

Mutual Funds in Developing Markets:

Addressing Challenges to Growth



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Acronyms and Abbreviations

ACD	Authorised Corporate Director
ANBIMA	Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (Brazil)
AUM	Assets Under Management
CIS	Collective Investment Scheme
EEA	European Economic Area
ETF	Exchange-Traded Fund
EU	European Union
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
ICI	Investment Company Institute
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRA	Individual Retirement Account
MMF	Money Market Fund
NAV	Net Asset Value
OECD	Organisation for Economic Co-operation and Development
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission (U.S.)
SRO	Self-Regulatory Organization
UCITS	Undertakings for Collective Investment in Transferable Securities

Executive Summary

Background

An estimated 76,200 mutual funds worldwide currently control about \$30 trillion¹ in assets under management, representing just over 20 percent of total global assets under management on behalf of investors worldwide.² Mutual funds have typically come about as an outcome of developed financial markets, not a cause of it. Unsurprisingly, therefore, developed markets control roughly over 90 percent of mutual fund assets.³ Yet many developing countries are currently seeking to foster a domestic mutual fund sector, because mutual funds provide cost-effective, professionally managed diversification of risk to investors, while supporting economic growth.

Mutual funds are a major intermediary between savers and borrowers, gathering savings out of bank deposits and investing these savings into money market instruments, bonds, and equities issued by governments and corporates. Mutual funds are essentially designed to diversify risk for smaller savers who do not have enough money to achieve this diversification themselves; thus, mutual funds tend to be a middle class savings vehicle. However, these funds are also a valuable investment vehicle for institutional investors and corporates who likewise benefit from this cost-effective professional management of diversification of risk. Mutual funds therefore play a significant role in investing for retirement as well as serving as an underlying investment vehicle for insurance companies. Likewise, corporates find the cost-effective diversification of risk offered by money market funds (which invest predominantly in short-term debt instruments) attractive for treasury management.

Mutual fund markets sometimes develop organically. However, in many emerging markets, and sometimes developed markets, mutual funds are often “synthetically” developed by first establishing the legal and regulatory framework, based on international standards, for such funds to exist. In the United Kingdom, the United States, and Zimbabwe, funds developed first and fund-specific law and regulation came later. In other cases, such as Kenya, Morocco, or Spain,⁴ fund law and regulation were set up before funds were actually created.

The varying scale of domestic mutual fund markets around the world—in both developing and mature markets—is a function of many different interacting factors. The diversity of fund sectors also reflects the diversity of environments in which they operate.⁵ Moreover, mutual funds themselves defy clear comparison because

they are not standardized in terms of legal structure, investment focus, or management style; nor are they always consistently categorized in available data. Policy makers and regulators must understand the mutual fund sector to realistically assess the sector’s ability to function, and to effectively facilitate and supervise these funds.

This study provides policy makers in developing countries who seek to foster the domestic mutual fund sector with a handbook to understand the sector; it presents a range of legal/regulatory and market-related factors that drive or impede mutual funds. The objective of this report is to lay out salient features that help develop the mutual fund industry in developing countries and unlock some of the key drivers and impediments that typically assist or stunt their growth. Few reports so far have drawn on cross-country studies to examine developing country mutual fund sectors. This study explores the nature of mutual fund sectors in different developing countries and presents, through illustrative examples, the heterogeneity in characteristics that arise for mutual fund sectors developed in different geographic and economic contexts.⁶

The study focuses primarily on publicly offered, domestic mutual funds (legally domiciled in the host country in which they are primarily distributed). The study draws from five country case studies of mutual fund sectors conducted by the World Bank in 2012—Brazil, Kenya, Morocco, Peru, and Turkey—and on various other examples. The details of these studies are provided in the chapters that follow, using data and insights from the time of the respective case studies, with updated data where possible. The study also draws on a 2013 global survey conducted by the International Organization of Securities Commissions (IOSCO) on mutual fund markets in developing countries. Throughout the

report these case studies are referenced to depict the heterogeneity as well as similarities in trends of mutual fund sectors globally. The reader must note that these examples are not meant to reflect best or worst practice, but rather are used for illustrative purposes.

Introduction to Mutual Funds

A mutual fund is a form of open-ended collective investment scheme,⁷ or investment fund. It is a pool of savings collected from multiple investors who buy units representing proportionate ownership of the fund. The resulting pool of funds, or the fund's capital, is collectively managed by a professional management company, in line with the investment objective outlined in the fund's prospectus. Mutual funds are typically understood to mean open-ended funds; that is, funds that are obliged to buy back their shares or units from holders on a regular (usually read as "daily") basis. This form of collective investment scheme is closely regulated because it is legally eligible to gather savings from the public and is required, in turn, to invest those savings in a diversified portfolio of transferable/tradable securities.

Mutual funds typically consist of four main types of funds, defined by their asset exposure: (1) funds that invest predominantly in equity securities, (2) funds that invest predominantly in debt securities, (3) funds that invest in a hybrid of both equity and debt securities, and (4) funds that invest in short-term debt instruments (money market funds).⁸

These funds are set up through one of three common legal structures: trust, corporate, or contractual-type funds. The country's legal tradition, whether civil code or common law, will influence the type of legal structure enabled for mutual funds. The legal structure typically embeds governance requirements to deal with some of the principal-agency risks inherent in the mutual fund model.⁹ The legal structure also determines the arrangements for operating the fund, safeguarding its assets, and ensuring third-party supervision. Despite the prevalence of different legal structures, the operational characteristics of mutual fund structures are becoming increasingly similar, as regulatory frameworks cohere around the IOSCO principles on collective investment schemes (outlined in Chapter 2) and, increasingly, regional standards.

Demand for mutual funds derives from institutional investors (including corporates) and retail investors. In some countries, such as Peru, the mutual fund sector is virtually 100 percent retail owned. In other cases, such as Morocco, institutional investors own more than 90 percent of assets under management in mutual funds. Although in many countries funds can be licensed and taxed as mutual funds only if they meet the diversity of ownership test, in other countries it is possible for a fund to be created and sold exclusively to a single institutional client under the same legislative and regulatory requirements as funds that are offered to the public.¹⁰ This is the case in Brazil, for instance, where Article 71 of Instrução 409 permits a fund to be created exclusively for a single client. Similarly, in Morocco, the mutual fund industry is characterized by a large number of "dedicated" funds; that is, a relatively large proportion of funds are set up as investment structures dedicated

to a limited number of investors, using the same legal framework set up for funds sold to retail investors.¹¹

Development of Mutual Fund Sectors

For policymakers seeking to initiate or expand a mutual fund sector, the first step is to identify the current level of development and success of the mutual fund sector.

If there is no mutual fund sector in the economy, and the country seeks to initiate such funds, policymakers should first consider the nature and scale of the capital markets. They should assess, for instance if capital markets are expanding and offering potential for mutual funds to expand; and if there is sufficient liquidity in the market to allow mutual funds to easily operate. Because mutual funds must be able to invest new money flowing into them and be able to raise money by selling assets when investors wish to exit the fund, they cannot operate in narrow and illiquid capital markets. If the stock market, for instance, lists 30 or fewer securities and most or all of these are rarely traded,¹² then it is unlikely that mutual funds could function effectively. In such cases, before developing mutual funds, policy makers could first seek to improve the level of issuance and market turnover in the capital markets. They could also prioritize improving the environment for closed-ended funds—such as venture capital and private equity funds—that do not need liquid assets to function, since these funds can also help add to issuance listed on exchanges.

If, on the other hand, the country has a mutual fund sector, policymakers must understand the current health and level of development of this sector. They must assess how the mutual fund market has developed relative to the economy;¹³ whether the market is perceived to offer good potential for development;¹⁴ how effective the sector has been in mobilizing savings;¹⁵ and the relative success of mutual funds with respect to other savings vehicles. If the mutual fund sector is thought not to be growing sufficiently, the next step is to identify the reasons for inadequate growth. Typically (but not always) these reasons will fall into one or more of the following categories which are further explored in the chapters of this study:

- **Quality of law and regulation and supervision.** While a good quality legal and regulatory framework in itself will not create a successful mutual fund market,¹⁶ the market needs adequate regulation and supervision to create investor confidence. On the other hand, excessively complex regulation may well be a deterrent: Most highly developed markets started without any regulation and had to create frameworks to tackle problems as they arose, continually adapting them over time. Law and regulation governing pension funds and other institutional investors may also limit their investment into mutual funds; this, in turn, may affect the mutual fund sector's success.
- **Level of savings.** If there is an insufficiently large middle class with surplus savings that are willing to risk and deploy these savings for the long term in mutual funds, demand for mutual funds will quite simply be inadequate. In this case it can be useful to facilitate institutional investors such as pension

funds to invest in mutual funds, while greater retail demand for mutual funds develops.

- **Financial literacy and awareness of financial products.** If financial literacy and awareness is low, there may be decreased retail interest in mutual funds. Awareness and education programs to develop retail demand is a long-term and expensive exercise, which a nascent sector may not be able to undertake, so government or regulatory support may be needed. Developing a financial advisory sector may also develop retail demand for mutual funds, since many people prefer to get face-to-face financial guidance.¹⁷
- **Tax treatment of mutual funds.** If mutual funds have less favorable tax status than other types of savings vehicles (such as bank deposits or insurance products), then they are unlikely to attract savings from individuals or investments from institutional investors.
- **Competition from other savings media, in particular mandatory pension fund savings and bank deposits.** Where pension saving is mandatory, this may affect mutual funds either positively or negatively. If pension funds can invest in mutual funds, then mutual fund growth may be affected positively; if they cannot, and particularly if required levels of mandatory pension saving are high, this will tend to crowd out other savings, including mutual funds. If saving into pension funds is voluntary and such funds are more tax efficient than mutual funds and cannot or do not invest in mutual funds, this is likely to reduce the potential for mutual fund sector growth. Similarly, if interest rates on bank deposits are high, investors may find little incentive to risk capital in mutual funds investing in shares or bonds, particularly if deposits are more tax efficient than investing in mutual funds.
- **Competition from foreign domiciled funds.** If funds domiciled in foreign jurisdictions can be publicly offered, and these funds offer wider global investment coverage, better tax treatment or tax avoidance, or greater credibility than domestically domiciled funds, then local funds will find it harder to compete.
- **Stage of development of stock market.** As a recent ICI study¹⁸ notes “there is strong evidence that the relative size of a country’s capital market is correlated with the size of the mutual fund industry in that country.” A prerequisite to growth of the mutual fund industry around the world is access to an adequate supply of tradable stocks and bonds. Capital markets also need to be liquid; that is, the supply of securities must trade with some regularity. If capital markets are not expanding, mutual funds are also unlikely to expand.
- **Access to distribution.** Mutual funds need distributors that have an incentive to sell units to the public. If banks (which dominate the distribution of financial services) or financial advisers do not find it sufficiently remunerative to market mutual funds to the public, this could reduce the potential for mutual fund expansion. Bank domination of distribution

channels for mutual funds can also restrict independent fund operators from entering the market.

- **Flexibility in marketing mutual funds.** If the legal and regulatory framework does not enable innovative fund structures—such as master-feeders; umbrella funds; and multi share or unit classes—mutual fund operators may not have adequate flexibility to market mutual funds, which may impede the sector from accumulating assets.

If mutual funds are sufficiently attractive to investors, then operators will come forward to create, offer and manage these funds, and distributors will be ready to distribute them. In general, a mutual fund market (or a sector of that market) may rapidly expand if the operators of mutual funds find a particular advantage that can be exploited. The nature of the advantage may vary from country to country: In one country a money market fund may be able to offer higher returns to investors because income paid out by the fund is not subject to withholding tax, whereas interest paid on a bank deposit is; in another, a mutual fund may offer an institutional investor a way to conveniently and cost effectively achieve instant exposure to a domestic or foreign market.

Given the heterogeneity of contexts within which mutual funds operate, it is not possible to identify a single path that can ensure a mutual fund sector’s success and make certain that the sector contributes effectively to the economy of a country. On the contrary, many factors intersect to influence outcomes, as outlined in the chapters of this report.

Endnotes

1. Source: Investment Company Institute 2014.
2. UK Fund Management 2014, The Financial Markets Series, TheCityUK, September 2014.
3. ICI Statistics on global mutual fund markets.
4. In Spain, a mutual fund sector came into being after the country passed a mutual fund law, following the European Union’s Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) in 1985. UCITS is a set of European Union Directives that provide collective investment schemes a passport to operate throughout the EU once in compliance with the directive and authorized by a member state.
5. Plantier, L. Christopher. 2014. "Globalisation and the Global Growth of Long-Term Mutual Funds." *ICI Global Research Perspective* 1, no. 1 (March). Available at www.iciglobal.org/pdf/icig_per01-01.pdf.
6. Although this report seeks to broadly explore striking aspects of the mutual fund sector in emerging markets, it does not go into specific issues related to mutual funds. Such specific issues include but are not limited to the debate on whether or not actively managed funds outperform passively managed funds, details on the nature and development of relatively new mutual fund products such as exchange-traded funds, and delving into the nature of offshore fund centers and the impediments to their development. The report also does not examine specific learnings from mutual

- fund sector events in developed country contexts, such as the mutual fund market timing scandal of 2003 in the United States.
- 7. “Collective investment scheme” is the term used by IOSCO to designate such funds.
 - 8. Funds can be further subdivided by investment objective (income, growth, capital preservation, or a mixture of these) or by geographic focus (e.g., global equity) or sector focus (e.g., technology stocks).
 - 9. The operator (or “agent”) who manages the fund does not own the assets of the fund. The assets are either beneficially owned by those who own units in the fund—the investors (the “principals”—or they are owned by the fund itself when it is a company, which is in turn owned by its shareholders (the investors in the fund). This dichotomy leads to the possibility of conflicts of interest.
 - 10. Since these funds are set up under the same legal and regulatory requirements as publicly offered investment funds, these are included in this analysis.
 - 11. Out of the 330 authorized mutual funds, about 145 were dedicated to a single investor, as of December 31, 2011. Dedicated mutual funds represented 41 percent of total assets under management in Morocco at end of 2011.
 - 12. That is, stock market turnover as a percentage of market capitalization is less than 10 percent.
 - 13. Total mutual fund assets under management as a percentage of gross domestic product over time.
 - 14. Progression in the number of mutual fund operators over the previous the ten years, or since inception of the industry.
 - 15. Mutual fund assets under management as a percentage of value of total bank deposits.
 - 16. Indeed many markets have state-of-the-art regulation and no activity.
 - 17. However, this is a complex area to develop and regulate since such advice should cover a wider range of financial services than mutual funds.
 - 18. Plantier, L. Christopher. 2014. "Globalisation and the Global Growth of Long-Term Mutual Funds." *ICI Global Research Perspective* 1, no. 1 (March). Available at www.iciglobal.org/pdf/icig_per01-01.pdf.

1. Overview of Mutual Fund Sector Characteristics in Select Developing Countries

Objective

Mutual funds developed spontaneously in mature markets such as the United States and United Kingdom before legislation governing such funds developed. These funds became prevalent relatively late in developed markets—beginning in the 1920s—along with the formation of a sizeable middle class population, which diversified their investments through such funds; and the development of financial markets, which featured a broad range of liquid securities in which such funds could invest their capital.

Many developing countries are currently seeking to foster a domestic mutual fund sector. This is because mutual funds offer individual investors a diversified spread of professionally managed risk, thus mobilizing capital out of bank deposits and into money and capital markets, where they finance governments and corporates and contribute to long-term economic development. Institutional investors and corporates may also invest in mutual funds; typically this is because the mutual fund offers a specific advantage to these organizations, such as lower cost or greater tax efficiency or greater flexibility than making direct investments on their own behalf.

In emerging markets, mutual funds are growing as economies develop, savings increase, and capital markets expand. In 2013 Investment Company Institute (ICI) data covering 46 countries and territories indicated 14 middle-income countries with mutual fund sectors in the global database.¹ Policy makers in developing countries that wish to encourage capital mobilization through mutual funds need to understand the key factors in their success.

This study provides policy makers in developing countries with an overview of the diversity of factors that drive or impede the development of the sector. The mutual fund sectors of different countries are not easy to compare. In each country they are an outcome of different combinations of different factors, such as legal histories, cultural preferences, pension systems, and fiscal treatment. In addition, statistical analyses may categorize mutual funds differently. Few reports so far have drawn on cross-country

studies to examine developing country mutual fund sectors. The objective of this report is to aid policy makers by laying out salient features of mutual fund sector growth in developing countries and identifying some of the key impediments that typically stunt their growth so that these can be minimized or avoided. The study explores the nature of mutual fund sectors in different developing countries, with specific focus on Brazil, Kenya, Morocco, Peru, and Turkey,² and presents, through illustrative examples, key lessons for policy makers that can be derived from these country cases.³

Definition

A mutual fund is a form of collective investment scheme⁴ or investment fund. A fund is a pool of savings collected from multiple investors who buy units representing equal proportionate rights over the income or capital gains generated by the fund. The resulting pool of money, or the fund's capital, is collectively managed by a professional management company, in line with the investment objective outlined in the fund's prospectus. As a result of this professional management, the pool of capital earns income from (1) dividends received on the shares the fund has bought, (2) interest on bonds or deposits the fund holds, and/or (3) from rental on real estate the fund owns. When shares, bonds, or real estate are sold by the fund at a profit (or a loss), the fund makes capital gains (or losses). The fund may distribute income or capital gains to holders; alternatively these may be reinvested in the fund, in which case, the investor “realizes” the income or gains when they sell the units they own.

More specifically, a mutual fund is a form of collective investment scheme (CIS) that is closely regulated because it is legally eligible to gather savings from the public and is required in turn to invest those savings predominantly in a diversified portfolio of transferable/tradable securities.⁵ The term “mutual fund”⁶ used in this report relies on the term typically used in Canada and the United States to refer to regulated and publicly offered collective investment schemes. Usually structured as open-ended funds (see box 1.1), these funds meet regulatory requirements for unrestricted offer to the general public and are obliged to buy back shares or units from their holders at request on a regular basis at the current value of those shares or units. These funds may take any of typically three legal structures: contractual, corporate, or trust (this is discussed more in chapter 2) and in some countries may be required to have diversified ownership.

