

**INTERNATIONAL LAW ASSOCIATION**

**TORONTO CONFERENCE (2006)**

**INTERNATIONAL SECURITIES REGULATION**

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**SEVENTH INTERIM REPORT**

**Part I - Overview**

Again as was the case prior to the Association's 69<sup>th</sup> (London, 2000) and 71<sup>st</sup> (Berlin, 2004) Conferences, the topics of 'corporate governance' and 'market regulation' have been particularly prominent in the realm of securities regulation during the biennium that concludes with the Toronto Conference (June 2006). They are therefore again the subject of selective review and analysis in this Report. Both topics continue to be illustrative of the internationalisation of legal challenges faced by market participants and regulators in the Committee's assigned field and of the convergence of national responses to these trans-national challenges. It is worth noting that these very factors – internationalisation and convergence -- gave rise to the establishment of the Committee nearly 20 years ago.

A trend toward more diverse sources of standards for the conduct of markets and the regulation of business entities, reflecting what the Committee's Rapporteur has categorised as a species of 'path dependence'<sup>1</sup>, is also recognised in this Report, with the inclusion of a separate Part IV dealing with the adoption of 'Syariah' (Islamic law) principles for securities transactions in Malaysia.

Officials of the Association, others participating in the Association's activities through their respective national Branches, and unaffiliated readers of this Report are invited to consider its contents in the light of a set of contrapuntal themes that appear to the Committee to underlie the discrete issues here reviewed and reported on: first, the impact – beneficial but also constrictive -- of convergence in national responses to market issues;

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<sup>1</sup> [http://en.wikipedia.org/wiki/Path\\_dependence](http://en.wikipedia.org/wiki/Path_dependence): 'Path-dependence exists when the outcome of a process depends on its past history, on the entire sequence of decisions made by agents and resulting outcomes, and not just on contemporary conditions....These principles tell us that "history matters" in understanding social and physical sciences.'

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second, the presence or absence of structures for accountability by securities market regulators to the markets which their regulation serves; third, the implications – for market interaction and also for the ability of individual financial markets to perform their necessary functions – of ‘path dependence’ as exemplified in ‘Syariah’-governed countries; and finally, the extent to which national and international ‘law’ in the securities field is now created by transnational regulatory networks such as CESR and IOSCO rather than by States or Supra-National Entities – an issue that has been of interest to the Committee for nearly a decade.

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The Committee functioned during this most recent biennium through e-mail correspondence and a series of conference telephone calls, culminating in conference calls in the European, Asian and American time zones in the early spring of 2005 in which topics for study and reporting were discussed and evaluated. Thereafter, Part II of this Report was initially drafted by Professor Etsuro Kuronuma (summarising pending Japanese legislation), Dr Anna Gardella (summarising the legislative process leading to the E.U. Takeover Directive), Professor Emiliios Avgouleas (reporting on implementation of the E.U. Financial Action Plan) and Ms Ida Levine (reporting on unbundling and new soft commission arrangements in the UK). Part III was initially drafted by Dr Dittmar Hagedorn (summarising German legislation as well as implementation of the E.U. Corporate Governance Action Plan) and Ms Barbara Green (reporting on U.S. developments affecting ‘mutual funds’). Part IV (reporting on adoption of ‘Syariah’ principles for securities transactions in Malaysia) was initially drafted by Dr Nik Norzrul Thani. Part V reflects an effort by the Chairman to frame four fundamental themes for consideration by the Committee at its working session in Toronto and, to the extent justified during the working session and approved by the Director of Studies and the Advisory Committee on Research, for extended study during the next biennium. Editing and compilation was done by the Rapporteur and the Chairman, prior to submission of the Report in draft form to the Committee members and alternates and thereafter in response to comments received from the membership.

## **Part II – Selected Developments in Financial Services Law**

### **A. Japan’s proposed new Financial Instruments and Exchange Law**

1. *Overview of the Reform.* On 13 March 2006, a bill to enact the ‘Financial Instruments and Exchange Law’ was submitted to the Japanese Diet. The resulting Act would bring a sweeping change to securities and financial services law in Japan and would be the largest reform during the last 50 years.<sup>2</sup> The basic objectives of this reform are twofold: first, to provide investors with cross-sectional protection affecting a wide range of financial instruments and, second, to establish a flexible regulatory structure through the introduction of differentiated regimes depending on the characteristics of the financial instruments or the sophistication and experience of the investors. The bill also aims to reform the disclosure system for issuers of traditional securities so as to reinforce its reliability and to reform the regulation of tender offers and large shareholding reports. There has been no revision to the bill in the Lower House of the Diet as of this writing. When enacted, most provisions of the Law will be effective on such date as may be designated in a Cabinet Order, but not later than 18 months from the enactment of the law.

2. *Cross-sectional Protection of Investors in the Various Types of Investments.* Although the original Japanese Securities Trading Law was modeled after the U.S. Securities Act of 1933 and Securities Exchange Act of 1934, the definition of ‘securities’ has been limited to government bonds, municipal bonds, corporate bonds, stocks, interests in investment trusts and investment corporations, and securities derivatives. Therefore, purchasers of investments other than ‘securities’ have not been protected under the Law. The proposed Financial Instruments and Exchange Law will expand its ambit by defining financial instruments as including interests in trusts, interests in collective investment schemes (funds) and derivatives generally. The definition of ‘collective investment scheme (fund)’ will reach any scheme that collects money or similar properties from two or more persons, conducts business using the money, and distributes to investors profits or properties originated from the business, so any form of ‘fund’ such as a partnership based on the Civil Code or a secret partnership based on the Commercial Code will be included in the definition unless all the investors are in fact involved in the business. Entities that conduct business in any class of investments such as securities, real estate, commodities,

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<sup>2</sup> An outline of the bill is available at <http://www.fsa.go.jp/en/news/2006/20060324.pdf>.

and so on will be regulated as investment firms. The definition of 'derivatives' will include futures, forwards, options, swaps, credit derivatives, weather derivatives, and others to be designated by cabinet order. Although foreign currency-denominated deposits or insurance, derivative deposits, variable insurance or annuities, commodity futures contracts, and contracts for real estate syndication will not be defined as financial instruments, rules governing the sale and solicitation of financial instruments will be applied to these instruments as well.

3. *Classification of Investors.* The bill proposes to classify investors into professional investors and general investors. Professional investors will consist of two groups: the Japanese government, the Bank of Japan, and qualified institutional investors will always be treated as professional investors. Public companies as well as non-public companies above a certain size will be designated as professional investors but could opt to be treated as general investors. General investors will also consist of two groups: companies other than those described above and individual investors meeting certain criteria would be treated as general investors but could opt to be treated as professional investors, while individuals who do not meet the specified criteria will always be treated as general investors. Under the Securities Trading Law securities offerings to qualified institutional investors have been exempted from disclosure requirements; the Financial Instruments and Exchange Law will, once enacted, apply the new fourfold classification of investors to rules on sales and solicitation. Sales and solicitation of financial instruments to professional investors will not be required to be accompanied by designated sales documents and will not be subject to the regulation of advertisements. However, the suitability requirements will apply to professional investors.

4. *Disclosure System.* Disclosure requirements under the Financial Instruments and Exchange Law would be revised to take into account the nature of the particular investment instruments. First, focusing on the different types of investments, disclosure contents and disclosure delivery procedures would be different between corporate finance-type instruments and asset finance-type instruments. Second, disclosure concerning investment instruments with low liquidity would be made by direct delivery of disclosure documents to investors. Third, as to investment instruments with high liquidity (such as stocks of listed companies), disclosure requirements would be reinforced. While listed companies have been required to make periodic disclosure semiannually under the Securities Trading Law and to produce quarterly disclosure reports under the self-regulatory rules of stock exchanges, the Financial Instruments and Exchange Law would introduce a statutory quarterly reporting system for listed companies. The new Law would not create a statutory duty of timely disclosure, although self-regulatory rules of Japanese stock exchanges require listed companies to disclose price-sensitive information on a rapid basis. The new law would, however, mandate that the managements of listed companies submit internal control reports as well as certifications of the report by accounting firms, in a reflection of the U.S. Sarbanes-Oxley Act and in response to recent financial reporting scandals in Japan.

5. *Regulation of Financial Instruments Business.* The Financial Instruments and Exchange Law will integrate various types of securities and investment businesses into a coherent regulatory regime. The various forms of investment services businesses will be grouped in four categories: 'sales and solicitation,' 'investment management,' 'investment advice' and 'administration of money and securities.' Regulation of financial services firms (for example, investment banks, broker-dealers, investment advisors, investment trust managers) will be tailored to the type of services/businesses that each firm offers/conducts. One important issue was the regulatory treatment of the management of investment funds. Previously, regulation of sales and solicitation of interests in funds or of investment management of interests in funds had been minimal. Under the proposed Law, however, if the funds are directed to general investors, registration of the funds will be required and the regulation on sales and solicitation and on investment management will be applied, while minimum regulations will be retained for funds targeting professional investors.

6. *Tender Offers and Large Shareholdings Reports.* Regulation of tender offers in Japan is very complicated. Regulation modeled after the U.S. Williams Act was introduced in 1973. Subsequently, in 1990, a mandatory bid rule modeled after the U.K. Takeover Panel Code (with a threshold of 33 percent ownership) was introduced, along with large shareholdings reports modeled after U.S. securities regulation. However, the Securities Trading Law mandated that tender offers be made only when market purchase of target stocks was not prohibited so that all shareholders could participate in the market transactions. The recent surge of hostile takeovers in Japan has prompted revision of tender offer regulation, but the basic idea of allowing market purchase is not changed in the Financial Instruments and Exchange Law.

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The new bill proposes to amend several rules on tender offers. First, in order to prevent evasion of the mandatory bid rule, the proposed Law will make clear that rapid increase in shareholdings beyond the 33 percent threshold by combining a purchase of the stock off the market and a purchase on the market is subject to the tender offer regulation. Second, to provide increased information to investors, the Law will require the filing of an opinion report by the target company and will afford an opportunity for the target company to ask questions of the bidders. Third, upper and lower bounds of the tender offer period will be extended from 20 days and 60 days to 20 business days and 60 business days. A target company will be able to extend a tender offer period to the extent of 30 business days. Fourth, responding to the availability of various defensive measures, withdrawal of a tender offer or change in tender offer condition will be allowed when the target company decides to activate takeover defenses like poison pills. Fifth, in order to protect minority shareholders from the risk of delisting, a bidder will have to make an offer to buy all shares tendered when the shareholdings owned by the bidder rise beyond 2/3rds after the purchase. Sixth, a shareholder with more than 1/3rd in shareholdings will be required to make a tender offer to purchase stock of the target company and will be prohibited from market purchases during the period of another tender offer made by another bidder.

7. *Comments on the reform proposals.* Reform of securities regulation by the proposed 'Financial Instruments and Exchange Law' will be the second step towards enactment of a Japanese Financial Services Law. The first step was the enactment of the Sale of Financial Instruments Act of 2000, which stipulated the duty of sellers to explain the risk of financial instruments. In that Act the definition of financial instruments included deposit and insurance contracts as well as securities. In contrast to the 2000 attempt, however, the 2006 proposal carefully excludes banking and insurance businesses. Despite its name, therefore, the scope of the new law is quite narrow. Although rules on sale and solicitation of securities will be applied to commodities futures, derivative deposits, and variable insurance, disclosure requirements of the new law will not apply to such financial instruments. True, the definition of collective investment scheme is open and functions as a basket clause, but an investment contract between one person and another will not be a financial instrument nor will it be subject to the anti-fraud provisions of the proposed Financial Instruments and Exchange Law. In these regards the new law may be considered incomplete.

