

EXAMINATION OF GOVERNANCE FOR COLLECTIVE INVESTMENT SCHEMES

PART II

*Independence Criteria, Empowerment Conditions and Functions
to be performed by the 'Independent Oversight Entities'*



OICJ-IOSCO

**A Report of the Technical Committee of the International
Organisation of Securities Commissions**

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I – MAIN CONCLUSIONS OF PART ONE OF THE GOVERNANCE PROJECT: THE RECOMMENDATIONS IN TERMS OF GOVERNANCE STRUCTURES

The IOSCO Technical Committee (“TC”) has published part I of the Report on the Examination of Governance for Collective Investment Schemes (CIS), carried out by its Standing Committee 5 on Investment Management (“SC5”), in June 2006. This report includes a detailed description of the approach of each SC5 jurisdiction to this issue.

In part I, CIS Governance is 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 investors, and not in the interests of CIS insiders"*.

As a result of part I of the report, the TC has released a second part of the report, in order to identify one primary general principle of independent review and oversight of CIS Operators to be applied in all TC-jurisdictions, regardless of the structural form of the CIS.

The main conclusions of part I of the report were as follows. After describing the main legal environments from which a CIS Governance model could be further developed (the corporate and the contractual structures and also a Hybrid model), it explains how the principle of independent oversight (by Independent Entities) applies to, or should be evidenced in, the different structural forms of CIS that could be chosen in SC5 members jurisdictions.

There is no unique structural or optimal solution to the implementation aspects of governance in the case of CIS.

In some cases, one single entity, that can meet all necessary independence requirements, is empowered with sufficient capacities to fulfil the whole array of tasks to be entrusted with this entity. This first solution seems possible to a certain extent in the case of a CIS structured as a corporate entity with an independent board of directors and enough capacities to actually control the various aspects of CIS management.

This solution may seem unrealistic in other legal environments, though, in so far as the spectrum of the governance functions may be too broad for a single Independent Oversight Entity to review all the Governance related issues. Various structures can be set up, with different capacities, each of them being entrusted with a specific portion of the overall responsibility within the independent oversight function. This is mainly the case for the contractual structure, where alternative solutions should be recommended, as there seems to be no single entity that can take full responsibility for all aspects of Governance under such a scheme.

Under those circumstances, when the setup of different entities is necessary to accomplish the entire governance function, a mix of solutions is available depending on the nature of the function to be accomplished, so that the various roles are allocated to the

most relevant Independent Oversight Entities. For example, in the case of the contractual structure, the following options have been implemented in some jurisdictions:

- For all general or specific compliance related matters, there are independent members within the board of directors of the CIS Operator itself who are directly responsible for controlling the respect of all legal and contractual obligations and which form the reporting structure for the internal control and the compliance departments of the CIS Operator;
- In some jurisdictions, for the more operational aspects, the Depositary or the Trustee seem to be best placed for ensuring that legal obligations, the correct valuation of the CIS assets and pricing of units, the best execution of transactions in the market and other administrative functions are appropriately fulfilled by the CIS Operator. For valuation, accounting and fee related matters, the CIS Auditor can be a key element for complementing¹ or double checking the controls that are carried out by the Depositary or the Trustee ;
- An Independent Review or Compliance Committee² or the Supervisory Board of the CIS or CIS Operator, representing the interests of the CIS or the unit holders of the CIS to oversee and address potential conflicts of interest between the CIS and CIS Operator. This type of entity may further review the overall performance of the CIS and the adequacy of the management fees of the CIS.

These various tasks can be directly or indirectly fulfilled by the Independent Oversight Entities. The CIS Regulator also plays a central role in a CIS Governance structure. Additionally, Self-regulating Organizations, External auditors, Depositaries or Trustees, can bring significant contribution in terms of gathering the appropriate information and making their own assessment of the operational management of the CIS.

Within this framework, Independent Oversight Entities should be empowered with sufficient capacities to exercise their functions in an effective and independent manner. In this context, within the scope of the two main CIS legal structures that have been identified in part I and in consideration of the conclusions of part I, the present document aims at developing:

- the concept of independence **(II)**;
- the powers that Independent Oversight Entities should obtain **(III);and**
- the precise functions and tasks to be entrusted to those Entities **(IV)**.

The generic principles presented subsequently should be considered as applicable by all TC-jurisdictions. Based on the terms of reference of SC5, these principles aim at promoting the establishment and the maintenance of consistently high regulatory

¹ For the cases where the Depositary or Trustee does not have a specific responsibility of these matters (verifying certain valuation, accounting or fees).