Although mutual funds meet requirements for funds offered to the public, they may also be attractive to institutional investors. In some countries mutual fund assets under management may derive more from institutional investors than from individual members of the public. This is most likely to arise where such funds are a tax-efficient and cost-effective way of holding a portfolio of assets and where they are permitted to meet the needs of a single investor. In many countries funds can be licensed and taxed as publicly offered

mutual funds only if they meet a diversity of ownership test, which aims to prevent individuals or corporates from misusing funds’ tax privileges to avoid or evade tax. In other countries a fund can be created to be sold exclusively to a single institutional client under the same legislative and regulatory requirements as funds that are offered to the public. This is the case in Brazil,¹⁵ where Article 71 of Instrução 409 permits a fund to be created exclusively for a single client; and in Morocco, where a relatively large proportion of funds are set up as investment structures dedicated to a limited number of investors (such as an insurance company, a public pension management institution, a government fund, or a private foundation).¹⁶ These funds provide the convenience of having a portfolio managed within a well-structured and supervised legal framework while providing the level of customization required by the investor, notably in terms of asset allocation, investment style, and risk profile. Permitting funds with a single investor can be a way to kick-start mutual fund development before retail demand for such vehicles develops.

This study focuses primarily on domestic mutual funds, that is, mutual funds that are legally domiciled in the host country in which they are primarily sold.¹⁷ The study builds on the five country case studies alluded to above as well as a global survey conducted by the International Organization of Securities Commissions (IOSCO)

Box 1.1: History of Investment Funds⁷

History of Investment Funds

The earliest investment fund was a closed-ended fund formed in the Netherlands in 1774. In 1868, such a fund was formed in Britain and in 1893 in the United States. The first open-ended mutual fund, which could continuously create and cancel units and thus vary its capital, was the Massachusetts Investment Trust created in the United States in 1924.⁸

The first British fund’s objective remains true for that of a modern investment fund, specifically “to provide the investor of moderate means the same advantage as the large capitalist in diminishing risk by spreading investment.”⁹ Following the Wall Street crash of 1929, legal and regulatory frameworks specific to mutual funds started to be introduced, for example, the U.S. Investment Company Act of 1940 and the U.K. Prevention of Fraud (Investments) Act of 1939.¹⁰

Open-Ended Mutual Fund

Mutual funds are typically open-ended funds, that is, funds that are obliged to buy back their shares or units from holders on a regular (usually read as “daily”) basis. These funds can issue and redeem shares or units, allowing investors to invest in or divest from the fund. The fund assets are valued at their market price (mark-to-market) on a daily basis, hence allowing the daily calculation of net asset value of each share or unit in the fund that is the basis of the price at which investors buy or sell shares or units. This means that investors do not have to search for a seller of a share/unit in a mutual fund in the market. Instead the investors can purchase the share/unit directly from the fund, usually through the fund management company. Conversely, the holder of a share in a mutual fund does not have to look for a buyer but can sell it directly to the mutual fund.

Open-ended funds are managed either passively—that is, tracked to an index—or actively—whereby the fund management company employs a specific strategy to invest assets. To ensure they can meet the potential liquidity demands on the fund, these funds are required to invest predominantly in liquid securities such as high-quality bonds, equities, and commercial paper or short-term deposits.¹¹ Volatile, illiquid, or shallow capital markets are thus not suitable to such funds because they cannot easily buy or sell assets to meet demand for sale or redemption.

Another distinctive feature of open-ended funds is their pure equity capital structure: that is, they may raise money only by sale of shares or units and are not permitted to issue debt securities.¹² Generally open-ended funds may only borrow up to 10 percent of their value, but only for the short term, and not to leverage returns.¹³

Together, these features assure an investor into a publicly offered open-ended mutual fund that they are undertaking an unleveraged, diversified, and highly liquid investment.

This “open” and see-through structure means that when an investor purchases mutual fund shares, the capital of the fund increases, and when an investor redeems shares, the capital of the fund decreases: hence the term “variable capital” also applied to these funds.¹⁴

on mutual fund markets in developing countries. Throughout the report these case studies are referred to, to depict the heterogeneity as well as similarities in trends of mutual fund sectors globally. The reader must note that these examples are not meant to reflect best or worst practice, but rather are used for illustrative purposes.

Role of Mutual Funds

A key reason for encouraging the development of mutual funds is that they mobilize the savings of small investors, which might otherwise remain in bank deposits, into capital markets. These mobilized savings provide a source of longer-term financing for companies and governments issuing bonds and for companies issuing equities, thus supporting economic growth. Money market funds (MMFs), while typically investing only in instruments with a duration of under one year, can also provide finance by buying short-term instruments such as Treasury bills (T-bills) and corporate paper. Further, the returns earned by fund investors should over time reduce the potential for dependence upon the state in retirement and make household finances more resilient. In the United States, the biggest mutual fund market in the world, mutual funds held almost 25 percent of all U.S. stock at the end of 2012, making them one of the largest investors in U.S. financial markets.

Mutual funds also have economic benefits for their investors: They provide cost-efficient spread of risk for retail investors, institutional investors, and corporates. Generally most individual investors do not have large sums of money to invest, and creating a diversified portfolio of shares or bonds would require tens or hundreds of thousands of U.S. dollars. Further, the cost of acquiring such a portfolio would be high relative to the amount these investors have available to invest, and the selection of the portfolio would require expertise that they may not have. Mutual funds, which typically accept subscriptions of \$500 or \$1,000, provide this diversification for them. By investing through a mutual fund, retail investors are assured that their savings are managed by investment professionals who diversify risk at relatively low transaction costs because they buy and sell assets in greater bulk than an individual investing small amounts could achieve.¹⁸ Since mutual funds are generally invested in very liquid financial instruments, mutual fund shares or units are usually redeemable on a daily basis, and investors can redeem their shares at will.¹⁹ Institutional investors often invest in mutual funds to also gain exposure to a particular asset class or geographical region where the cost of investing via a mutual funds is lower than the cost of hiring experts to manage the desired portfolio.²⁰ Studies show that mutual funds have become “the primary financial wealth accumulation vehicle in American society, especially for middle-market consumers and the “emerging affluent.”²¹

Mutual funds can play a significant role in investing for retirement. Both defined benefit and defined contribution pension schemes may be investors in mutual funds. In the case of defined benefit schemes, this is likely to be for the reasons given above. In the case of defined contribution schemes, individual scheme members may choose to hold shares or units in mutual funds in their defined contribution accounts. In the United States, for

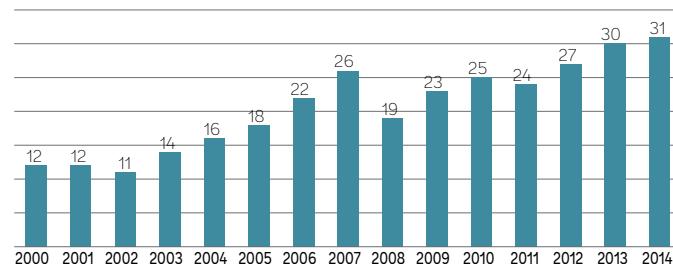
instance, in 2013, 81 percent of mutual fund-owning households owned shares or units in these funds through employer-sponsored defined contribution retirement plans.²² Mutual funds are also underlying investments for other defined contribution pension schemes, such as the 401(k).²³ As a key investment product in many retirement plans, American mutual funds play a critical role in the financial security of millions of individuals as they prepare them for retirement.

Money market funds—mutual funds that invest predominantly in short-term debt instruments issued by governments, companies, and financial institutions such as banks—also serve an important intermediary role by responding to the short-term liquidity needs of these issuers. These funds play an important cash management function in some countries because they are used by many corporates for treasury management. They may also assist in financing banks by investing in certificates of deposit and as counterparts to sale and repurchase transactions that provide liquidity to banks.²⁴ For retail, corporate, and institutional investors, MMFs represent a strong alternative to term deposits in the banking system if, for instance, these funds pay a higher interest rate than that available on a deposit,²⁵ or if they are not subject to withholding taxes payable on interest from deposits. MMFs managed globally \$4.76 trillion as of end 2013 (nearly 16 percent of total assets under management in mutual funds)²⁶ and are one of the pillars of the shadow banking system. The downside to this is that if MMFs are major providers of short-term finance to corporates or banks (as in the United States), and there is a run on one or more of such funds, this could disrupt the flow of short-term funds to corporations, financial institutions, and governments, thus potentially presenting systemic risk.

Asset Accumulation

An estimated 76,200 mutual funds worldwide currently control about \$30 trillion²⁷ in assets under management, representing just over 20 percent of total global assets under management on behalf of investors worldwide (see figure 1.1).²⁸ The mutual fund industry has been characterized as “one of the most successful financial innovations.”²⁹ Various reasons have contributed to the strong growth of the mutual fund industry globally. Fernando et al. refer to the global development of capital markets, which has contributed to investor confidence in the integrity, liquidity, and efficiency of financial markets, and market-based financial

Figure 1.1: Global Mutual Fund Assets under Management (in \$ trillions)

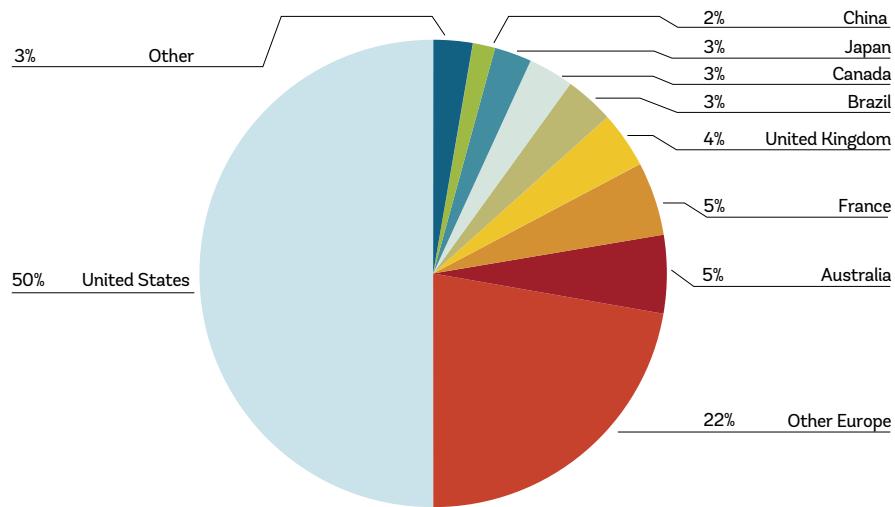


Source: ICI 2014.

systems as being factors that led to this growth.³⁰ At the level of the individual investor, with globalization has also come increasing awareness of investment products, rising personal incomes, and a stronger appetite for risk—all of which contribute to the attractiveness of investment products such as mutual funds. Following the 2007–2008 Global Financial Crisis, net sales were generally positive but somewhat volatile, and total global mutual fund assets under management took until 2012 to pass the previous peak of \$26.2 trillion achieved in 2007.³¹ Mutual funds sales worldwide have benefited from the opportunities presented by the growth of retirement assets, particularly defined contribution pension plans.³²

Ninety percent of global mutual fund assets³³ under management derive from developed markets. The United States has by far the largest mutual fund market worldwide with more than 50 percent of global mutual fund assets under management.³⁴ European funds, propelled by a cross-border regional market,³⁵ collectively manage just over 30 percent of global mutual fund assets.³⁶ Some European markets have a high proportion of mutual fund assets expressed as a percentage of gross domestic product (GDP); for example, France's mutual fund sector has assets valued at almost 57 percent of GDP. Figure 1.2 and box 1.2 show the other key worldwide markets for mutual funds.

Figure 1.2: 2013 Largest Mutual Fund Assets under Management by Country/Region



Source: ICI 2014.

Box 1.2: Key Mutual Fund Markets Worldwide

United States

With net assets of more than \$15 trillion at year end 2013, or almost half of total global mutual fund assets under management, the world's largest mutual funds industry is located in the United States. Just over 46 percent of all U.S. households owned mutual funds at that date, many of them through retirement plans.³⁷

Europe

Collectively European funds constituted just under a third of global mutual fund assets (\$9.4 trillion) at year end 2013. Two international financial centers for funds sold across borders, Ireland and Luxembourg, respectively accounted for \$1.4 trillion and \$3 trillion of these assets.³⁸ At year end 2013, France (\$1.5 trillion) and the United Kingdom (\$1.2 trillion) were the largest domestic mutual fund markets in Europe.

Financial integration in Europe has also catalyzed the development of a single market for mutual funds. Under the Undertakings for Collective Investment in Transferable Securities (UCITS) directive, mutual funds can be marketed across borders; that is, a fund that is formed and approved in one European Economic Area (EEA)³⁹ country under the directive can be marketed in another EEA member country, without additional approval.

At the end of December 2013, the total value of European mutual funds was \$9.3 trillion deriving from 34,743 funds, compared with \$15 trillion invested in 7,582 U.S. mutual funds at the same date.⁴⁰

Asia-Pacific

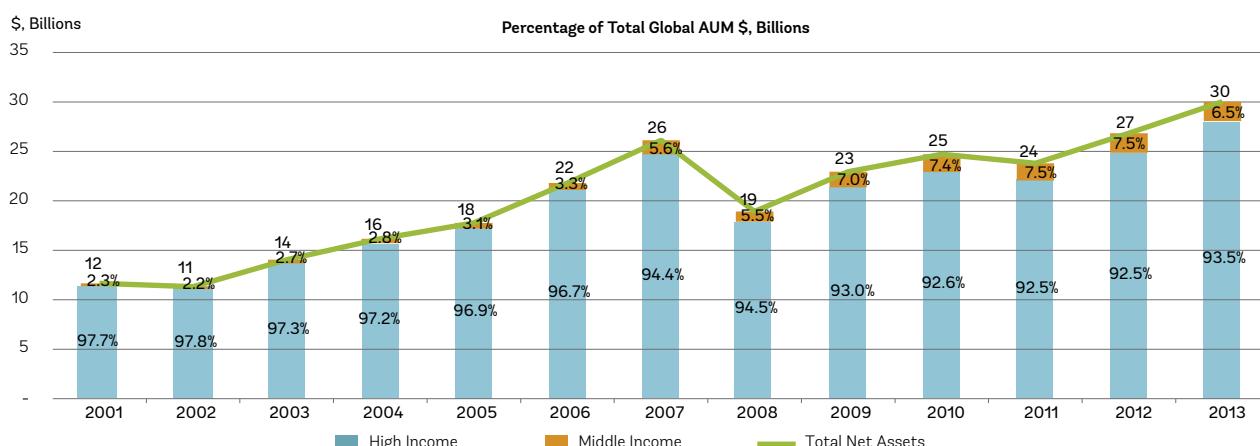
At year end 2013, the Asia-Pacific region controlled \$3.4 trillion in mutual fund assets, with approximately half the assets held by mutual funds in Australia (\$1.6 trillion and 1,415 funds). China (\$479 billion and 699 funds) and Japan (\$774 billion and 4,922 funds) also have sizeable mutual fund sectors.⁴¹

Mutual fund sectors are becoming increasingly common in developing countries, despite still being quite small. According to data collected by ICI, mutual fund assets under management in middle-income countries have grown from 2.3 percent of global mutual fund assets in 2001 to 6.3 percent in 2012,⁴² although high-income countries held over 93 percent of assets under management (see figure 1.3). But emerging markets, with the notable exception of Brazil, often have relatively small mutual fund sectors. At year end 2013, Brazil had the fifth largest domestic fund market globally and the largest mutual fund industry in the developing world, with more than \$1 trillion of assets under management and an unusually large number of funds, totaling just over 8,000.⁴³ The next largest market in Latin America was Mexico, with roughly a tenth of Brazil's mutual fund assets (or \$120 billion in assets under management [AUM]) at the end of 2013. Most other emerging market mutual

fund sectors are much smaller in comparison to Brazil in terms of size. China (\$479 billion) and Korea (\$285 billion) are the largest mutual fund industries after Japan in Asia. In Africa, the largest market is South Africa, with \$143 billion at year end 2013. Nigeria has the second largest market in Sub-Saharan Africa, with \$953 million in AUM at year end 2013,⁴⁴ and Kenya, with approximately \$270 million in AUM in mid-2012, is the smallest mutual fund sector included in this analysis. In Europe, the smallest mutual fund sector among developing countries was Bulgaria with \$504 million at year end 2013; Turkey, a case study country, with \$14 billion under management, is the tenth smallest market in Europe.⁴⁵

Mutual fund sectors across developing countries have experienced variable growth. As figure 1.4 shows, mutual fund sectors in several emerging markets have recorded double-digit

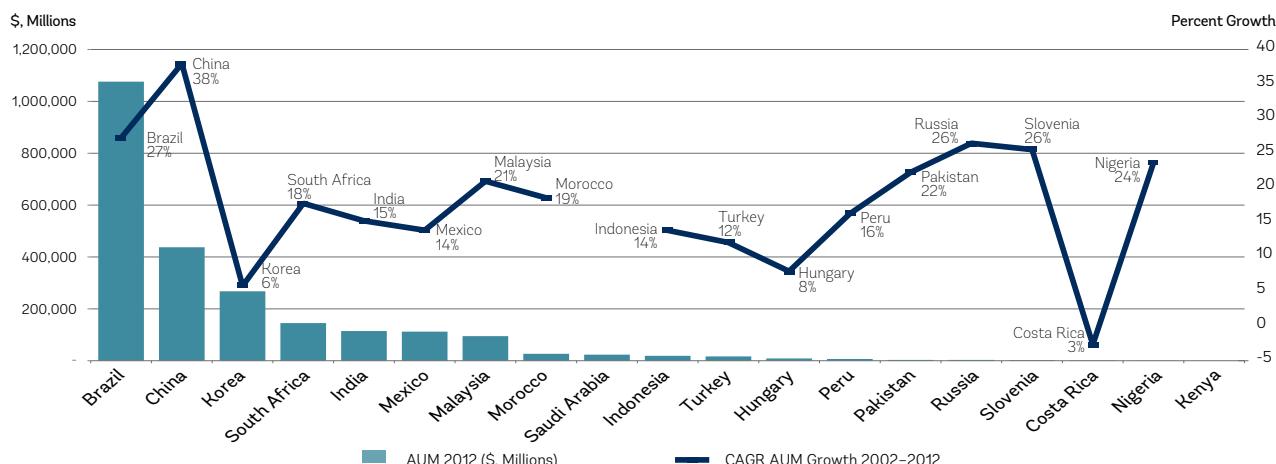
Figure 1.3: Total Mutual Fund Assets under Management: High-Income MF sectors versus Middle-Income MF Sectors



Source: ICI data using World Bank group country classifications as of 2013.