Japanese securities regulation has traditionally developed with reference to the experiences of U.S. securities regulation. In the 2006 proposal the influence of the E.U. Markets in Financial Instruments Directive (2004/39/EC)<sup>3</sup> is visible in the classification of investors and the regulation of investment businesses. How Japanese regulation, which is based on rules rather than based on standards, will be affected by the introduction of rules that reflect the E.U.'s approach to regulation of investment services and investment markets is an interesting issue. As to disclosure, Japan has had a comprehensive regulatory framework on the disclosure of listed companies and of public offerings; how and whether the disclosure system should be reconstructed is another debatable issue. And, as regards the regulation of tender offers, the original purpose was to assist shareholders in deciding whether or not to tender their shares to bidders. Since the introduction of the mandatory bid (33 percent) rule, however, the purpose of tender offer regulation has gradually changed so that many provisions of the proposed Financial Instruments and Exchange Law seem rather to be directed to 'fair treatment' of bidders and target companies. In the process of statutory reform, the effect of new legal provisions on the economic functioning of society should not be put out of mind.

## **B. The E.U. Takeover Directive: Towards a Market for Corporate Control in Europe?**

1. *History and Negotiation Process.* In the spring of 2004, the European Union finally enacted Directive 2004/25/EC<sup>4</sup> of the European Parliament and of the Council on takeover bids, almost 17 years after the publication of the Commission's first proposal in 1989. Originally included within the 1985 White Paper on Internal Market, the enactment of this thirteenth Company Law Directive has had a troublesome history and underwent a prolonged negotiation process in which all the European institutions, and the European Parliament

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<sup>3</sup> See n.8 below.

<sup>4</sup> Directive of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 12. For a thorough analysis, see G. Ferrarini, K.J. Hopt, J. Winter, E. Wymeersch (editors), *Reforming Company and Takeover Law in Europe* (Oxford, 2004).

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in particular, played a very active role. The sharp division within Parliament in 2001 on the compromise text caused the proposal to be rejected (273 votes for and 273 votes against), with Parliamentary criticism focused on (i) the need for shareholder approval in order for the board of the target company to take defensive measures; (ii) the inadequacy of the protection afforded to the target company's employees; and (iii) the failure to reach a level playing field with the United States. Despite this rejection by Parliament, there was a consensus on the urgency and importance of obtaining approval of the takeover bid directive in revised form. Its adoption was therefore included by the Commission among the top ten priorities of the Financial Services Action Plan, launched to strengthen financial integration in Europe<sup>5</sup>. To avoid a second disappointment, the Commission appointed a Group of High-Level Company Law Experts chaired by Professor Jaap Winter ('Group of Experts') entrusted with the task of resolving the matters raised by Parliament in its rejection of the previous proposal, and the report published by the Group of Experts was significantly taken into account by the Commission in drafting the 2002 proposal.<sup>6</sup>

2. *The Compromise.* The text eventually approved in the spring of 2004 was therefore the result of a compromise between opposing interests: on the one side the liberalist forces envisaging a free market for corporate control as a necessary mechanism to reach market efficiency, and on the other side the supporters of tradition seeking to maintain a certain degree of protection having the effect of discouraging hostile takeover bids and of rewarding medium- to long-term company investments as well as stakeholder interests. Article 12 epitomises the battle of these opposing views on hostile takeover bids and the difficulty of reaching agreement on such highly political matters. To avoid any further rejection of the Directive, Article 12 allows Member States to opt out from Article 9, which embodies the 'frustration rule', and/or from Article 11 on break-through, the two most controversial provisions of the Directive.

3. *General Rules: Regulation And Jurisdiction.* The Directive lays down a legal 'framework' on takeover bids, providing for common principles and minimum requirements. Member States must implement the minimum requirements but also retain a great deal of discretion as to the way of doing so; in addition, they are free to impose higher standards. The preference for a relaxed normative approach is supported by the acknowledgment of the need for flexible rules capable of adjusting to changes in market practices.

The legal framework provides rules on regulation and on jurisdiction. Member States must designate authorities to supervise the bidding process, the only requirement being that their decision be susceptible of review by an independent court or tribunal. The Directive lays down three subordinate rules on jurisdiction. The general provision is that the competent supervisory authority is that of the Member State where the target company has its registered office, provided that its securities are listed on a regulated market of that Member State. Should this double condition not be met, the market criterion will prevail and jurisdiction will rest in the supervisory authority of the Member State on whose regulated market the target company's securities are admitted to trading. In the event that a target company's securities are listed on regulated markets in more than one Member State, the company must determine the competent supervisory authority on the first day of trading.

4. *Key provisions.*

(a) *Mandatory Bid.* Article 5 imposes a mandatory bid on any person or entity that has acquired, alone or acting in concert with others, the control of a target company. The definition of the shareholding percentage giving control of the target company is left to the discretion of Member States. The offeror must make the bid at the equitable price, i.e. the highest price paid by the offeror in a period of time to be determined by the Member State, ranging from not less than six months to not more than 12 months before the bid.

(b) *Squeeze-out Offers.* Article 15 gives the offeror the right to squeeze out the minority shareholding, following a bid made to all the holders of the target company's securities for all of their securities, once the offeror has acquired 90%-95% of the share capital and voting rights of the target company. The shareholding percentage triggering the right of squeeze-out will be determined by national law. In such case, holders of the

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<sup>5</sup> See n.7 below. Periodic reports and current post-FSAP developments are available at [http://www.europa.eu.int/comm/internal\\_market/en/finances/actionplan/index.htm](http://www.europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm).

<sup>6</sup> The Final Report by the Group of Experts presented on 4 November 2002 is available at [http://europa.eu.int/comm/internal\\_market/company/modern/index\\_en.htm](http://europa.eu.int/comm/internal_market/company/modern/index_en.htm).

minority shareholding must be paid a fair price, equivalent to the equitable price in case of a mandatory bid. The reciprocal right (of sell-out) is given to the holders of the minority shareholding.

(c) *Transparency.* All companies subject to the Directive are required to comply with transparency requirements and to disclose additional information in their annual reports, including details of share capital, of restrictions on share transfer and of shareholder agreements containing restrictions on share transfer.

(d) *Frustrating Action and Break-through.* Articles 9 and 11 are the Directive's crucial and most controversial provisions. By prohibiting both post-bid and pre-bid defences, they embody the idea of opening companies to the market for corporate control in Europe by outlawing defences of the target company. Article 9 prevents the target company's board from frustrating the bid by adopting post-bid defensive measures, such as issue of new shares, without first gaining shareholder approval. Article 11 prevents provision of pre-bid defences, in the target company's articles of association or in contractual agreements, concerning restrictions on share transfers, concerning voting rights, or allowing the existence of shares carrying multiple-vote rights. After acquisition of 75 percent of the shareholding of the target company, the acquirer has the right to break through such defence.

(e) *Opt-out.* Article 12 is the compromise solution that has made adoption of the Directive possible: it enables Member States to opt out from Article 9 and/or Article 11. The Member State that opts out under Article 12 must permit individual companies to opt in if they so desire; the opt-in option is reversible. In addition, opt-in Member States may exempt the application of either or both Article 9 and Article 11 if the offeror's jurisdiction is an opt-out Member State (reciprocity). Member States are thereby given a double choice: whether to opt in or out of Articles 9 and/or 11; and whether to apply reciprocity. The interaction of opt-out clauses with reciprocity and the actual content of substantive law are likely to give rise to a certain degree of unpredictability requiring a cross-border country-by-country analysis in each individual instance. Companies will therefore be well served to examine with care whether they obtain any benefit in opting back in. The position of non-E.U. bidders, too, is not crystal clear and is likely to raise questions, in particular as to whether the reciprocity clause applies.

5. *Assessment; Implementation.* Evaluations of the effect of the Directive, of the kind suggested immediately above, must, however, await the time when the Directive has been implemented in most if not all Member States. Action is supposed to be taken in that regard by 20 May 2006, but as of this writing many Member States appear to be tardy in respecting that term.

### **C. Developments in EC Securities Regulation: FSAP Implementation and the Way Ahead**

1. *Introduction.* In the field of securities markets, legislation passed under the E.U.'s Financial Services Action Plan ('FSAP')<sup>7</sup> included measures that promote the aim of integrated financial markets, such as the Directive on Markets in Financial Instruments,<sup>8</sup> the Public Offers and Admissions Prospectus Directive,<sup>9</sup> and the Directive on Takeover Bids,<sup>10</sup> and protective legislation such as the Market Abuse Directive<sup>11</sup> and the Transparency Directive.<sup>12</sup> In summary, the FSAP Directives have created self-standing E.U.-wide regulatory regimes in the areas of: (a) regulation of licensed financial exchanges and alternative trading systems ('ATSs'); (b) public offer

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<sup>7</sup> Commission Communication, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM (1999) 232. For an overview, see E. Avgouleas, 'A Critical Evaluation of the New EC Financial Market Regulation: Peaks and Troughs in the Road Ahead', 15 *Transnational Lawyer* 178 (2005).

<sup>8</sup> Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments ('MiFID') amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 O.J. (L 145) 1.

<sup>9</sup> Directive 2003/71/EC of 4 November 2003 on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and amending Directive 2001/34/EC, 2003 O.J. (L 345) 64.

<sup>10</sup> See n. 4 above.

<sup>11</sup> Directive 2003/6/EC of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16. For analysis of the Market Abuse Directive and of its implementing measures, see E. Avgouleas, *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis*, ch. 6 (Oxford, 2005).

<sup>12</sup> Directive 2004/109/EC of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and amending Directive 2001/34/EC, 2004 O.J. (L390) 38.

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of securities, and their admission to trading on securities exchanges; (c) conduct of business by investment firms and other investment professionals; (d) availability of information to investors in the single market, and (e) market abuse. It is envisaged that the new legislation, especially MiFID and its implementing measures, will have a profound impact on the structure of the E.U.'s financial markets and financial services industry.<sup>13</sup> However, not only does the challenge of successful implementation of FSAP legislation by E.U. member states remain an on-going task,<sup>14</sup> but also the new legislation creates a number of new challenges in the supervision of the integrated securities market and of investment intermediaries conducting business within it. In fact, the implementation of MiFID is largely pending,<sup>15</sup> and the date for its transposition to the national legal orders has been extended.<sup>16</sup> Finally, FSAP legislation has mostly focused on the wholesale markets, and market fragmentation is clearly visible in the field of retail financial services.

2. *The Regulatory Agenda until 2010.* On 12 December 2005, the European Commission published its White Paper 'Financial Services Policy 2005-2010' in which it presented its new financial services strategy<sup>17</sup>. This strategy has the dual aim of: (i) addressing the supervisory challenges created by the implementation legislation enacted under FSAP, and (ii) deepening the internal market for financial services, especially in areas that have not been tackled by FSAP legislation such as clearing and settlement of securities trading, asset management, and the creation of more competition between service providers, especially those active in retail markets. Publication of the White Paper was preceded by wide ranging consultation, following the publication in May 2005 of the Commission's Green Paper concerning its financial services strategy for 2005-2010.<sup>18</sup> During that consultation a large number of industry organisations, individual experts, national authorities and consumer associations expressed their views both in respect of the Commission's plans and the challenges associated with the successful implementation of FSAP legislation. The main theme of those responses was that any future regulation at the E.U. level should be at a lower scale than FSAP legislation and much more targeted.