² This can be the Depositary or the Trustee if conditions exist for their effective independence from the CIS Operator.

standards for the asset management industry in the area of CIS Governance. The specific cases in this report that are presented to illustrate how these principles could be practically applied should be interpreted as guidance based on examples of best practices³.

II - THE CONCEPT OF INDEPENDENCE: DEFINITION AND KEY FEATURES

The concept of independence takes different forms among the various CIS Governance structures but it is the main condition for Independent Entities to provide an “outside perspective” to protect CIS Investors. With reference to the possible governance solutions described in part I, the following forms can be identified:

- In some jurisdictions with a corporate model, independence refers to the status of certain directors as being unaffiliated to the CIS or other significant entities such as the CIS Operator, and also refers to the percentage of independent directors on the CIS Board of Directors;
- In other jurisdictions, particularly those where the contractual model is predominant, independence derives from specific requirements like, for example,
 - o a minimum number of independent directors in the board of the CIS Operator who are in charge of specific controls over the management function of the CIS Operator, or
 - o a mandated independent review committee comprised of at least three members, all required to have no direct or indirect material relationship with the CIS Operator or CIS, and who are responsible for reviewing conflicts of interest between the CIS and CIS Operator, or
 - o a regulatory framework requiring that the Depositary or Trustee and the CIS Operator are economically and functionally separate entities (if need be, through appropriate "Chinese walls"), and
 - that there are no common board members or directors among the two entities, or
 - that these entities are not subsidiaries of one another.

The legal framework can also impose a joint liability mechanism between the Depositary and the CIS Operator, which is enforceable in the cases where the Depositary does not correctly or fully fulfill its oversight duties.

Regardless of the different forms under which a CIS is incorporated and the specific nature of the Independent Entities, the concept of independence could be defined as “*a set of arrangements that provide Independent Entities with appropriate legal conditions and autonomy to exercise their powers and functions without constraints or interferences from the CIS Operator or its related parties, and allow adequate and objective oversight of the CIS and CIS Operator’s activities, with the objective of protecting CIS Investors and their assets*”.

³ In this sense, these examples should not be considered as an imposition to develop the same governance structures.

As a consequence, a common set of principles and criteria are to be adhered to in all jurisdictions to ensure that this independence principle is properly implemented and respected. They obviously have to be transposed within the context of the specific legal structures prevailing in each jurisdiction. After all, certain requirements for independence that are feasible within the context of a certain CIS Governance structure could be inappropriate or even incompatible in others.

The principles described below are applicable to all CIS and should allow the Oversight Entities to be independent in all cases. Each of these specific developments help illustrate in more detail their practical implementation in the context of the different CIS models.

II.1. The Independent Oversight Entities should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interests with the CIS Operator and its related parties.

The following examples can illustrate the more precise rules that could help enact such a principle, depending on the type of CIS structures in place in the various jurisdictions:

- The Independent Oversight Entities, or their members, could be directly elected by the CIS unit holders or could be designated in such a transparent way as to help assure that the Independent Oversight Entities or their members do not face any conflicts of interests with the CIS Operator and its related parties⁴. The aim of this possible rule is to ensure that investors are given the opportunity to decide or oversee in one way or another the decision about the designation of the Independent Oversight Entities, or the persons who will represent them within the Independent Oversight Entity, since these Entities or these persons will have precisely the investors' protection as primary goal. The transparency of the designation process of these Entities, or their members, reduces the probability of occurrence of conflicts of interest between the Independent Oversight Entities and the CIS Operator, whose activities the Entities will have to control.

In the cases of the board of directors of the CIS, of the board of directors of the CIS Operator, or of an Independent Review or Compliance Committee, the independent members should be:

- elected by the CIS unitholders; or
- self-appointed after the first instance; or
- appointed in a transparent way; or
- under the CIS unitholders' oversight; or
- under the control of the regulatory authority; or

⁴ In the United States, independent directors themselves can constitute the Independent Oversight Entity.

- pursuant to the relevant statute.

The appointment or replacement of the Depositary or the Trustee of the CIS should be managed in such a transparent way that the CIS unit holders are informed about potential conflicts of interests. In some countries, the CIS Regulator can play this role on behalf of the CIS unit holders when it is not manageable for them to have a direct control on these matters. In other countries, disclosure of any conflicts can be made to an Independent Review or Compliance Committee;

- The Independent Oversight Entities or their members could not be dismissed by the CIS Operator without disclosed and motivated explanations, or without prior, direct or indirect, control by the CIS unit holders or by the CIS Regulator. The termination of the relationship and the replacement of the Independent Oversight Entities could be approved by the CIS unit holders, or by another independent party under the CIS unit holders' control, or by the Regulator of the CIS. The main objective for this rule would be to ensure that the CIS Operator, by having the power to dismiss the Independent Oversight Entities or their members, does not constrain or create barriers to the controls and responsibilities of the Independent Oversight Entities. This is of particular importance when the Independent Entity is to take action against the CIS Operator's decisions that deviate or are detrimental to the CIS investors' best interests.