Note: This information is derived from the ICI Global Mutual Fund Sector database, which did not include any low-income countries. High-income countries are both OECD and non-OECD.⁴⁶

Figure 1.4: 2012 Mutual Fund Assets and Compound Annual Growth Rate, 2002–2012

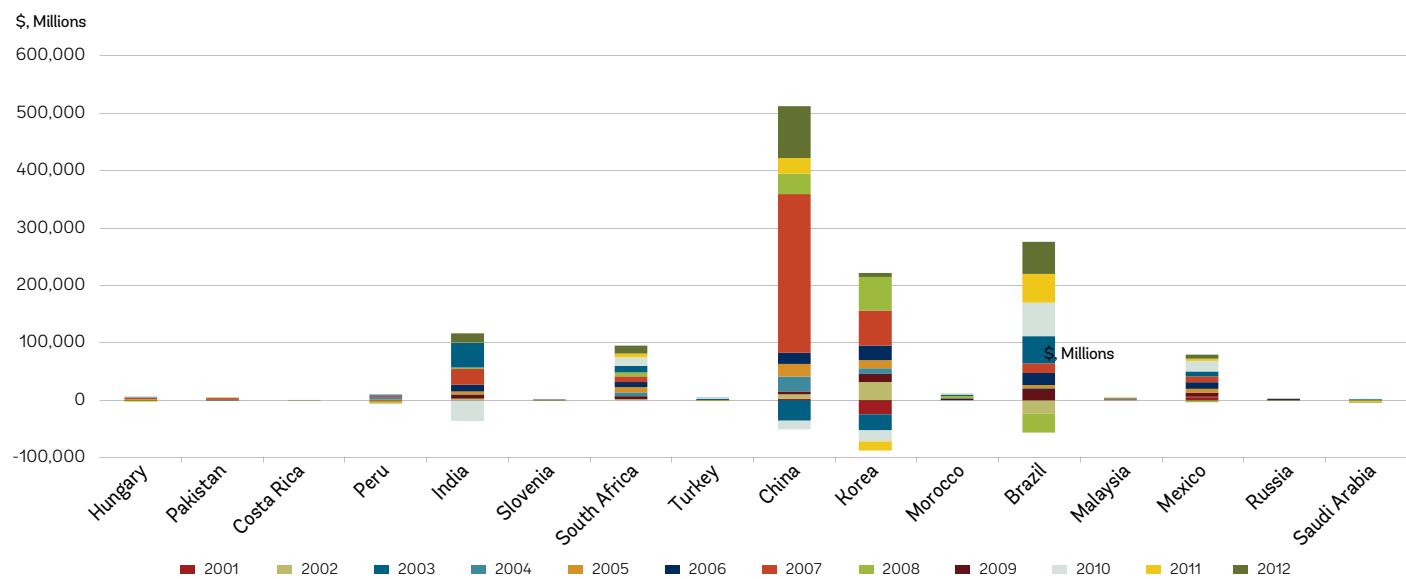


Sources: IOSCO Survey, ICI, trade associations, World Bank case studies, regulator websites and data. Source of 2002 data for developed countries is Investment Company Institute Fact Book 2005, table 44, http://www.ici.org/pdf/2005_factbook.pdf

Note: For Morocco and Russia, 2011 numbers have been used, because data for 2012 were unavailable.

growth rates in the last 10 years, versus developed markets such as France (6 percent), Japan (9 percent), the United Kingdom (13 percent), and the United States (7 percent).⁴⁷ For instance, figure 1.4 shows that Brazil (27 percent) and China (38 percent) have experienced considerable annual growth between 2002 and 2012 in their mutual fund sectors. China's growth has been particularly striking, from \$17 billion in 2002 to almost \$440 billion in 2012, aided by strong sales in the mutual fund sector as shown in figure 1.5. Although Nigeria, Pakistan, Russia, and Slovenia still had relatively small mutual fund markets of around \$700 million to \$3 billion in AUM at the end of 2012, these industries have experienced considerable growth over the last 10 years, as displayed in figure 1.5. Nigeria's mutual fund sector grew from \$77 million in 2002 to over \$600 million in 2012; Pakistan's mutual fund sector grew from \$425 million in 2002 to over \$3 billion in 2012; Russia's mutual fund sector grew from \$372 million in 2002 to more than \$3 billion in 2011,⁴⁸ and Slovenia's mutual fund sector experienced pronounced growth from \$244 million in 2002 to over \$2 billion in 2012. On the other hand, Korea's mutual fund sector has experienced 6 percent growth, in line with developed nations, whereas Costa Rica's mutual fund sector shrank (-3 percent) over the last 10 years. The reasons for such growth vary from country to country and are due to complex interactions between a range of factors, such as mutual funds' relative tax efficiency, the availability of investments, whether pension funds and insurance companies have developed and if so whether they are able to invest in mutual funds, and the rates of return mutual funds can achieve relative to those available on bank deposits and other competing investments. As an example, a key driver of sales of bond and equity funds in developed markets in recent years has been the very low levels of interest available on bank deposits, which has caused savers to seek out investments with higher yields.

Figure 1.5: Annual Net Sales, 2001–2012



Sources: IOSCO survey, ICI, trade associations, World Bank case studies, regulator.

Note: Indonesia, Kenya, and Nigeria are not included because net sales data are unavailable

Enabling a variety of fund structures allows greater flexibility in marketing to investors and can help accumulate assets in both developed countries and emerging markets. The master-feeder structure, for instance, is a relatively rare structure globally that is widely used in Brazil and accounts partly for the proliferation of funds in this market; it is used to enable investment in foreign funds, which otherwise is not permitted in Brazil. The master-feeder structure allows one fund—the feeder, based in country A—to have essentially only one investment—shares or units in a “master” fund, based in country or territory B. Any number of feeder funds can invest in a master fund. Thus, for example, within the EU, feeder UCITS created and based in France, Germany, Italy, Spain, and the United Kingdom could buy units in a master UCITS, based in Luxembourg, which in turn invests in European equities. This structure and other structural variants are discussed in more detail in chapter 2.

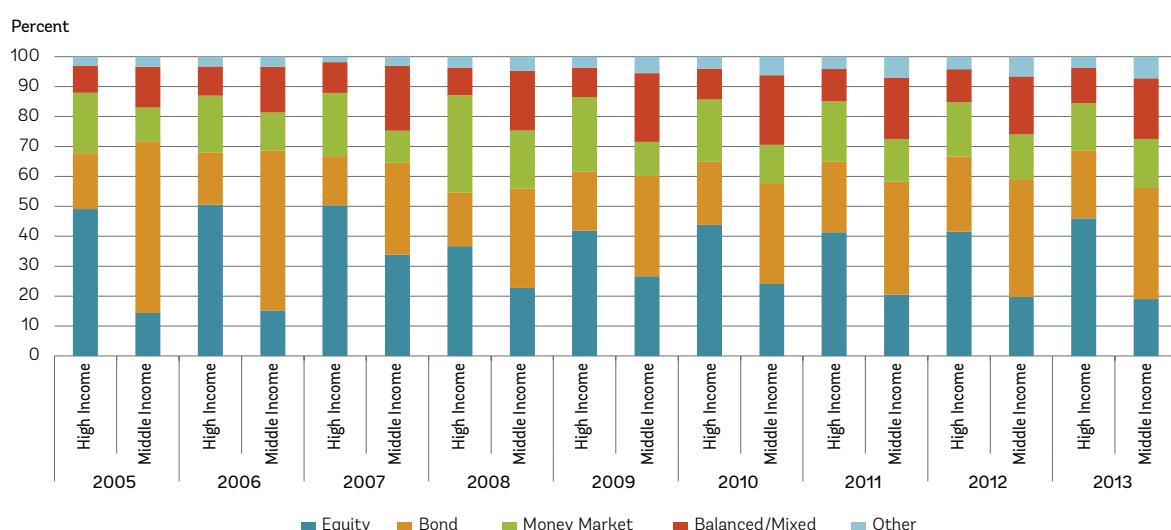
Financial Intermediation and Mutual Fund Investments

Mutual funds invest in tradable securities that are grouped by asset class. Mutual funds typically consist of four main types of funds, which are defined by the regulator or trade association: (1) funds that invest predominantly in equity securities, financing companies; (2) funds that invest predominantly in debt securities, financing governments or companies; (3) funds that invest in a hybrid of both equity and debt securities; and (4) funds that invest in short-term debt instruments (MMFs), financing governments and companies. Funds can be further subdivided by investment objective (income, growth, capital preservation, or a mixture of these) or by geographic focus (e.g., global equity) or sector focus (e.g., technology stocks).

Mutual fund sectors in developed and developing markets have varying asset class exposures. Figure 1.6 shows ICI data for mutual fund sectors in high-income versus middle-income countries, broken down by asset class exposure. These data show that over the last eight years high-income country mutual fund sectors have had on average over 40 percent of assets invested in equity funds and roughly 20 percent or less invested in bond funds. MMFs ranged from 16 percent to 31 percent of assets, but only about 10 percent of assets was invested in hybrid funds. For example, in the United States, equity funds constituted over 50 percent of U.S. mutual fund assets at year end 2013, and funds that invested primarily in U.S. domestic equity held 38 percent of total mutual fund assets. Bond funds constituted 22 percent of

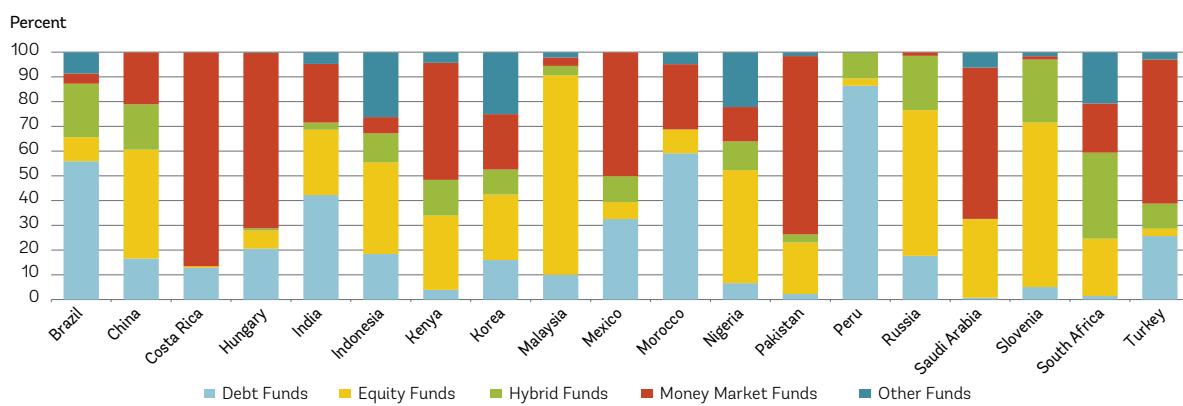
U.S. mutual fund assets.⁴⁹ Although the data for middle-income countries are limited to 14 countries in this database, it shows that in these countries, assets invested in equity funds have been limited to an average of approximately 20 percent over the last eight years, but assets invested in bond funds are almost double this at about 40 percent. Assets invested in MMFs were about 15 percent, whereas those invested in balanced funds were about 20 percent. In emerging markets, mutual funds generally have higher exposures to fixed-income and money markets (short-term debt instruments) and less exposure to equities. Figure 1.7 shows the value of assets invested in the different categories of mutual fund at year end 2012 for various economies. Exposure to equities is often low in emerging markets, with among the lowest worldwide

Figure 1.6: ICI Data for Mutual Fund Sector Asset Exposure: High-Income versus Middle-Income Countries



Source: ICI 2014.

Figure 1.7: 2012 Mutual Fund Asset Exposure Broken Down by Asset Class



Sources: IOSCO survey, ICI, trade associations, World Bank case studies, regulator.

Note: For Malaysia, Morocco, Peru, and Russia, 2011 numbers were used because 2012 numbers were unavailable. For Kenya, June 2012 numbers from a World Bank case study were used.

being Costa Rica (1 percent), Mexico (7 percent), Peru (3 percent), and Turkey (3 percent). In countries such as Brazil and Peru, mutual funds have significant exposure to bonds. In Peru, for instance, 96 percent of assets under management in mutual funds are invested in fixed-income or MMFs.⁵⁰ Similarly, in Morocco 85 percent of the total value of mutual funds is invested in fixed-income and MMFs. In fact, Moroccan mutual funds were heavily invested in government securities in the early 2000s and started to diversify only in the middle of the last decade. However, since 2002, corporate securities have been growing steadily, and corporate bonds represent 13 percent of total assets under management in Morocco.⁵¹ Chapter 3 discusses some of the reasons for such trends.

High MMF exposures in many emerging markets imply that these sectors are as yet failing to mobilize savings into longer-term instruments. Figure 1.7 shows this to be the case in countries such as Costa Rica (87 percent MMFs), Hungary (71 percent), Mexico (50 percent), Pakistan (72 percent), Turkey (58 percent), and Saudi Arabia (61 percent). In Turkey, the mutual fund sector has been dominated by MMFs—almost 60 percent of AUM at end 2012. In Morocco, MMFs represented more than 25 percent of total AUM at the end of 2011 and have been growing at an average annual rate of 23 percent since 2005. Chapter 3 provides some reasons why MMFs tend to be successful in many emerging markets.

Ownership of Mutual Funds: Institutional and Retail Investors

When analyzing mutual fund ownership, what is categorized as an institutional or a retail investor may vary from country to country. “Retail” investors are individuals that make their own decisions (whether with or without advice) to buy and sell mutual fund shares or units. An institutional investor is an investment vehicle that gathers money from a number of persons (legal or physical), and whose manager takes the investment decisions as to what to buy and sell for the fund’s portfolio in alignment with its objectives but without reference to members of the scheme. However, the distinction made between what is categorized as a retail and institutional investment in a mutual fund can vary, so that it is difficult to make definitive comparisons. In some cases, there may, of course, simply be no data, if countries do not differentiate between retail and institutional sales in their statistics; this is the case, for instance, in Kenya. In some countries sales may be classified as retail, which in other countries may be classified as institutional. This is a particular problem for sales that are made through defined contribution pension schemes, which, for example, in the United States are categorized as retail (since the mutual fund investments held by the scheme are chosen by the individual), whereas in France these “workplace pensions” are categorized as institutional. Of course, at the end of the day, all demand derives from individuals because it is their money that contributes to pension schemes and pays for insurance policies.

Institutional investors are often active and substantial owners of mutual funds in both developed and developing countries, but in some emerging markets, retail investors are more dominant. Often a key driver of institutional investment into mutual funds is

whether, and to what extent, their legal and regulatory framework allows such investors to invest in mutual funds.⁵² Institutional investors may be a significant force in mutual fund markets. The Moroccan mutual fund industry has achieved remarkable growth—approximately 20 percent per annum over the last decade—largely because of institutional investors⁵³ that own more than 90 percent of total assets under management. In Brazil, only 18 percent of assets under management was held by retail investors; the rest was owned by pension funds, corporates, public institutions, foreign investors, and others.⁵⁴ However, institutional investment is not always dominant in mutual fund sectors. In 2012, institutional investment in mutual funds in Turkey was only 1 percent, which is probably partly because both pension schemes and life insurance were at the early stages of development.⁵⁵ This is very low when compared to France (69 percent) or Germany (54 percent) where workplace pensions and special investment funds for institutional investors, respectively, are significant owners of mutual funds. It is low even in comparison with Hungary (6 percent) and Romania (4 percent).⁵⁶ Peruvian pension funds, on the other hand, typically do not own domestic mutual funds, but instead channel their capital to foreign mutual funds such as UCITS based in Dublin or Luxemburg. Chapter 3 discusses some of the reasons for variance in institutional demand.

Distribution of Mutual Funds

Distribution of mutual funds primarily refers to how mutual funds are sold to the public, which may be through affiliated or unaffiliated entities (see box 1.3). Mutual funds may also be sold “direct” through direct mail, advertising, or their website without the intervention of a distributor.

In many countries, individuals may choose mutual funds as underlying assets of their pension plan. Employer-sponsored defined contribution plans typically deduct savings from employee paychecks to allocate toward retirement (the employer may also contribute). The employee can then choose to invest these savings in a menu of funds. Similarly, individuals using a personal pension plan can choose to use mutual funds as their underlying investment (e.g., U.S. IRAs). This form of defined contribution scheme is in effect a personal account that is a tax-efficient “wrapper.” The wrapper holds retirement savings that are chosen by the individual concerned (with or without advice). This type of defined contribution scheme is less common in developing markets, where the well-known Chilean model can be seen instead. For instance, in Peru and in Turkey, individuals select the pension scheme that they wish to invest in, and the manager invests their savings according to stated objectives.

Distribution channels are usually more diversified in developed countries with larger and more affluent populations and individuals can choose a pension plan. Although banks often dominate retail distribution of funds in developed countries, this varies from country to country and over time. In continental Europe when the first UCITS directive was passed in 1985, banks were the predominant distributors of mutual funds. However, over time as investor affluence and knowledge have grown, more providers of financial advice have developed and more investors have started to

Box 1.3: Captive and Third-Party Distribution Channels

A “captive” distribution channel is usually part of the same corporate group as the entity that operates the fund and typically will only sell the funds of the in-house fund operator. The most typical example of this is a bank that owns a fund management company and sells its mutual funds through bank branches. Another example would be an insurance company that owns a fund management company and uses its insurance direct sales force/agents to sell its funds.

In contrast, a “third-party” distribution channel is independent of the operator of the fund and its affiliates. Third-party distribution channels include sales through independent financial advisors,⁵⁷ private banks,⁵⁸ wealth management firms, and securities brokers. In turn, these advisers may receive fees and commissions from the fund’s operator (or more rarely the fund) for successful sales⁵⁹ or be remunerated by way of fees payable by the client.

