

## **Corporate Governance and (Self-) Regulation- An Investment Fund Perspective**

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### **Abstract:**

*As a result of the global financial turmoil, calls for regulation of financial services enjoy a strong political tailwind. Aside from that, the last years have shown that self-regulation is of increasing importance in terms of complex financial market issues. This contribution reflects the issue of financial regulation and thereby describes the self-regulatory efforts of the investment fund industry. This industry has always been at the forefront of these developments acknowledging that as economic theory and in particular the principal-agent relationship indicate that state regulation is mostly reactive than pro-active.*

*Against this background, the paper reflects the status quo of self-regulatory efforts of the European investment fund industry and attempts an outlook on how a successful future symbiosis of government regulation and self-regulation could look like.*

### **1. Introduction**

The global financial crisis put a big question mark on the often stressed benefits of financial globalization. Numerous government actions were necessary worldwide to stabilize the financial system. Moreover, questions regarding the effective strength of financial institutions and the suitability of the regulatory and supervisory systems have been on the daily agenda. At the international level, the recent G-20 summits<sup>1</sup> focused on these issues and on the European level, the Larosi re Report<sup>2</sup> came up with substantial recommendations regarding the future financial architecture focusing on the reform of EU regulatory supervision and global coordination.

Moreover, in particular the bankruptcy of Lehman Brothers and the Madoff fraud highlighted that corporate governance rules and its practice within financial institutions need a review. The European Commission in its Communication of 4 March 2009<sup>3</sup> announced that it will examine the practice of corporate governance rules within financial institutions, particularly banks in the light of the financial crisis and where appropriate make recommendations or propose regulatory measures to remedy any weaknesses in the corporate governance system of the financial sector.

However, it always seemed that the corporate governance framework for financial institutions is well developed and sophisticated as numerous initiatives have already been

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<sup>1</sup> Here reference shall be made in particular to the G-20 "Leaders Statements" of the Pittsburgh Summit (Sept. 24-25, 2009) the London Summit (April 2, 2009) and most recently the Toronto Summit (June 27, 2010).

<sup>2</sup> Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009 available at [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf).

<sup>3</sup> COM (2009) 114 final.

in place for many years such as the *OECD Principles of Corporate Governance of 2004*<sup>4</sup>, the *Basel Guidelines on “Enhancing Corporate Governance for Banking Organizations”*<sup>5</sup>, the *OECD Guidelines for Pension Funds Governance*<sup>6</sup>, the *OECD Guidelines for Insurer’s Governance*<sup>7</sup> or the *EFAMA Code of Conduct for the European Investment Management Industry*<sup>8</sup>.

Recently, the European Commission published the Green Paper “*Corporate Governance in Financial Institutions and Remuneration Policies*”<sup>9</sup> that shall be understood as part of the response from the European Commission on this subject by examining and laying down a series of considerations on the status quo of corporate governance practices in financial institutions. It can be expected that this Green Paper will trigger substantial discussions about corporate governance practices in Europe. In particular the observance of existing corporate governance principles and their nature in general will get in the focus. In this regard, this contribution will try to analyze the issue of corporate governance from both a general regulatory as well as a specific fund perspective.

## 2. The Crucial Role of Financial Regulation

### 2.1. A Quick Review

When dealing with corporate governance, it is important to spend some general thoughts on the issue of regulation. In particular as a result of the global financial crisis, regulation became a political topic that can easily be sold to the public and requests for a stronger regulation of banks and other financial institutions enjoy a significant tailwind. However, leaving political and ideological considerations aside, it needs to be stressed that the financial sector has traditionally been heavily regulated. This can be derived from its essential status in the economy and the need for a stable and sound financial system.

It is interesting to note that in the 1990s a clear trend towards integrated financial market regulation and supervision can be observed. The Scandinavian countries Norway (*Kredittilsynet* in 1986), Denmark (*Finanstilsynet* in 1988) and Sweden (*Finanzinspektionen* in 1991) were among the first ones to set up integrated financial market authorities. Singapore finished this institutional integration already in 1984 with the creation of the *Monetary Authority of Singapore* and Canada set up the *Office of the Superintendent of Financial Institutions* in 1987. South Korea established its *Financial Supervisory Service* in April Japan its *Financial Services Agency* in June and Australia *Prudential Regulation Authority* in July 1998, as well as 1998. Austria (*Finanzmarktaufsichtsbehörde* in April 2002) and Germany (*Bundesanstalt für Finanzdienstleistungen* in May 2002) followed with some delay.<sup>10</sup>

As these examples show, a significant transformation occurred in financial sector regulation. Until the 1980s, regulation was predominantly imposed on the financial sector in general and on international financial transactions. However, over time, the dominating

<sup>4</sup> See [www.oecd.org/dataoecd/32/18/31557724.pdf](http://www.oecd.org/dataoecd/32/18/31557724.pdf).

<sup>5</sup> See [www.bis.org/publ/bcbs122.pdf?noframes=1](http://www.bis.org/publ/bcbs122.pdf?noframes=1).