In some countries, the CIS Regulator can play this role on behalf of the CIS unitholders when it is not manageable for them to have a direct control on these matters. In all cases, the termination of the relationship and the replacement of the Independent Oversight Entities would be clearly explained and disclosed to CIS unit holders and to the CIS Regulator when this latter plays a role on behalf the unitholders;

- The Independent Oversight Entities could not be entities, or could not be composed of a majority of individuals⁵, that have direct or indirect relationships with the CIS Operator or an entity related to CIS Operator in such a way that it creates conflicts of interests or situations impeding the independence of their assessment. Therefore, in the case of the board of directors of the CIS or of an Independent Review or Compliance Committee, the Independent Oversight Entities may only be composed of a majority of individuals (respectively independent directors or representatives of the CIS unitholders) who are:
 - o not affiliated to the CIS Operator; or
 - o not immediate family members of an affiliated person to the CIS Operator; or
 - o not affiliated with any person in the same group as the CIS Operator; and
 - o do not serve on multiple boards in the CIS Operator's group⁶.

The same rule could be applied to the independent directors in the board of the CIS Operator.

⁵ In the United States, at least 40% of the CIS directors must be "independent" (as defined under U.S. law)

⁶ This does not include persons who serve as directors of multiple CIS in the CIS Operator's group.

This last rule provides additional safety to CIS Investors since it ensures that the majority of the persons that make up the Independent Entity does not have any potential conflict of interests with the CIS Operator. This aims to create an appropriate ‘environment’ for independent entities to formulate independent and critical judgments about the activities of the CIS and the CIS Operator.

In the case of the Depositary or the Trustee, the last rule could require that if the CIS Operator is in a situation to control directly or indirectly the activity of the Depositary or of the Trustee, the independence of the Oversight Entities may not be reduced because of legal or operational conditions. The organization and the functioning of the Oversight Entities should be clearly segregated from any CIS Operator activity (namely, by prohibiting direct or cross shareholdings or even contractual arrangements regarding corporate control). When there is an actual or potential, legal or economic dependency between the CIS Operator and the Depositary or the Trustee, the CIS should at least be required to implement the appropriate mechanisms to enable the Depositary or the Trustee to act independently from the CIS Operator under all circumstances. This requirement could be complemented with the existence of a joint liability mechanism between the entity and the CIS Operator, so that they can be held responsible (in legal and economic terms) for the inappropriate exercise of their powers and functions. When the Depositary or the Trustee cannot meet any of these independency requirements under any circumstance, their activities should be put under the control of an Independent Oversight Entity that can meet those requirements.

II.2. The organization and the practical functioning of the Independent Oversight Entities should allow them to be out of the control or the influence of the management of the CIS Operator or its related parties.

This principle aims at providing for strict separation between managing and supervisory functions, by legally and practically ensuring that the Independent Oversight Entities can freely fulfill their obligations without facing potential conflicts of interests with the CIS Operator. Conversely, the CIS Operator could not have any possibility to control the actions and the decisions of the Independent Oversight Entities. If, by any legal or operational means (common directors, cross shareholdings or contractual commitments for instance), independence is likely to be endangered, the Independent Oversight Entities can be controlled by the management of the CIS Operator or its affiliated parties.

II.3. There should not be any confusion between responsibilities of the Independent Oversight Entities when exercising their oversight function on the one side and the CIS Operator in its asset management role over the CIS on the other side.

Again, as a matter of examples, more precise rules in this area could be as follows:

- The Independent Oversight Entities could not have any delegated power with regards to the management of the assets of the CIS. The objective of this rule is to provide for an adequate separation between asset management and supervisory functions. The Independent Entities, or their members, are essentially required to perform a supervisory function and are not to be involved with the management of the assets⁷, or the operational aspects of the CIS. This could lead them to oversee a management function that they had previously fulfilled. After all, with respect to independence of the oversight process, there is indeed a major incompatibility between performing one task and then checking it;
- The persons appointed within the Independent Oversight Entities could not be able to exert major influence on the management or policies of the CIS⁸. This rule would entail that the persons that are involved in critical supervisory functions at the Independent Oversight Entities' level, such as:
 - independent board members sitting at the board of the CIS or of the CIS Operator; or
 - representatives of the CIS unitholders within an Independent Review or Compliance Committee; or
 - members of the Depositary or the Trustee,cannot combine these functions with any operational and management tasks within the CIS normally undertaken by CIS Operator;
- The Independent Oversight Entities could not receive any remuneration or incentives from the CIS Operator which may bias the independence of its assessment in such a way that it could be detrimental to the interests of CIS Investor's⁹. The primary goal of this requirement would be to ensure that the Independent Oversight Entities, or their members, do not exercise their powers or their functions in a biased way, due to economic interests in the CIS Operator's decisions, which are not in line with the interests of the CIS investors.

⁷ However, this does not exclude the possibility that in certain jurisdictions some persons within the Independent Oversight Entities, such as Trustees or Boards of Directors of CIS's, may exercise influence over the management and policies of the CIS.

⁸ However, in some jurisdictions it is the obligation of the Independent Oversight Entity (e.g. the board of a corporate CIS) to establish the general management policies of the CIS, in the best interests of the CIS.

⁹ In some jurisdictions, compensation from the CIS Operator to the members of the Independent Oversight Entity generally would not bias the independence function when the terms of the compensation are determined by the Independent Oversight Entity and are disclosed to unitholders (e.g. custodians or depositary fees).

III - THE POWERS OF THE INDEPENDENT OVERSIGHT ENTITIES:

As stated in the introductory part of this paper, Independent Oversight Entities should be empowered with sufficient legal capacities to exercise the effective oversight of the CIS Operator and of the various functions that the Operator are responsible for. Again, if a CIS does not meet the necessary independence requirements to properly use one of those powers or cannot legally centralize all necessary functions, it is necessary to implement a mix of various solutions involving Independent Entities. The powers of Independent Entities may be granted by way of statutory or regulatory rules or by contractual obligations between themselves and the CIS Operators.

The analysis of the various regimes in place in the SC5 jurisdictions allows for the definition of a common set of generic powers that Independent Oversight Entities should have, regardless of the type or legal structure of CIS in which they operate.

<p>III.1 – The Independent Oversight Entities should be entitled to receive all relevant information enabling them to perform their oversight function in a proper manner.</p>

The following are examples of rules that aim at providing the Independent Oversight Entities with relevant information that is essential for them to exercise their functions adequately.

- For instance, Independent Oversight Entities could receive copies of documents and be periodically informed about the conditions of management of conflicts of interests between the CIS and the CIS Operator. Independent Oversight Entities should also be entitled to receive all necessary information if any compliance or legal issue is detected that may be of relevance to the CIS unitholders.
- The Independent Oversight Entities could be informed about the procedures and policies of the CIS Operator that relate to the CIS and which are in a position to periodically verify their implementation. They could be informed about all significant cases of breaches of the compliance procedures. They could also be informed of the designation and the dismissal of the CIS Operator's chief compliance officer, and of the motives thereof. This rule aims at allowing the Independent Oversight Entities to satisfy themselves of the independence of the compliance function and its effectiveness in meeting its obligations to investors.
- The Independent Oversight Entities could be informed about all significant cases of breaches of the application of the CIS Operator's internal code of ethics affecting the CIS and the corrective actions taken to implement material changes to this code.

III.2 – The Independent Oversight Entities should be given the necessary means to carry out their duties without relying exclusively on the CIS Operator's assistance.

The following are examples of rules implementing this principle.

- Independent Entities are given the capacity to call upon independent legal advice within specific expense and time limits. This rule ensures that the permanent control exercised by the Independent Oversight Entity over the CIS Operator's activities relating to the CIS is not exclusively supported by legal or financial experts, who are directly or indirectly under control of the CIS Operator, and whose interests could consequently conflicts with those of the Independent Oversight Entity.
- Independent Oversight Entities should be allowed to meet periodically and separately from the CIS Operator or the directors that are not independent from the latter. This rule aims at periodically providing the Independent Oversight Entities with an outside perspective on how the CIS Operator is managing the CIS and on any major issues that have been detected and duly reported.
- Depositaries or trustees have their own legal resources. Subsequently they are given the necessary means to carry out their duties independently without relying exclusively on the CIS operator's assistance.

III.3 – The Independent Oversight Entities should be given the right to review the legal and operational conditions of the CIS management in relation with the CIS in a reasonable way.