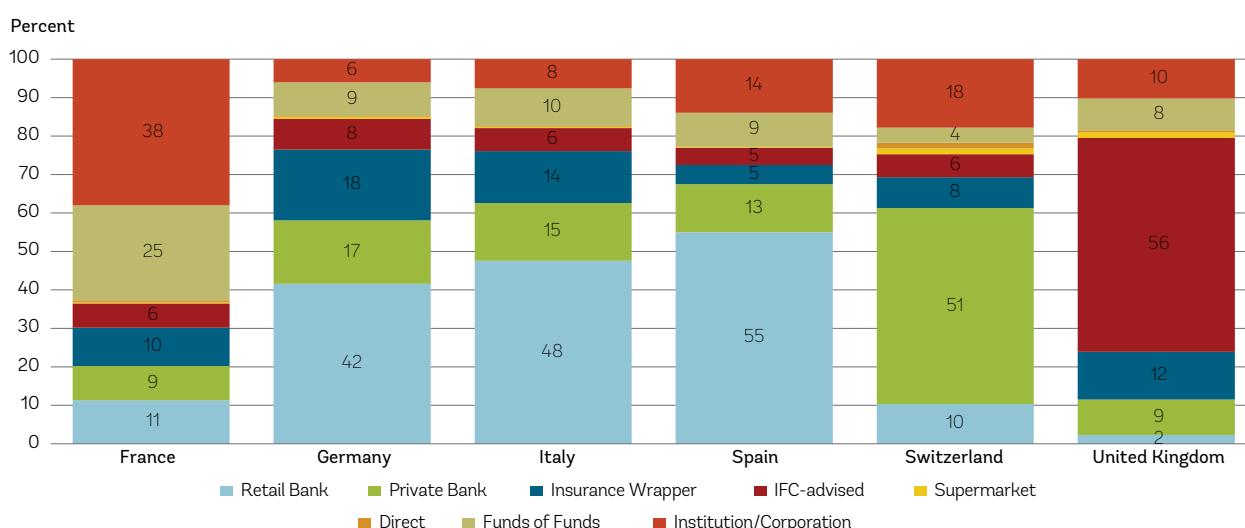
In many countries “fund supermarkets” provide third-party (usually online) platforms that house information on funds and allow different investment managers or fund families to sell their funds to individuals who use that platform. Such platforms may be owned by unaffiliated third parties, but they may also be owned by fund management companies; increasingly they provide services in more than one country in a region.

seek out funds other than those offered and managed by affiliates of the banks they use. The growth of distribution through private banks, financial advisers, and fund supermarkets in recent decades is associated with these trends. Figure 1.8 shows that retail banks still dominate distribution in Germany, Italy, and Spain, but distribution channels in France are more diverse. Bank sales of funds of funds (funds that invest in other funds that may or may not be managed by nonaffiliated entities) and “open architecture” sales by banks of nonbank managed funds may have assisted in maintaining bank dominance. However, they have also enabled nonbank-managed funds to access bank distribution in recent years. In the United Kingdom, on the other hand, banks historically have not been major distributors of funds. This may partly have been because U.K. banks preferred to retain deposits and maintain lending capacity, and partly because of concerns that if they sold

funds that performed badly, clients might exit the bank relationship altogether. As figure 1.8 shows, the majority of retail distribution in the United Kingdom take place via independent financial advisers.

In emerging markets, the range of retail distribution channels tends to be narrower, and banks tend to be dominant (see table 1.1). Less developed emerging markets do not typically feature independent financial advisers or fund supermarkets, because these businesses would not be financially viable in a nascent financial market: There will simply not be enough demand for their services.⁶⁰ In Uganda, for example, the only major financial adviser is foreign owned and primarily services those who invest offshore. Given that banks typically have a large and established client base and nationwide branch networks, they are clearly well placed to sell financial products, such as mutual funds, to their clients and indeed can add another revenue stream

Figure 1.8: Distribution Channels for Mutual Funds in Selected European Countries, 2011



Source: MackayWilliams LLP.

Table 1.1: Main Distribution Channels for Mutual Funds by Country, Year End 2012

Country	Banks	Insurance Companies	Securities Brokers	Financial Advisers	Sales Agents	Fund Supermarket
Brazil	✓					
China	✓		✓		✓	✓
Costa Rica			✓	✓	✓	
Hungary	✓		✓			
India	✓			✓	✓	
Indonesia	✓		✓			
Kenya		✓	✓	✓		
Korea	✓		✓	✓	✓	
Malaysia	✓		✓		✓	
Morocco	✓		✓			
Pakistan	✓		✓	✓	✓	
Peru	✓		✓			
Saudi Arabia	✓		✓			
South Africa	✓	✓			✓	
Turkey	✓		✓			

Source: IOSCO survey.

by doing so.⁶¹ In Turkey until 2012 mutual funds were predominantly both founded by, and distributed by, banks; indeed only financial intermediary institutions such as banks and brokerage firms were allowed to distribute funds. Similarly, in Brazil banks not only dominate distribution of mutual funds to retail investors; they also administer these funds. In Peru, mutual funds are sold almost exclusively to the customers of the banks that own the fund management companies who control 96 percent of assets under management. Sales of mutual funds (and many other financial products) in nascent markets will tend to be driven by commissions to distributors rather than suitable advice to potential investors. Chapter 3 discusses some of the ensuing consequences of this domination by banks, such as the rise of barriers to entry for new players and switching costs for clients.

Direct sales by fund management companies to retail investors usually represent a lower proportion of fund sales. Typically “direct” sales are conducted through mail, e-mail, advertisements in print media, or the website of the promoter, but in recent years this has not been a major distribution channel, as is indicated in figure 1.8 on European fund distribution. In Kenya, for instance, “direct” sale of unit trusts is understood to be minimal. In Morocco, only one of the 16 asset management companies actually distributed its mutual funds through the Internet.⁶² “Pure” online sales of funds are usually not possible unless electronic signatures are legally enabled in the country concerned. In many (developed and developing) countries an investor can open an account to purchase and redeem units only by providing a physical document with “wet ink” signature, although they can trade online using security codes thereafter.

Institutional sales, such as to insurance companies or pension schemes or corporations and funds of funds, are usually also made directly between the fund management company and the potential client. For instance, Brazil’s “exclusive funds” discussed above are sold directly to clients and not through third-party distributors. Similarly, in Morocco, because institutional investors dominate, mutual funds are generally distributed directly by fund management companies to large investors such as insurance companies, pension funds, and commercial companies.

Mutual Fund Charges

Operators of mutual funds typically receive two types of remuneration: (1) charges levied on investors as they buy fund shares or units, or sell fund shares or units and (2) annual management charges. The entry charge levied on an investor when they buy shares or units in a fund is essentially designed to remunerate the fund management company for the cost of attracting that investor to the fund. An exit charge, if payable, is typically levied only on an investor who is redeeming a fund share or unit that was not subject to an entry charge.⁶³ Such a charge is designed to disincentivize redemption in the short term. An annual management charge is levied on the fund to compensate the operating entity for the cost of managing the fund. From an investor’s point of view, the performance of the fund equals the returns on the fund, minus its charges and any other expenses. Therefore the higher the costs related to entering or leaving a fund, or being an investor in a fund, the lower the return to the investor. This highlights a fundamental conflict of interest between the fund management company and the investor: The fund management

company is motivated to maximize potential profitability by levying as high a charge as is feasible whereas the investor wishes to pay the lowest charges possible to maximize returns. Funds may be able to issue different classes of units or shares, each of which may have a different charging structure related to the way those shares or units are distributed and the associated cost of this type of distribution. (See box 1.4 for details; table 1.2 shows typical fees for different types of funds.)

Annual management charges vary according to the class of assets in which the fund invests, and in most countries this charge is expressed as a stated percentage of assets under management, regardless of the size of the fund. In both emerging markets and developed markets, charges are typically lower for MMFs, higher for bond funds, and highest for equity funds and for

funds of funds. When funds are small (e.g., \$10 million or less) most service providers will not earn enough from a percentage-based fee to cover their costs, so they will tend to charge a stated flat fee for their services, which can lead to high annual costs for funds. A study of European equity funds sold across borders showed that funds with €10 million or less under management had additional annual operating costs (excluding the cost of buying and selling fund assets) of around 2 percent on top of annual management charges of around 1.4 percent, totaling 3.4 percent, whereas funds with €500 million or more under management had additional costs of around 0.2 percent on top of annual management charges of around 1.4 percent, totaling 1.6 percent.⁶⁶ The U.S. mutual fund market is an exception, where a fund may report, for example, a management fee of 0.40 percent on the first \$500 million in assets, 0.35 percent on all assets between \$500 million and \$1 billion, and

Box 1.4: Fund Charges and Share Classes

Annual Management Charge

The annual management charge, usually defined as a percentage of the value of fund assets, is paid by the fund to the fund management company or founder. This charge is primarily for selecting and managing the portfolio of the fund.

Other Annual Costs Paid by Funds

Although the cost of servicing investors in the fund is sometimes covered by the annual management charge, typically a separate administration or registration charge is made to the fund to cover such costs. The fund may also pay other charges separately for board remuneration and costs, fund administration, safe keeping of assets (custody), and supervision by a trustee or depositary (these may be a stated amount or a percentage of value or a mixture of these). One-off costs such as audit and legal fees are also typically paid by the fund. The investment research firm Morningstar finds that annual expenses are the most reliable predictor to a fund's performance; thus investors are best off with funds that have low annual expenses.⁶⁴

Entry Charge

Fund management companies have historically paid sales commissions to those who sell funds on their behalf (distribution channels), although this trend is changing in some developed and developing markets. Typically the fund management company pays the distributor an introductory commission from the entry charge it receives from investors subscribing to the fund and/or a "trail" commission (a percentage of the annual management fee that is paid annually for as long as the investor remains in the fund). Usually the fund management company negotiates the level of commission payable with the distributor concerned. However, increasingly in developed markets regulation requires investors, rather than the fund management company, to agree to any fee or commission payable with the distributor.⁶⁵

Exit Charges

Exit and redemption charges are paid by the investor when they leave the fund. These charges help the fund management company manage the daily flows out of the fund.

Share Classes and Charging Structures

A fund can issue different classes of units or shares, each of which may have a different charging structure. As a general rule, the higher the charges of a fund, the more likely higher commissions are being paid to a distributor.

For instance:

- *Institutional investors:* Funds can issue a class of shares to institutional investors with no entry and no exit charge and a lower annual management charge (since in this case distributors are not being paid commissions).
- *Retail investors reached through a distributor:* Funds can issue a class of shares to retail investors through a distributor, with higher entry charge and higher annual charge (used to pay commission to that distributor) but no exit charge.
- *Retail investors reached directly:* Funds can issue a class of shares sold directly to the retail investor by the fund management company that may have no entry charge, a fairly high annual charge, and an exit charge.

Table 1.2: Typical Fund Charge Rates

Fund Type	Entry Charge		Annual Management Charge		Redemption Charge	
	Developed	Emerging	Developed	Emerging	Developed	Emerging
Money market funds	0–1%	0–5%	0.1–0.5%	0.25–2.68%	0%	0–3.6%
Equity funds	0–6	0–6.5	0.1 ^a –2	0.75–7.25	0–5	1–10
Bond funds	0–5	0–5	0.5–1.5	0.2–3.15	0–5	0–3.6
Mixed funds	0–6	0–5	0.5–2	0.39–7.15	0–5	0–4.2

Sources: World Bank–IOSCO survey and World Bank estimates.

a. The lowest charges are typically associated with exchange traded funds or indexed (passively managed) funds.

0.30 percent on assets in excess of \$1 billion. Thus, if the fund contains \$1.5 billion in total net assets, the management charge is scaled back accordingly.⁶⁷ This sliding scale is not, however, a common practice globally.

Annual management charges can often be higher in developing countries (see table 1.2). In developed markets, generally, a 2 percent annual charge would be on the highest end of the scale. Funds in emerging markets may have few economies of scale and therefore may need to charge higher fees. In Kenya, annual management charges of most mutual funds can be as high as 3.5 percent. In Turkey, banks used to charge 5.5 percent in annual fees for MMFs (the most popular mutual fund in Turkey), which is exorbitant by international standards because typically annual costs for such funds are less than 0.8 percent; however, this level of charges was acceptable in an environment where MMFs were sold by banks for clients to receive interest where none was payable on current accounts and when interest rates were as high as 50 percent. The Turkish regulator subsequently capped the annual fees on these MMFs at 1.1 percent;⁶⁸ this made operating such funds much less remunerative, and with spreads on lending becoming more attractive, banks had a greater incentive to promote deposits. Even in Brazil, where the mutual fund sector is large, the taxa de administração or annual management charge can range from 0 percent to 3 or 4 percent for some retail equity funds.⁶⁹ Cultural attitudes to charges vary: In some countries, investors may resist high entry charges but not resist high annual management charges, whereas in others they may not resist high entry charges but are deterred by high annual charges. Investor preference may also be influenced by how long they intend to stay invested: Those that have shorter horizons would clearly prefer low or no entry charges, and longer-term investors would prefer the opposite.

We see a trend away from entry and exit fees caused by regulatory change in some developed and emerging markets. Regulators increasingly are requiring investors to agree or to pay commissions to distributors instead of the fund management company agreeing these with the distributor. This has the effect of reducing or eliminating entry charges. In some markets regulators are concerned that if there are high exit fees these may deter investors from exercising their key right—that is, to redeem—and regulators may seek to place limits on such charges. In Canada, as of December 2011, investors had purchased more than 30 percent of mutual fund assets at “no load”; that is, the fund or investor did

not offer sales commission to an advisor (e.g., direct sales), nor were the investors charged for exiting the fund.⁷⁰

Interdependency with Banks, Pension Funds, and Insurance Companies

Many mutual fund markets, both developed and developing, display a significant interdependency between banks and mutual funds. This is partly because banks often own mutual fund management companies and distribute mutual funds but also because mutual funds may invest in banks and also compete with bank products.⁷¹ For example, shares in banks may be listed and form a major part of stock market capitalization and so form part of the portfolio of equity funds. In emerging markets, typically a few fund management companies control the bulk of mutual fund assets, and banks often dominate the mutual fund sector either directly (as in Turkey where banks have been able to found funds) or through owning investment management firms (as in continental Europe). For instance, in Peru, at the time of the case study, four banks, each owning a fund management company,⁷² controlled 95 percent of assets under management. Banks also often dominate mutual fund offering and distribution. This dynamic can pose potential conflicts because MMFs are essentially a substitute for bank deposits.⁷³ (See chapter 3 for more on this discussion.) MMFs also may invest to a substantial extent in certificates of deposit (CD) and commercial paper issued by banks and in repos, creating another source of interdependency.⁷⁴ A rapid decline of MMFs could thus have an impact on liquidity for the banking sector. As at year end 2011, more than 50 percent of Turkish MMF assets were invested in reverse repos⁷⁵ where banks were the main counterparties. In Morocco, mutual funds held more than an estimated 30 percent of assets under management in bank bonds or equity. Moroccan mutual funds have also provided significant liquidity to the banking sector in the form of repos, term deposits, and CDs.⁷⁶

Mutual fund sectors also display significant interdependency with pension funds and insurance companies, because longer-term mutual funds compete with pension funds or insurance products, and mutual funds are often the underlying investment for these institutional investors. In countries where contributions to pension schemes are mandatory, individuals are less likely also to voluntarily make additional investments such as in mutual funds. In such cases, if these pension schemes cannot themselves invest into mutual funds (because of law or regulation) or do not invest in

them (because they offer no advantage), it is not likely mutual fund sectors will expand—with the possible exception of MMFs, but these would have to be more tax efficient than bank deposits or produce higher levels of interest. In Peru, the domestic mutual fund sector is small both because individuals are mandated to save 10 percent of their salary into pension schemes and because these schemes do not invest in domestic mutual funds (although they do invest in mutual funds based outside Peru for international exposure). In Australia, by contrast, where 9.5 percent (rising gradually to 12 percent in 2019) of one's salary must be contributed to mandatory pension savings (known as superannuation), mutual funds have been used extensively as an underlying investment, and the mutual fund sector has expanded strongly, being the second largest domestic market in the world at the end of 2013. (This is discussed more in chapters 2 and 3.) Similarly, longer-term mutual funds may compete with life insurance savings products, while also benefiting from investments of insurance companies as institutional investors or being used by them for unit-linked products. Insurance companies may also own fund management companies and distribute mutual funds. In Kenya, for instance, three fund management companies owned by insurance firms managed an estimated 70 percent of mutual fund assets, and the majority of retail sales were thought to derive from insurance sales forces. Last, both pension funds and insurance companies may outsource their asset management to fund management companies that run mutual funds.