<sup>6</sup> See [www.oecd.org/dataoecd/18/52/34799965.pdf](http://www.oecd.org/dataoecd/18/52/34799965.pdf).

<sup>7</sup> See [www.oecd.org/dataoecd/54/28/40990025.pdf](http://www.oecd.org/dataoecd/54/28/40990025.pdf).

<sup>8</sup> See [www.efama.org/index.php?option=com\\_docman&task=doc\\_details&gid=150&Itemid=-99](http://www.efama.org/index.php?option=com_docman&task=doc_details&gid=150&Itemid=-99).

<sup>9</sup> COM (2010) 284 final. This Green Paper has to be seen in conjunction with the Commission Staff Working Paper “*Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices*” both published on 2 June 2010.

<sup>10</sup> For further details see *Grünbichler/Darlap* (2003), 7ff.

concerns regarding financial market stability shifted towards the quest for efficiency. Therefore the major deregulations of financial sectors in most Western countries during the 1980s and 1990s are a consequence of this shift in focus which also reflected the awareness of the growing importance of financial markets.

Moreover, since financial institutions, in particular banks transformed into multinationals<sup>11</sup>, the increasing possibilities of technological innovations and the need for regulatory changes became stronger. It turned out to be a positive side effect of the deregulations that the financial sector has been enabled to better perform its task of allocating capital and risk<sup>12</sup> over time and space.

## 2.2. Motives For Financial Regulation

Regulation in the sense of government intervention is considered to be necessary in case of market failure because general economics assumes that since the market is not able to cope with certain problems on its own, the state has to intervene<sup>13</sup>. Market failure is typically a situation in which markets do not efficiently organize production or allocate goods and services to consumers.

Against the background of market failures and its accompanied impacts on financial markets, four motives for financial market regulation can be identified: systemic risks, enhancement of efficient allocation of funds and risks, consumer protection and other motives.

### 2.2.1. Systemic Risk as a Motive for Regulation

The main intention of financial regulation is to ensure that no systemic risks can potentially harm the financial system.<sup>14</sup> The common example of systemic risk is when financial problems of one bank lead to a general bank run which undermines the confidence in the banking system. This causes a collapse of the payment system as well as of the money supply and potentially ends in a recession or depression. In this regard and from a financial market perspective, settlement systems and the liquidity of markets are of major concern. In particular in these two cases, government supervision is needed in order to avoid serious financial problems.

### 2.2.2. Efficient Allocation as a Motive for Regulation

Based on the general dogma of efficiency<sup>15</sup>, economic theory implies that the market structure is most efficient when agents can compete freely without any government intervention. Nevertheless, there exist some problems in free markets which have a special relevance for securities markets: asymmetric information, public goods, externalities and market power.

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<sup>11</sup> With regard to multinational banks and how they influence the behaviour of national regulators, see *Calzolari/Lòranth* (2005).

<sup>12</sup> A comprehensive framework for analyzing the capital allocation and capital structure decisions facing financial institutions is provided by *Froot/Stein* (1996).

<sup>13</sup> It is commonly understood that the four main sources of market failure from a law and economics point of view are (i) monopoly and market power, (ii) externalities, (iii) public goods and (iv) severe informational asymmetries.

<sup>14</sup> *De Bandt/Hartmann* (2000) developed an interesting concept of systemic risk which is a basic economic concept for the understanding of financial crises.

<sup>15</sup> The dogma of economic efficiency consists of maximization of aggregate consumer and producer surplus.

Asymmetric information has direct relevance for financial markets because in case of any trading in these markets it is possible that one counterpart is better informed than the other. As *Glosten/Milgrom* (1985) point out, there is always a loss in such trades, since informed traders will only buy when the asset is undervalued and sell when the asset is overvalued. Therefore, adverse selection exists which leads to lower welfare of all traders and transaction costs, with the consequence that if the asymmetric information is large enough, the market may collapse completely. However, asymmetric information is not considered to be a typical market failure, primarily because market solutions such as signaling, guarantees or standardized contracts exist.

Aside from asymmetric information, externalities have to be mentioned. In case more traders access a specific trading system, the benefits for everybody being active in the system will rise. Externalities therefore have an impact on market liquidity. It also has to be stressed that externalities often cause a consolidation of trading to a limited number of trading venues. Such concentration tendencies are likely to limit competition and thus, financial markets have many features in common with natural monopolies.

Another case for externalities is that market participants would be better off if everybody would follow high ethical standards. Nevertheless, market participants often have strong incentives to break such standards as long as everybody else acts in an ethic manner. Without government intervention some participants would break these rules, but everybody else would be worse off. This leads to a lack of coordination and constitutes a classical prisoner's dilemma.

### 2.2.3. *Consumer Protection as a Motive of Regulation*

An often stressed motive for financial regulation is the need for a proper protection of consumers and unit holders. In this regard, the aim is to ensure that the price formation process is efficient and transparent as well as that there is enough competition between traders, brokers and other market participants.