(a) *The Challenge of Proper Implementation of FSAP legislation.* According to the Commission's White Paper, the task of proper implementation and enforcement of FSAP legislation involves: (i) the safeguarding of the effective transposition of EC financial services law into national regulation and more rigorous and E.U.-consistent enforcement by supervisory authorities; (ii) continuous ex post evaluation whereby the Commission will monitor carefully the application of these rules in practice and their impact on the European financial sector. Consolidation of existing legislation may also be achieved through new, but limited in number, legislative initiatives.

(b) *General Regulatory Challenges.* The Commission's White Paper has singled out the re-enforcement of obligations to cooperate, especially to co-operate in crisis situations, and to exchange information among supervisors as the areas of greatest priority in the post-FSAP era. The achievement of these objectives involves, inter alia, the following tasks: (i) clarification and optimisation of home-host responsibilities as integration accelerators, and dealing with potential spill-over effects that might involve failure of a group operating on a pan-European basis or of a systemically-important institution operating in one Member State, while the responsibility for group supervision resides in another; (ii) exploring delegation of tasks and responsibilities,

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<sup>13</sup> For the importance of MiFID, see E. Avgouleas, 'The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets', in *Yearbook of European Law 2004* 321 (Oxford, 2005).

<sup>14</sup> For the state of play regarding the transposition of the Lamfalussy directives as of 31 March 2006, see [http://www.europa.eu.int/comm/internal\\_market/securities/docs/transposition/table\\_en.pdf](http://www.europa.eu.int/comm/internal_market/securities/docs/transposition/table_en.pdf).

<sup>15</sup> The Commission released two draft implementing measures in February 2006: Draft Commission Directive implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, 62006, available at [http://www.europa.eu.int/comm/internal\\_market/securities/docs/isd/dir-2004-39-implement/dir-6-2-06-final\\_en.pdf](http://www.europa.eu.int/comm/internal_market/securities/docs/isd/dir-2004-39-implement/dir-6-2-06-final_en.pdf); and Draft Commission Regulation implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, 062006, [http://www.europa.eu.int/comm/internal\\_market/securities/docs/isd/dir-2004-39-implement/reg-6-2-06-final\\_en.pdf](http://www.europa.eu.int/comm/internal_market/securities/docs/isd/dir-2004-39-implement/reg-6-2-06-final_en.pdf).

<sup>16</sup> See Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/39/EC on markets in financial instruments, as regards certain deadlines, COM(2005) 253 final, Brussels, 142005, [http://www.europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2005/com2005\\_0253en01.pdf](http://www.europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2005/com2005_0253en01.pdf).

<sup>17</sup> EU Commission, 'White Paper on Financial Services Policy 2005-2012', COM (2005) 629 Dec. 2005, available at [http://EC.Europa.eu/internal\\_market/finances/docs/white\\_paper/white\\_paper\\_en.pdf](http://EC.Europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf)

<sup>18</sup> EU Commission, 'Green Paper on Financial Services Policy (2005 - 2010)', COM (2005) 177, available at [http://www.europa.eu.int/comm/internal\\_market/finances/docs/actionplan/index/green\\_en.pdf](http://www.europa.eu.int/comm/internal_market/finances/docs/actionplan/index/green_en.pdf).

while ensuring that supervisors have the necessary information and mutual trust; (iii) necessary improvement in the efficiency of supervision by avoiding duplicative reporting and information requirements; and (iv) more consistent and timely cooperation and development of a pan-European supervisory culture. The Commission highlights the importance of developing common decisionmaking and enforcement practices, in particular for multi-country or cross-sectoral groups, joint inspections, peer reviews and practical measures such as staff exchanges, joint training between supervisors, exchange of information and expertise.

(c) *Cross-border Clearing and Settlement.* Successive consultations held by the Commission have found that cross-border clearing and settlement infrastructures are far more costly than at the domestic level, and their level of safety and efficiency is lower. The reasons for the high cost of cross-border clearing and settlement of transactions are technical, legal and fiscal obstacles. There is also no regulatory framework at the E.U. level. These obstacles may prove a serious drawback to the implementation of ambitious plans for market integration upon which MiFID was built. The Commission suggested in its Communication of 2004<sup>19</sup> that a framework Directive may be needed for an efficient, safe and cheap cross-border clearing and settlement industry. In this regard, the Commission is carrying out a very thorough consultation and impact assessment and will finally decide on its preferred course of action during 2006.

(d) *Regulation of the Asset Management Industry.* The Commission has identified a number of inadequacies and inconsistencies in the implementation of UCITS Directives.<sup>20</sup> Its work in this area intends to ensure consistent implementation of existing UCITS legislation, to facilitate the functioning UCITS passport, and to achieve a clearer understanding of investment limits. During 2006 the Commission is poised to compensate for years of inaction with some hyper-activity in this area. This includes the planned release of White Papers on the regulation of Investment Funds and the marketing of UCITS, where the creation of a single market faces several challenges, and the publication of an interpretative Communication clarifying the definitions of eligible assets for UCITS.<sup>21</sup>

(e) *Capital Requirements Directive.* The Directive on capital requirements<sup>22</sup> incorporates into E.U. law the main approaches to capital adequacy controls and safeguards that were set out in the revised Basle Capital Accord (BASLE II). The objective of the Capital Requirements Directive is to modernise the existing framework in order to make it more comprehensive and risk-sensitive and to foster enhanced risk management among financial institutions. In the Commission's view the new approach will maximise the effectiveness of the capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers. One of the main innovations of the Capital Requirements Directive is that it introduces a harmonised set of rules for capital requirements for securitisation activities and investments.<sup>23</sup> The Commission expects that these new rules will provide a significantly improved capital requirements framework, allowing credit institutions to take advantage of the funding, balance-sheet management and other advantages that such transactions can deliver, and that it will also reduce the extent to which securitisation has been seen as an instrument of capital arbitrage. The implementation of the Directive by Member States is expected to take place in phases between 2006 and 2008.

(f) *Better Regulation.* The White Paper sets out the concrete steps that the Commission and the other stakeholders will have to follow in order to improve the quality and consistency of financial services legislation throughout Europe in the context of the Lamfalussy process and beyond -- the so-called 'Better Regulation' initiative. Relevant actions include: (i) a larger number of open consultations and an effort to include in them all

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<sup>19</sup> E.U. Commission, Clearing and Settlement in the European Union – The Way Forward, COM(2004) 312 final, 28.4.2004.

<sup>20</sup> An overview of the current situation of the asset management sector can be found in the Commission's 'Green Paper on the Enhancement of the EU Framework for Investment Funds' (SEC (2005) 947), available at [http://www.europa.eu.int/comm/internal\\_market/securities/docs/ucits/greenpaper\\_en.pdf](http://www.europa.eu.int/comm/internal_market/securities/docs/ucits/greenpaper_en.pdf).

<sup>21</sup> See Final CESR advice to the European Commission on eligible assets for investments of UCITS, Clarification of Definitions concerning eligible assets for investments of UCITS, January 2006, CESR/06-005.

<sup>22</sup> See Proposal for Directives of the European Parliament and of the Council re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. The Commission's draft directive was endorsed by the European Parliament on 28.9.2005 and by the Council on 11.10.2005; see IP/05/1250, Brussels, 11 October 2005.

<sup>23</sup> See Articles 94-101 and the relevant technical provisions in Annex IX to the Proposed Capital Requirements Directive.

stakeholder groups; (ii) impact assessments accompanying any new Commission proposal, including, where appropriate, the impact on financial stability and on proper functioning of markets and consumer protection; (iii) *ex post* evaluations, approximately four years after implementation, to answer the fundamental question whether the rules actually achieve their objective, which will entail close monitoring of the overall state of financial integration described in the Financial Integration Monitor report, full economic and legal assessment of all FSAP measures, and modification or repeal of specific legal texts determined not to have functioned as intended; and (iv) simplification, codification and clarification of financial services legislation so that E.U. and national implementing rules on financial services function as one coherent corpus of law. The Commission will carry out sectoral and cross-sectoral consistency checks and, in investigating legal coherence, will study the approaches taken by Member States. Where any incorrect implementation of Community law is found, the Commission will take appropriate action, including the use of infringement proceedings, to ensure a consistent and effective regulatory regime across the E.U.

3. *Refining the Lamfalussy Process.* The Commission has kept faith with the Lamfalussy Process.<sup>24</sup> Its priorities in that respect for the next five years, as set out in the White Paper, refer to (i) the enhancement of the transparency and accountability of the bodies involved in the production of legislation at the various stages, and (ii) the consistent transposition and application of new legislation at a national level in order to make Level 3 of the process effective and homogeneous.

Both the Commission<sup>25</sup> and the Committee of European Securities Regulators ('CESR'),<sup>26</sup> one of the key bodies of EC law-making in the field of securities markets, have sought to optimise the structures and processes underpinning Level 3 of the Lamfalussy process. In particular, on 15 November 2004 the Commission released an internal report that set out its views on the effectiveness of the Lamfalussy process.<sup>27</sup> According to the Commission the most distinct strengths of the Lamfalussy process are the "three Ts"—transparency, trust, and teamwork. The first 'has resulted in an improvement in the quality of legislation and an acceleration of the legislative process, and it has encouraged regulatory and supervisory convergence within Europe.'<sup>28</sup> Furthermore, 'the cooperative working framework that has been developed between all the Institutions, working with regulators, market participants and other stakeholders,'<sup>29</sup> has likewise contributed to the creation of procedures that enjoy the trust of all parties involved. The Commission sets out in the same document the main areas of the Lamfalussy process that need further improvement. These include recommendations for:

- Focusing Level 1 Directives, above all, on general rules and principles;
- Careful calibration of Level 2 technical measures so as to avoid over-prescriptive regulation and/or duplicative requirements at the E.U. level;
- Articulating more clearly the role of Level 3 in the Lamfalussy process;
- Strengthening Level 4 through clear, practical arrangements, whereby the Commission, working with the Member States and national regulators, should lead a major effort to implement and enforce effectively the set of existing rules;
- Taking steps to obtain better input from consumers in consultation processes; and,
- Making sufficient resources available to carry out the required consultations.

Finally, there is an urgent need for the creation of a framework for Level 4, the "big unknown" of the Lamfalussy process, especially with respect to the Commission's own powers and responsibilities.

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<sup>24</sup> See 'Final Report of the Committee of Wise Men on the Regulation of European Securities Markets', Brussels, 15.02.2001.

<sup>25</sup> Commission Staff Working Document, 'The Application of the Lamfalussy Process to EU Securities Markets Legislation, A Preliminary Assessment by the Commission Services', 15.11.2004, SEC (2004) 1459.

<sup>26</sup> CESR, Preliminary Progress Report, 'Which Supervisory Tools for the EU Securities Markets? An Analytical Paper by CESR', October 2004, CESR 04-333f, available at [http://www.cesr-eu.org/data/document/04\\_333f.pdf](http://www.cesr-eu.org/data/document/04_333f.pdf) (the 'Himalaya Report').