In Summary

- 1. A mutual fund is a form of collective investment scheme or investment fund; that is, it is a pool of savings typically collected from multiple investors who buy shares or units representing proportionate ownership of the fund.** The resulting pool of funds, or the fund's capital, is collectively managed by a professional management company, in line with the investment objective outlined in the fund's prospectus. This form of collective investment scheme is closely regulated because it is legally eligible to gather savings from the public and is required in turn to invest those savings in a diversified portfolio of transferable/tradable securities.
- 2. Mutual funds can be a major channel of intermediation between savers and borrowers, gathering savings and investing them into shorter- or longer-term securities issued by governments and corporates.** These funds are a valuable investment vehicle for retail investors, institutional investors, and corporates. They may play a significant role in investing for retirement as well as serving as an underlying investment vehicle for insurance companies. MMFs may play an important cash management function where they are used by corporates for treasury management.
- 3. Mutual funds typically consist of four main types of funds, which are defined by the regulator or trade association:** (1) funds that invest predominantly in equity securities, (2) funds that invest predominantly in debt securities, (3) funds that invest in a hybrid of both equity and debt securities, and (4) funds that invest in short-term debt instruments (MMFs).
- 4. Mutual funds are essentially designed to provide diversification of risk for smaller savers who do not have enough money to achieve this diversification themselves; thus, they tend to be a middle class savings vehicle.** However, institutional investors are often active and substantial owners of mutual funds in both developed and developing countries. In some emerging markets, institutional investors are not as dominant, sometimes because the institutional investor base itself is small or because these investors channel investments elsewhere.
- 5. Distribution channels for mutual funds are usually more diversified in developed countries with larger and more affluent populations, although banks often play a large part.** In emerging markets, the range of retail distribution channels tends to be narrower, and banks tend to be the dominant distribution channel. Although the operator is responsible for the sales policy and distribution of a mutual fund, licensed distributors usually sell the fund(s) on the operator's behalf.
- 6. The scale and success of development of mutual funds in any one country is the outcome of complex interactions between a variety of factors,** such as mutual funds' relative tax efficiency, the availability of investments and of investments that offer real rates of return, whether pension funds and insurance companies have developed and are able to invest in mutual funds, and the rates of return mutual funds can achieve relative to those available on bank deposits and other competing investments.
- 7. The next chapter provides an overview of the legal and regulatory drivers and impediments related to mutual fund sector growth.**

Endnotes

1. These middle-income countries included Argentina, Brazil, Bulgaria, China, Costa Rica, Hungary, India, Mexico, Pakistan, Philippines, Romania, South Africa, and Turkey. The study uses World Bank definitions of developed countries as high-income OECD and high-income non-OECD classification, and for developing countries World Bank definitions of low-income and middle-income economies (as of 2013) The ICI is a global trade association for regulated investment funds, based in the United States, that compiles international statistics on behalf of the International Investment Funds Association, an organization of national mutual fund associations.
2. The World Bank undertook case studies on the mutual fund sectors of these countries in 2012.
3. Although this report seeks to broadly explore striking aspects of the mutual fund sector in emerging markets, it does not go into specific issues related to mutual funds. Such specific issues include but are not limited to the debate on whether or not actively managed funds outperform passively managed funds, details on the nature and development of relatively new mutual fund products such as exchange traded funds, and delving into the nature of offshore fund centers and the impediments to their development. The report also does not examine specific learnings from mutual fund sector events in developed country contexts, such as the mutual fund market timing scandal of 2003 in the United States.
4. "Collective investment scheme" is the term used by IOSCO to designate such funds.
5. This description also broadly fits defined contribution pension schemes, which operate in the same way as mutual funds but are subject to pension-specific tax treatment and to limitations upon withdrawal from the scheme. Both defined benefit and defined contribution pension schemes may be investors into mutual funds. The study does not include hedge funds, which are a generic term for a fund that may be open ended or closed ended and may take a variety of legal structures including a limited partnership but that do not meet the regulatory requirements for offer to the general public.
6. This is a generic term used worldwide, although it has no legal significance.
7. This section is drawn from discussion of the history of investment funds in a World Bank study in Turkey.
8. A. Khorana, H. Servaes, and P. Tufano, "Explaining the Size of the Mutual Fund Industry around the World," *Journal of Financial Economics* 78 (2005): 145–85.
9. Foreign & Colonial Investment Trust Prospectus 1868.
10. See chapter 2.
11. This liquidity/variable capital feature leads to important consequences in computing the net asset value of the fund, which is the basis of the sale and redemption price of such funds, as well as the performance of the fund, and its daily management.
12. For instance, the U.S. Investment Company Act of 1940 prevents these open-ended funds from issuing senior debt or any type of borrowing. The all-equity capital structure distinguishes such funds from hedge funds and closed-ended funds that typically apply leverage to enhance returns. See Conrad S. Ciccotello, "The Nature of Mutual Funds," in *Mutual Funds: Structures, Analysis, Management, and Stewardship*, ed. John A. Haslem (New York: Wiley, 2010), pp. 3–15.
13. Ciccotello, "The Nature of Mutual Funds."
14. In contrast, with a closed-ended fund, which is typically traded on a stock exchange, as Ciccotello explains in his article, "The Nature of Mutual Funds," which has a fixed number of shares or units in issue (like an ordinary listed company) that are bought and sold on stock exchanges.
15. Since these funds are set up under the same legal and regulatory requirements as publicly offered investment funds, these are included in this analysis.
16. Out of the 330 authorized mutual funds, about 145 were dedicated to a single investors, as of December 31, 2011. Dedicated mutual funds represented 41 percent of total assets under management in Morocco as at year end 2011.
17. Foreign funds can be construed in two ways. One is a domestic fund created in and operating in the host country but investing abroad; the other is a fund based outside the country concerned but sold into it. For example in Turkey, a "foreign fund" does not operate in Turkey but is sold into Turkey.
18. Deepthi Fernando, Leora Klapper, Victor Sulla and Dimitri Vittas (2003), "The Global Growth of Mutual Funds", World Bank Policy Research Working Paper (WPS3055).
19. Typically a feature of open-ended mutual funds, which are the main subject of this report. This is described in box 1.1.
20. Such investors may also be able to change their exposures to particular assets or markets more easily and more rapidly by disinvesting from one fund and investing in another fund than by disinvesting from a directly held portfolio and buying a new directly held portfolio.
21. Ciccotello, "The Nature of Mutual Funds."
22. Michael Bogdan and Daniel Schrass, "Profile of Mutual Fund Shareholders, 2013," ICI Research Report (February) (Washington, DC: Investment Company Institute, 2014).
23. Ciccotello, "The Nature of Mutual Funds."
24. Investment Company Institute.
25. Because they can access wholesale market interest rates that are not accessible otherwise.
26. Investment Company Institute 2013.
27. Investment Company Institute 2014.
28. UK Fund Management 2014, The Financial Markets Series, TheCityUK, September 2014; the other 80 percent is pension funds, insurance funds, private equity funds, sovereign wealth funds, hedge funds and private wealth.
29. Khorana et al., "Explaining the Size of the Mutual Fund Industry around the World."
30. Fernando et al., "The Global Growth of Mutual Funds."

31. This is partly because more countries are added to the Investment Company Institute database but also because of growth in sales (versus performance).
32. See McKinsey & Company report “Searching for Profitable Growth in Asset Management: It’s about More than Investment Alpha” (2012), http://www.mckinsey.com/insights/clientlink/searching_for_profitable_growth_in_asset_management.
33. This is according to Investment Company Institute statistics, which record (as of 2013) 14 middle-income country mutual fund sectors and 33 high-income countries. The study uses World Bank definitions of developed countries as High-income OECD and high-income non-OECD classification, and for developing countries as WB definitions of low-income and middle-income economies (as of 2013).
34. Investment Company Institute 2014.
35. The UCITS Directive allows mutual funds that comply with the directive to market freely across the European Economic Area.
36. Lipper, “European Fund Market Review,” 2013 <http://www.lipperweb.com/Handlers/GetReport.ashx?reportId=4480>.
37. 2014 Investment Company Institute Fact Book.
38. Investment Company Institute Worldwide Mutual Fund Market Data.
39. European Union member countries plus Iceland, Lichtenstein, and Norway.
40. Investment Company Institute.
41. Investment Company Institute.
42. Investment Company Institute data for developing countries started including Pakistan in 2006, China in 2007, and Bulgaria in 2008.
43. Investment Company Institute data for mutual funds; however overall there are a total of 11,500 funds of various types in Brazil.
44. SEC Nigeria website data as of January 4, 2014.
45. ICI data shows Bulgaria as the smallest mutual fund sector in collected data worldwide, with 2013 AUM of \$504 billion.
46. Middle-income countries (both lower middle-income and upper middle income) in the database included Argentina, Brazil, Bulgaria, China, Costa Rica, Hungary, India, Mexico, Pakistan, Philippines, Romania, South Africa, and Turkey.
47. Data from a combination of IOSCO survey and Investment Company Institute.
48. For Russia, the 2011 number was used because the 2012 number was unavailable.
49. Investment Company Institute 2013. Money market funds held 18 percent and hybrid funds 8 percent.
50. Source: FundPro Latam; see Peru Case Study, p. 18.
51. Moroccan mutual funds are heavily invested in fixed-income securities. A little more than one-quarter of totals assets under management were invested in government bonds at the end of 2011. Negotiable debt securities, which are by far dominated by certificates of deposits issued banks, became the second asset class in size in 2011, representing slightly more than 22 percent of total assets under management. Investments in equities represented only 10 percent of total assets under management.
52. In the case of pensions, such limits will often relate to some degree to the nature of the pension—whether it is defined benefit or defined contribution in type. In the case of some personal pensions, where the pension account belongs to the individual and is portable as they move between jobs, pension savings may be permitted to be invested wholly into mutual funds as in the case of the U.S. Independent Retirement Account (IRA).
53. Retail investors in Morocco tend to be steered by banks toward other financial products such as savings accounts, term deposits, or life insurance investment products. Most individual investors also tend to be high net worth. Data show that the average ownership of mutual fund assets per individual was approximately \$117,000.
54. However, a further 15 percent of AUM was held by high net worth, or “private” investors.
55. European Fund and Asset Management Association, “Asset Management in Europe 2014,” <http://www.efama.org/Pages/EFAMA%27s-Asset-Management-Report-2014.aspx> (exhibit 25 for reference).
56. “Asset Management in Europe.”
57. An “independent financial adviser” is a firm licensed to give independent financial advice to clients about a range of financial products.
58. “Private bank” is a bank (which may be owned by a “retail bank”) that serves only very affluent clients.
59. This trend is declining in developed markets where increasingly fund management firms are not permitted to agree to pay commissions to advisers; instead any fee or commission must be agreed between the investor and the adviser.
60. If they focused on advising on or selling only mutual funds, this would be even more true.
61. Although some regulatory frameworks establish requirements governing this (these may be financial sector laws or broader consumer laws such as that governing competition or unfair contracts).
62. Although almost all asset management companies advertise their mutual funds online, even though the level of information available is limited.
63. In American terminology, this is a “no load” share class or fund.
64. Morningstar, “Global Fund Investor Experience 2013 Report” (Chicago: Morningstar).
65. Morningstar, “Global Fund Investor Experience 2013 Report.”
66. Lipper.
67. This also may explain why overall weighted average American mutual fund fees are lower than many others internationally.
68. See the discussion in chapter 2 on issues arising in relation to capping charges.
69. In Brazil, this encompasses all costs of administration, custody and management except for transaction costs, unlike other regimes where the management charge does not express the

totality of charges made to the assets or income of the fund. The transaction cost is the cost of commissions or fees or taxes incurred in buying and selling assets for the portfolio of the fund. There is no need therefore to calculate a "total expense ratio" as is necessary in many other fund regimes.

70. Canadian Securities Administrators, Discussion Paper and Request for Comment 81-407, "Mutual Fund Fees," December 13, 2012.
71. Bank ownership of mutual fund managers is not atypical in developed countries, but there is no clear pattern. In Europe banks predominate, but in some countries are losing such dominance. In the United Kingdom few fund management companies are owned by banks. U.S. ownership of mutual fund management companies is to a great extent a function of Glass Steagall.
72. The fund management companies are Credifondo (affiliated to Banco de Credito), BBVA Fondos Continental, Scotia Peru (Scotia Bank), and Interfondo (Interbank).
73. In Brazil, for instance, outflows in mutual funds were offset by inflows in bank deposits in three crisis events. In Morocco, investors redeemed their shares from money market funds in 2012 because term deposits started to provide higher interest.
74. Many countries' funds have high exposures to banks as investments, hence the limit that is often placed on funds that they may not have more than a certain percentage of a fund invested in the issuance and deposits of any one issuer.
75. Repos are "a form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day. For the party selling the security (and agreeing to repurchase it in the future) it is a repurchase or repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase or reverse repo agreement."
76. The proportion of funds invested in cash, term deposits, repos almost doubled from 16 percent in 2002 to 31 percent in 2009, before falling back to 19 percent of total assets—showing the long-lasting appetite of mutual funds for liquid and "risk-free" investments.

2. Legislation, Regulation, and Taxation of Mutual Funds

Introduction

A mutual fund sector will not expand strongly unless people are confident that mutual funds are worthy of their trust. Thus law and regulation must adequately protect investors, and a regulator must effectively and fairly enforce this legal and regulatory framework. A weak legal and regulatory framework or failure to enforce compliance with an adequate framework can negatively affect the mutual fund industry. When investors are not confident in the market, they either do not invest or pull out of mutual funds. In extreme scenarios, a loss of confidence in a mutual fund can lead to a “run” on the fund, similar to a “run” on a bank, which means the operator of the fund has to sell assets to meet redemption requests. If the operator cannot raise the cash to meet redemption demands, investors may further lose confidence, causing the “run” to accelerate. This could spill over to investors losing confidence in all mutual funds, giving rise to systemic risk.¹

One of the key objectives of regulating publicly offered mutual funds is to maximize the potential for confidence by effectively protecting the interests of the fund investors from conflicts of interests and asymmetries of information. Mutual fund regimes address asymmetries of information and conflicts of interest between the fund operator and the investor and seek to prevent the possibility of the fund operator (or its affiliates) stealing or misusing fund assets.

Fund regimes also seek to protect investors from being defrauded or misled by unregulated collective investment schemes. The law thus typically describes the characteristics of a collective investment scheme and requires that any vehicle that has the stated characteristics and that is offered to the public must meet the requirements of the law applicable to such schemes. This enables regulators to require any public offer of an unregulated scheme either to come into line with law and regulation or to be shut down. Therefore regulators are able to act against Ponzi² schemes which are unregulated investment vehicles that collect money from investors, by promising—usually unrealistically—high returns. Instead of making investments, these schemes use new subscribers' money to pay “returns” to existing investors and hence collapse when new inflows are insufficient to pay “returns.”

Such schemes are commonly seen in both developed and emerging markets: They present dangers not only to investors but also to legitimate collective schemes that cannot pay similarly unrealistic levels of return and whose reputation may be damaged when the inevitable collapse occurs. Examples of such schemes in emerging markets include the MMM scheme in Russia in the 1990s, involving millions of Russians, which could partly explain the relatively weak subsequent development of mutual funds in Russia. In Albania, investors lost an estimated \$1.2 billion through a high-profile Ponzi scheme in the late 1990s. In Kenya and Tanzania, another Ponzi scheme, the Development Entrepreneurship for Community Initiative, led to losses for thousands of investors. There were no mutual funds yet in either Albania or Tanzania (apart from the state-sponsored Unit Trust of Tanzania) as at the end of 2013, and the Kenyan industry has been developing slowly. An OECD study thus notes that “the toleration of collective investment activities operating outside the recognised legal framework for CIS undermines confidence in the entire financial system and may pose risks to financial stability.”³ (See box 2.1 for a history of mutual fund legislation.)

Regulatory frameworks need to align with the stage of market development. The framework has to achieve a delicate balance

Box 2.1: History of Mutual Fund Legislation

The first mutual funds were created before legislation specific to these vehicles was written. These funds were set up both in the United States and the United Kingdom in the 1920s and 1930s, respectively, using existing law governing either companies or trusts.

However, during and following the Wall Street Crash of 1929, investors into many of these funds suffered major losses because the funds took on excessive leverage (borrowing), and because operators of these funds were self-dealing, churning investors (moving them from fund to fund to generate commissions for sales persons), and sometimes stealing from the fund outright. These events created the impetus to introduce legislation governing mutual funds and protecting their investors. In 1939 the U.K. Prevention of Fraud (Investments) Act was passed. Research conducted in the 1930s in the United States revealed rampant fraud among members of the investment company industry and was the basis for the U.S. Congress's considering it necessary to regulate funds. This was the genesis of the Investment Company Act of 1940.⁴

Similar development patterns may be seen in some emerging markets. Unit trusts were set up in Zimbabwe, for instance, before the Collective Investment Schemes Act was passed in 1997. However, given lessons learned from global experiences with mutual funds, governments that want to develop mutual fund sectors typically seek to establish legal and regulatory frameworks to enable such funds before they start operation.

between regulating enough to protect the investor, but also not overregulating to the extent that the industry is stifled or unable to operate. Overregulation can impose unnecessary costs, deter market entrants, and make mutual funds less attractive than other investment vehicles, thus preventing—or slowing—market development. Simply adopting international standards from mature markets in a newly emerging market can lead to overregulation because of fundamental differences between countries in the early stages of market development and mature financial markets. For example, a nascent financial sector may not have the range of investments and levels of liquidity that occur in developed markets. As discussed later in this report, Uganda adopted much of the U.K. framework for publicly offered funds wholesale, which led to impracticable diversification and liquidity requirements being imposed on the fund sector. Compliance with IOSCO standards, which are general principles discussed later in this chapter, is possible without replication of the full panoply of developed markets' regulatory frameworks.

This chapter outlines key elements of the legal and regulatory frameworks that typically govern mutual funds or affect their development. The chapter discusses elements of good regulation, which lends comfort to an investor and results in the growth of the mutual fund sector, and bad regulation, which may include overregulation that presents barriers to entry for mutual fund promoters and thus impedes competition, or poor quality regulation, which fails to facilitate mutual funds' development. It draws on examples from the country studies and from a selected series of other emerging markets that participated in a World Bank–IOSCO survey and seeks to identify factors that may impede the development of mutual fund sectors. The chapter discusses the principles developed by IOSCO for regulating and supervising collective investment schemes.⁵ The chapter also illustrates examples from developed countries that have longer histories of regulating the mutual fund industry. It looks at the importance of effective, even, fair, and consistent application of this framework by a competent and adequately resourced regulator. Last, although this report does not focus on taxation, the chapter considers elements of the tax regime of mutual funds and their effect on the industry's growth.

Legal and Regulatory Apparatus

The mutual fund legal and regulatory apparatus consists of a series of components that together act to set and apply standards for the establishment of mutual funds, their offering, management, and governance. The presence of these components will vary over time as mutual fund markets develop and in line with the scale of the market (see table 2.1).

Primary Legislation

As discussed above, the key objective of primary legislation is to define the nature of a collective investment scheme and to protect investors by requiring that only a scheme that has met legal and regulatory requirements may be offered to the general public. Provided that this definition is well drafted, it will enable a regulator to act against unregulated investment vehicles that are offered to the public, such as Ponzi schemes, requiring them either to come into compliance with the law or to cease such business. Such legislation typically will also seek to protect investors by requiring that only entities approved by the regulator may operate or provide certain services to such funds, and that these entities must comply with law and regulation.

Fund legislation should seek to address the principal-agency risk embedded in the structure and organization of mutual funds by placing an overriding duty on those who operate funds to act in the interests of fund investors and with due diligence, expertise, and professionalism. The operator (or "agent") who manages the fund does not own the assets of the fund. The assets derive from those who have bought shares or units in the fund and are either beneficially owned by fund investors (the "principals"), or they are owned by the fund itself when it is a company, which is in turn owned by its shareholders (the investors in the fund). This dichotomy leads to the possibility of conflicts of interest, where the operator could use fund assets to the advantage of itself or its affiliates rather than the advantage of fund investors. Another risk is theft, namely, that an unscrupulous operator holding the assets of funds could easily misappropriate these assets: Hence the legal requirement to act in the interest of fund investors. Another risk is theft, namely, that an unscrupulous operator holding the assets of funds could easily misappropriate these assets: Hence the IOSCO requirement (see box

Table 2.1: Components of the Legal and Regulatory Apparatus for Mutual Funds

Primary legislation	<ul style="list-style-type: none"> Lays out basic principles of mutual fund structure and governance and establishes definitions.
Secondary legislation	<ul style="list-style-type: none"> Lays out detailed rules on fund operations and management, in tandem with legislation.
Regulator	<ul style="list-style-type: none"> Typically develops (and sometimes passes) secondary legislation and detailed guidance in tandem with primary legislation. Is responsible for enforcing the legal and regulatory framework, specifically by issuing licenses, regulating operators and service providers of mutual funds, and applying sanctions on those who fail to comply.
Self-Regulatory Organization (SRO) ^a	<ul style="list-style-type: none"> In some cases, the regulator may delegate to an SRO the power to regulate operators or service providers of mutual funds. In this case, the regulator issues the license or permission to undertake the business. However, the license holder is required to become a member of an SRO (or the SRO) and is subject to its rulebook and supervision.
Trade association of mutual funds/operators	<ul style="list-style-type: none"> May establish standards and monitor their members' compliance with these standards. Sometimes also provides guidance to members on how to implement regulation. May also develop proposals for new or amended law or regulation.
Third-party regulation	<ul style="list-style-type: none"> Law or regulation may place a duty on a depositary or a trustee to a mutual fund to undertake a day-to-day supervisory role, which includes being responsible for safekeeping the fund assets (such entities are also subject to regulatory supervision). Law or regulation usually requires that an independent auditor audits each mutual fund and prepares annual financial statements for fund investors and the regulator. In some cases, the auditor may also be responsible for checking fund compliance with laws and regulations, and may be obliged to report any irregularity directly to the regulator.
Judicial system of courts and other arbiters ⁶	<ul style="list-style-type: none"> Addresses investor grievances. Conducts civil or criminal proceedings upon application of the regulator.

a. A body whose role is defined in the relevant law and whose sole objective is to regulate the conduct of its members.