The ratio behind this is that if markets are efficient, all trades will be performed at correct prices and the need for consumer protection would not be such a big issue. This implies that consumers are better protected in an efficient market than in a less efficient market, which furthermore means that ensuring efficient markets is of highest priority for securities regulators. However, financial markets are not perfectly efficient, mostly due to asymmetric information so that information is not equally spread between investors. Typically small investors have less access to information. Therefore, securities regulation is mostly intended to either reduce asymmetric information between agents, or to diminish the potential danger of asymmetric information.

However, it often not clear what consumers need to be protected against. Risk is central to financial securities and therefore regulation should basically not protect investors against making losses, taking risks or making mistakes.<sup>16</sup> Therefore, securities regulation should be designed to correct market imperfections and failures. Another reason for not protecting investors against losses or taking risks is that individuals primarily trade through professional intermediaries which have numerous information duties. Due to the importance of the relationship between customers and professional intermediaries, the focus of regulation has to be laid here in order to achieve efficient consumer protection.

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<sup>16</sup> See *Llewellyn* (1995), 16.

#### 2.2.4. *Other Motives for Regulation*

Moreover, competitiveness and money laundering are also motives: Competitiveness is in many cases of national interest since some countries very actively set proper frameworks to ensure having a competitive financial sector and consequently an efficient market.

Due to the enormous number of international financial transactions it became easier to make use of the financial system to hide criminal revenue and transform them into legitimate financial positions. As a consequence, significant reporting requirements and specific anti-money laundering legislations have been passed.

### 2.3. **Problems With Financial Regulation**

#### 2.3.1. *General Remarks*

Even though the described motives call for financial regulation, numerous problems are associated with it such as the assessment of the costs and benefits of any new regulation. Moreover, any kind of regulation has to be accepted so the acceptance among the regulated agents is of highest importance because if regulation is not accepted, it will not be effective. Consequently, the question of how to obtain acceptance of respective regulation is crucial. In this regard, six main problems are stressed in literature: the ability of the regulator, moral hazard, enforceability, consumer over-protection, time and conflicts.

#### 2.3.2. *The Ability of the Regulator*

The regulator has to have the ability, the motive and the knowledge to impose regulations meaning that both, the availability of information as well as the enforceability of the regulation, are granted. The *IOSCO Objectives and Principles of Securities Regulation* state that the regulator has to have clear and objectively stated responsibilities and should be operationally independent and accountable in the exercise of its functions and powers. Consequently, the regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise of powers. When fulfilling these tasks, the regulator should adopt clear and consistent regulatory processes, which should be carried out by a staff which has to observe the highest professional standards. Moreover, in specific cases interest groups may have some influence on the regulator so potential conflicts of interests shall be avoided in this regard. Furthermore, since a proposed solution by the regulator may not be optimal and causing drawbacks and resistance, it is always worth considering if not an unregulated situation is preferable.

#### 2.3.3. *Moral Hazard*

Imposing new financial market regulation may shift the incentives of the agents acting in these markets with the side-effect that individual agents might become less careful. Standards of risk management can have the effect that moral hazard occurs so that the regulated institutions take even higher risks. A careful evaluation of the effectiveness of regulation, its effects on transparency and existing regulations is necessary.

#### 2.3.4. *Enforceability*

Financial market regulation always has to be seen in the light of enforceability. It might happen that the imposed regulation is practically not enforceable, meaning that a wrong solution was chosen. Consequently, the regulator has to make sure that enforceable regulations are issued.

### 2.3.5. *Consumer Over-Protection*

Regulation should in general not protect investors against making losses, taking risks or making mistakes. However there is always the lure that regulators try to over-regulate financial markets by stressing the argument of consumer protection. The general question of to what extent individuals should and can be protected can neither be answered easily nor generally because due to the changing environment of financial markets, the regulator has to balance the national interests with the international developments and competition.

### 2.3.6. *Time*

Time is crucial in the context of financial market regulation in particular when considering the speed and innovation of these markets. Despite the regulator might be a step behind the market, it shall be attempted that regulation is pro-active and not reactive.

### 2.3.7. *Conflicts*

Regulation has to cope with potential tensions so the regulator has to find the balance between flexibility and predictability of regulation, harmonization and competition of regulatory frameworks, between consumer protection and efficiency and also between the different levels of regulation.

## 2.4. **The Various Types Of Financial Regulation**

### 2.4.1. *Regulation in General*

Regulation in general can have various forms and therefore regulations can either codify already existing notion of what is acceptable behavior, or they can have a normative purpose of trying to change the public notion of what should be outlawed.<sup>17</sup>

However, any regulation should have the intention to achieve a better outcome but since many regulations reflect a compromise, the effects are not always socially optimal. In order to change individual behavior by regulation, the regulator must be in the position of having higher goals, better information or better possibilities to identify and then correct a market failure. Moreover, the enacted regulation needs to be accepted because otherwise the authority of the regulator will be diminished.

