

Corporate Governance in Investment Management Companies

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This Article aims at undertaking an in-depth study of the prevalent investment management regime. Companies which provide asset management services for third parties have to pursue good corporate governance as an integral part of their activities. This should be applicable in terms of responsible control and administration inside the company (Internal Corporate Governance) as well as the exercise of the voting rights or any additional shareholder rights by the companies as institutional investors in the interest of their clients (External Corporate Governance). The governance issues become all the more relevant in the light of the fact that they have an impact on the affairs of the companies in the fund portfolio. Thus, the companies should act independent of the interests of the owners, affiliated corporations and third parties, and instead act solely in the interest of the investors. At present the, the Asset Management Companies are governed by the SEBI guidelines and regulations. However, there is a void so far as the issues of corporate governance are concerned.

Therefore, in view of the corporate governance of the asset management companies, an attempt has been made to provide suggestions for the mitigation of potential conflict of interests, most notably where the fund's sponsor has business relationship or any other affiliations with the companies held in the fund's portfolio. The case of the HP-Compaq merger, aided by Deutsche Bank that held HP shares under their Asset Management Scheme, provides an insight into the very same problem. In light of the nature of the business conducted by the asset management companies, the viability of a more stringent disclosure mechanism would also be discussed. Furthermore, specific recommendations in the nature of a code for governance of the Asset Management Companies will be proposed.

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I. Introduction

In 1996, SEBI made registration of Asset Management Companies mandatory and imposed regulations.¹ In the past 12 years, while the regulator has experimented with minor changes in disclosure norms for listed companies, there has hardly been any revision for MFs despite the rapid growth of the industry making it grossly under-par. While the SEBI Regulations seem to be elaborate and extensive, there seem to be certain loopholes and ambiguities in the legal framework which leave scope for misuse. Thus, in the light of the primary concerns like conflict of interest and disclosure requirements, it is proposed that a holistic and comprehensive legal framework be adopted.

II. Conflicts of Interest

Legally, it is the directors of an investment company who are the guardians of the interests of both the company and its shareholders² putting them in a position to affect the reputation and the standing of any investment management company. However, conflicts are inherent in any relationship in which one party undertakes to act on behalf of another and are thus, inevitable in an investment management company. These conflicts reduce the ability of directors to fulfil their fiduciary duty, and therefore are of concern to the law.

¹ Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (hereinafter referred to as the Regulations).

² *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). c.f. Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 Del. J. Corp. L. 1 (2003) (considering whether and why corporate directors are motivated to advance the interests of their companies).

It is undeniable that the investment funds have grown to such colossal proportions that it often plays an instrumental role in the shaping of the securities market and consequently a nation's economy. Further, the costs of the agency relationship in mutual funds is far more acute in comparison to an operating company because the fund investors have to be seen as both the customers and the shareholders of the mutual fund, placing a far greater duty on the Investment company. .

In such circumstances the potential weaknesses of investment fund accountability is a source of grave concern. These funds are registered as either a corporation or a trust, but differ from these entities because it is "organized and operated by people whose primary loyalty and pecuniary interest lies outside the enterprise." Such a fund has no employees of its own, but instead is organized and managed by a separate "sponsor," which, along with independent contractors, provides all services necessary for the fund's operation. The sponsor may be a bank, insurance firm, financial services firm, or securities broker. The sponsor employs and compensates any and all officers of the fund, including the board of directors.

This structure may result in significant conflicts of interest, especially where the fund's sponsor has business relationships with the companies held in the fund's portfolio. This was precisely the case which had happened in the corporate scandal of the Hewlett Packard merger with Compaq, aided by Deutsche Bank. In this case of the HP-Compaq merger, Deutsche Bank's investment banking division had a contract with HP for merger-related

³ Div. of Investment Mgmt., U.S. SEC, Protecting Investors: A Half-Century of Investment Company Regulation 251 (1992).

services and was slated to earn an additional \$1 million upon the merger's completion. At the same time, Deutsche Asset Management earned fees from investors for managing shares of HP stock in its mutual fund holdings, shares that had voting rights that Deutsche exercised in support of the merger.⁴ Although the SEC's investigation did not establish that Deutsche Bank's relationship with HP affected its vote for the merger, and the Hewlett lawsuit was dismissed, the conflict of interest was identified.