<sup>27</sup> See n.25 above.

<sup>28</sup> Commission Staff Working Document 14, n. 25 above.

<sup>29</sup> *Id.*

## D. Unbundling and New Soft Commission Arrangements in the UK

1. *The Myners Report and FSA Consultation Paper 176*. In April 2003, the UK Financial Services Authority ('FSA') issued Consultation Paper 176 (Bundled Brokerage and Soft Commission Arrangements) ('CP 176').<sup>30</sup> The FSA's investigation of this issue had been foreshadowed by a report ('Myners Report'),<sup>31</sup> prepared in 2001 by Mr Paul Myners, then Chairman of a major UK-based fund manager. The Myners Report reviewed institutional investment in the UK including, among other topics, (i) payment of trading commissions to brokers by investment managers for purchases and sales of securities on behalf of the managers' pension fund clients, and (ii) the manner of managers' charging these transaction costs to clients. It noted the disparity in the ways that the principal costs of managing a pension fund – management fees and trading commissions – were treated: management fees were transparent to the client and subject to considerable scrutiny and negotiation by pension fund trustees and their advisers when hiring an investment manager, while trading commissions were not transparent since they were charged directly to the fund on a transaction-by-transaction basis without any breakdown. As a result, clients were less able to determine how much commission they were paying and, in particular, how much of that commission was being used to fund goods and services (including research) other than execution.<sup>32</sup> The Myners Report concluded that there was an incentive for investment managers to direct business to brokers to obtain additional services that would reduce the managers' own operating expenses rather than to obtain the most favorable trade execution ('best execution') for their clients, and that this incentive resulted in an unacceptable market distortion.

In CP 176, the FSA identified the Myners Reports' conclusions as giving rise to substantive concern. It also expressed concern that (i) the control over managers' incentives exerted by normal market disciplines was weak and uneven since, although managers were judged on performance, isolating the effect on performance of bundling and soft commissions from other factors was impossible, particularly in the absence of disclosure, and (ii) both bundled commissions and soft commission arrangements created similar incentives and had similar economic effects, so treating them differently in regulatory terms would not be helpful and could in itself create distortions. As a result, CP 176 contained two proposals:

- a proposed prohibition on the use of soft commissions to purchase goods and services (other than execution); specifically covering market pricing and information services such as dealing screens, and possibly also to include other services such as custody, and computer hardware and software and other equipment; and
- the proposed 'unbundling' of the cost of research from commissions paid to brokers, as a result of which FSA-regulated investment managers would be required to rebate this research cost to their clients (the 'rebate proposal').

The FSA saw the benefits of these proposals in terms of increased competition and more attractive UK markets. In particular, the proposals were anticipated to afford investment managers a stronger incentive to control the demand for, and costs of, additional broker services (while also protecting against a preference for broker-generated over independent investment research); to improve transparency and accountability to clients for the expenditure of client commissions; to strengthen the incentive for managers to direct business to brokers on the basis of 'best execution'; and to reduce the incentive for larger institutional funds to seek recovery of their commissions through commission recapture and directed commission arrangements.<sup>33</sup>

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<sup>27</sup> FSA, Consultation Paper 176 'Bundled Brokerage and Soft Commission Arrangements' (April 2003), available at <http://www.fsa.gov.uk/pubs/cp/cp176.pdf>.

<sup>31</sup> P.Myners, Institutional Investment in the UK: A Review (March 2001), available at <http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf>.

<sup>32</sup> Myners Report, paragraphs 5.102-5.113.

<sup>33</sup> Commission recapture and directed commission arrangements are variants of bundled and soft commission arrangements. The client -- for example, a pension fund -- instructs the investment manager to direct, or provides the manager with a goal to direct, a certain proportion of trades, and therefore commissions, generated by the manager on the fund's portfolio to a specific broker or brokers. In return, the broker or brokers supply services or cash rebates back to the pension fund client.

2. *FSA Policy Statement 04/13*. In May 2004, the FSA issued Policy Statement 04/13 ('PS 04/13')<sup>34</sup> heralding the demise of the 'softening' of goods and services (other than research) and the start of 'unbundling' in the UK. In PS 04/13 the FSA set out their assessments of the responses to CP 176, concluded that their analysis of the problems arising from the use of commissions to fund the purchase of goods and services, in addition to execution, was basically sound, and articulated a general consensus that improvements in transparency and accountability were desirable but that alternatives to the rebate proposal could deliver these improvements. In summary:

- the FSA advanced its earlier proposal banning 'softening' of goods and services, other than 'execution' and 'research', with client commissions. The goods and services banned from 'softening' subsequently included, among others, services relating to the valuation or performance measurement of portfolios; computer hardware; dedicated telephone lines; seminar fees; subscriptions for publications; travel, accommodation or entertainment costs; office administrative computer software; membership fees to professional associations; purchase or rental of standard office equipment or ancillary facilities; employees' salaries; and direct money payments.
- the FSA left scope for managers to enter into what are colloquially known in the UK as 'step-outs,' or 'CSAs' (commission sharing arrangements), under which brokers agree that part of the commission they earn will be used to purchase their own research or redirected to one or more third parties as payment for research that the third parties will provide to the managers. These CSAs were permitted so long as they were transparent to clients and created effective disclosure of the cost of investment research.
- regulatory action on the second earlier proposal on 'unbundling' was deferred until the end of 2005 to give the industry, through the instrumentality of the UK Investment Management Association ('IMA'), a chance to find and present a 'comparative disclosure' solution. The FSA indicated that this disclosure should show the split of brokers' commissions between (i) execution services and (ii) 'investment research.' The FSA left the industry with a veiled threat that they would reinstate their rebate proposal if the disclosure subsequently proposed by the industry was not effective in affording transparency.

3. *IMA Response to the Rebate Proposal*. On the 'unbundling' side, IMA took up the FSA's challenge and, working closely with the National Association of Pension Funds ('NAPF') and with input from the London Investment Banking Association, delivered an updated version of the IMA/NAPF Disclosure Code<sup>35</sup> (provided to UK pension fund clients). This enhanced Disclosure Code provides information on an investment manager's approach to using commissions to acquire 'execution' and 'research' services (and, in particular, information on the percentage split between 'execution' and 'research').

4. *FSA Rules: Initial Results and Prospects*. Proposed rules were issued by the FSA in March 2005 in Consultation Paper 05/5,<sup>36</sup> and final rules were announced in July 2005 in Policy Statement 05/9<sup>37</sup> implementing PS 04/13. Thus, the UK is now in its first year in an 'unbundled' environment. It remains to be seen whether the exemplary objectives of the FSA will be served, but the early signs are that markets for unbundled research and execution are beginning to develop, that incentives of investment managers are changing, that there is more information in the marketplace on what investment managers are acquiring with client commissions, and that commission rates are going down (with commission recapture and directed commission arrangements being negatively impacted). The preferred route for many UK investment managers has been to negotiate CSAs with their brokers. This has provided more transparency to clients as to the split between the execution and research components of commissions agreed by managers and brokers, but it has not to any substantial extent altered the economics of the manager-broker relationship. Clients are still paying for execution and research as before and, in the absence of a free-standing market for research, it is difficult to assess the appropriateness of the commission split agreed between managers and brokers.

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<sup>34</sup> FSA, Policy Statement 04/13 'Bundled brokerage and soft commission arrangements: Feedback on CP176' (May 2004), available at [http://www.fsa.gov.uk/pubs/policy/ps04\\_13.pdf](http://www.fsa.gov.uk/pubs/policy/ps04_13.pdf).

<sup>35</sup> UK Investment Management Association,; *Pension Fund Disclosure Code* (second edition, March 2005), available at <http://www.investmentuk.org/news/standards/pfdc2.pdf>.

<sup>36</sup> FSA, Consultation Paper 05/5 'Bundled brokerage and soft commission arrangements: proposed rules' (March 2005), available at [http://www.fsa.gov.uk/pubs/cp/cp05\\_05.pdf](http://www.fsa.gov.uk/pubs/cp/cp05_05.pdf).

<sup>37</sup> FSA, Policy Statement 05/9 'Bundled brokerage and soft commission arrangements: Feedback on CP 05/5 and final rules' (July 2005), available at [http://www.fsa.gov.uk/pubs/policy/ps05\\_09.pdf](http://www.fsa.gov.uk/pubs/policy/ps05_09.pdf).

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Given the global nature of the fund management and brokerage businesses, the unbundling phenomenon has already (necessarily) become international in its focus, so the reactions of regulators and markets outside the UK are likely to play an important role in determining whether and how unbundling develops over the years to come. There have been questions raised as to whether MiFID will pre-empt the FSA's approach to unbundling. This would be an example where convergence in the E.U. response constricts, rather than encourages, the UK position.

### Part III – Selected Developments in Corporate Governance Law

#### A. Developments in Corporate Governance in Germany and at the E.U.

1. *Amendments to the German Corporate Governance Code*<sup>38</sup> since 2004. A German government commission<sup>39</sup> focussed on the supervisory board and made important changes in three major areas:

(a) *Independence of Supervisory Board Members.* To permit each supervisory board to render independent advice and supervision of the management board, the supervisory board must include what it considers to be an adequate number of independent members. A supervisory board member is considered independent if he or she has no business or personal relations with the company or its management board which could cause a conflict of interest.<sup>40</sup> This definition corresponds with the requirements of the European Commission for non-executive directors.<sup>41</sup> A special problem results from participation by German workers in the German supervisory boards. The workers' representatives are elected by the employees under a German co-determination law. Normally, employees of companies are in principle considered non-independent, but, since those elected employees are covered by special protection against dismissals, they are deemed for this purpose to be independent,<sup>42</sup> and the European Commission has granted a special regulation to Germany in this respect.<sup>43</sup>

(b) *Management Board Members Joining the Supervisory Board.* Normally, persons ceasing to serve as management board chairman or a management board member shall not immediately become supervisory board chairman or chairman of a supervisory board committee. If such an immediate supervisory board position is to be offered, special reasons shall be presented to the annual general meeting.<sup>44</sup> It will remain the responsibility of the supervisory board to elect its chairman and the chairmen of its several committees; the intention to elect a former management board member to one of those positions has to be explained to the annual general meeting so that the shareholders can take this factor into account when they elect new members to the supervisory board. The government commission rejected a cooling-off period for former management board members since there was no empirical evidence that a cooling-off period would increase the independence of a former management board member and since a mandatory cooling-off period could result in loss of the experience of the former management board member. One might disagree with this conclusion on the grounds that (i) a cooling-off period could allow the successor of a former chairman of the management board to develop and implement his or her own strategy without having to take the possible resistance of the former chairman of the management board into account, and (ii) a conflict of interests of the former management board chairman could be avoided if he or she were prohibited from immediately taking over the position of the supervisory board chairman. Other amendments with regard to elections to the supervisory board require the elections to be made on an individual basis and require that proposed candidates for the supervisory board chairmanship must be disclosed to the shareholders.<sup>45</sup>

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<sup>38</sup> Deutscher Corporate Governance Kodex ('GCGC').

<sup>39</sup> Regierungskommission Deutscher Corporate Governance Kodex.

<sup>40</sup> GCGC §5.4.2.