### 2.4.2. *State Regulation and Self-Regulation*

In terms of types of regulation two main pillars namely state regulation and self-regulation have to be distinguished:

*State regulation* can have the form of supranational agreements, national laws or actions by government agencies. Supranational agreements are in particular those adopted by the European Union and they have in common that they result from consultations, negotiations and reflect a compromise. Moreover, these agreements are only valid if ratified, enacted and in particular implemented into national laws. Unlike supranational law, national laws immediately support regulation with an enforceable component such as prohibitions and penalties. At state level, it is also common to delegate regulatory competences to specific government agencies such as financial market authorities or central banks. These government agencies issue rules, whereby financial supervisory authorities issue secondary regulation by specifying or interpreting national laws.

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<sup>17</sup> See Niemeyer (2001), 40.

*Self-regulation* in form of self-binding contracts, rules and regulations exist in various forms. Typically, three types of self-regulations can be distinguished<sup>18</sup> with the first one being that self-regulatory rules are set up by mainly private organizations, whereas the second type of self-regulation is constituted when industry organizations set up rules for accepted practices mostly in the form of special clauses in standardized contracts with the result of lowered transaction costs and the third type being that a single company adopts specific self-regulatory measures.

When considering the differences between state regulation and self-regulation, the advantages and disadvantages of both types of regulation can be listed as follows:

- Institutions imposing self-regulations have a better market proximity and therefore a better knowledge of the market
- Self-regulation is flexible in terms of modifications and its application.
- Self-regulation is effective because it incorporates market practices and monitors the market from an economic, reputational and regulatory self-interest perspective.
- Self-regulation is cost-efficient since the regulatory costs are internalized in the tradeoff between regulatory costs and benefits.
- Self-regulation only implies to members of the system and is based on voluntary contracts.
- Self-regulatory rules often become industry standards, so non-members have to comply with them as well.
- The enforcement of self-regulation is challenging because self-regulatory institutions are often not able to monitor compliance and non-compliance of its members.
- Self-regulation can cause conflicts of interest between the involved but also versus external parties.
- Self-regulation often focuses rather on specific than on general issues.

Against this background it becomes clear that state regulation is most effective in case of a need for stable, unambiguous and predictable rules<sup>19</sup>. Contrary to this, self-regulation is more specific, flexible and market-oriented.

## 2.5. The International Dimension

The increasing integration of international financial markets has tremendous effects on the role of government regulation and self-regulation. Already before the financial turmoil, voices in literature pointed out<sup>20</sup> that there is a need for international financial regulation and supervision. In this regard, the International Organization of Securities Commissions (IOSCO) has to be introduced because IOSCO has always been active by setting international recommendations and guidelines, such as the *IOSCO Objectives and Principles of Securities Regulation* in May 2003, a document that focuses on (i) the protection of investors; (ii) ensuring that markets are fair, efficient and transparent; and (iii) the reduction of systemic risk. This important document which is currently under review and will be amended by the recently published draft of the *IOSCO Objectives and*

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<sup>18</sup> Further general details on industry self-regulation can be found in *Chuah /Hoffmann* (2003).

<sup>19</sup> See *Niemeyer* (2001), 48.

<sup>20</sup> See e.g. *Agenor* (2001) or *Kane* (2000).

*Principles of Securities Regulation* in June 2010 which adds eight more principles to the 2003 paper which has over the last years been the cornerstone of attempting to set out international principles for financial market regulation.

Not surprisingly, this changed dramatically with the financial turmoil and IOSCO came up with numerous guidelines and recommendations to various issues. As an example in this context, the in May 2010 published *Principles Regarding Cross-Border Supervisory Cooperation* that analyze the different types of regulated entities that operate globally and how regulators can enhance the cross-border cooperation to better supervise these globally active entities, shall be mentioned. However, a more detailed analysis of all IOSCO activities would go beyond the scope of this contribution so that the scope is limited to corporate governance from a fund perspective.

Regarding corporate governance and self-regulation, IOSCO put forward Principle 9 of the draft *IOSCO Objectives and Principles of Securities Regulation 2010* as follows:

*Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.*

This single principle basically calls for a supervision of those institutions that introduce self-regulatory frameworks. Interestingly enough, IOSCO put more emphasis in its principles on investment funds since five principles for collective investment schemes are put forward:

*The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme. (Principle 24)*

*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 25)*

*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 26)*

*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. (Principle 27)*

*Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight. (Principle 28)*

These five principles broadly request proper governance rules and disclosure requirements of collective investment schemes. However, it is interesting to note that no reference can be found to self-regulation.

### 3. Self-Regulation in the Area of Investment Funds

#### 3.1. The European Landscape

The European landscape of self-regulatory initiatives of the fund industry seems to be manifold since at both the supranational and the national level such regimes are in place. However, it is interesting to note that despite various national self-regulatory approaches exist they all show certain similarities such as rather detailed recommendations of the various aspects of investment fund business, the intention to strengthen the integrity and reputation of the market and the industry as well as to ensure a high level of investor protection. Moreover, most of these codes address the enforcement of the principles set forth which shall also be in line with the legal requirements at the national level.

