying out the instructions of the Management Company, except if they are either against the law or the CIS rules.

The Management Company and the Depositary, while exercising their functions, must act in an independent manner and in the exclusive interest of the unit-holders.

Even though there are no requirements of legal and economic independence between the Management Company and the Depositary³¹ this last one has the ‘motivation’ for exercising its supervisory functions properly because otherwise it would have to respond with its own funds for misconducts or frauds committed by the operator.

This is a direct result of the principle stated in CIS Law that the management company and the depositary are jointly responsible upon unit holders for the accomplishment of the obligations acquired in the law and in the CIS rules.

The Depositary’s responsibility is not affected by the fact of confiding the guardianship of the CIS’s assets, in whole or partially, to a third party.

The replacement of the Depositary depends on an authorization of the Portuguese regulator.

In **Switzerland, Italy, Germany, Spain, France and Luxemburg** contractual CIS are organized in a very similar way as in Portugal.

In **Switzerland** there is a statutory duty imposed on the Custodian Bank to review compliance of the Operator with all laws, regulations and the CIS Rules of each specific CIS and report serious wrongdoings immediately to the regulator.

The concept of Independent Directors within the CIS Operator has not been considered relevant, because investors in Swiss contractual funds have been protected by a different concept, which combines a mix of supervision by the Regulator, Fiduciary Duties of the Operator and Compliance Review by staff of the Custodian Bank independent from the Operator.

In **Italy**, the majority of CIS (about 98%) have a contractual type structure even though the corporate form is also a possible way of organizing a CIS.

³¹ Since the Management Company and the Depositary may belong to the same group.

In contractual type CIS the Board of Directors of the Management Company is responsible both for the management of the operator and for the management of the CIS.

The responsibility for overseeing the Board is imposed both on the Depositary and on the Audit Committee being this last one appointed by the Management Company shareholders.

The Depositary is mainly responsible for:

- checking the legitimacy of the operations of issuing and redeeming units;
- checking the correctness of the NAV calculation or, if appointed, making the calculations itself;
- carrying out the instructions of the management company unless they conflict with the law, the CIS rules or the prescriptions of the supervisory authorities.

The Depositary bank is liable to the Management Company and unit holders for any loss suffered by them as a result of its failure to perform its obligations.

The Audit Committee is responsible for checking:

- compliance with the law and the bylaws by the Board of Directors;
- the adequacy of the asset management company's organizational structure and of the procedures to supply its authorized activities;
- in particular, the adequacy of the internal control system.

The Audit Committee must notify the regulator without delay about the violations of the Management Company's duties.

In what regards to the independence of the Board of Directors, Independent Directors represent, generally, a minority and they are responsible for overseeing the decisions of the Board before they are carried out, in order to assure that the CIS is operated in the best interests of shareholders.

In this global context, CIS governance in Italy is therefore based on:

- A general provision that states that members of the Board Directors and members of the Audit Committee must be independent;
- Statutory duties imposed on the asset management companies in order to avoid/minimize conflicts of interests; in particular, it is defined that the CIS Operator must act independently and refrain from any conduct that might benefit one mutual fund or individual portfolio at the expense of another;
- Self-discipline codes from asset management professional associations that have developed a "Protocol of Independence", containing rules that are recommended to be included in bylaws of CIS Operators.

As an example, the Code states that asset management companies shall ensure that Boards of Directors include at least one-third of Independent Directors with a minimum of two.

According to the said Code, Independent Directors must:

- check the adequacy and the compliance with the best interests of investors of the contracts having a significant impact on CIS portfolio (i.g. dealing, underwriting);
- express their judgement on the subjects submitted to them by at least two directors of the Board;
- address potential sources of conflicts of interest in order to submit them to the examination of the Board; their judgement is not binding and the Board can take decision against the assessment expressed by the Independent Directors, in this case, however, the Board must motivate such decision;
- express a separate opinion on the appropriate compensation of the Board of Directors, the general manager and the management team;
- verify that the assets of CIS are not burdened with otherwise avoidable costs or excluded from the enjoyment of otherwise accruable benefits;
- address the decision-making process followed in exercising the administrative rights attaching to financial instruments under management and submit proposals to the Board with regard to this point; invest in CIS on whose Boards they serve;
- Avoid, for at least two years since the end of the appointment, to act as employee or to undertake professional or income relationships with CIS Operator, its subsidiaries, the shareholder or group of shareholders who controls the company and the executive directors.