<sup>41</sup> Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

<sup>42</sup> *Id.*, Section III, clause 13.2.

<sup>43</sup> *Id.*, Annex II, clause 1(b).

<sup>44</sup> GCGC §5.4.4.

<sup>45</sup> GCGC §5.4.3.

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(c) *Qualifications of the Chairman of the Audit Committee.* The chairman of the audit committee is now required to have specialised knowledge and experience in the application of accounting principles and internal control processes.<sup>46</sup> This requirement reflects the provisions of the U.S. Sarbanes-Oxley Act pursuant to which at least one member of the audit committee has to have the knowledge of a ‘financial expert’.

## 2. *Other Prospective Changes in German Practice.*

(a) *Transparency of Management Board Compensation.* On 11 August 2005, the law for disclosure of the compensation of the management board was implemented in Germany.<sup>47</sup> Starting in 2007, all listed companies will be required to disclose the total compensation of every member of the management board, with separate disclosure of performance-related and non-performance-related elements as well as disclosure of compensation provided in the case of early termination of a contract. After a number of important German companies rejected voluntary disclosure of these amounts, the German government decided to regulate this question by law. An exception from the obligation to disclose the compensation of the board members is only granted if holders of more than 75 percent of the shares voting at the annual general meeting of shareholders vote in favour of such an exception.<sup>48</sup>

(b) *Qualifications of Supervisory Board Members.* In the future the government commission may well look more closely at the question of qualifications of the supervisory board members, particularly in the case that a not-sufficiently-qualified member is elected as chairman of a supervisory board committee. In such a case there is an increasing risk that the elected member as well as the electing supervisory board members could be held legally liable for any resulting losses.

(c) *Transparency Affecting Stockholders.* In the future the government commission may well also pay closer attention to additional transparency not only from the side of the company itself but also from the side of the stockholders and their decisionmaking procedures. To date there has not been unanimity of view as to whether the commission and the German government should recommend closer supervision of activist shareholders (for example, hedge funds) by the authorities.

## 3. *E.U. Developments.*

(a) *The European Corporate Governance Forum.* On 21 May 2003 the European Commission issued its Corporate Governance Action Plan,<sup>49</sup> for which a key implementation measure was the creation in October 2004 of the European Corporate Governance Forum (‘Forum’). The mission of the Forum is to provide to the Commission high level policy advice focusing on listed companies, to develop best practice considerations and to seek to ensure global coherence in particular with regard to corporate governance developments in the United States and the OECD countries. The Forum held three meetings in 2005 at which three principal topics were discussed: (i) application and harmonisation of the ‘comply or explain’ principle in Europe; (ii) facilitation of the exercise of shareholder rights across borders, in particular voting rights, and (iii) increase in the efficiency of the supervisory function of the board of directors, in particular relating to amendment of internal control processes after the recent incidents of failure of controls in the United States and in Europe. During its three meetings to be held in 2006, the Forum is expected to discuss these three issues in greater detail.

(b) *European Corporate Governance Code vs. Convergence of the Systems.* With respect to the possibility of a future European corporate governance code, it is the position of the German commission that, because of the diversity of the governance systems used and the differences in the legal systems as well as corporate and financial cultures within Europe, a standard code for Europe cannot be the best solution. Rather, a stronger convergence of the corporate governance systems in Europe should be the aim of the efforts made on the European level. As an example of the fundamental differences in the legal systems, the German commission cites the two different management systems that coexist in Europe: the one-tier system has only one board,

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<sup>46</sup> GCGC §5.3.2.

<sup>47</sup> Gesetz ueber die Offenlegung der Verstandsverguetungen (Vorstandsverguetungs-Offenlegungs Gesetz – Vorst OG)

<sup>48</sup> Vorst OG Article 2(b) – HGB (German Commercial Code) §286(5).

<sup>49</sup> COM (2003) 284 – Modernising Company Law and Enhancing Corporate Governance in the European Union -- A Plan to Move Forward.

consisting of both executive and non-executive members, while the two-tier system has two boards, the management board and the supervisory board. Both systems work in completely different fashion with regard to major aspects like responsibilities of the chairman and other members of the board, and this great difference has to be taken into account when the Forum tries to elaborate common corporate governance principles for the whole European Community.

## **B. Developments in U.S. Mutual Fund Regulation**

1. *Introduction.* For the first time in several years, there appears to be a calm in the seas of ‘mutual fund’<sup>50</sup> regulation in the United States. In late 2003, the highly publicised investigations by New York State Attorney General Eliot Spitzer of market timing activities and late trading triggered a whirlwind of enforcement and regulatory activity by New York and other States and by federal and self-regulatory bodies and prosecutors.<sup>51</sup> Of this activity, the most long lasting impact on the mutual fund industry will most certainly result from regulatory changes made in the past two years by the U.S. Securities and Exchange Commission (‘SEC’), the primary regulator of mutual funds in the United States.

Following the first reports of Mr Spitzer’s investigations, the SEC directed massive investigative and enforcement resources to reported abuses in the mutual fund industry, which ultimately resulted in numerous settlements, accompanied by fines and disgorgements, estimated to total more than US\$2.2 billion, with some of the most highly respected and well established companies in the industry as well as with broker-dealer firms, individual advisory and brokerage personnel and traders.<sup>52</sup> During the same period, the SEC implemented an aggressive rulemaking agenda under the Investment Company Act of 1940 (‘Investment Company Act’),<sup>53</sup> the primary U.S. statute regulating funds, and the Investment Advisers Act of 1940 (‘Advisers Act’),<sup>54</sup> the primary U.S. statute regulating investment advisors, with the goal of providing greater protection for fund investors and restoring confidence in the fund industry. The most significant rulemakings were directed to the areas of compliance and corporate governance, where the SEC put into place measures requiring most funds and fund complexes to redesign their compliance systems and to restructure fund boards giving greater power and responsibilities to independent directors.

2. *New requirements to address Market Timing ,Selective Portfolio Holdings Disclosure, Breakpoint Discount Problems and Directed Brokerage.* Within months of the announcement of Mr Spitzer’s investigations, the SEC initiated an array of regulatory proposals to address perceived abuses that had surfaced in the mutual fund industry. Many of these proposals were swiftly adopted by the SEC, and by the end of 2005 most mutual funds were complying with the new requirements.

(a) *Market Timing Disclosures.* In early 2004, the SEC adopted new requirements for enhanced disclosure regarding mutual fund practices relating to frequent purchases and sales of mutual fund shares.<sup>55</sup> While noting that ‘market timing’ may take many forms, the SEC used the term to refer to ‘arbitrage activity involving the frequent buying and selling of mutual fund shares in order to take advantage of the fact that there may be a lag between a change in the value of a mutual fund’s portfolio securities and the reflection of that change in the fund’s share price.’<sup>56</sup> Pursuant to the new requirements, a mutual fund must now describe in its prospectus the risks (such as interference with efficient portfolio management or increasing transaction or administrative costs), if any, that frequent purchases and redemptions of fund shares may present for other shareholders, and must

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<sup>50</sup> In this Part IIIB, the term ‘mutual fund’ or ‘fund’ is used to refer to a registered open-end management investment company. A mutual fund typically offers for sale or has outstanding redeemable securities that it issues. A mutual fund generally offers and sells shares to the public on a continuous basis. In contrast, a closed-end fund typically engages in a traditional underwritten offering of a fixed number of shares and, in most cases, does not offer its shares to the public on a continuous basis.

<sup>51</sup> See ‘Spitzer Casting a Very Wide Net,’ The New York Times, 12 Oct. 2003; ‘The Coming Mutual Fund Reforms,’ BusinessWeek, 10 Nov. 2003.

<sup>52</sup> SEC Release No. IC-26985, 85 SEC Docket (CCH) 2504, 2516 (30 June 2005), 70 Fed. Reg. 39390, 39399 (7 July 2005) (Concurring Views of Chairman Donaldson).

<sup>53</sup> 15 U.S.C. 80a ff. (2005).

<sup>54</sup> 15 U.S.C. 80b ff. (2005).

<sup>55</sup> SEC Release No. IC-26418, 82 SEC Docket (CCH) 2357 (16 Apr. 2004), 69 Fed. Reg. 22300 (23 Apr. 2004).

<sup>56</sup> *Id.*, n.11, 82 SEC Docket (CCH) 2359, 69 Fed.Reg. 22301.

describe with specificity the policies and procedures, if any, adopted by the fund's board of directors for deterring frequent purchases and redemptions of fund shares and the circumstances under which any restriction will not apply. A mutual fund also is required to describe in its statement of additional information ('SAI')<sup>57</sup> any arrangements to permit frequent purchases and redemptions of fund shares, naming the person or groups so permitted and any compensation or other consideration received by the fund or any other party pursuant to such arrangements.

(b) *Fair Value Pricing.* The Investment Company Act requires funds to calculate their net asset values daily using the market value of the portfolio securities when market quotations are readily available, and using the fair value of a security when a market quotation is not readily available. In the SEC's view, fair value pricing of a mutual fund's portfolio securities under circumstances when market quotations for its portfolio securities are not readily available (including times when quotations are not reliable) can serve to foreclose arbitrage opportunities available to market timers. To underscore the importance of using fair value pricing, the SEC also adopted new requirements that a mutual fund, other than a money market fund, explain in its prospectus both the circumstances under which it will use fair value pricing and the effects of using fair value pricing.<sup>58</sup>

(c) *Mutual Fund Redemption Fees.* Under the Investment Company Act, a mutual fund issues redeemable securities and, upon redemption, a shareholder is entitled to receive approximately his or her proportionate share of the net asset value of the fund. To address perceived market timing abuses, the SEC adopted a new rule allowing mutual funds to impose a redemption fee of up to two percent of the amount redeemed.<sup>59</sup> The rule gives mutual fund boards discretion to consider whether such a fee is necessary and appropriate, and to fix the amount of the fee, if any. It also includes provisions to assist mutual funds in enforcing their market timing policies when their shares are held in omnibus accounts by financial intermediaries. Mutual funds generally must enter into written agreements with these intermediaries (such as banks and brokers) that hold securities in nominee names requiring the intermediaries to provide the funds with certain information regarding trading by shareholders who hold shares through an account with the intermediary.<sup>60</sup> The intermediaries must also agree to execute any instructions from the mutual fund to restrict or prohibit further purchases or exchanges of the mutual fund's shares by a shareholder who has been identified by the mutual fund as having engaged in transactions in the fund's shares (directly or indirectly through the intermediary) that violate the mutual fund's market timing policies.

Compliance with the new redemption fee rule is currently required by autumn 2006. As many large mutual funds have relationships with thousands of intermediaries, a significant amount of time and effort will be required to implement this rule. In addition, open issues regarding the new redemption fee rule's implementation led the SEC to propose further rule changes earlier this year.<sup>61</sup> In light of these open issues and the need to enhance systems, industry participants have urged the SEC to delay the date for compliance with the redemption fee rule.

(d) *Selective Disclosure of Portfolio Holdings.* In the course of the investigations begun in 2003, the SEC alleged that certain mutual funds gave frequent updates of their portfolio holdings to favored shareholders, in some cases hedge funds, allowing them to trade to their advantage and, in some instances, to engage in short-term trading, to the detriment of other mutual fund shareholders. To address this problem on a broader scale and to reinforce mutual funds' and advisors' obligations to prevent the misuse of selectively disclosed portfolio information, the SEC adopted new requirements governing the selective disclosure of portfolio holdings.<sup>62</sup> Many mutual funds now make portfolio holdings available periodically on their websites.