These similarities can be explained by the fact that since 1985 a European framework for collective investment schemes, the so-called UCITS<sup>21</sup> regime is in place which allows UCITS to operate freely throughout the EU on the basis of a single authorization of one member state. This framework has been amended on a regular basis, notably in 2001 as UCITS III and in 2009/2010 as UCITS IV<sup>22</sup>.

Consequently, the UCITS regime has been harmonizing the European investment fund business which is reflected in various self-regulatory approaches at the national level. In order to better understand this, the 2006 EFAMA Code of Conduct and selected national codes shall be introduced.

##### 3.1.1. The EFAMA Code of Conduct

At the European level, the European Fund and Asset Management Association (EFAMA)<sup>23</sup> issued in 2006 *A Code of Conduct for the European Investment Management Industry – High Level Principles & Best Practice Recommendations*<sup>24</sup> which represents an industry initiative to preserve and strengthen the integrity of the European investment fund market and its reputation worldwide, the confidence of investors, the high level of investor protection and the high quality of authorized investment managers. This Code of Conduct sets forth high-level principles which are complemented and interpreted by best practice recommendations. It is expected that self-regulatory approaches on the national level comply with these principles.

The EFAMA Code of Conduct covers the various aspects of investment fund business by also taking into account that investment fund business in Europe despite primarily regulated by the UCITS regime is also impacted by MiFID.<sup>25</sup> This is important since the EFAMA Code of Conduct reflects the various implementations of the MiFID into national law ranging from a clear-cut distinction between the two regimes in Austria to the “MiFIDization” of investment fund regulation in the UK.

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<sup>21</sup> UCITS stands for Undertakings for Collective Investments in Transferable Securities.

<sup>22</sup> See in general on the UCITS developments e.g. *Kammel* (2008).

<sup>23</sup> See [www.efama.org](http://www.efama.org).

<sup>24</sup> See [www.efama.org/index.php?option=com\\_docman&task=doc\\_details&gid=150&Itemid=99](http://www.efama.org/index.php?option=com_docman&task=doc_details&gid=150&Itemid=99).

<sup>25</sup> See EFAMA Code of Conduct (2006), 3.

From a material point of view, the fourteen principles of the EFAMA Code of Conduct address:

- 1) ***the fiduciary duty<sup>26</sup> and the governance<sup>27</sup> of an investment management company***  
These principles underline the fiduciary duty of the investment management company and the requirement to act in the best interest of the investor. Moreover, the governance structure of the investment management companies shall ensure that investors receive the benefits and services they are entitled to and that conflicts of interests are resolved.
- 2) ***conflicts of interest<sup>28</sup>***  
The investment management company has to identify the potentially conflicting interests of the parties involved in investment fund business and define rules and procedures to avoid, manage or disclose such conflicts.
- 3) ***organization and procedures<sup>29</sup>***  
In order to properly carry out its activities, the investment management company has to have the necessary means, resources and expertise. Acting with due skill, care and diligence is expected as well as the application of the “four-eye” principle.
- 4) ***compliance<sup>30</sup>***  
The investment management company has to constantly monitor its compliance with the law, regulation and rules, in particular those that protect the interests of investors and mitigate conflicts of interest. In this regard, the compliance function shall be performed independently from any operative functions.
- 5) ***delegation/outsourcing and service providers<sup>31</sup>***  
If the investment management company delegates functions to third parties, a clearly defined policy with respect to the selection of service providers has to be in place and such delegation does in no way reduce the responsibility of the investment management company.
- 6) ***investment decisions<sup>32</sup>***  
Since investment decisions require a high level of diligence, the investment management company has to monitor that in case of third-party management all objectives and policies relevant to the portfolio are met. Moreover, an appropriate risk management process has to be in place.
- 7) ***best execution<sup>33</sup>***  
The investment management company has to have effective arrangements to achieve the best possible execution of investment decisions in place.
- 8) ***broker relations<sup>34</sup>***  
For the selection of counterparties for trade execution such as brokers, the investment management company has to act according to defined procedures and criteria and also has to disclose its policies in this regard.

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<sup>26</sup> See Principle 1 EFAMA Code of Conduct.

<sup>27</sup> See Principle 2 EFAMA Code of Conduct.

<sup>28</sup> See Principle 3 EFAMA Code of Conduct.

<sup>29</sup> See Principle 4 EFAMA Code of Conduct.

<sup>30</sup> See Principle 5 EFAMA Code of Conduct.

<sup>31</sup> See Principle 6 EFAMA Code of Conduct.

<sup>32</sup> See Principle 7 EFAMA Code of Conduct.

<sup>33</sup> See Principle 8 EFAMA Code of Conduct.

<sup>34</sup> See Principle 9 EFAMA Code of Conduct.

**9) *asset valuation***<sup>35</sup>

The investment management company has to ensure that the portfolio reflects the fair value of the assets and whenever possible the “mark to market” principle has to be applied. In any case, the valuation of assets always has to be performed independently from the management function.