Furthermore, these asset management companies are in itself a public company with its own shareholders, thus are bound by the fiduciary duties owed to those shareholders while at the same time the fiduciary duties owed to investors of the mutual funds which it advises.

There is another particular situation where an inherent conflict of interest arises in the investment management companies where a mutual fund's management of the retirement plan assets of a company whose stock is also held in that mutual fund. This was epitomised in the corporate scandal at Tyco. In this case Fidelity Investments voted against a shareholder proposal requesting that Tyco International maintain a majority of independent board members. At the time of the vote, Fidelity was managing Tyco's employment benefit plan and was earning millions of dollars in fees for this service.⁵ In the aftermath of the corporate scandal at Tyco, Fidelity's vote may lend acceptance to the assertion that mutual funds have inherent conflicts of interests that must be mitigated through regulation or other mechanisms.

⁴ Ariana Eunjung Cha, *Deutsche Bank Pays \$750,000 in SEC Settlement*, Wash. Post, Aug. 20, 2003, at E1.

⁵ Matthew Benjamin, *Leaving the Little Guy Behind*, U.S. News & World Rep., Oct. 21, 2002, at 50.

Conflicts of interest can also arise in an investment company because of the relationship that normally exists between the company and its investment adviser. An investment company, which is usually created by its investment adviser, generates income for the adviser through the fees it pays the adviser, but all other things being equal, these fees reduce the profits earned by the company and hence by the company's shareholders. Shareholders will always seek to maximize their profits, a goal that requires investment companies to minimize costs. Accordingly, the fees paid by an investment company to its investment adviser promote a divergence between, on the one hand, the goals of the company and its investors and, on the other hand, the goals of the adviser.⁶ Because most advisers control the investment companies they advise,⁷ directors of an investment company can be aligned with the adviser and are subject to an obvious conflict of interest.

In light of the above, it is essential that the mitigation of this conflict of interest is done through the existing legal framework and develop better laws for corporate governance of the investment management companies. In India, the trustees are subject to disclosure of conflict of interest requirements in the similar manner as directors of a company. All the trustees must furnish to the board of trustees particulars of interest in any other company or institution or financial intermediaries. Each trustee is required to file the details of his transactions of dealing in securities with the mutual fund on a

⁶ Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. IC-24083, 64 Fed. Reg. 59877 (Nov. 3, 1999) (this is an interpretation provided to the Investment Company Act of the United States which can be squarely applicable throughout India).

⁷ Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24082, 64 Fed. Reg. 59826, 59827 (Nov. 3, 1999).

quarterly basis with SEBI.⁸ Nonetheless in India the conflict of interest is ill-defined and hence the certain suggestions have been incorporated in the later chapter. In the absence of a concrete and consolidated definitional framework as to the ambit and scope of the interest it becomes very difficult to pin-point the specific violations of the safeguards against the "conflict of interest"

A. Fiduciary Duty

The fiduciaries are granted broad discretion to make investments; however, they are subject to a standard of prudence that they are expected to exercise in making all investment decisions. This is known as the 'prudent person' investment standard⁹ and in its modified form the 'prudent investor' standard¹⁰. The standard of prudent behaviour is used to examine the discharge of the fiduciary duty and serves as a guiding principle for the managers when there is a conflict of interest. A duty to divest within reasonable time, to diversify the investments and reduce risk also flows from this standard of prudence.

At common law, prudence is measured by the performance of each investment, although under the modern portfolio theory, it is to be measured by performance of the portfolio as a whole, rather than by each investment

Regulation 15(5) r.w. the Third Schedule of the Regulations; Aparna Viswanathan, *Indian Capital Markets: An Introduction To Regulation Of Mutual Funds*, (Corporate Law and Practice Course Handbook Series, PLI Order No. 11926 February-March, 2007).

⁹ *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446.