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<sup>57</sup> The SAI is part of the fund's registration statement and includes information about the fund additional to the information in the fund's prospectus. The SAI is publicly available on the SEC electronic document delivery system and is required to be delivered by the fund to investors upon request.

<sup>58</sup> SEC Release No. IC 26418, n.55 above.

<sup>59</sup> SEC Release No. IC 26782, 84 SEC Docket (CCH) 3664 (11 Mar. 2005), 70 Fed. Reg. 13328 (18 Mar. 2005).

<sup>60</sup> *Id.* at 3667 and 13330.

<sup>61</sup> SEC Release No. IC 27255, 87 SEC Docket (CCH) (28 Feb. 2006), 71 Fed. Reg. 11351 (7 Mar. 2006).

<sup>62</sup> SEC Release No. IC 26418, n.55 above.

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(e) *Breakpoint Disclosure Requirements.* In addition to perceived market timing abuses, the SEC focused on various distribution-related practices. One area that the SEC addressed was whether mutual fund investors were receiving the breakpoint discounts available to them. In the U.S., mutual fund shares that are sold through an intermediary often are subject to a sales charge or ‘front-end sales load’ that is based on the purchase price. A ‘breakpoint’ is the investment level required to obtain a reduced sales load when purchasing shares of a mutual fund with a front-end sales charge. To address this issue, the SEC adopted new requirements for mutual funds to provide enhanced prospectus disclosure (with more detailed information permitted to be in the SAI) regarding breakpoint discounts on front-end sales loads.<sup>63</sup>

(f) *Ban on Mutual Fund Directed Brokerage.* For many years in the U.S., mutual fund advisors were permitted to follow a disclosed policy of considering sales of mutual fund shares as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution. This policy has been called ‘directed brokerage’. In 2003, the SEC began investigating this practice and, in 2004, decided to ban directed brokerage<sup>64</sup> on the basis that the practice could have an adverse impact on best execution of fund transactions, could result in circumvention of legal limits on distribution expenses, could impair the transparency of distribution expenses and could ‘corrupt’ the relationship between broker-dealers and their customers.<sup>65</sup> As a result of the ban, a mutual fund may not compensate a broker-dealer for any promotion or sale of the mutual fund’s shares by directing brokerage transactions to that broker-dealer or by participation in ‘step-out’ or similar arrangements in which the selling broker receives a portion of the commission. In addition, if the mutual fund uses a selling broker to execute transactions in portfolio securities, the mutual fund’s board must approve policies and procedures to further implement this ban.

3. *Expanded Disclosure Regarding Portfolio Managers, Portfolio Holdings, Fund Performance and Mutual Fund Expenses.* During 2004, the SEC’s attention also turned to a number of disclosure initiatives intended to improve the quality and timeliness of information given to fund investors. Some of these initiatives focused on portfolio managers, their potential conflicts of interest, their incentives and the level of their investments in the funds they manage. Others addressed the call for more frequent and more useful disclosure of portfolio holdings and greater transparency of ongoing asset-based fees.

(a) *Portfolio Manager Team Members.* New SEC disclosure requirements added significant categories of information regarding a fund’s portfolio manager that must be included in the prospectus and SAI for mutual funds and in reports to shareholders for closed-end investment companies.<sup>66</sup> In the past, if a team was jointly and primarily responsible for managing a fund, the fund was only required to disclose that it was managed by a team but did not need to disclose information about the team members. The SEC was concerned that investors did not know who was actually managing the fund and that team members could change frequently without notice to investors. Under the new requirements, additional information about members of a management team responsible for the day-to-day management of the fund’s portfolio must be disclosed in the fund prospectus.

(b) *Other Accounts Managed and Potential Conflicts of Interest.* At the same time the SEC imposed new requirements that a fund’s SAI disclose other accounts and total assets managed by each portfolio manager in the following categories (including all those where there is a performance fee): SEC-registered investment companies, other pooled investment vehicles (such as hedge funds) and other accounts.<sup>67</sup> Any material conflicts of interest that may arise in connection with the portfolio manager’s management of the fund, on the one hand, and these other accounts, on the other hand, also must be disclosed, such as any material conflicts in investment strategy or the allocation of investment opportunities. These new disclosures are intended by the SEC to allow investors to assess the conflicts of interest to which a portfolio manager may be subject as a result of managing these other portfolios. The SEC had considered prohibiting portfolio managers of publicly offered funds from managing side-by-side certain other types of accounts, such as hedge funds, but did not do so, mainly because

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<sup>63</sup> SEC Release No. IC 26464, 82 SEC Docket (CCH) 3441 (7 June 2004), 69 Fed. Reg. 33262 (14 June 2004).

<sup>64</sup> SEC Release No. IC 26591, 83 SEC Docket (CCH) 2106 (2 Sept. 2004), 69 Fed. Reg. 54728 (9 Sept. 2004).

<sup>65</sup> *Id.* at 2108-2109 and 54729-54730.

<sup>66</sup> SEC Release No. IC 26533, 83 SEC Docket (CCH) 1802 (23 Aug. 2004), 69 Fed. Reg. 52788 (27 Aug. 2004).

<sup>67</sup> *Id.*

such a prohibition could reduce access to talented portfolio managers and hurt smaller firms without the resources to maintain separate staffs for different types of accounts.<sup>68</sup>

(c) *Portfolio Manager Compensation and Ownership of Fund Shares.* To promote understanding of a portfolio manager's incentives in managing a fund and to shed light on possible conflicts of interest, the SEC also adopted new requirements that call for a description in the SAI of the structure of, and the method used to determine, each portfolio manager's compensation from the fund, the fund's advisor or any other source with respect to the fund and other accounts.<sup>69</sup> Notably, the SEC did not require disclosure of the actual dollar value of a portfolio manager's pay. A further new requirement calls for disclosure (within dollar ranges) of each portfolio manager's beneficial ownership of the equity securities of each fund he or she manages. While concluding that this ownership information will help investors to assess how well aligned the manager's economic interests are with those of the fund's shareholders, the SEC also recognized that a portfolio manager might have reasons for not owning shares of a specific fund unrelated to the level of confidence the manager has in the fund. In those circumstances, such as, for example, where the manager's personal investment objectives do not match the fund's, the SEC encouraged funds to explain why the manager does not own fund shares.<sup>70</sup>

(d) *Fund Portfolio Holdings.* A number of new SEC requirements relate to the timing and form of disclosure of portfolio holdings.<sup>71</sup> In the past, a fund included a complete portfolio schedule twice a year in the annual and semi-annual reports to shareholders. The SEC has now changed this to allow funds to include in reports to shareholders a summary portfolio schedule which includes each of the fund's 50 largest holdings in unaffiliated issuers and each investment in an unaffiliated issuer that exceeds one percent of the fund's net asset value. A tabular or graphic presentation of a fund's portfolio holdings by identifiable categories, such as industry sector, geographic region, credit quality or maturity, also is now required in shareholder reports. The SEC believed that the combination of the summary portfolio schedule and a tabular or graphic asset allocation presentation would be more useful to many investors than a complete listing of the portfolio holdings. The full portfolio schedule must still be filed with the SEC and provided to shareholders upon request, free of charge. In addition, funds must now file complete portfolio schedules with the SEC on a quarterly basis within 60 days of the end of each quarter.

(e) *Mutual Fund Expenses.* In order to address concerns that mutual fund investors did not understand the nature and effect of ongoing asset-based charges, the SEC adopted a new requirement that mutual funds disclose in reports to shareholders the fund expenses borne by shareholders during the reporting period. Mutual fund shareholder reports now must include (1) the cost in dollars associated with an investment of \$1,000, based on the fund's actual expenses and return for the period, and (2) the cost in dollars associated with an investment of \$1,000, based on the fund's actual expenses for the period and an assumed return of 5% per year.<sup>72</sup> The first number is intended to allow investors to estimate the actual dollar costs borne by shareholders over the reporting period, while the second number is intended to give investors a basis for comparing the level of expenses in the current period of different funds.

(f) *Management's Discussion of Fund Performance.* The SEC also decided to require that mutual funds, other than money market funds, include a Management's Discussion of Fund Performance ('MDFP') in the fund's annual report to shareholders<sup>73</sup> – something that some mutual funds have done voluntarily for many years. In the SEC's view, having the MDFP in the fund's annual report to shareholders will aid investors in assessing the fund's performance over the prior year, while fitting naturally with the other 'backward looking' information provided in the annual report.<sup>74</sup> Previously, funds had the option of including the MDFP in the fund's prospectus.

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<sup>68</sup> *Id.* at 1807 and 52791.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 1809 and 52792.

<sup>71</sup> SEC Release No. IC 26372, 82 SEC Docket (CCH) 943 (27 Feb. 2004), 69 Fed. Reg. 11244 (9 Mar. 2004).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 957 and 11254.

4. *Strengthening Fund and Advisor Compliance Programs.* In early 2003, prior to the reported scandals, the SEC had proposed new compliance rules for funds and advisors. When troubles beset the mutual fund industry later that year, the SEC moved quickly to adopt these new fund and advisor compliance rules with the stated goal of ensuring that all funds and advisors have a strong system of controls in place to enhance compliance with the federal securities laws and to protect fund investors.<sup>75</sup>

(a) *New Fund and Advisor Compliance Rules Generally.* The new fund and advisor compliance rules require registered funds and advisors to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, to review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (CCO) to be responsible for administering the policies and procedures. These rules, which represent a comprehensive rethinking of the SEC's approach to investment management compliance, have expressly placed the oversight responsibilities for fund compliance on the shoulders of fund boards and have required fund complexes and advisors to devote enormous resources and time to their compliance policies and procedures and, in many cases, to restructure their compliance programs in part or in whole.

(b) *Coverage of the Advisors' and Funds' Compliance Programs.* The compliance rules give considerable flexibility as to the content of the policies and procedures, but the SEC gave detailed guidance regarding the areas that should be covered.<sup>76</sup> The boards of directors of funds also must adopt written compliance policies and procedures, including policies and procedures that provide for the oversight of compliance by each investment advisor, principal underwriter, administrator, and transfer agent of the fund.<sup>77</sup>

(c) *Chief Compliance Officer.* The rules also require each fund and advisor to have a chief compliance officer (CCO).<sup>78</sup> While the fund CCO may be an employee of the investment advisor or administrator, the fund CCO must report directly to the fund board of directors. The fund board must approve an individual's designation as CCO and his or her compensation. The fund board also must have the power to remove the CCO at any time and to prevent the advisor or any other service provider from removing the fund CCO without the board's concurrence, and fund affiliates are prohibited from coercing, manipulating, misleading or fraudulently influencing the fund's CCO. The fund CCO must annually give the board a report on, among other matters, the operation of and material changes to the fund's policies and procedures and those of the service providers as well as any material compliance matters arising since the CCO's last report. Further, the fund CCO must meet in executive session with the independent directors of the fund at least once a year, although in practice the fund CCO is likely to meet with the independent directors on a much more frequent timetable.