**10) *custody of portfolio assets***<sup>36</sup>

The portfolio assets always have to be kept segregated from those of the investment management company and it has to be ensured that a depository holds the portfolio assets in custody in the interest of the investors.

**11) *fund unit trading***<sup>37</sup>

The investment management company has to establish a procedure discouraging frequent unit trading and other practices that potentially harm the interests of long-term investors and also has to disclose its policies in this regard.

**12) *shareholder and creditor rights***<sup>38</sup>

The investment management company has to use shareholder and creditor rights attached to portfolio holdings in the best interest of investors and to enhance the portfolio value. Moreover, a procedure has to be in place and disclosed how voting rights attached to portfolio company holdings are exercised.

**13) *investor information***<sup>39</sup>

Information about products and services directed to investors and the public have to be true, fair and not misleading in particular regarding the investment objectives and policy, potential returns and risks and the costs for the investor. Moreover, the information has to be properly disclosed and allow comparability as well as that the investment management company complies with it.

**14) *clients & intermediaries***<sup>40</sup>

When providing advice, the investment management company has to obtain information about the customer and provide information in order to ensure the suitability of the advice and the appropriateness of the products for that particular investor. Moreover, a policy has to be in place in this regard.

For high-level principles, the EFAMA Code of Conduct is pretty detailed in particular when considering the best practice recommendations that interpret the principles. However, by its nature such industry standard is a living document and needs to be updated on a regular basis which EFAMA is constantly pursuing.<sup>41</sup>

At first sight, the biggest weakness of the EFAMA Code of Conduct is its lack of enforcement since EFAMA cannot impose any sanction on its member in case of not complying with the principles. However, since the EFAMA Code of Conduct sets a framework for a self-regulatory regime for the European fund industry, it is the task of the national associations to ensure that the codes of conduct at the national level comply with it. Moreover, EFAMA’s corporate members are also expected to comply with the EFAMA Code of Conduct.

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<sup>35</sup> See Principle 10 EFAMA Code of Conduct.

<sup>36</sup> See Principle 11 EFAMA Code of Conduct.

<sup>37</sup> See Principle 12 EFAMA Code of Conduct.

<sup>38</sup> See Principle 13 EFAMA Code of Conduct.

<sup>39</sup> See Principle 14 EFAMA Code of Conduct.

<sup>40</sup> See Principle 15 EFAMA Code of Conduct.

<sup>41</sup> Currently an EFAMA working group is analyzing potential amendments to the 2006 EFAMA Code of Conduct.

### 3.1.2. Selected National Codes

At national level, almost all EU member states hosting an investment fund industry have self-regulatory regimes in the form of national codes of conduct. As in particular national associations are the issuers of self-regulatory approaches at national level, also ensuring that these approaches are compliant with the EFAMA Code of Conduct, a few of these initiatives shall be reflected:

- *Austria*

In Austria, the Austrian Association of Investment Fund Management Companies (VÖIG)<sup>42</sup> introduced the so-called *Quality Standards of the Austrian Investment Fund Industry* in 2002 and substantially amended it in 2008. This Quality Standards consist of more than 40 principles that apply to all investment fund management companies in Austria. Moreover, an annex to the Quality Standards had been introduced that applies to investment fund management companies that also provide discretionary portfolio management services and therefore partly fall under the MiFID regime.

The 2008 *Quality Standards of the Austrian Investment Fund Industry* comply with the EFAMA Code of Conduct and interpret the Austrian Investment Fund Act (InvFG). Moreover, compliance with the Quality Standards is audited by an auditor who has to report the result of the audit to the management and the board of directors of the investment fund management company.<sup>43</sup>

In analogy to the Quality Standards, a self-regulatory framework for real estate investment fund companies, the *Quality Standards of the Austrian Real Estate Investment Fund Management Companies* had been introduced in 2009.

It is important to note that both self-regulations had been issued in accordance with the Finanzmarktaufsichtsbehörde (FMA)<sup>44</sup> which approved both codes as industry standards.

- *France*

In France, the association française de la gestion financière (AFG)<sup>45</sup> has a long tradition in setting rules of good asset management practice since 1990. These activities are also motivated by Article 314-2 of the AMF General Regulation stipulating that professional organizations can draw up a code of conduct.

The *Règlement de déontologie des OPCVM et de la gestion individualisée sous mandat* had been last amended in 2009 and consists of 38 principles and 92 dispositions. Aside from this very detailed code that complies with the EFAMA Code of Conduct, AFG has also (co-)issued a *code de bonne conduite – présentation des performances et des classements des OPCVM* in 1998 (and amended in 2005), a *Règlement de déontologie des OPCVM de l'AFG: dispositions spécifiques concernant le gestionnaire de fond commun de*

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<sup>42</sup> See [www.voieg.at](http://www.voieg.at).

<sup>43</sup> See Standards 43 and 43a Quality Standards of the Austrian Investment Fund Management Companies.

<sup>44</sup> See [www.fma.gv.at](http://www.fma.gv.at).

<sup>45</sup> See [www.afg.asso.fr](http://www.afg.asso.fr).