¹⁰ "Prudent Investor" standard requires the actual expertise of a prudent person familiar with the investment matter under discussion, or the acquisition of such expertise through the advice of expert consultants, *Estate of Beach*, 542 P.2d 994, 1001 (Cal. 1975)

transaction. This theory appears more rational because the philosophy behind mutual funds is diversification and thus, it is only justified that an investment and its entailing risks be judged on a broader horizon. Under the latest school of thought however, prudence should not be measured by the performance rather by the process through which investment strategies and tactics are developed, adopted, implemented, and monitored. In other words, prudence ought to be demonstrated by the process through which risk is managed.¹²

Under the Indian legal framework, an overall reading of the Regulations imposes upon the trustees a fiduciary duty to act in the interest of the unit-holders. However, the fiduciary duties of the fund managers are vague, virtually unenforced fiduciary duties that mandate that fund directors and advisers act in the best interests of fund shareholders, and thus, almost meaningless. And thus, strengthening fiduciary duties has become one of the key elements for effective reform of the way investment companies are governed.

B. Need for Disclosure

Earlier, financial markets relied on competitive forces to determine 'optimal' levels of disclosure on the grounds that 'if disclosure is worthwhile

¹ See Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund through Relationship Investing*, 20 J. Corp. L. 413.

¹² Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* 35, at 84 (1986) *c.f.* Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund through Relationship Investing*, 20 J. Corp. L. 413.

to investors, the firm can profit by providing it.' However, soon it was recognised and accepted that disclosure is of utmost importance to protect the interests of the investors.

The fund managers owe a fiduciary duty towards the investors and, as a corollary to this it flows that the discharge of the fiduciary duty must be 'disclosed to the persons to whom the duty is owed'. The autonomy enjoyed by fund investors suggests that the regulatory response should focus on improving disclosure so that the investors may reach informed decisions. It also serves as an effective tool to examine the efficiency of the operations and helps in the timely detection of frauds.

However, such disclosure norms have also been opposed on the grounds that the trustees ought to be the appropriate overseers of the investment advisers' duties and mandating disclosure undermines their existing functions. Further, it is argued that such disclosure increases costs when in fact, the individual investors are not interested in most of the information sought to be disclosed, rather only the performance results.¹⁴ They invest in mutual funds because they lack the time, expertise or the willingness to research the portfolio investments and therefore, such additional disclosures would be futile.

¹³ Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 213 (1991) c.f. H. Anne Nicholson, *Securities Law: Proxies pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 Okla. L. Rev. 687.

¹⁴ Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why not disclose?*, 23 Cardozo L. Rev. 1419.

However, the investors benefit in terms of the impact such disclosure requirements will have on the investment companies. Without a disclosure mandate an investment company has no incentive to act in the interests of the client because then it cannot be held accountable. Mandatory disclosure, on the other hand, will elicit the required fiduciary behaviour which justifies the costs of such disclosure.

C. Investment Function

Regulations should look to promote corporate governance in an investment fund by mandating the disclosure and maintenance of extensive records of their constitutive and internal governance documents, trading transactions, portfolio investments and positions, investment authorizations and investment advisory materials.¹⁵ Detailed and binding disclosure with respect to the fund's investment function; the fund's objectives, strategies and limitations are required to be disclosed in the fund's prospectus.⁶

Effective disclosure should also focus on the costs attendant to any investment, whether those costs are borne directly by the fund investor or the fund itself. Additional disclosure requirements may be called for to apprise the fund investor of how his or her broker is compensated in the sale of mutual fund shares, including not only the receipt of commissions or sales loads and

¹⁵ Investment Company Act of 1940 § 30(a)(1).

¹⁶ Securities Act of 1933 § 13.

distribution fees paid by the funds them-selves, but also management fee revenues that the fund's adviser may be sharing with the broker.¹⁷

D. Proxy voting policies ■

Mandatory disclosure of proxy voting policies and procedures as also how potential conflicts of interest between the management of the funds and the investors will be resolved has of late been a widely discussed issue.

Investment management companies, as part of their responsibility of corporate citizenship are expected to play a key role in corporate governance of the portfolio companies. Earlier these investment management companies, especially mutual funds were relatively passive players, although now they have realised that they cannot always easily sell blocks of poorly performing stock, and have instead sought to improve performance in portfolio companies. And, proxy votes have proven to be the principal way to influence the governance activities of a publicly traded corporation. Thus, active participation by such investment companies plays a dual role by benefitting not only to the investors in these investment companies but also the individual shareholders of the portfolio companies. It is hence, not surprising that the disclosure of proxy voting policies has received greater importance.