(d) *Investment Advisor Codes of Ethics.* Some months after the new compliance rules were adopted, the SEC also approved a new rule requiring investment advisors to adopt and enforce codes of ethics applicable to their supervised persons.<sup>79</sup> This new rule was designed 'to prevent fraud by reinforcing the fiduciary principles that must govern the conduct of advisory firms and their personnel.'<sup>80</sup> Under this new rule, an investment advisor's code of ethics is required to include certain minimum provisions.<sup>81</sup> Each advisor is allowed to formulate its own code that takes into account the specific nature of that advisor's business. By early 2005, each advisor had presumably adopted its code of ethics and was prepared to maintain and enforce it.

5. *Advisory Agreement Disclosure Requirements.* The Investment Company Act prohibits any individual or entity from serving as an investment advisor to a fund except under a written contract initially approved by a majority vote of the fund shareholders and usually re-approved at least annually by either shareholders or the board of directors. The terms of renewal of any advisory contract must be approved by a majority vote of the fund's independent directors, and fund directors must request and evaluate, and the fund's advisor must provide, information that may be reasonably necessary to evaluate the terms of any advisory contract. In the past, the SEC

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<sup>75</sup> SEC Release No. IC 26299, 81 SEC Docket (CCH) 2775 (17 Dec. 2003), 68 Fed. Reg. 74714 (24 Dec. 2003).

<sup>76</sup> *Id.* at 2779 and 74716.

<sup>77</sup> *Id.* at 2781-2785 and 74717-74720.

<sup>78</sup> *Id.* at 2786-2788 and 74720-74722.

<sup>79</sup> SEC Release No. IC 26492, 83 SEC Docket (CCH) 829 (2 July 2004), 69 Fed. Reg. 41696 (9 July 2004).

<sup>80</sup> *Id.* at 829 and 41696.

<sup>81</sup> *Id.* at 830-835 and 41697-41700.

has required disclosure of the basis for a board's approval of an advisory contract in the SAI and in proxy statements seeking shareholder approval of an investment advisory contract.

In mid-2004, the SEC adopted requirements that funds provide enhanced disclosure in their reports to shareholders regarding the board's deliberations in approving investment advisory contracts.<sup>82</sup> The disclosure must indicate, among other matters, whether the board relied on comparisons of the services to be provided and the amounts to be paid with those under other advisory contracts, such as contracts of the same and other investment advisors with other funds and other kinds of clients, such as pension funds and other institutional accounts. This category is the least traditional and most controversial as the services provided to mutual funds tend to be quite different from those provided to large institutional clients.<sup>83</sup> These rule changes, which clarify and enhance existing disclosure requirements in fund proxy statements and address SEC concerns that some funds do not provide adequate specificity regarding the board's basis for its recommendations to shareholders to approve investment advisory contracts, are resulting in greater and more intensive work for fund independent directors and echo the theme of the increased responsibilities and power of the independent directors.

#### 6. *New Fund Governance Requirements.*

(a) *The New Role of Independent Directors.* The fund industry woes resulted in a harsh spotlight on the role of independent directors. While others disagreed, in Congressional testimony in the fall of 2003, Mr Spitzer reportedly charged that fund boards of directors had been 'inert' and 'passive' and that they had 'failed.'<sup>84</sup> Reacting to calls for fund board reforms, the SEC, in a split vote, adopted new requirements addressing the governance standards of funds and the independence of the members of their boards of directors.<sup>85</sup> While drawn merely as conditions to availability of a number of exemptions from constraints of the Investment Company Act, these requirements will in effect apply to nearly all mutual funds. In its adoptive release, the SEC made clear that its new requirements were intended to restructure corporate governance at fund complexes by enhancing the power and increasing the responsibilities of the independent directors. In particular, these changes were directed at strengthening the role of independent directors in overseeing fund operations including compliance matters, in policing conflicts between management's interests and the interests of fund shareholders, in negotiating with fund management and in exerting greater control over the activity and agenda of and information flow to the board.

(b) *Substantive Standards.* To comply with the requirements, a fund must meet certain standards.<sup>86</sup> First, at least 75 percent of the directors must be independent. The 75 percent standard represents an increase from both the pre-existing SEC standard of a simple majority of independent directors and the two-thirds standard recommended by the Investment Company Institute, the U.S. fund industry's trade association. The SEC originally estimated that 40 percent of all funds in the U.S. did not meet the 75 percent condition and, as a result, the other 40 percent would need to change the composition of their boards of directors to satisfy this requirement. Second, the board's chairman, or the person who otherwise presides over meetings of the board of

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<sup>82</sup> SEC Release No. IC 26486, 83 SEC Docket (CCH) 261 (23 June 2004), 69 Fed. Reg. 39798 (30 June 2004).

<sup>83</sup> Mr Spitzer and others have been critical of the level of fees charged to mutual funds by their advisors and, in particular, how these fees compare to fees charged to other types of client accounts, such as institutional clients. In a number of market timing related settlements with mutual fund companies, Mr Spitzer imposed a reduction in advisory fees and a requirement that the reasonableness of proposed management fees be determined by the fund board using either an annual competitive bidding process (including at least three sealed bids) or an annual independent written evaluation prepared by or under the direction of an independent third party. See, for example, 'Alliance Agreement Includes New Form of Relief for Shareholders' (press release issued by the Office of the New York State Attorney General, 18 Dec. 2003); and 'Pilgrim Baxter Settles Market Timing Case' (press release issued by the Office of the New York State Attorney General, 12 June 2004). In the latter settlement, the independent evaluation has to consider various factors, including the level of fees charged to institutional clients for like services and the fees charged to other mutual funds for like services. In yet another case, an action has been brought in federal court seeking to enjoin Mr Spitzer from involving himself in the subject of the level of advisory fees, which has traditionally been the province of the SEC. See *J. & W. Seligman & Co., Incorporated, et al. v. Eliot Spitzer, Attorney General of the State of New York*, Civil Action No. 05 CV 7781 (USDC SDNY filed 6 Sept. 2005).

<sup>84</sup> See 'Spitzer on Scandal: Directors have Failed,' *Board IQ*, 11 Nov. 2003, 3, and Testimony of State of New York Attorney General Eliot Spitzer Before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, 4 Nov. 2003.

<sup>85</sup> SEC Release No. IC 26520, 83 SEC Docket (CCH) 1384 (27 July 2004), 69 Fed. Reg. 46378 (2 Aug. 2004).

<sup>86</sup> *Id.* at 1390-1395 and 46381-46385.

directors and has substantially the same responsibilities as a chairman of the board, must be an independent director. Third, the board must evaluate, at least annually, the performance of the board and its committees, including considering the effectiveness of the committee structure and the number of funds on whose boards each director serves. Fourth, the independent directors must meet at least quarterly in a session outside the presence of non-independent directors. Last, the independent directors must be authorised to hire employees and to retain advisors and experts necessary to carry out their duties.

(c) *Ensuing Litigation.* The requirements that the fund's board chairman as well as 75 percent of a fund's directors be independent proved to be highly controversial. In response to a lawsuit brought by the U.S. Chamber of Commerce (the 'Chamber') challenging the new rules, the U.S. Court of Appeals for the District of Columbia in June 2005 remanded these requirements for further consideration by the SEC.<sup>87</sup> The court found that the SEC, in violation of the Administrative Procedure Act ('APA'),<sup>88</sup> had not adequately considered the costs for funds or a proposed disclosure alternative to the independent chairman requirement. Within days following the court ruling and on the next-to-last day of then SEC Chairman William H. Donaldson's tenure, the SEC again considered these requirements and determined that their benefits 'far outweigh[ed]' their costs and that the disclosure alternative did not afford adequate protection to fund shareholders.<sup>89</sup>

The Chamber challenged the SEC's actions a second time, and the Court again found that the SEC had violated procedures mandated by the APA, this time by relying on materials outside of the rulemaking record without providing an opportunity for the public to comment, to the prejudice of the Chamber. The Court vacated both requirements but gave the SEC 90 days to solicit public comment and provide a status report to the Court.<sup>90</sup> The requirements for an independent chairman and for 75 percent independent directors have therefore not yet gone into effect, but there remains a reasonable possibility that they, or something similar, will take effect -- later if not sooner. What the impact may be, whether these requirements may overburden independent directors or make their role more akin to that of management rather than the more traditional board role of oversight, at this writing remains a matter of speculation and debate.

## Part IV

### Developments in Market Regulation in Malaysia: Adoption of *Syariah* Principles

1. *Introduction.* This Part IV reports on recent developments in market regulation in Malaysia, with emphasis placed on the adoption of *Syariah* principles in securities transactions. Islamic finance<sup>91</sup> has developed at a remarkable pace since its inception three decades ago, and the number of Islamic finance institutions worldwide has risen to over 300 today in more than 75 countries. Islamic finance institutions are principally concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia the biggest hubs) but have also established a presence in Europe and the United States. Total assets worldwide are estimated to exceed \$250 billion, and are growing at an estimated 15 percent a year.

The Malaysian government has expended considerable effort in putting into place infrastructure more conducive to development of Islamic Banking and Finance. In the 9<sup>th</sup> Malaysia Plan, the government has stated that it will continue to undertake strategic initiatives to strengthen the country's position as a global Islamic financial hub. Tan Sri Dr. Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, has recently stated that fundamental to the development of Islamic financial markets is a strong regulatory and legal environment that enforces international financial standards such as capital adequacy and provides reliable financial disclosure.<sup>92</sup>

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<sup>87</sup> Chamber of Commerce of the United States of America v. Securities and Exchange Commission, 412 F. 3d 133 (D.C. Cir. 2005).

<sup>88</sup> 5 U.S.C. 551 ff. (2005).

<sup>89</sup> SEC Release No. 26985, 85 SEC Docket (CCH) 2504 (30 June 2005), 70 Fed. Reg. 39390 (7 July 2005).

<sup>90</sup> Chamber of Commerce of the United States of America v. Securities and Exchange Commission, No. 05-1240, slip opinion (D.C.Cir. 7 Apr. 2006).

<sup>91</sup> By way of introduction and background, see B.Ingham, 'The Essence of Islamic Finance' in *CFA Magazine* (Mar.-Apr. 2005) 6, and S.Trammell, 'Islamic Finance' in *CFA Magazine* (Mar.-Apr. 2005) 16.

<sup>92</sup> See Z. Akhtar Aziz, 'Building a Robust Islamic Financial System', Governor's Keynote Address at the 2<sup>nd</sup> International Conference on Islamic Banking: Risk Management, Regulation and Supervision (Kuala Lumpur, 7 Feb. 2006).

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2. *The Financial System of Malaysia and its Legal Infrastructure.* The Malaysian financial system can be divided into three parts: (i) the banking sector, (ii) non-bank financial intermediaries, and (iii) the financial markets. Within this system the primary legislation that complements the development of Islamic finance is the Islamic Banking Act 1983 governing Islamic banks and imposing requirements for those banks to conform to the practices of Islamic banking. The Banking and Financial Institution Act 1989 ('BAFIA') governs conventional banks. Section 124 of BAFIA permits conventional banks to operate Islamic banking business. BAFIA was introduced to provide an integrated system of supervision of the Malaysian banking and financial system and to modernise the laws relating to banking and finance in Malaysia.