*placement d'entreprise* in 1999, a *code de deontologie des societees de gestion beneficant d'un agreement pour le capital investissement, de leurs dirigeants, et des membres de leur personnel* in 2001 or *cadre de remuneration par les societees de gestion des services fournis par les intermediaries de marche* in 2006.

Like in Austria, the good practice rules drafted by AFG are also officially approved by the Autorité des Marchés Financiers (AMF)<sup>46</sup>.

- *Luxembourg*

In Luxembourg, the Association of the Luxembourg Fund Industry (ALFI)<sup>47</sup> issued an *ALFI Code of Conduct for Luxembourg Investment Funds* in 2009 which follows a longer tradition of self-regulatory initiatives. This code which is not designed to supersede applicable laws and regulations provides boards of directors with a framework of high-level principles. This code consists of eight main recommendations that are interpreted and specified by further recommendations. The *ALFI Code of Conduct for Luxembourg Investment Funds* complies with the EFAMA Code of Conduct and shall be enforced by the respective board of directors that shall confirm the adherence to the code in the financial statements.

Moreover, this code has to be seen in the context of various other guidelines and recommendations such as the *ALFI Recommendations on NAV calculation on closed / half-closed bank business days that are not public holidays in Luxembourg* in December 2009, the *ALFI Best Practice Guidelines for Depository Banks* of September 2009 or the *ALFI Guidance on the UCITS Borrowing Principles* of July 2009.

- *Switzerland*

In Switzerland, the Swiss Funds Association (SFA)<sup>48</sup> substantially amended its *Code of Conduct for the Swiss Fund Industry* in March 2009 which has been issued on the basis of FINMA Circular 09/1 Guidelines on Asset Management as minimum standards recognized by Eidgenössische Finanzmarktaufsicht (FINMA)<sup>49</sup>. This Code of Conduct which complies with the EFAMA Code of Conduct has to be understood as the general self-regulatory regime for the Swiss Fund Industry and is supplemented by the *Code of Conduct for Asset Managers of Collective Investment Schemes* of March 2009, the *Guidelines on the valuation of the assets of collective investment schemes and the handling of valuation errors in the case of open-end collective investment schemes* of June 2008, the *Guidelines on the calculation and disclosure of the TER and PTR of collective investment schemes* of May 2008, the *Guidelines on the calculation and publication of performance data of collective investment schemes* of May 2008, the *Guidelines on the Distribution of Collective Investment Schemes* of May 2008 and the *Guidelines for Real Estate Investment Funds* of April 2008.

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<sup>46</sup> See [www.amf-france.org](http://www.amf-france.org).

<sup>47</sup> See [www.alfi.lu](http://www.alfi.lu).

<sup>48</sup> See [www.sfa.ch](http://www.sfa.ch).

<sup>49</sup> See [www.finma.ch](http://www.finma.ch).

- *United Kingdom*

In the United Kingdom, the Investment Management Association (IMA)<sup>50</sup> chose to follow a slightly different path than its European counterparts since it issued, together with the Association of British Insurers (ABI), The Association of Investment Companies (AIC) and the National Association of Pension Funds (NAPF) a *Code on the Responsibilities of Institutional Investors* in November 2009. This code can be considered as the first formal code for investors setting new standards of disclosure and verification. Aside from some technical standards, IMA also offers a *Pension Fund Disclosure Code* of 2007 and *Guidance of Good Practice* of October 2004.

Another important piece of self-regulation has just recently been published by the Financial Reporting Council (FRC)<sup>51</sup> with the *UK Stewardship Code* which is addressed to firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts and other collective investment vehicles. Important principles of this code include the monitoring of investee companies, the escalation of activities taken to protect or enhance shareholder value, collective engagement, voting policy, managing conflicts of interests and public reporting as well as reporting to clients.

### 3.1.3. *Status Quo of Self-Regulatory Efforts in the Investment Fund Industry*

As the examples of self-regulatory efforts of the investment fund industry at both the supranational and the national level indicate, the various codes of conduct can be characterized as living documents in the sense that they are amended on a regular basis to reflect the developments in regulation and product innovation. Furthermore, all codes stress investor protection as the overriding principle and emphasize on the importance of the reputation of the industry and the integrity of the market.

Another interesting aspect is that the various codes – except the EFAMA Code of Conduct – are detailed and constitute a comprehensive self-regulatory framework as the Austrian example shows or are embedded in a structure with other recommendations or guidelines, as the examples of the UK or Switzerland reveal.

Moreover, the codes of conduct either directly apply to the different stakeholders of the investment fund industry or are addressed to them in connection with special guidelines like the *ALFI Best Practice Guidelines for Depositary Banks* or the French *code de deontologie des societees de gestion beneficant d'un agreement pour le capital investissement, de leurs dirigeants, et des membres de leur personnel*.

The requirements for enhanced transparency, the disclosure of procedures and policies, the true, fair and not misleading investor information can be found in every code of conduct underscoring the importance of investor confidence for the industry.