2.2) that fund assets are segregated and held and safeguarded by a third party approved by the regulator to undertake that activity (a depositary, trustee, or custodian, depending on the nature of the fund). Those who operate funds know much more about the fund than potential or existing fund investors and can exploit that asymmetry in knowledge; legislation and regulation again seek to minimize the potential for this by requiring that operators act in the interests of fund investors (see IOSCO conflicts of interest requirements in box 2.2). Legislation also seeks to address the risk that one holder in a fund may be advantaged to the detriment of another: For instance, the operator may share information with some investors and not others. An OECD study⁷ elegantly summarizes the problems fund legislation has to address: The mutual fund sector “is characterised by complex agency relationships and asymmetries of information and market power. Large amounts of assets are owned by a dispersed group of investors with incomplete information. The assets are under the control of institutions with considerable power to control flows of information. These asymmetries of power and information require transparent and disciplined procedures to ensure equitable treatment of investors.”

Law governing mutual funds is usually established through one of three approaches, summarized as follows. The approach chosen by any one country will depend upon its legal traditions, the level of development of financial markets, and its existing institutional framework, among other factors (see table 2.2).

- **Financial services legislation.** In this relatively rare case, the overarching law that governs the financial services sector—banks, capital markets, insurance, pensions, etc.—also governs mutual funds and their operators. Examples include the U.K. Financial Services and Markets Act 2000 and the Republic of Korea Financial Investment Business and Capital Markets Act 2007. Such legislation typically also empowers a “megaregulator,” such as a central bank, ministry of finance, or a government agency—to supervise the whole sector.⁸
- **Securities markets (or capital markets) legislation.** In this more common approach, the law governing securities (or capital) markets also governs mutual funds and their operators. Examples include the Kenya Capital Markets Act 2000 and Turkey Capital Markets Act 2012. Such legislation typically empowers a securities or capital market regulator to supervise the sector.
- **Fund-specific legislation.** In another common approach, a fund-specific law will govern mutual funds and their operators.⁹ Examples include China’s Securities Investment Fund Law of 2012, Morocco’s Law no. 1-93-213 dated 1993, and South Africa’s Collective Investment Schemes Control Act No. 4 of 2002. In this case the law will also empower a regulator to supervise mutual funds and their operators. This may be a central bank, ministry of finance, a “megaregulator,” a nonbank financial services regulator, a market conduct regulator, or a securities regulator.

Box 2.2: IOSCO Principles on Collective Investment Schemes (CIS)

Principle	Purpose of a CIS Legal and Regulatory Regime	Coverage
Legal form and structure	Provide for the legal form and structure to provide certainty to investors in assessing their interest in the CIS and enable the pool of investors' funds to be distinguished from the assets of other entities ("segregation" of assets).	Law
Custodian, depositary or trustee	Ensure the physical and legal integrity of the assets of the CIS is protected and separated from the assets of the operator and its affiliates, other CIS, the custodian, depositary, or trustee, and all other entities. CIS assets must be held by a custodian, depositary, or trustee that is required to meet fit and proper and resources and diligence requirements and to be at least functionally independent of the operator.	Law
Eligibility to act as an operator	Establish that the operator of a CIS must meet fit and proper resources and diligence requirements on an ongoing basis and establish their powers and duties and requirements to operate the scheme and achieve ongoing compliance.	Law and regulation
Delegation	Require that the operator is responsible for exercising the powers and undertaking the duties under law or regulation, and that while it may delegate activities it remains responsible for oversight of these and the competence of any entity to which it delegates. Such delegation must not diminish the effectiveness of supervision of the CIS.	Law or regulation
Supervision	Provide for a regulatory authority with adequate powers to take overall responsibility for supervision of CIS in its jurisdiction and to license, monitor, inspect, and investigate CIS and their compliance with law and regulation. Third-party supervision of the operator of a CIS by the depositary or trustee and sometimes by auditors may also be envisaged.	Law
Conflicts of interest	Ensure that the exercise of responsibilities is undertaken with full regard to the best interests of CIS investors and establish prohibitions or controls on situations and transactions that may give rise to conflicts of interest.	Law and regulation
Asset valuation and pricing	Provide a system for valuation of CIS assets based on market value, and for pricing CIS shares or units, and procedures for entering or exiting a CIS that are fair to entering, exiting, and ongoing investors. Provide that CIS must redeem upon request and suspend such redemption only in certain stated circumstances and follow certain procedures, must sell and redeem shares or units at net asset value plus or minus a charge as appropriate, and provide for distribution or reinvestment of income.	Regulation
Investment and borrowing	Establish investment restrictions, portfolio diversification requirements, and borrowing limitations that address the investment goals, the risk profile, and the degree of liquidity required for a CIS to meet redemptions in all market conditions. The need for liquidity typically contemplates a CIS investing primarily in transferable securities, money market instruments, and derivatives. Borrowing should be limited in extent and only permitted on a temporary basis.	Law and regulation
Investor rights	Provide investors with certain rights including the right to redeem and to participate in decision taking in certain circumstances and as relevant to the legal structure of the fund; specify access to remedies.	Law and regulation
Marketing and disclosure	Require full, accurate, and timely (prospectus) disclosure to prospective investors providing all the information necessary to make an informed investment decision. Require that annual or semiannual financial reports on the management and operations of the CIS are provided to investors and filed with the regulator; these reports should be subject to review by an independent third party (auditor). Annual or semiannual reports must contain accounting information that must be prepared in accordance with applicable accounting standards.	Regulation

Source: IOSCO Principles for Collective Investment Schemes 1994.

Table 2.2: Legislation Enabling Mutual Funds in Selected Emerging Markets

Financial Services Legislation	Securities Markets Legislation		Fund-Specific Legislation
Korea	Brazil	Malaysia	China
	Costa Rica	Nigeria	Mexico
	Hungary	Pakistan	Morocco
	India	Peru	Russia
	Indonesia	Saudi Arabia	Slovenia
	Kenya	Turkey	South Africa

Sources: World Bank case studies, country legislation, various sources as at year end 2012.

A country's legal tradition will influence the legal structure of mutual funds that can be enabled. The legal tradition could be civil code, which is widespread, for instance, in continental Europe and which was adopted in other countries influenced by their legislation such as Eastern Europe (which has tended to follow Germanic legal tradition), and Latin America (which has followed Spanish or Portuguese traditions). Or the legal tradition could be common law, which originated in England and is found primarily in former British colonies. Table 2.3 shows some of the variations in the structures in which mutual funds are enabled as a result of a country's legal tradition. A later section of this chapter discusses mutual fund legal structures in more detail.

Secondary Legislation and Regulation

Although there is no one clear rule as to what is in primary versus secondary mutual fund legislation, it is usually better to establish basic principles in primary legislation (which is not easily changed) and set out details in secondary legislation, which can be changed as the market evolves. Primary legislation should ideally create a sound legal basis for mutual funds to be established, licensed, supervised, operated, and wound up. Secondary legislation—called regulations or rules—would then set out more detailed requirements such as aspects of fund operation or standards applicable to operators and third-party supervisors of funds, because primary legislation cannot easily be changed to respond to changing environment or to bring industry practice up to date without the national legislative body being involved. No clear line is seen between the content of primary and secondary legislation (regulation) because this varies across countries and their legal traditions. The IOSCO principles given in box 2.2—which

are essentially derived from a survey of common global regulatory standards—note what aspects of the legal and regulatory framework are more commonly covered by law or regulation.¹⁰ When mutual fund provisions are part of a more comprehensive capital markets or securities law, regulations will typically hold most of the details. On the other hand, if the law is specific to mutual funds, primary legislation may contain more detail. In general, civil code jurisdictions tend to have more detail in primary legislation and may then specify the areas to be regulated, whereas common law jurisdictions tend to leave detail to the regulations, and it may be necessary only to empower the regulator to promulgate these regulations.

Ideally a single set of rules covers all mutual fund-related provisions, rather than provisions being dispersed in a variety of regulations, rules, instructions, and guidance; good practice also suggests timely (but not very frequent) updates of regulation.¹¹

Consolidating market rules allows new entrants or participants to clearly identify the rules applicable to them. Peru and Turkey, for example, largely cover all relevant provisions in a single set of rules. On the other hand, Brazil and India have a complex series of documents diversely covering different aspects of funds; this makes it difficult to identify what element of which document is relevant to a particular issue.¹²

Regulators

Primary legislation should empower a regulator—the entity varies depending on country—to monitor and enforce compliance with the legal and regulatory framework governing mutual funds and their service providers. The responsibilities of the regulator may vary from country to country but should be clearly and objectively stated in law. Regulators typically develop detailed regulations or rules governing mutual funds and their operation and may also issue “guidance,” which further interprets these rules. The regulations will establish minimum entry standards for mutual fund operators and service providers and to set up a mutual fund. The regulator will license entities that meet these requirements, monitor their activities and compliance with law and regulation through regular reports and inspections, and if necessary investigate failures and enforce compliance (see table 2.4). The nature of the regulator will also vary from country to country and may change over time: In the United Kingdom, for instance, when the first legislation governing funds was passed in 1939, the regulator was a government ministry, the Board of Trade. However, several permutations later, the regulator is now a market conduct regulator under the Financial Services Act 2012. In the United

Table 2.3: Variations in Primary Legislation Enabling Mutual Funds as at Year End 2012

Country	Legal Tradition	Primary Legislation Enabling Mutual Funds
Brazil	Civil code	Law 6.385 of 1976 enables open-ended funds in the form of condominiums
Kenya	Common law	Capital Markets Act 2000 enables open-ended funds in trust and corporate structure
Morocco	Civil code	Law no. 1-93-213 of 1993 enables open-ended funds in corporate and contractual form
Peru	Civil code	Law on the Securities Market enables open-ended funds of contractual type
Turkey	Civil code	Capital Markets Act of 2012 enables open-ended funds in contractual and corporate form

States, the regulator was and remains the Securities and Exchange Commission (SEC), a specialist securities regulator created under the Securities Exchange Act of 1934. In Zimbabwe, the Registrar of Collective Investment Schemes, an employee of the Reserve Bank of Zimbabwe (the Central Bank), was the identified regulator when the Collective Investment Schemes Act was enacted in 1997, but the regulator subsequently became the Securities and Exchange Commission.

In general, five possible types of entities can regulate the mutual fund sector, although most often mutual funds are governed by the securities markets regulator, which may be a government agency or under the purview of the Ministry of Finance. Good practice suggests the mutual fund industry should be regulated by one entity, rather than multiple entities. This helps concentrate regulatory power in one entity and simplifies the regulatory burden and cost of compliance for market participants.¹³ IOSCO principles require that if there are divisions of responsibility, these should be

Table 2.4: Mutual Fund Regulators in Selected Markets¹⁴

	Regulator of Mutual Funds				
	Securities Markets Authority	Central Bank	Market Conduct Regulator	Mega-regulator	Nonbank Financial Services Regulator
Brazil	x				
China	x				
Costa Rica	x				
Hungary		x			
India	x				
Indonesia				x	
Kenya	x				
Korea				x	
Malaysia	x				
Mexico				x ^a	
Morocco	x			x	
Nigeria	x				
Pakistan					x
Peru	x				
Russia		x			
Saudi Arabia	x				
Slovenia	x				
South Africa					x
Turkey	x				

Sources: World Bank case studies, country legislation, various sources as at year end 2012.

a. Regulates securities markets and banking but not insurance and pensions.

clear and gaps or inequities avoided. Variants in regulatory entities responsible for regulation of mutual funds include the following:

- **Central banks:** An example is the Monetary Authority of Singapore, which is also a megaregulator, and governs mutual funds through the Securities and Futures Act of 2002. Another example is the Central Bank of Russia, also a megaregulator, which took over securities markets regulation in 2013. In Brazil the Central Bank regulated mutual funds until the early 1990s, following which the Securities and Exchange Commission of Brazil became the regulator.
- **“Megaregulators”:** These are empowered by an overarching law governing the financial services sector (e.g., the Financial Services Authority under the U.K. Financial Services and Markets Act 2000) or by a law specifically creating the regulator (e.g., South Korea’s Act on the Establishment of the Financial Services Commission of 2008).
- **Nonbank financial institutions regulatory authorities:** These regulators are generally empowered by a law that creates the regulator and are mandated by that law to apply specified financial sector laws, for instance, laws governing pensions, insurance, and securities markets, including collective investment schemes. Examples include the Financial Services Board of South Africa under the Financial Services Board Act of 1990 and the Securities and Exchange Commission of Pakistan created under a 1997 Act.
- **Securities markets regulatory authorities:** These regulators may be empowered by securities legislation that both governs the sector and establishes the regulator and its powers; an example is the Capital Markets Act 2000 of Kenya. Alternatively, a law could also be specifically enacted to empower such a regulator, for example, the Securities Commission of Malaysia under the Securities Commission Act of 1993.
- **A market conduct regulator:** Under the “twin peaks” model of financial regulation, a prudential regulator focuses on capital and systemic risk, and a separate market conduct regulator would typically regulate securities markets, including collective investment schemes and their operators. Examples are the U.K. Financial Conduct Authority formed under the Financial Services Act of 2012 and the Australian Securities and Investments Commission under the Australian Securities and Investments Commission Act of 2001. In 2013 South Africa was in the process of moving to this model.

IOSCO principles¹⁵ require that a regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers. These powers should include comprehensive inspection, investigation, surveillance, and enforcement powers that include in relation to mutual funds and their operators and service providers the power to approve such funds, monitor and supervise their operation, and investigate and fine misdemeanours. However, the power of regulators in fact may vary, for instance, in relation to the ability to pass regulations and the ability to impose sanctions such as fines. In addition, although the role of the regulator is

primarily to ensure that the investor is protected, it may be tasked with other objectives, such as fostering competition in the industry. For instance, the U.S. regulator is required to consider “efficiency, competition, and capital formation” in the industry.¹⁶ This can be important because regulation can be a mechanism by which entry of new competitors in an industry is restricted, increasing concentration and decreasing competition. Regulators may also be given market development mandates, as in Kenya, although this may create an uneasy tension between protecting investors and adopting a more permissive stance to allow the market to expand.

Where possible, primary legislation should give the regulator the legal standing to pass regulation, so that regulations can be updated in a timely manner in keeping with market trends (see table 2.5). However, it is quite common for only a ministry to have such a power in which case if the regulator is not given this status, it will have to compete for the attention of the relevant ministry (usually Ministry of Finance) to get regulations adopted. The risk in this case is that regulations may take a long time to pass, which may hinder the ability to respond to change and to innovation in the market. It is preferable also for regulators to be empowered to issue whatever regulations are needed to protect investors or to fulfil its responsibilities, rather than being empowered only to pass regulations governing a specified list of areas, which again may limit a regulator’s ability to accommodate market innovation.

Regulators with inadequate resources and powers are unlikely to be able to create and maintain the market confidence crucial to mutual fund sector development. The regulator’s task can be quite enormous, given that one may find large numbers of operators and of mutual funds. Brazil’s Securities and Exchange Commission, for instance, had the task in 2012 of supervising an industry with more than 400 managers and more than 11,500 separate funds.¹⁷ In practice, regulatory powers to enforce and impose sanctions vary greatly. If the regulator is not given adequate powers in legislation, as well as adequate resources to apply those powers, market participants can misbehave without deterrent and public confidence in the market will dwindle: For instance, a regulator cannot effectively deter misbehavior if their only real disciplinary power is to apply fines of a few hundred U.S. dollars. Conversely, checks and balances (such

Table 2.5: Ability of the Regulator to Issue Regulations in Case Study Markets as at Year End 2012

Country	Regulator	Ability to Pass Regulations
Brazil	Securities and Exchange Commission	Yes
Kenya	Capital Markets Authority	No
Morocco	Securities Ethical Council	Yes
Peru	Securities Market Superintendency	Yes
Turkey	Capital Markets Board	Yes

Source: Relevant legislation.

as tribunals and ombudsmen) will be needed if the regulator has very strong powers (see box 2.3). In Brazil the law governing mutual funds empowers the regulator, the Securities and Exchange Commission, to investigate and, if appropriate, punish irregularity. Penalties range from warnings and fines to revoking licenses.

Self-Regulatory Organizations and Trade Associations

In some countries, legislation enables regulators to delegate some of their powers to self-regulatory organizations (SROs). SROs are essentially regulators funded through regulatory fees paid by the sector that they regulate. They typically monitor and inspect members and may have powers to discipline them through fines or other measures. These organizations can be effective only if all licensed entities of a specified category are mandated to join them. If given a choice of which SRO to join, market participants could engage in regulatory arbitrage, exploiting any uneven standards of regulation. The regulator will typically set the licensing requirements for entities subject to self-regulation, and the law will require that all licensed entities have to join an SRO and obey its rules. The Capital Markets Law of 2012 of Turkey, for example, requires all relevant institutions to join the SRO, the Capital Markets Association of Turkey.²⁰ IOSCO principles require that regulators have oversight over SROs.

Box 2.3: Regulating by “Function” or “Institution”

When a country is considering establishing or regulating financial or securities markets, it will need to decide on an optimal regulatory approach, as well as how to empower, resource, and establish the regulator.