3. *Regulatory Framework of the Malaysian Financial System.* At the center of the regulatory authorities in Malaysia is Bank Negara Malaysia ('BNM'), the central bank of Malaysia, which acts under the jurisdiction of the Ministry of Finance. Under Section 4 of the Central Bank of Malaysia Act 1958, the two main objectives of BNM are to promote monetary stability and sound financial structure and to influence the credit situation to the advantage of Malaysia. The Securities Commission ('SC') of Malaysia was established on 1 March 1993 by the Securities Commission Act. Its mandate is to supervise the country's capital and securities markets, to act as a watchdog for financial futures as well as capital market instruments (including matters relating to the Islamic capital market), and to regulate the industry including issuing licenses and introducing relevant guidelines.

4. *International Standard Setting.* Apart from the SC and BNM, the Islamic Financial Services Board ('IFSB') was established in 2002 in Kuala Lumpur. It serves as an international standard setting body of regulatory and supervisory agencies that have an interest in ensuring the soundness and stability of the Islamic financial services industry, including banking, capital markets and insurance. IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with *Syariah* principles, and recommends those standards for adoption. The 84 members of IFSB include 20 regulatory and supervisory authorities as well as the International Monetary Fund, the World Bank, the Bank for International Settlements, the Islamic Development Bank, the Asian Development Bank, and 59 financial institutions from 16 countries. Malaysia, the host country of IFSB, has enacted the Islamic Financial Services Board Act 2002 to give IFSB the immunities and privileges that are usually granted to international organisations and diplomatic missions.

#### 5. *Recent Developments.*

(a) *Islamic REITs.* On 21 November 2005, the SC unveiled the first ever Guidelines for Islamic Real Estate Trust Funds ('IR Guidelines'). Adoption of the IR Guidelines furthers the process of easing foreign investment rules, liberalising the Islamic financial sector and reinforcing Malaysia's position as regional Islamic financial hub. Generally, Islamic REITs share similar features with conventional REITs: they are collective investment vehicles that invest at least 50% of their total assets in real estate, and they are designed with an open investment structure (unlike the concepts of *mudharabah* (profit sharing) and *musyarakah* (partnership) which restrict investors to a limited pool). Islamic REITs' investments must comply with the IR Guidelines, complementing the prior Guidelines on Real Estate Investment Trusts issued by the SC on conventional REITs. The IR guidelines do not supersede the conventional REIT Guidelines; rather, both sets of Guidelines operate in congruence with each other in regulating the establishment of an Islamic REIT investment scheme. Among the key features of the IR Guidelines is the requirement for appointment of a *Syariah* Advisor/Committee to ensure that the subject matter of the investment is *Syariah*-compliant. For example, tenants in the property must carry out activities that are *halal* (i.e. not forbidden under Islamic law). Among the rental activities banned are financial services based on *riba* (interest), gambling, tobacco, hotels and resorts, and conventional insurance. The IR Guidelines also mandate that an Islamic REIT must ensure that all financial instruments used are in compliance with *Syariah* and that the insurance utilised to insure the REIT is in compliance with cooperative or mutual insurance principles (*takaful*).

(b) *Islamic Securities.* The SC's Guidelines on the Offering of Islamic Securities ('IS Guidelines') stipulate the criteria which must be met with regard to any issue, offer or invitation of Islamic securities. The release of the IS Guidelines in July 2004, facilitated the development of more innovative and sophisticated Islamic instruments that meet the requirements of both local and global investors, especially those from the Middle East. As a result,

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the Malaysian Islamic bond market has since witnessed the issuance of new Islamic instruments structured using the *Syariah* principles of profit-sharing (*mudharabah*) and partnership (*musyarakah*). The IS Guidelines also provided issuers with flexibility in managing their distinct financing requirements, using different financial structures and *Syariah* principles. As at the end of 2005, there were 857 issues of *Syariah*-compliant securities, comprising 85 percent of the total listed securities on Bursa Malaysia. The IS Guidelines require the appointment of a *Syariah* Adviser to advise on all *Syariah*-related provisions of such instruments.

6. *Future Enhancements.* The principal governmental participants in the development of market regulation in Malaysia have shown great eagerness to enhance the development of Malaysia's Islamic Finance and Banking sector. As evidenced in the 9<sup>th</sup> Malaysia Plan, much emphasis will be placed, in the future, on the development of Islamic Finance and Banking with a view to making Malaysia a key banking and financial center. Realisation of this aspiration will require the creation of an effective regulatory framework encouraging the liberalisation and modernisation of the Islamic Banking and Finance industry while boosting investor confidence generally. Further efforts will include: (i) incorporating the tenets and principles of *Islam Hadhari* (an approach that emphasises market development, consistent with the tenets of Islam and focused on enhancing the quality of life) in the framework of regulations; (ii) strengthening the Islamic Banking Act (1983) whereby the distinct characteristics of Islamic Banking will be given recognition without compromising the regulatory aspects; (iii) fine-tuning BAFIA to further accommodate the unique characteristics of Islamic Banking; (iv) introducing a separate capital adequacy, statutory reserve and liquidity requirement for Islamic banks; (v) harmonising *Syariah* opinions on Islamic banking and finance in order to enhance efficiency and promote market development; and (vi) attracting more non-Muslim participation in Islamic Banking and Finance.

## Part V

### Conclusion

Six years ago, in an effort to gain perspective on the potential contribution of the Committee, and of the Association, in the rapidly-evolving area of international securities regulation, a draft report prepared for the Committee included the following statements, which merit repetition here:

Reflexive adaptation of regulation to the rapidity and extent of change in international securities markets has at times taken on an aura of *sauve qui peut*; the Association, happily, is afforded the opportunity for more considered reflection. Responses that may have seemed promising to the Committee and to the Association as recently as two years ago require re-thinking and reaffirmation or revision today. That is the goal toward which the Committee looks in the processes of the [forthcoming] Working Session... and in its efforts in the ensuing biennium.

With those thoughts in mind, the Committee's chairman, reaching into and below the several reports (Parts II to IV above) of national and trans-national 'developments' in the Committee's area of study during the past biennium, seeks to lay out in this Part V, four fundamental themes that transcend the immediate 'developments' discussed and underline the need for 'more considered reflection'. That they are inter-related themes will come as no surprise.

It was the recognition of internationalisation of legal issues in the Committee's field of study that gave rise to the creation of the Committee nearly 20 years ago. The phrases 'internationalisation of the capital markets' and 'the need for regulatory convergence' both appear on the second page of the Committee's very first Report to the Association, followed shortly by the following conclusion: '[T]here appears to be agreement that autarchy in securities regulation can only result in unnecessary restraints on capital flows and unreasonable barriers to the integration of the offering of financial services in what is now an integrated global capital market.'<sup>93</sup> To this day that remains a credo of the Committee. As convergence becomes increasingly the default approach in dealing with a succession of challenging trans-national issues, however, the question arises whether the benefit of similarity in trans-national regulatory response carries with it a degree of constriction of market conduct

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<sup>93</sup> Report of this Committee in ILA, *Report of the 64th Conference* (Queensland, 1990) 441, 442.

inhibiting attempts to pursue legitimate alternative market activity in any single (or multiple) marketplace. Examples are myriad: First and Second Level action plan legislation in the E.U. (for one prospective instance, see Part IID4 above), Principles and Standards published by IOSCO, and governmental prescription of independence requirements affecting enterprise overseers, among others, come quickly to mind. In each case the benefit sought is simple and clear; in each case there is market cost in terms of substitutes unexplored and alternatives foregone. The price may well be worth paying, but the fact of cost and the amount of payment require to be recognised and understood. The Committee has raised analogous issues in past Reports.<sup>94</sup>

In the Committee's Reports in more recent years, the lengthy recital of legislators' or regulators' actions addressing perceived capital market failures or the summary of challenges to traditional regulatory notions has suggested, if only sub silentio, that market-damaging conduct and failure to act is not limited to private market participants but may also be laid at the charge of those vested with a measure of public responsibility for market oversight.<sup>95</sup> The standards for accountability of market participants are laid out in detail in the civil and criminal laws and rules of each jurisdiction in which a capital market exists or from which the capital-raising and trading facilities of a capital market, functioning elsewhere, can be accessed. Per contra, the standards for accountability of those vested with responsibility – or who take to themselves responsibility -- for market rulemaking and market oversight are inherently political in nature and, except in the rare instance of judicial intervention (for one instance of intervention, see Part IIIB6 above), are enforceable principally by legislative and regulatory self-analysis and self-restraint. When market rulemaking or market oversight is exercised at a further remove, as for example by committees within transnational regulatory networks such as IOSCO or CESR, even that tenuous political discipline is curtailed, and accountability to the markets and market constituents being served in essence disappears. Accountability of governors is a critical issue and almost by default has emerged as a new focus of academic study in the context of international securities markets. Crafting accountability mechanisms and assessing the effect of their presence or absence is a subject that the Committee has not previously explored in depth.

Part IIB2 of this Report, in its summary of the prospective operation of Articles 9, 11 and 12 of the E.U. Takeover Directive, describes a series of opt-outs and opt-ins to address a thorny problem rooted not only in differences in the economic interests of private market actors but also in differences of national tradition and culture. Whether described as a 'compromise solution' (as in Part IIB2) or under the rubric 'harmonisation'<sup>96</sup> or discussed and accepted as parallel but not-necessarily-irreconcilable treatments of common issues in separate if interacting markets, 'path dependent' responses of this kind add to the total measure, as well as to the resounding cacophony, of global securities market experience. The fact that 'path dependent' responses draw upon diverse sources of standards for market conduct gives an encouragement to mutual recognition, among the 'hierarchy of approaches' to inconsistent legal and regulatory treatment of similar market practices. The Committee is already familiar with such approaches, and it may be appropriate to resume the Committee's discussion on this subject where it was left ten years ago.

Finally, the Committee has more than once observed that international securities regulation serves as a paradigm of a new form of international 'law' creation by market actors other than States or Supra-National Entities acting, as is usual, through their diplomatic departments and officials.<sup>97</sup> Much of the present Report illustrates how these actors – specialist national agencies, professional self-regulatory organisations and councils of national regulators (who are not themselves de jure governmental legislators) -- have exercised their in-jurisdiction authority and cross-jurisdictional influence to alter national law, for the most part with the effect of convergence toward consistent standards of market practice. Even more so than was concluded at the Committee's working session in Berlin, the effects of this phenomenon may merit the Committee's increased attention and in-depth analysis.

Taken together, these four themes/issues/matters present more than mere topics for discussion for the Committee at its workshop in Toronto. Taken together, they provide more than sufficient grist for the

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<sup>94</sup> See, for example, the Report of this Committee in ILA, *Report of the 67<sup>th</sup> Conference* (Helsinki, 1996) 477, 483.

<sup>95</sup> See, for example, the Report of this Committee in ILA, *Report of the 68<sup>th</sup> Conference* (Taipei, 1998) 344, 355 ff.

<sup>96</sup> See the Report of this Committee in ILA, *Report of the 67<sup>th</sup> Conference* (Helsinki, 1996) 477, 483 ff.

<sup>97</sup> See the Report of this Committee in ILA, *Report of the 71<sup>st</sup> Conference* (Berlin, 2004) 441, 479.

Committee's work in the next biennium. Taken together, they pose a challenge to conventional notions of appropriate principles for international securities regulation, not an affront or an interdiction but a challenge to reconsider, to reinforce and to reaffirm or to seek reform as and where the Committee, and the Association, find those courses justified.

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