Additionally and in order to prevent conflicts of interests due to directors that serve on multiple companies Boards:

- the executive directors of a regular CIS's broker-dealer, underwriter or company that provides the related activities may not be appointed to perform operational functions in the CIS;
- persons appointed to perform management functions (Independent Directors being in a position that let influence CIS's investment choices) may not be members of the Board of directors of companies whose securities are among the funds assets under management;
- persons appointed to perform management functions in the asset management company may not be Board chairman, CEO, general manager or manager responsible for the organization of the custodian bank.

This last requirement is imposed by the Bank of Italy which is responsible for the supervision of custodian banks.

As in Italy, in **Germany** the majority of CIS have a contractual type structure even though the corporate form is also possible according to the Investment Act.

A statutory duty to review compliance of the CIS operator with all laws, regulations and the CIS rules is imposed to the Depositary. Apart from a statutory controlling function of the Depositary, the Investment Act requires the consent of the Depositary for specific transactions of the CIS operator. The Depositary does not have a duty of report to the regulator, but it may refuse to carry out the instructions of the CIS operator, in case they contravene statutory provisions and the terms and conditions of the CIS. Furthermore, the Depositary is entitled and obliged to assert claims of investors against the CIS operator in its own name for breaches of the Investment Act or of the fund rules.

The CIS operator and the Depositary can belong to the same group. In order to ensure independence and “Chinese Walls” the Investment Act requires that managers of the Depositary, its holders and agents with powers of representation in the entire scope of its business may not, at the same time, be employees of the CIS operator and vice versa.

The CIS Operator must be established in the legal form of a stock corporation or a company with limited liability with a Board of management directors (composed of at least 2 members). In both cases a Board of management directors (composed of at least 2 members) and a Supervisory Board (composed of at least 3 members) is obligatory. The Supervisory Board oversees all funds under management. The appointment and retirement of members of the Board has to be notified without undue delay to regulator to enable an appropriate check of their fitness and expertise. The regulator does not have the authority to order a dismissal of a member of the Supervisory Board, but it has the right to take part in the meetings of the Board and can take interim measures of investor protection.

Although the members of the supervisory board are not independent as defined in the corporate model for the case of the United States - since they act in most cases as management directors of the parent company - the supervisory board plays an important role in the practical supervision. The supervisory board is insofar an important function as it has the power to dismiss management directors of the CIS operator. Before demanding dismissal of a management director of a CIS operator by formal legal supervisory measures, the regulator, in most cases, may promote contacts with the chairman of the supervisory board to induce a dismissal of the management director who has violated his duties on their own initiative. The supervisory board is in most cases interested to avoid the publicity of a formal dismissal procedure conducted by regulator and dismiss management directors by their own initiative.

In Spain, CIS governance provisions deals primarily with the following issues:

Authorization requirements for the Management Company:

- The Board of Directors must be composed of, at least, three members that must be professionally honorable and have enough experience with regard to financial matters.
- Internal control systems requirements:
 - The management company must have an administrative and accounting organization, computer security mechanisms and internal, management and risk control procedures appropriate for its activity. It must also have measures and procedures to avoid money laundering.
 - The management company must have a compliance function (control unit) comprising one or more persons who are not involved in any operational and business functions and which reports directly to the Board of Directors. The Board of Director of the Management Company assumes full responsibility for the implementation, development and on-going effectiveness of internal control.

Conduct Rules:

- There are broad principles enshrined in the Spanish Securities Market Law regarding the general duty to act in the best interest of investors and guarantee the equal treatment of investors and the obligation for financial entities must be organized and structured in such a way as to minimize the risk of conflicts of interest, and in case of conflict, give priority to the clients interest (the Law requires Chinese walls for activities of “separated areas”).
- More detailed principles are developed in the “General Code of Conduct” for securities markets regarding conflicts of interest.
- “Internal Codes of Conduct” must be approved by every management company in order to avoid conflicts of interests. This must be subscribed by every person in the Board of directors, directors and all the employees with some responsibility related to the management activity.
- Finally, related party transactions are subject to a special regime, including the establishment of procedures to ensure that related party transactions have been made at market price or better, and the public disclosure of these transactions.

Independent Review:

By the Depositary:

- Securities and other financial assets of the CIS must be kept by its Depositary entity.
- Independence between the Management Company and depositary is required.

Nevertheless, separation rules exist between the Management Company and the Depositary when they belong to the same group, namely:

- No existence of common board members or directors.