In considering the regulatory approach to the financial services industry, policy makers will need to consider whether to regulate by function or by institution:

- If regulating by function, each financial services activity, which may (or may not) be under a financial services conglomerate—whether banking, insurance, or mutual fund management—will need to be clearly distinguished¹⁸ and be separately subject to regulation and a specific regulator for that function (for example, securities business under a securities regulator and banking under a banking regulator).¹⁹
- If regulating by institution, the financial services institution—typically a bank—will be given blanket permission under a single banking license to carry out all categories of financial services business, which will be regulated by the banking regulator.

Generally, regulating the mutual fund sector by “function” rather than by “institution” is preferable because it allows clearer definition and helps to eliminate conflicts of interest by creating internal “Chinese walls.”

In some jurisdictions, a trade association may take on some aspects of self-regulation, while not formally acting as an SRO.

Trade associations may be composed of members that are either the mutual funds themselves (e.g., the U.S. Investment Company Institute) or, more commonly, the managers of mutual funds (e.g., India's Association of Mutual Funds)²¹ or wider groupings such as asset managers. Trade associations typically promote the sector and seek to facilitate its development, not regulate it. They often collect, analyze, and publish data on mutual funds and their performance.²² However, trade associations may sometimes carry out a degree of self-regulation by setting codes and standards (for instance, for advertising) and monitoring compliance. In some cases regulation may even require members to adhere to trade association standards. However, trade associations are different from SROs: Usually membership of trade associations is voluntary, unlike with an SRO, and they rarely have the power to discipline their members other than by expelling them from membership.²³ Examples of trade associations include Singapore, where all licensed funds join the Investment Management Association of Singapore, which develops voluntary codes of conduct and guidelines.²⁴ In Morocco, all asset management companies are members of the trade association, ASFIM, which represents the industry in its relations with policy makers. Brazil's Association of Financial and Capital Markets (ANBIMA) is a trade association of funds (and other securities activities), which also has a self-regulatory role. It publishes voluntary codes and standards for its members on aspects such as marketing, valuation, investment management, and distribution. Although not a statutory regulator, ANBIMA's contract²⁵ with its members even allows it to discipline and fine its members in case of misconduct. Some trade associations, such as India's Association of Mutual Funds, establish criteria for mutual fund distributors and may also register and monitor fund distributors. Table 2.6 shows SROs and trade associations in select countries. Ideally there should be only one mutual fund trade association (unlike in Kenya, which had two at the time of the case study) because the regulator can "divide and rule" if the two organizations lobby for different things.

Although self-regulation has benefits, it is possible that self-regulation can be undermined by member self-interest. SROs can relieve the regulator's capacity constraints because they allow more of the cost of regulation to be borne by the sector instead of the government. Second, SROs are more likely to be aware of the trends in the sector and thus may be better equipped than the regulator to identify misbehavior. However, SROs may also be inclined to keep out new market entrants (which are required to be a member of the SRO) to protect the business interests of their existing members. SROs may also not wish to punish their fellow members for activities in which they themselves may indulge.

The sector must have sufficient scale to support a self-regulator and/ or a trade association in addition to the regulator. In considering the role of SROs, policy makers may also wish to consider whether the sector to be governed by the SRO has sufficient scale to finance this, because the SRO will be solely dependent on revenues from members; if it lacks resources, it is unlikely to be able to be effective. Where securities markets are small, governments can and often do subsidize the regulator, and trade associations may be operated on a low-cost basis through members providing services, so financing these institutions may be less of an issue.

Table 2.6: SROs and Trade Associations in Selected Markets at Year End 2013

Country	Self-Regulatory Organization	Trade Association
Brazil	✗ (voluntary) ^a	✗
China	✗ (statutory)	✗
Costa Rica		✗
Hungary		✗
India	✗ ^b	✗
Indonesia		✗
Kenya		✗ ^c
Korea	✗ (statutory)	✗
Malaysia	✗ (statutory)	✗
Mexico		✗
Morocco		✗
Nigeria		None
Pakistan		✗
Peru		✗
Russia		✗
Saudi Arabia		None
Slovenia		✗
South Africa		✗
Turkey	✗ (statutory)	✗

Sources: World Bank case studies, country legislation, various sources.

a. ANBIMA is both a trade association and an SRO.

b. Distribution-related only.

c. Kenya had two fund trade associations that were understood to be in the process of merging.

"Third-Party" Regulation

"Third-party" regulation refers to the day-to-day supervisory role entrusted to a mutual fund's depositary or trustee in many countries. The depositary or trustee is usually required to have the appropriate license and is responsible for holding all a fund's assets, including cash, and keeping them safe and segregated. Given that it holds all the assets and cash, the depositary or trustee either has to deliver assets when they are sold or pay cash when they are bought. This allows the entity to gauge whether a fund complies with investment and borrowing regulations better than the regulator. The trustee or depositary should be required by regulation to supervise certain aspects of the fund's operations such as the process of creating or canceling shares or units, the valuation and pricing of shares or units, compliance with investment limits, and the payment of income to investors. It is important to note that not all law or regulation holds the trustee or depositary responsible for such oversight. Where the fund has a board of directors or of individual trustees, the board will have supervisory duties either instead of, or in addition to, the depositary; where the fund is contractual a fund council (similar to a board) may undertake such oversight; and sometimes the founder or sponsor of the fund is responsible for supervising fund operations. In these cases, the fund will have a custodian that only safe keeps assets and does

not have third-party supervisory duties. In some cases, as in Brazil and in Turkey, the custodian is a central securities depository and not a commercial provider of custody services.

The auditor of the fund is also sometimes referred to as a “third-party” regulator and may be required to undertake compliance checks. IOSCO requires that auditors should be independent of the entity that they audit and should be subject to adequate levels of oversight. Law or regulation should require audited financial statements depicting the fund’s financial health to be provided to fund investors annually and filed with the regulator, usually within stated deadlines. In some regimes the auditor may also be responsible for checking the fund’s compliance with laws and regulations. In addition, they may be obliged to report irregularity directly to the regulator. For example, in Morocco, the statutory auditor must report any irregularity it finds during audit to the supervisory authority, Le Conseil Déontologique des Valeurs Mobilières (CDVM or Securities Ethical Council).

Effective third-party regulation must be consistently maintained. Regulation should require that if a mutual fund’s trustee, depositary, or auditor resigns, they inform the regulator why they have chosen to resign and whether they have concerns about the operation of the fund; they may also not be allowed to resign unless an eligible replacement has agreed to serve in their place.

Key Aspects of the Legal/Regulatory Framework

Defining a Collective Investment Scheme

It is useful for legislation to describe what a collective investment scheme is and require that any publicly offered scheme must meet specified requirements and be approved by the regulator.²⁶ As noted above, defining a collective investment scheme is important because it enables the regulator to require entities operating as such schemes without a license either to become licensed or to cease undertaking such business. However, the definition of a collective investment scheme can be rather broad and may catch a range of vehicles in its regulatory net, such as pension schemes, cooperatives, or microfinance organizations, which would need to be excluded. If not carefully drafted, such provisions may require all schemes—whether publicly or nonpublicly offered—to meet requirements for publicly offered schemes (as was the case in Kenya). This would effectively prevent the domestic operation of higher risk funds that are not publicly offered and that are offered only to professional or qualified investors. In turn, this may reduce the range of funds operating domestically and the diversification of revenue streams to operators (and, indeed, send such business offshore).

Enabling Mutual Funds and Determining Roles and Responsibilities in Different Legal Structures

One of the key functions of the legal and regulatory framework is to define the legal structures in which mutual funds can be created. The legal structure of the fund typically embeds governance requirements to deal with some of the risks inherent in

the mutual fund model, defines investor rights, and determines the arrangement for three key responsibilities.²⁷ These are the following:

- **Operating the mutual fund:** This typically means being responsible for managing the investments and marketing and administrating the fund, although some of these activities may be delegated. The entity termed the “operator” in this study—commonly a fund management company—is usually responsible for operating the mutual fund.
- **Safeguarding mutual fund assets:** The depositary or trustee is typically legally responsible for this, or a custodian that has no other function than safeguarding the assets (in some countries the custodian may be a central securities depository, which may be helpful in markets where commercial custody services have not yet developed).
- **Third-party supervision of the conduct of the mutual fund:** If a mutual fund does not have a board of directors or supervisory council, third-party supervision is usually required to be undertaken by a depositary or trustee.

The legal tradition of the country typically drives the legal structure for a mutual fund, with the most common structures being trust, corporate, and contractual. Funds can be formed as companies under both common law and civil code legal traditions, but funds traditionally take the trust form only in common law countries, such as India and Kenya. Civil code countries that do not have trust law or precedent create mutual funds in contractual form, such as in Indonesia, Peru, and Russia.²⁸ The condominium form used in Brazil is similar to the contractual fund, but derives from Portuguese legal traditions where the Roman law concept of condominium was recognised. However, some countries deliberately introduce legal structures for funds (and other uses) that do not derive from the legal traditions of the country concerned. For instance, Korea introduced trust law and trust-type mutual funds, and the United Kingdom (a common law country) has introduced contractual schemes (although these cannot be used by mutual funds that are eligible for public offer). Variations on fund legal structures are many and various. The summary given below does not seek to itemize every variation but to outline the key features of each element of the structure and their significance.

In the investment company structure, the fund is a legal entity, capable of taking its own decisions through directors and shareholders, and may be taxable. The investor acquires shares in the open-ended investment company and typically has the right to redeem these shares upon request, as well as shareholder rights under ordinary company law (unless the law governing mutual funds states otherwise). In many countries, this will include the right to vote at annual general meetings and at extraordinary general meetings. Given that investment companies are a special form of company, however, mutual fund law or regulation may augment the usual shareholder voting rights for companies by providing additional rights to vote on changes to investment objectives or policy and increases in costs.²⁹ The investment company structure has three variants: the U.S. model, the continental Europe model, and the U.K. model (see box 2.4).

Box 2.4: Variants on Mutual Funds Formed as Open-Ended Investment Companies

U.S. Model

The U.S. model is most like an ordinary company, with a board of directors. Typically an operator takes the initiative to create the fund. The board of directors is responsible for protecting fund investors. The Investment Company Act of 1940 requires 40 percent³⁰ of these directors to be independent of the operator. The law also requires fund directors to supervise fund operations and oversee areas of conflict of interest (such as fees) between the operator and investors. The U.S. model relies heavily on the availability of competent and experienced persons to serve as fund directors, which would be more challenging in emerging markets with nascent mutual fund sectors. Since the U.S. model places strong fiduciary duty upon the directors also, it requires products such as directors' liability insurance, which may not be available in a developing market. Hence the U.S. model may be difficult to replicate in developing countries.

- **Operating the fund:** The board of directors is responsible, and contracts the various providers of services to the fund.
- **Safeguarding assets:** The board of directors contracts a custodian to safeguard the assets.
- **Third-party supervision:** This role is undertaken by the directors of the fund.

Continental Europe Model

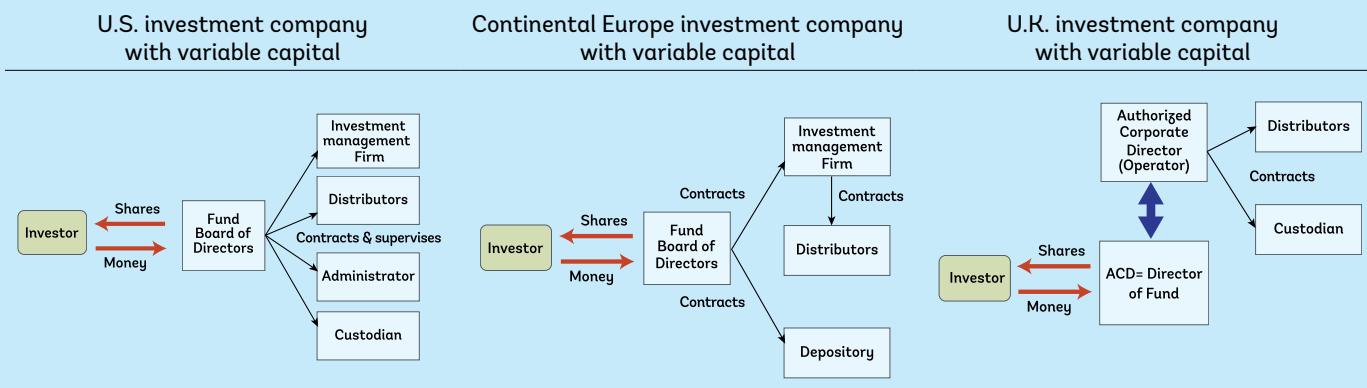
In the continental European model, the operator (typically the fund management company) will again take the initiative to create the fund and will appoint directors. Although the investment company has a board of directors, this model gives the depositary a high level of responsibility. The depositary is responsible both for safekeeping the assets of the fund and supervising its operation. The depositary is required to be at least functionally independent³¹ from the operator of the fund.

- **Operating the fund:**
- For an externally managed fund, the directors will enter into contracts with various entities to provide services to the fund (this variation is "externally managed").
- For a self-managed fund, the directors appoint staff to manage the investments of the fund and operate the fund, although some activities may be contracted out. Although this model is unusual, investment companies can be self-managed in some continental European countries (e.g., Luxembourg).
- **Safeguarding assets:** The depositary is responsible for safeguarding the assets.
- **Third-party supervision:** This role is undertaken by the depositary.

U.K. Model

The U.K. model³² includes the novel concept of an Authorised Corporate Director (ACD). Although the U.K. investment company with variable capital can have individual directors, it is required to have an ACD or a legal entity licensed to manage a CIS. The ACD is thus the operator of the fund. Because the ACD cannot act as a director to supervise the operator of the fund (itself), the depositary, which is required to be legally independent of the ACD, is required to undertake this role. The logic behind this approach is that it is easier to regulate a licensed entity, and require this entity to have adequate capital and insurance, than to regulate individual fund directors or recover substantial damages from them.

- **Operating the fund:** The ACD is responsible for operating the fund.
- **Safeguarding assets:** The depositary is responsible for safeguarding the assets.
- **Third-party supervision:** This role is undertaken by the depositary.



When formed as a unit trust, the fund is not a legal entity (but is taxable), and decisions can be implemented only through the trustee (or trustees) and the operator. A unit trust, being a trust, must have a trustee or trustees, whether corporate or individual. In this structure, the investor acquires units in the fund and is technically the beneficiary of the trust with legal rights as such and can redeem their units upon request. Typically investors have the right to vote only at extraordinary general meetings, because such funds do not usually have annual general meetings (Kenya is an exception). Investors usually have the right to vote at extraordinary

general meetings on fundamental changes proposed to the fund such as changes to investment objectives or policy and increases in costs from those stated in the prospectus. There are essentially three variants on the unit trust form. The first two relate to the ability to use either a licensed corporate trustee or a board of individual trustees (very similar to a board of directors). In the third variant a “responsible entity,” which is in effect the corporate trustee and the operator of the fund combined, operates the fund. Box 2.5 describes these variants in unit trust form.

Box 2.5: Variants on Mutual Funds Formed as Unit Trusts

Unit Trust Formed by Trust Deed between Operator and Licensed Corporate Trustee

This is the most common variant and is used in the United Kingdom and in various emerging markets including Kenya and Nigeria. The trustee usually must be completely legally independent of the operator of the fund.

- Operating the fund: The fund management company is responsible for operating the fund.
- Safeguarding assets: The trustee is responsible for safeguarding the assets.
- Third-party supervision: The trustee is responsible for supervising the operation of the fund.

Unit Trust Formed by Trust Deed between Operator (or “Sponsor” of the Fund) and Individual Trustees

This is an uncommon variant seen, for instance, in India. In India the trust deed may be either between the “sponsor” of the fund and a licensed corporate trustee (who must be fully independent of each other), or between the “sponsor” and a board of individual trustees (at least two-thirds must be independent of the sponsor). In the second case, the board of trustees functions similarly to the board of directors of investment companies. The “sponsor” must be an entity holding a financial services license that meets certain fit and proper requirements and that owns at least 40 percent of the appointed investment management firm.

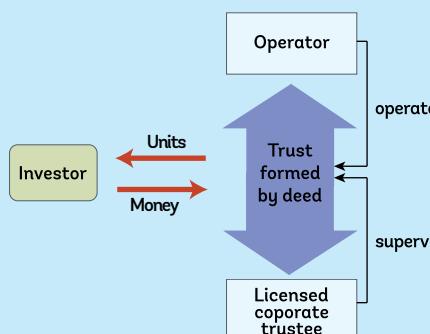
- Operating the fund: The fund management company or sponsor is responsible for operating the fund.
- Safeguarding assets: The assets must be held by a custodian, which can be affiliated to the operator or sponsor but must act independently of the sponsor.
- Third-party supervision: The individual trustees or the corporate trustee are responsible for supervising the operation of the fund.

Unit Trust Formed by Its Constitution and the Responsible Entity

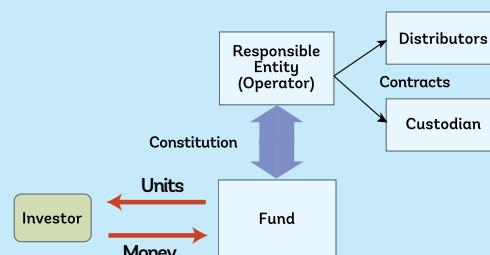
In this last variant, the trustee and the operator are “rolled up” into a single licensed firm known as “the responsible entity,” as seen in Australia. The fund is formed through a constitution, or a legally enforceable document between the responsible entity and the fund members. The constitution lays out the rights, duties, and liabilities of the responsible entity in operating the fund.

- Operating the fund: The responsible entity operates the fund.
- Safeguarding assets: The assets are held by a custodian, appointed by the responsible entity. The custodian must be functionally independent from the responsible entity.
- Third-party supervision: The responsible entity supervises the operation of the fund

Unit trust formed by trust deed between operator and licensed corporate trustee



Unit trust formed by its constitution and the responsible entity



A contractual fund is not a legal entity and is regarded for tax purposes as a collection of individuals; only the individuals are taxable, not the fund. The contractual fund does not typically exist in ordinary law, so the nature and functioning of the fund has to be completely enabled by fund law and regulation. In the contractual form, the investor acquires units in the fund and is known as a unitholder or participant. Investor rights completely depend upon provisions made in the law and regulation governing such funds but always feature the right to redeem units upon request. Typically such funds do not have annual general meetings, so investors may be able to vote on fundamental changes to the fund only at extraordinary general meetings. However, in many cases, legislation and regulation governing contractual funds do not even require an extraordinary general meeting for such decisions.³³ There are essentially three variants of the contractual fund, with the second variant being only a slight adjustment on the first. The condominium form used in Brazil is also discussed as a contractual fund (see box 2.6 for details).