In the case of mutual funds or other intermediaries, individual investors implicitly or explicitly delegate voting rights to the fund itself. A representative from the fund, typically the investment manager, votes the

¹⁷Eric D. Roiter, *An Apology for Mutual Funds: Delivering Fiduciary Services to Middle and Working Class Investors*, 23 Ann. Rev. Banking & Fin. L. 851.

proxies on behalf of the individuals invested in the fund. However, since the representative is voting on behalf of the investors, there is a fiduciary obligation to vote in way that promotes the interests of the beneficiary; and the discharge of this fiduciary duty ought to the persons to whom it is owed.

Furthermore, disclosure of proxy votes will assist in the mitigation of the conflict of interest present when an investment company votes proxies for a company with which it has any business affiliation. Disclosure also increases the responsibility on the fund managers and ensures that they vote with a certain degree of seriousness rather than unilaterally 'rubber stamping' management decisions.

III. Indian Legal Framework

There is a comprehensive legal framework which has been developed in India.¹⁹ In 1992, the Government of India decided to open up the business of mutual funds to the private sector. The primary regulations governing mutual funds are Securities and Exchange Board of India (Mutual Funds) Regulations, 1996. Each mutual fund must be authorized by SEBI and shall be operated by separately established asset management companies (AMCs). The SEBI guidelines also prescribe detailed disclosure and reporting. All mutual funds are required to make clear and unambiguous advertisements of the objectives, features, methods and periodicity of investment, valuation.

¹⁸ H. Anne Nicholson, *Securities Law: Proxies pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 Okla. L. Rev. 687.

¹⁹ Aparna Viswanathan, *Indian Capital Markets: An Introduction to Regulation Of Mutual Funds*, (Corporate Law and Practice Course Handbook Series, PLI Order No. 11926 February-March, 2007).

Certificate of Registration by the SEBI - In order to obtain a certificate of registration, the sponsor who establishes the mutual fund must fulfil the prescribed requirements.

In the form of Trust- Mutual funds are in the form of trusts. The trust deed must contain certain mandatory clauses intended to safeguard the interests of the unit holders. The trustees must be approved by the SEBI and can be removed only with the approval of SEBI. An asset management company or any of its officers or employees cannot be appointed as a trustee of a mutual fund. A person who is appointed as a trustee of a mutual fund cannot be appointed as a trustee of any other mutual fund unless such person is an independent trustee and prior approval of the mutual fund of which he is a trustee has been obtained.

The trustees are required, under the trust deed, to appoint an asset management company (AMC) approved by the board of trustees. The trustees must enter into an Investment Management Agreement, containing the prescribed clauses, with the asset management company. The scheme of a mutual fund is managed by an asset management company because a trust cannot, under company law, hold shares in its own name. But the trustee is responsible to ensure that the AMC works diligently. A custodian is appointed to keep custody of the securities and carry out the custodian activities.

Reporting Requirements- Each mutual fund is subject to stringent reporting requirements. On a half yearly basis, the trustees must provide SEBI with the requisite report and certificate of prescribed conduct.

Asset Management Company- The SEBI has to approve the constitution of the asset management company (AMC). In order to obtain such approval, the eligibility criteria of Regulation 21 of the Mutual Fund Regulations need to be fulfilled like the sound track record, adequate professional experience, clean record, non-interested constitution, etc. Further, Regulation 22 prescribes the terms and conditions like a director of an AMC cannot generally be a director in any other AMC, appointment of directors must be by prior approval of trustees, requirements to be fulfilled before making any change in the controlling interest of the AMC, etc.

An AMC is subject to restrictions on its activities and which must be incorporated in the Investment Management Agreement like disclosure to invest, not acting as a trustee of any mutual fund, etc. An AMC may not undertake any business activities except portfolio management services, management and advisory services to offshore funds, pension fund, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial banks if any of such activities are not in conflict with the activities of the mutual fund, unless as provided. The Investment Management Agreement (IMA) signed by the AMC and the mutual fund must provide that the AMC may not acquire any of the assets out of the scheme property which involves the assumption of any liability which is unlimited or which may result in encumbrance of the scheme property in any way.