- The effective management of the CIS operator must be independent to the depositary entity.
- The CIS can not invest more than 1% of its assets in securities issued by the depositary entity.
- A physical separation must exist between the CIS operator and the depositary entity.

If the CIS management and the Depositary are part of the same group, additional procedures are required:

- To ensure independence and to avoid conflicts of interest.
 - Disclosure to investors of the relationship between them.
 - The periodic information to investors must include any purchase or sell of securities where the depositary entity acted as counterparty.
- The supervisory role of the Depositary includes:
- Valuation and pricing (NAV calculation methods).
 - It also has a role in the subscription and redemption process. The depositary is the only entity authorized to order payments against the bank accounts of the CIS, including redemption under the CIS operator instructions.
 - Compliance with diversification rules, and oversight of the management carried out by the management company.
 - A duty of Communication to the regulator any non-fulfillment of those regulatory provisions.

In France, the framework for CIS Governance is based on three main principles:

- Transparency;
- Compliance functions under the regulator's supervision;
- External control by the Depositary and the Auditors.

The Management Company³² must define appropriate procedures to monitor both their own activities and those of their intermediaries, depositaries and custodians. The implementation of a control structure of the asset management company, supervised by a person specifically appointed for this purpose by the company, is essential to the reliability of and compliance with control procedures, the prevention of operational risk and, ultimately, the security of the services provided to the investors.

In this sense, a compliance officer responsible for internal controls and compliance must be designated by the Management Company.

This control unit is responsible for compliance with the rules established by the regulator and the professional associations recognised by the regulator. For this

³² Both in the corporate as well as in the contractual forms.

purpose, it must conduct an ongoing review of the internal accounting control, risk monitoring and management procedures and systems. Its function is to evaluate compliance with all the established measures and limits, to verify their validity but also to propose any modifications it considers necessary. It is also responsible for notifying punctually the Board of Directors of any inadequacies observed in the system and for ensuring the separation of the functions of the CIS manager and the Depositary.

The CIS assets are kept by a single Depositary, which is also responsible for ensuring that the decisions of the CIS comply with laws, regulations and the CIS prospectus (investment allocation rules, nature of the products constituting the assets).

In accordance with the French regulation, CIS Depositaries exercise two main functions:

- Control of compliance with rules and investors' interests;
- Custody of the assets of the funds. This custodian activity may be delegated to other custodians under the responsibility of the Depositary.

The Depositary must be independent from the Management Company (or not affiliated with the SICAV)³³ and they both must act in a independent manner.

Furthermore, the Management Company and the Depositary are as applicable, individually or jointly, liable toward third parties or shareholders for breach of the laws and regulations applicable to CIS, for breach of fund rules or errors.

The main aspects of the preservation of good CIS Governance are therefore:

- Rules governing the custodian's independence and oversight;
- Control over persons in authority;
- Control over regulatory ratios, the specific investment rules set out in the prospectus and the rules on capital ratio for the CIS;
- Annual control of custodial functions by the statutory auditors of the custodian, including checks of the accounts opened in the books of the custodian on behalf of the CIS

The French *Fonds Communs de Placement d'entreprise (FCPE)* scheme can also be exhibited as it presents an interesting specificity. This scheme is organized in the form of a mutual fund whose shares can be exclusively subscribed by employees of a given company. As other mutual funds, French FCPEs are managed by a management company. However, the activity of the management company of such funds has to be monitored by a specific Supervisory Board and 50% of the members of this Supervisory Board are, at least, employee representatives. This Board fulfills the role of a sort of an "independent review committee".

³³ No single company can act both as Management Company and Depositary.

In Luxembourg the local Law requires that each CIS appoints a Depositary. The Depositary is primarily responsible for the safekeeping of the assets of the CIS and, in addition, has various monitoring and supervisory functions, the extent of which depends upon the corporate or contractual form chosen. For both forms OF CIS, the Depositary must ensure that:

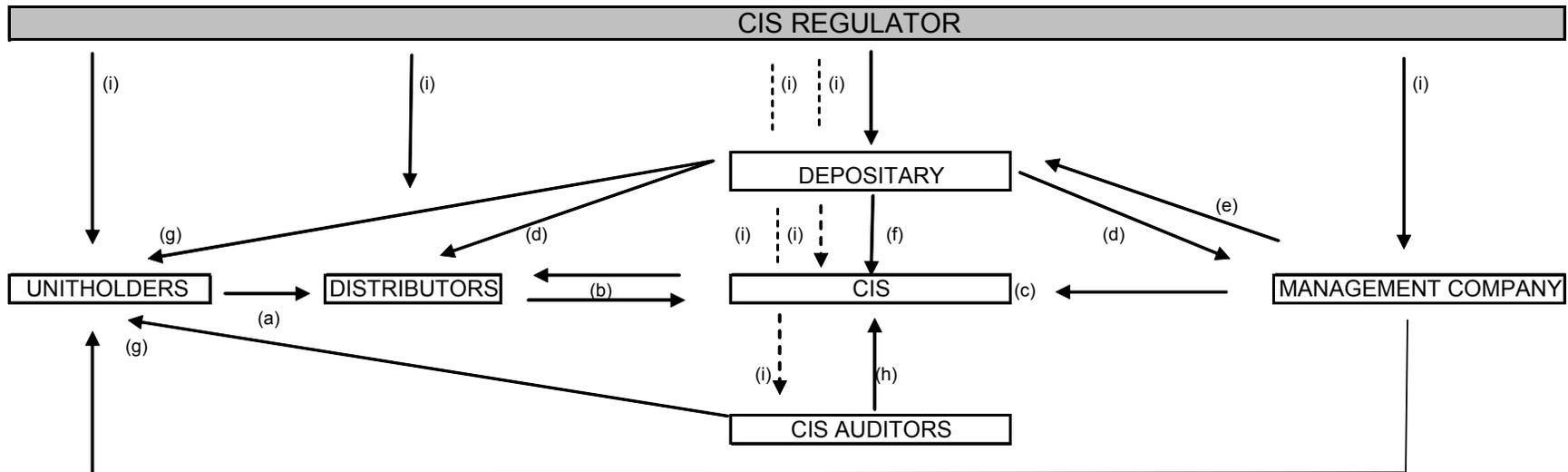
- the sale, issue, redemption and cancellation of units/shares effected /by the Management Company/by or on behalf of the CIS is carried out in accordance with the law or the management regulations/articles of incorporation
- in transactions involving the assets of the CIS, the consideration is remitted to it within the customary time limits; and
- the income of the fund is applied in accordance with its management regulations/articles of incorporation.

Moreover, for contractual CIS, the Depositary has to ensure that the value of CIS units is calculated in accordance with the law and the management regulations and to carry out the instructions of the Management Company, unless they are in conflict with the law or the management regulations.

The Luxembourg law expressly provides that the Management Company and the Depositary must act independently and solely in the interest of the unitholders with regard to their respective roles.

In the case of **Brazil**, even though the depositary is not required to supervise the activities of the CIS Operator nor must it be an independent entity, there are specific requirements concerning the segregation of functions and activities of both the CIS operator and Depositary.

Flowchart 3
CIS Governance Structure
Contractual Model 1 - Depositary



- (a) Placement of orders for subscription/redemption of CIS Unitshares.
- (b) Inflow/outflow of money and issue/amortization of Unitshares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and shared responsibility towards unitholders.
- (f) Oversight of CIS operations and safekeeping of assets.
- (g) Protection of CIS Unitholders 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 Unitholders best interests.

APPENDIX 4

Contractual model 2 - Trustee

In the **United Kingdom**³⁴, The functions of the manager and the trustee are somehow equivalent to the ones performed by the ACD and the Depositary in the UK corporate model for CIS.

The manager is appointed under the deed to carry out the daily management and promotion of the UT. In addition to the duties imposed on the manager under the trust deed there are additional requirements, rights and duties imposed on the manager under the legislative and regulatory framework, including trust law and ensuring compliance with investor protection rules. The manager must be a company which is an authorized person in its own right and has appropriate permission to act under the legislative provisions.

Under the regulatory framework the Manager must not retire voluntarily unless an eligible replacement has been found, is agreed by the trustee and becomes a party to the trust deed.

Under the legislative and regulatory framework the Trustee is responsible for monitoring and overseeing the manager's activities and holding the assets of the trust on trust for holders who are beneficially entitled to them. It has a direct relationship with, and must act only in the interests of, the unit holders. Like a Depositary, the Trustee must be an authorized person and must have the appropriate permission under the legislation to act. The Trustee must also be independent³⁵ of the UT manager.

Under the regulatory provisions the Trustee may only retire voluntarily (e.g if a Trustee ceases to offer trustee services) if a new Trustee has been appointed. If the trustee ceases to be an authorized person or does not wish to retire, the UT manager may appoint another eligible person by deed. The legislative provisions provide a mechanism for the trustee to alert shareholders of any problems it is aware of and which have led to its resignation.