In order to implement this principle, and when relevant, the CIS Operator's contract and all its subsequent amendments are subject to review by the Independent Oversight Entities, with the aim of checking the fairness and the adequacy of its terms and subsequently controlling the correct implementation of the contract by the CIS Operator. In some jurisdictions the Independent Oversight Entity are able to dismiss the CIS auditor.

The Independent Oversight Entities are informed of the results of the audit of the CIS and are able to hear the auditors separately from the CIS Operator. They are also informed of the proposals for the appointment and dismissal of the CIS Auditors, and of the motives of such changes. They should be in a position to verify that the designation process of new Auditors is conducted in a proper and transparent way.

The Independent Oversight Entities can formally approve or oversee implementation of the policies and procedures concerning the proxy voting relating to the securities portfolio of the CIS, with the objective of making sure that voting rights are exercised in the sole interests of the CIS unitholders. When there is no legal or economic requirement of independence between the CIS Operator and the Independent Oversight Entity (for instance the Depositary), this function should not be entrusted to the Independent Oversight Entity.

IV - FUNCTIONS TO BE PERFORMED BY THE INDEPENDENT OVERSIGHT ENTITIES

In close relation to the exercise of their powers, Independent Oversight Entities have to perform specific functions with the objective of exercising an overall control over the CIS Operator and the way it manages the CIS on behalf of the CIS unitholders. The purpose of this general responsibility is to verify the adequacy of the CIS management, its effectiveness and its compliance with existing rules, and the CIS Operator's contractual obligations and fiduciary duties, under all circumstances and most particularly in all the cases where the CIS Operators' decisions may have a significant impact on the CIS portfolio or on the CIS unitholders' interests.

The Independent Oversight Entities aim at protecting CIS Investors from divergent behavior of the CIS Operator.

In that sense, the functions that are more directly related to investor's protection and particularly those that may prevent and avoid the inappropriate erosion or expropriation of investor's wealth and interests in the CIS are of particular importance.

In this context, regardless of the type of CIS, the main functions undertaken by Independent Oversight Entities are as follows:

IV.1 – The Independent Oversight Entities, collectively, should have the function of overseeing the CIS Operator and CIS Operator's activities

Examples of specific functions that can be exercised by independent entities are:

- overseeing potential conflicts of interest with regard to transactions concluded with related parties or with regard to the outsourcing of functions of the CIS or the CIS Operator to related parties;
- overseeing decisions of the CIS Operator involving potential conflicts of interest between the CIS and CIS Operator;

- checking the compliance of the CIS portfolio with the applicable borrowing and investment limits and restrictions;
- controlling the appropriateness of the valuation process of the CIS assets and the proper calculation and disclosure of the CIS NAV and of the CIS unit price;
- assessing the accuracy of the calculation of the CIS Total Expense Ratio (TER); and
- checking the correct application of the principles and procedures for the exercise of shareholder's rights attached to the securities portfolio.

As a matter of example these functions would be best fulfilled by the board of the CIS in the case of the corporate model, or by the Independent Directors sitting at the board of the CIS Operator, or by a Supervisory Board or an Independent Review or Compliance Committee in the case of the hybrid corporate and contractual model. In certain countries, the functions mentioned in the second to the fourth indent above can be managed by the CIS Auditor.

IV.2 – The Independent Oversight Entities, collectively, should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investor's wealth and interests in the CIS

For instance, the Independent Oversight Entities can be in charge of:

- ensuring the segregation of CIS assets from the CIS Operator;
- ensuring that fees, expenses and other costs are charged in accordance to the regulatory regime or with the specific rules of the CIS;
- verifying that any income received by the CIS Operator is reflected in the CIS portfolio, on a timely and fair basis;
- where required by the regulatory regime, checking that the CIS Operator is exercising appropriate judgment about the use of 'soft' and 'hard' commissions or otherwise that information is properly passed on to investors about the CIS policy on this matter; and
- ensuring that investors are equally treated, within each class of unit shares, most particularly regarding subscription and redemption conditions.

It should be noted that in certain jurisdictions, depending on the model of CIS, some of these functions could be exercised by other entities, namely the CIS Regulator, CIS Auditor and Self-Regulatory Organizations, either on an exclusive or on a complementary basis to other Independent Oversight Entities' functions.

IV.3 – The Independent Oversight Entities should have a duty of reporting to the regulatory authorities or the CIS unit holders.

All types of Independent Entities should have the general function to inform the appropriate parties of:

- any material breaches or irregularities in terms of applicable rules or contractual obligations, detected in the course of their controls;
- any material situation whereby the CIS Operator has been considered as performing or operating in a way that would not meet the needs or the rights of the CIS unitholders.