Regarding the enforcement of the various codes differences occur because some codes like the EFAMA Code of Conduct are difficult to enforce by its nature whereas the compliance of others, such as the Austrian or the Swiss example are audited by the auditor. In addition to that, the majority of the self-regulatory approaches at national level are issued in accordance with the respective supervisory authority. This procedure results in the fact that some of the codes enjoy a higher legal quality as industry standard.

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<sup>50</sup> See [www.investmentuk.org](http://www.investmentuk.org).

<sup>51</sup> See [www.frc.org.uk](http://www.frc.org.uk).

## 3.2. New Initiatives and Its Tendencies

### 3.2.1. Regulatory Initiatives

The most obvious initiative affecting the self-regulatory landscape of the investment fund industry in Europe is the recently published *Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*<sup>52</sup> which sets out a new dimension in the field of corporate governance because it is characterized by a broad approach ensuring that an effective corporate governance system is achieved through control mechanisms and checks, leading to the main stakeholders of financial institutions, such as the board of directors, shareholders or senior management assuming a higher degree of responsibility. In this regard, the Green Paper identifies seven main deficiencies and weaknesses in corporate governance within financial institutions:

- the question of conflicts of interest
- the effective implementation of corporate governance principles
- the role of the board of directors not fulfilling the key role as principal decision-making body
- shortcomings in risk management
- the role and the lack of effective rights of shareholders to exercise control
- the role of supervisory authorities and their lack of carrying out effective supervision
- the role of auditors and their conflicts of interest

These broadly stated deficiencies are complemented by more detailed options for these seven target areas on which a public consultation had been issued until the beginning of September 2010. Without attempting to anticipate the result of this consultation, it seems that any initiative resulting from the Green Paper will cause a shift from self-regulation to (state) regulation.

### 3.2.2. Industry Initiatives

Aside from the initiatives of international or supranational institutions, the industry has shown significant activities in terms of self-regulation over the last years. Basically all relevant codes of conduct had been substantially amended within the last two years. Moreover, the global financial crisis and the substantial regulatory responses to it triggered further actions in this regard. Most importantly, the EFAMA Code of Conduct is currently under review which will likely cause some dogmatic change because in particular the new UCITS IV framework<sup>53</sup> lays out very comprehensive guidelines in terms of internal governance. This could have the consequence that an amended EFAMA Code of Conduct will only cover the external governance, which means a substantial limitation of self-regulation in this context.

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<sup>52</sup> See COM(2010) 284 final.

<sup>53</sup> See in more details [http://ec.europa.eu/internal\\_market/investment/ucits\\_directive\\_en.htm](http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm).

#### 4. Outlook

As the elaborations indicate, corporate governance is one of the hot plates on today's regulatory agenda, mostly due to the strong political tailwind pushing for such initiatives. Back in May 2008, European politicians primarily from the left articulated in a joint letter to the Slovenian EU presidency that "the financial market is not capable of self-regulation". Unfortunately, such broad and partly unjustified statements can in the current environment hardly be invalidated.

However, as the theoretical evidence shows, both types of regulation, state regulation and self-regulation have their respective advantages which cannot be substituted. Consequently, in particular in complex areas, such as financial regulation, self-regulation proved to be a useful tool to complement existing (state) regulation.

The European investment fund industry has always been at the forefront of self-regulatory initiatives. Numerous, partly very detailed codes of conducts in almost all EU member states successfully demonstrate that the industry has always considered self-regulation as an important instrument to strengthen investor confidence and the reputation of the industry. Moreover, the continuous amendments of the various self-regulatory approaches highlight the prominence of self-regulation for this industry. Not surprisingly, the European investment fund industry has a functioning self-regulatory framework on both the supranational as well as the national level in place.

As a result of the global financial crisis, new regulatory efforts to ensure an effective corporate governance regime have been initiated. Initiatives, such as the *Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies* are important but always run the risk to be carried to excess, in the current environment often described as "regulatory tsunami". Consequently, the interplay of state regulation and self-regulation is at stake and as the experiences in the European investment fund industry have proved, the continuation of an harmonic interplay between both types of regulation is of utmost importance because regulation for the sake of regulating cannot be the way forward.

**The Association of Austrian Investment Companies** (Vereinigung Österreichischer Investmentgesellschaften, VÖIG) was founded on 20 January 1988, and is an umbrella organisation for all Austrian investment fund management companies and all Austrian real estate investment fund management companies. VÖIG represents 100% of the fund assets managed by the Austrian investment fund management companies and real estate investment fund management companies.

The purpose and the duty of this Association, which is organised under the law of associations, are to promote the investment industry in Austria and to provide comprehensive support to the Association's members.

VÖIG participates in the evaluation of national and international (primarily European) rules that affect the interests of its members. VÖIG is in permanent contact with ministries, authorities and the Austrian Federal Economic Chamber (WKO) and exchanges information with national and international organizations and associations.

VÖIG is also a member of the European Fund and Asset Management Association (EFAMA), and the International Investment Fund Association (IIFA).

See [www.voeig.at](http://www.voeig.at)

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