The Trustee also has a right to convene a general meeting of the fund when it sees fit, and to be heard at any general meeting it attends on any part of the business of the meeting which concerns it as trustee.

³⁴ In the UK Unit Trusts are known as AUT (Authorized Unit Trust).

³⁵ The legislative framework requires independence between the Trustee and the Manager. The regulatory view is that independence is likely to be lost if by legal or operational means either relevant party could control the action of the other (by directors in common, cross shareholdings or contractual commitments.)

In addition to the specific duties mentioned above under the legislative and regulatory framework, the Trustee has a fiduciary duty associated with the control it has over scheme property and as such it is liable to account for any losses. The Trustee will receive all details of any corporate actions and may exercise all rights relating to the ownership of scheme property (as registered holder of investments and because the trust cannot act on its on behalf), but may only vote in accordance with the instructions of the manager. It is therefore obliged to pass all details of any corporate actions to the manager without undue delay.

Like a Depositary the trustee of an UT is prevented from delegating oversight and custody to the AUT manager and oversight but not custody and control of scheme property to any associate of the AUT manager as this could lead to compromise of investor protection.

In **Canada**, even though CIS can be mainly organized as either corporations or trusts, the majority of open-ended CIS are of this last type. Therefore, the prevalent legal structure of CIS in Canada is analogous to the contractual model.

CIS governance relies on the fiduciary obligations of CIS Operators (as well as Trustees and Investment Advisers), on statutory prohibitions, on regulatory oversight and on the remedies available upon abuse.³⁶ The CIS Operator is in a fiduciary role to the CIS and the investors in the CIS. This fiduciary duty arises at common law and civil law, and is reinforced in statutory standard of care provisions for CIS Operators set out in most jurisdictions in Canada.³⁷ For the trust-CIS Operator acting as Trustee (which is often the case), a fiduciary role additionally arises at trust law.

However, a proposed rule by the Canadian securities regulatory authorities will introduce independent review of conflicts of interest faced by the CIS Operator. It is expected this ‘independent oversight’ will have similarities to the role of the independent directors in the U.S. CIS governance corporate model.

In fact, a proposed national rule, published for comment by the Canadian securities regulatory authorities in January, 2004, introduces the requirement for open-ended CIS to establish an ‘independent review committee’ (IRC).³⁸ The CIS Operator

³⁶ Current remedies include the power of the regulatory authorities to investigate alleged problems and to issue orders, to levy fines or not to issue receipts for prospectuses, and the power of unit holders to commence litigation (including class actions in some jurisdictions).

³⁷ For example the *Securities Act* (Ontario) provides that “every person or company responsible for the management of a mutual fund (CIS) shall exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.”

The securities statutes of the provinces of British Columbia, Alberta, Saskatchewan, Nova Scotia and Newfoundland and Labrador are similar. In the province of Quebec, the statutory standard applies only to “registered” persons, not specifically CIS Operators.

³⁸ As currently drafted, it requires that an independent review committee (IRC) be composed of at least three members, and that all members be “independent”. “Independence” is defined to mean “no direct or

must refer to the IRC proposed actions where there is an inherent conflict of interest, or perceived conflict of interest, between the interests of the unit holders and the CIS Operator of the CIS.³⁹

The proposed role of the IRC has similarities to the role of the independent directors in the U.S. CIS governance model. The IRC's role will be as follows:

- Members of the IRC are intended to provide an independent check on CIS Operators. The proposed rule contemplates IRC members providing 'recommendations' to the CIS Operator. In response to comments received, the Canadian securities regulatory authorities may decide to require IRC approval for certain actions proposed by the CIS Operator.
- The proposed rule contemplates permitting CIS to engage in certain transactions (which are otherwise prohibited) with affiliated or related persons, if the CIS Operator refers the issue to the IRC and otherwise complies with the proposed rule.
- The IRC must act in the best interests of the CIS, and by extension, in the best interests of the CIS unit holders. The proposed rule contemplates the CIS Operator appointing the first members of the IRC, with the members independently appointing replacement members and setting their own compensation. The IRC is also free to engage independent legal counsel and other advisors it determines necessary (or useful) to carry out its duties.
- The proposed rule contemplates permitting CIS to effect certain changes upon IRC review, and subject to certain conditions, instead of the requirement of a unit holder vote. This would include a change in the CIS's auditor and in the case of a CIS merger or reorganization with another CIS with the same CIS Operator. In response to comments received, the types of changes allowed to proceed without a unit holder vote may be varied.