One of the most important regulation as regards the corporate governance and control mechanism for an AMC is Regulation 25 which categorically lays down various obligations of an AMC like exercising due

diligence and care in its investment decisions, compliance with the regulations and the investment management agreement, liabilities, report submission, disclosure and filing requirements, etc. One important addition was point 6A of Regulation 25 which provides that The Chief Executive Officer (whatever his designation may be) of the AMC shall ensure full compliance and shall also be responsible for the overall risk management function of the mutual fund.

The AMC must disclose the basis of calculating the repurchase price and NAV of various schemes of the fund in the scheme particulars and disclose the same to investors at intervals. The AMC must submit quarterly reports on the functioning of the schemes of the mutual fund to the trustees. The trustees have the right to obtain from the AMC all information concerning the operations of various schemes of the mutual fund.

Disclosure Requirements- The offer document must contain disclosures which are adequate in order to enable the investors to make informed decisions. SEBI has the right to cause the AMC to carry out modifications in the offer documents.

Investment Restrictions and Objectives -The Regulations further provide for specific investment restrictions which must be followed by the mutual funds in order to ensure that the money of the investors is put to the best use.

Code of Conduct- Fifth Schedule of the Regulations prescribes a code of conduct for the Mutual Funds that ensures good governance practices.

IV. Suggestions and Conclusion

A comprehensive reading of the regulations warrants the conclusion that due to its loosely framed language and vague provisions it can be easily circumvented. Thus, the authors propose that the legal framework be amended to provide for inclusive provisions dealing with instances of conflict of interest and specific safeguards.

A. Disclosure

- At present SEBI requires disclosure to evaluate the suitability of a collective investment scheme for an investor and the value of the investor's interest in the scheme. However, what are required are detailed disclosures norms along with enhanced regulation for funds to bring about the much-needed transparency.
- Furthermore, it is suggested that there is disclosure regarding the concentration of unit-holdings and the details of the bulk holders. This information is crucial to reduce vulnerability to large outflows by a handful of corporate investors.
- Furthermore, there should be a requirement to disclose the fees and expenses that are charged by the mutual funds in the prospectus to enable the investor to make an informed choice.

B. Proxy Voting

- As on date, the regulations are inadequate as regards the precautions to be followed in case of proxy voting. In this regard the US "Proxy

²⁰ Rajesh Gajra, *Mutual Funds: Investing in Transperancy*, available at <http://www.businessworld.in/index.php/Markets-Finance/Investing-In-Transparency.html> <last visited March 9, 2009>

voting by Investment Advisors" Regulations, 2003 serve as a good example which imposes upon the investment advisor a duty to develop policies and procedure relating to the voting of client proxies, particularly the steps the investment advisor should take in cases where there is a material conflict of interests. Furthermore, there are also stringent disclosure mandates for proxy voting.

C. Involving the Investors

- Although the regulations intend to safeguard the interests of the investors, they provide to do so without principally involving the investors. Despite the application of the concerned provisions of The Companies Act, 1956; the US example of The Investment Company Act, 1940 which specifically granted the shareholders of the investment companies voting rights as regards certain important matters (for e.g. Changing the sub-classification as close-ended or open-ended, underwriting, investment decisions, etc.) should be used as a guiding light to incorporate similar legal provisions in India.

D. Regulation of fees and expenses

- Another significant area that has the potential to generate substantial savings to investors is the reduction of fees and expenses charged by funds which needs stricter regulation. Fees in the nature of exit fees, fees to assist marketing of the mutual funds and other charges levied on the investors significantly cut into the returns fund investors receive and thus, these require to be regulated.

²¹ Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 Pace L. Rev. 133.

- Also, to reduce the costs of the agency relationship and promote the efficient operation of a fund by the manager's fee should be based upon the success of the fund.

E. Additional Areas

- The mutual fund regulation sets out provisions governing the broad activities of these funds, not the detailed regulations which will eventually be required to govern many of the technical and financial issues arising in connection with fund operations. Issues such as share offerings; anti-trust; methods to be used in valuing fund assets; specific accounting rules to apply to fund operations; and specific tax regulations to apply to the operations and profits of funds should be given due importance and coverage under the existing legal framework.