In Hong Kong, CIS can only be established in the form of a unit trust.

The centerpieces for CIS Governance are:

- the fund management company (CIS Operator);
- an independent trustee;
- an independent auditor.

indirect material relationship with the manager (CIS Operator), the mutual fund (CIS) or an entity related to the manager (a defined term in the instrument).” “Material relationship” is defined to mean “a relationship which could, in the view of a reasonable person, interfere with the exercise of the member’s independent judgement regarding conflicts of interest facing the manager.”

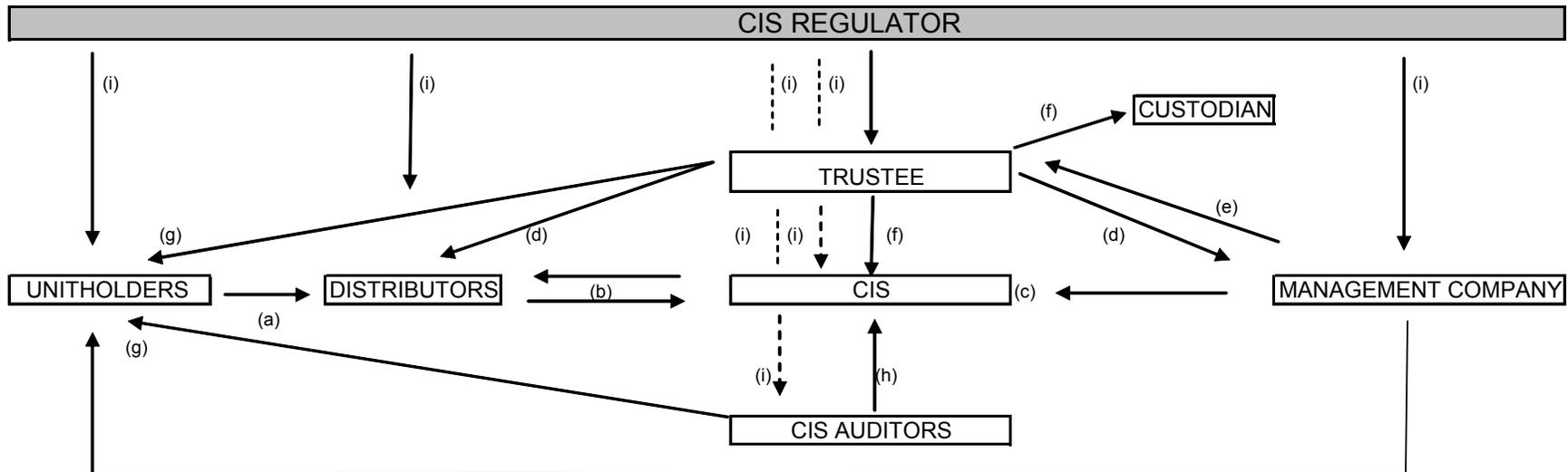
³⁹The proposed national rule recognizes CIS Operators, and those who work for CIS Operators, can find themselves in situations where their pecuniary interests conflict with their fiduciary duty or in situations where they have a diminished interest in pursuing the best interests of securityholders. Some of these conflicts are addressed by existing conflict rules while others are not.

Hong Kong laws require segregation and protection of assets of a CIS through the appointment of a trustee independent from the CIS Operator. Additionally, the regulator places certain supervisory responsibilities on the trustee of an authorized CIS. For instance, the trustee is responsible for ensuring that the operation of the CIS is in accordance with the provisions of the constitutive documents.

The Trustee plays also an important role in a possible CIS Operator removal since that is mandatory if the Trustee state in writing that a change in Management Company is desirable in the interests of the holders⁴⁰.

⁴⁰ Removal of the CIS Operator in the case of a unit trust, if holders representing at least 50% in value of the units outstanding deliver to the Trustee a written request to dismiss the operator.

Flowchart 4
CIS Governance Structure
Contractual Model 2 - Trustee



- (a) Placement of orders for subscription/redemption of CIS Unitshares.
- (b) Inflow/outflow of money and issue/amortization of Unitshares.
- (c) Day-to-day management of the CIS portfolio.
- (d) Oversight of CIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and submission to approval/ratification of contracts and certain restricted transactions.
- (f) Oversight of CIS operations and fiduciary property of CIS assets, although its safekeeping is entrusted to a custodian.
- (g) Protection of CIS Unitholders 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 Unitholders best interests.