Despite the prevalence of different legal structures, the operational characteristics of mutual fund structures are becoming increasingly similar, as regulatory frameworks cohere around the IOSCO principles and, increasingly, regional standards. (See table 2.7 on the key roles and responsibilities associated with the different legal structures.) IOSCO's international principles on Collective Investment Schemes (1994) established a series of benchmarks for the quality of regulation of mutual funds (see box 2.2)³⁴ and continue to inform the way in which regulation is structured and implemented regardless of the legal form of the fund. To facilitate regionalization, trade blocs, such as the European Union, increasingly set common operational and supervisory standards. The European Undertakings for Collective Investment in Transferable Securities Directive (UCITS) regards all legal structures of fund—contractual, company, and trust—as equal in terms of investor protection; provided such funds are created in a member state and comply with the directive, they can be sold in any other member country. A study undertaken by the OECD³⁵ concluded that “no legal form or governance structure for collective investment schemes has been accepted as inherently superior to other systems.”

Although more than one legal structure may be permitted by law, not all the legal forms may actually be in use by the mutual fund industry of a particular country (see tables 2.7 and 2.8). Among the 19 sample countries shown here, even if the corporate model was enabled, the most prevalent structure in practice was the contractual or trust fund. In fact, among the sample countries, only the mutual fund sectors in Mexico, Morocco, and Korea operated the corporate structure. Various reasons—tax efficiency, profitability for operator, flexibility of use, and the like—may account for one legal form being used over another, if multiple legal structures are offered by law. In some countries, one form may be more clearly defined by regulation. For instance, in Turkey, although the new Capital Markets Law of 2012 permitted open-ended funds to be structured either as investment companies or contractual funds, regulations for investment companies were not in place at the time of the case study. Hence in 2012 mutual funds were formed only

as contractual funds in Turkey. Similarly, in Kenya, although again the law enabled open-ended investment companies (as well as unit trusts), the CIS regulations at the time of the case study did not lay out clear requirements for these investment companies. Hence no mutual funds were structured as open-ended companies.³⁶ In some countries where both corporate and contractual funds are enabled, the contractual form may be more commonly used because of tax advantages or because it is cheaper or less complicated to operate. For example, in Morocco, primary legislation allowed the creation of mutual funds as investment companies (SICAVs) or as contractual funds (FCPs). Although the very first mutual funds were created in company form, market professionals rapidly stopped launching new investment companies and have used the contractual form, which is more flexible and less costly, ever since. In some cases, a corporate structure fund may be more suited to holding certain assets, such as real estate, because of tax efficiency, and so enabling more than one form may be necessary rather than optional.

Structural Variations That Facilitate Economies of Scale

In addition to the structures discussed above, legal and regulatory frameworks for mutual funds may permit additional structural options to allow the mutual fund sector to achieve economies of scale. These structural options are the “umbrella fund,” the “multishare (unit) class” structure, and the “master/feeder” structure.

An umbrella fund is a single mutual fund with multiple investment compartments, which can cater to different investor needs without the costs associated with creating separate funds. The umbrella fund³⁷ contains a number of “subfunds,” all of which fall under the umbrella fund’s single legal structure—corporate, trust, or contractual—and have the same operator and depositary/trustee/custodian. The subfunds under the umbrella structure each have a distinct investment objective and portfolio that is separately managed, reported on, and accounted for. The operator benefits from the umbrella fund structure because the regulatory process is undertaken once in full when the umbrella fund is approved, and subsequent funds can be added by a shorter notification process. Investors benefit because they can move from one subfund to another if they wish to change their investments and they also benefit from greater economies of scale within the umbrella fund.³⁸

A single fund or subfund can achieve greater economies of scale if regulation enables it to issue different classes of shares or units, each with a different charging structure and/or denominated in a different currency so it can attract capital from a wider range of target markets. This enables these units/shares to be sold across borders or to clients with different currency preferences and to suit different client or distributor needs, and it prevents the need to have multiple separate funds for different investors or for different currencies. The lack of ability to issue unit classes in different currencies was cited by operators as one barrier to developing the mutual fund market in Turkey.

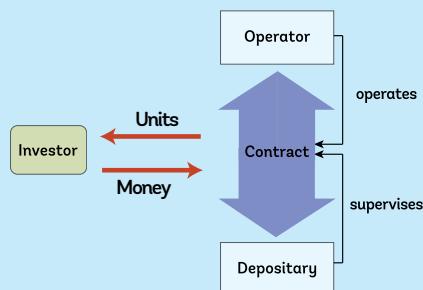
Box 2.6: Variants on Mutual Funds Formed as Contractual Funds

Classical Contractual Fund

This is a common form in continental Europe and countries influenced by continental European tradition, such as most of Central and Eastern Europe, Russia, Latin America, and Asia. These funds have different names in different countries; in France and Luxembourg, they are “Fonds Communs de Placement” (FCP); in Germany, they are “Investmentfonds”; in Spain they are known as “Fondos Comunes de Inversión” (FCI). Depending on the law of the country, the fund is typically created either by a contract between (1) the operator and the depositary, with the investor becoming a party to the contract by buying units in the fund or (2) the operator and the investor, where the investor buys units in the fund under the constitution and/or the prospectus of the fund.

- Operating the fund: The operator is responsible for operating the fund.
- Safeguarding assets: The depositary is responsible for safekeeping assets of the fund.
- Third-party supervision: The depositary is responsible for supervising the operation of the fund.

Contractual Fund Formed by Contract
between Operator and Depositary



Variant on Classical Contractual Fund

In this fairly rare variation, the fund is created by a contract between the operator and the custodian,^a or sometimes the operator and the investors. The fund must have a custodian to safeguard assets but does not require a depositary to supervise operation of the fund. In some cases, supervision is by the founder of the fund, as in Turkey until 2012. In others, as in Peru and Saudi Arabia, the fund has a “council” or “board” of individuals who may be elected by fund investors to oversee the operation of the fund and therefore have a supervisory role. This may be considered a weaker governance structure in terms of protecting investors because while the depositary supervises day-to-day fund operations, the council may meet intermittently and will depend on information provided to them by the operator.

- Operating the fund: The operator is responsible for operation of the fund.
- Safeguarding assets: The custodian^a is responsible for safekeeping assets of the fund.
- Third-party supervision: The council or the founder of the fund is responsible for supervising the fund.

Brazilian Condominium

The Brazilian condominium,³⁹ a form of joint ownership deriving from Roman law, is very similar to a contractual fund. A licensed entity, known as the “administrator,” creates the fund through a constitution. The administrator is responsible for both operating and supervising the fund. This is similar to the Australian “responsible entity,” which combines the roles of operator and trustee within a single entity. In the Brazilian model the administrator may appoint an investment management firm (to which it may or may not be affiliated) to manage the assets of the fund. The administrator will also appoint a depositary, which has both safekeeping and supervisory duties. The Brazilian administrator-based structure offers considerable flexibility and encourages sector development, because the administrators can create and operate mutual funds for independent investment managers that meet fit and proper and regulatory requirements.

- Operating the fund: The administrator is responsible for operation of the fund.
- Safeguarding assets: The custodian^a is responsible for safekeeping assets of the fund.
- Third-party supervision: The administrator is responsible for supervising the fund.

a. The custodian may be a central securities depositary.

Table 2.7: Legal Structures of Mutual Funds Envisaged in Selected Emerging Markets Countries as at Year End 2012

Legal Structure	Envisaged by Law		In Use	
Corporate	Kenya ^a Indonesia ^a Mexico Morocco ^b	Nigeria ^a South Africa ^a Korea ^b Turkey ^a	Mexico Morocco ^b Korea ^b	
Contractual	China Costa Rica Hungary Indonesia ^a Morocco ^b	Peru Russia Saudi Arabia Slovenia Turkey ^a	China Costa Rica Hungary Indonesia ^a Morocco ^b	Peru Russia Saudi Arabia Slovenia Turkey ^a
Trust	India Kenya ^a Malaysia Nigeria ^a	Pakistan South Africa ^a Korea ^b	India Kenya ^a Malaysia Nigeria ^a	Pakistan South Africa Korea ^b
Condominium	Brazil		Brazil	

Sources: World Bank country case studies, country legislation, various sources.

a. More than one legal structure enabled.

b. More than one legal structure used in practice.

Table 2.8: Key Roles and Responsibilities of Different Parties to Mutual Funds Worldwide, by Legal Structure

Legal Structure	Operator of Fund	Supervision of Operator	Administration	Investment Management	Custody
Trust	Fund management company or sponsor or responsible entity	Trustee/s or responsible entity	Fund management company or sponsor or responsible entity	Fund management company or sponsor or responsible entity	Trustee or responsible entity
Corporate	Self-managed by board	Board or depositary if law requires	Board	Board	Board or depositary if law requires
	Board	Board or depositary	Board	Board	Depositary or custodian
	ACD (fund management company)	Depositary	ACD	ACD	Depositary
Contractual	Fund management company or founder	Depositary or fund council or founder	Fund management company or founder	Fund management company or founder	Depositary or custodian
Condominium	Administrator	Administrator	Administrator	Administrator	Custodian

Sources: World Bank studies, various sources.

Enabling the master/feeder structure when mutual funds are sold across borders generates economies of scale in investment management. This structure allows one fund (the feeder) to have only one investment, that is, shares or units in the master fund. Generally, a fund must have a diversified portfolio: The feeder fund is permitted to meet this diversity requirement by investing in the master fund, which has to meet diversified portfolio requirements.⁴⁰ Because investment management is essentially done only at the master fund level, instead of separately by each feeder fund, this structure permits economies of scale to be generated at the

investment management level. For example, feeder UCITS could be created and based in France, Germany, Italy, Spain, and the United Kingdom; each of these funds may buy units in a single master fund based in Luxembourg, whose objective is to invest in European equities. Each feeder fund investor will be subject to tax on their feeder fund investment in their country of residence. However, the master fund in this structure must not be subject to tax, because otherwise investors in the feeders will suffer tax on their returns both at the master and at the feeder level.⁴¹

Enabling Funds of Funds May Improve Competition

Funds of funds are funds that are created specifically to invest in other investment funds, including mutual funds; they can be useful in facilitating the development of smaller specialist fund management companies and increasing competition. Funds of funds cannot operate unless they are permitted to invest predominantly in other funds. In Kenya, funds of funds cannot operate because regulation states that a fund cannot invest more than 25 percent of its value in collective investment schemes. Funds of funds have been very successful in Brazil, where they represent around 45 percent of all funds by number. They have two key uses. One is in asset allocation funds or multiasset class funds, because using funds as underlying assets enables more rapid and easier changes to asset allocations; units in an equity fund can be sold and units in a fixed income fund bought instead more quickly than selling a portfolio of equities and buying a portfolio of bonds. The second use of funds of funds is the so-called “best of breed” fund of funds, where a fund operator owned by a bank, which has its own distribution, will create the fund of funds under its own brand, but the fund of funds will then invest in a range of funds managed by other—often specialist—operators. This offers bank clients the reassurance of the bank’s brand together with the performance of the “best” of other funds. This is one way that independent fund managers who lack their own distribution networks can access the distribution power of banks.

Exchange-Traded Funds (ETFs) are Another Variant on the Mutual Fund Form

Exchange-traded funds are a variant on the mutual fund structure found only in more developed emerging markets such as China, India, Korea, South Africa, and Turkey as well as mature markets such as the United States. Smaller ETF markets include Hungary and Nigeria (with only one domestic ETF each) and Malaysia. This is because such funds usually track a named index, and so, like other passively managed mutual funds, they need both an index to track and the ability to trade the constituents of the index daily to replicate the index accurately. These needs cannot be reliably met in early emerging markets. Although ETFs have much in common with mutual funds, differences are found in the way that they are created and in the way fund shares or units are bought and sold, which is on an exchange (hence the name) rather than through the operator. ETFs are also more successful where they

enjoy a tax advantage compared to direct investment in mutual funds (as in America) or where they provide a cheaper method of passive management than indexed mutual funds.

The full range of structural variations is rarely seen in early emerging markets but is more common in more mature emerging markets such as Brazil. As can be seen from table 2.9, broadly, the more developed the capital market in the country concerned, the greater the variety of these structures that are enabled.

Permitted Founders of Mutual Funds

Law governing mutual funds should identify which entities or persons may found mutual funds. Usually this may be done only by an entity that has a specified type of license except where individual directors of a corporate fund are founders. However, the nature of the license required may vary from country to country (see table 2.10). In the United Kingdom, for instance, only an entity that has a license that permits it to operate a collective investment scheme may create a mutual fund; Peru has a similar requirement. However, in Brazil, investment funds are required to be founded by an entity licensed as a fund administrator under Instrução 306;⁴² these are typically major financial institutions, such as banks. The administrator is responsible for operating the fund and complying with regulations, but it may delegate investment management to another entity.⁴³ In Brazil, the administrator can also create funds at the request of suitable independent investment managers. In Kenya, although an entity holding a license as a fund manager could found an open-ended publicly offered fund, entities licensed as securities broker or investment banks could also do so (although only an entity with a fund manager’s license could manage the assets of these funds).

Licensing Requirements for Fund Operators, Custodians, Depositaries, and Trustees

Fund operators and the corporate entities that provide trustee and depositary services and take custody of mutual fund assets are required to be licensed to carry out their business. IOSCO principles require that both the operator of the fund and the entity that plays the role of custodian, depositary, or trustee must have human, financial, and technical resources necessary to operate and provide services to the fund and to ensure, on an ongoing basis, that the fund complies with the legal and regulatory framework. They

Table 2.9: Presence of Structural Variations in Case Study Markets as at Year End 2012

Country	Umbrella Funds	Multiple Share or Unit Classes	Master-Feeder Structures	Domestically Based ETFs	Funds of Funds
Brazil	✓	✓	✓	✓	✓
Kenya	✓	✓	✗	✗	✗
Morocco	✗	✗	✗	✗	✗
Peru	✗	✓	✗	✗	✓
Turkey	✓	✓	✗	✓	✓

Source: Case studies.

Table 2.10: Required Licensed Status for Entities Responsible for Mutual Fund Operation for Selected Countries

Country	Responsible for Mutual Fund			
	Creation	Investment Management	Administration	Marketing and Distribution
Brazil	Administrator	Administrator	Administrator	Administrator
Kenya	Promoter: fund management company, securities broker or investment bank	Fund management company	Fund management company	Promoter
Morocco	Fund management company and depositary bank	Fund management company	Fund management company	Fund management company
Peru	Fund management company	Fund management company	Fund management company	Fund management company
Turkey	Previously founder (a bank, insurance company, securities broker or pension or charitable fund), now fund management company	Previously founder, now fund management company	Previously founder, now fund management company	Previously founder, now fund management company

Source: World Bank case studies as at year end 2012.

must also meet standards for honesty, integrity, and competence, which would include a check to establish that the owners of the entity are “fit and proper.”

Regulation usually requires the fund’s operator to have a minimum amount of capital to be licensed; however, a very large initial capital prerequisite can be a barrier to entry and can perpetuate dominance by banks and insurance companies. Because operating a mutual fund is not in itself very capital intensive (unless delegation is not permitted, in which case systems and staffing demands may be greater), the minimum capital requirement largely plays a prudential role. Ideally, it ensures that an operator has sufficient liquid resources to continue to operate the fund even if there has been significant loss of revenue, or during an interim period if it is to be replaced by another operator.⁴⁴ However, a very high capital requirement can deter new entrants in the market. China has one of the highest capital requirements; founding a fund management company requires an initial fully paid in capital of Y 100 million (roughly \$16 million). Malaysia, on the other hand, requires shareholder funds of RM 10 million (roughly \$3 million) to manage a mutual fund. High capital requirements present barriers to entry to small entrepreneurial start-ups and thus may limit competition and perpetuate dominance by major financial institutions such as banks and insurance companies.

Some regimes require the fund management company to have minimum capital that is proportionate to funds under management. For instance, in the EU, fund management companies must have a minimum initial capital of €125,000 (roughly \$168,000 at the time of writing); however, this capital requirement increases as funds under management increase (up to a maximum of €10 million or \$11 million). Similarly in Turkey, the minimum capital required was TL 397,000 (\$186,000 approximately), which

increased as assets under management grew. And in Peru, although the minimum capital required for a fund management company is S/.750,000 (\$260,000 approximately), the paid-in capital must always be 2 percent of funds under management.

Mutual fund assets must typically be segregated and held by a licensed trustee, depositary, or custodian (depending on the nature of the fund). Regulation usually requires these entities to have a higher minimum capital requirement than fund management companies because generally they hold high values of assets on behalf of their clients. Typically the depositary or trustee or custodian to a fund will hold (and safeguard) its assets as a nominee.⁴⁵

The fund’s trustee, custodian, or depositary must be at least functionally independent of the operator to minimize potential for collusion. A 2013 Morningstar report found that more than half the countries surveyed allowed the management company and the custodian to be owned by a common entity.⁴⁶ Under the UCITS directive the depositary is not required to be fully legally independent of the operator but must be at least functionally independent from it. In the vast majority of countries with unit trust type funds, however, trust law or precedent requires the trustee to be fully legally and functionally independent of the operator. Kenya is unusual in this regard, because one entity is allowed to own up to 10 percent of the other.⁴⁷

It is generally easier for the regulator if banks—which most commonly provide depositary, trustee, or custodian services—undertake these activities through a separately capitalized subsidiary, because this subsidiary can be licensed and supervised under securities and mutual fund related law and regulation.⁴⁸ With a separately capitalized subsidiary, it is easier to identify

conflicts of interest because revenue flows to the subsidiary are easier to identify. Conflicts of interest could arise, for example, if a bank as depositary or custodian is privy to fund portfolios or trades that may be of interest to its investment banking operation or its proprietary trading desk and could make use of this knowledge. If banks do not have to form a separate subsidiary to undertake trustee, depositary, or custodian work, and the regulator does not also govern banking, it may be difficult to ensure that the trustee, depositary, or custodian is accountable to the regulator of mutual funds. In some countries, including Turkey, custody of mutual fund assets is undertaken by a specialized division of the central securities depositary. This may be the most practicable way forward in nascent markets where there may be a lack of providers of safekeeping or supervisory services (see table 2.11).

Whatever the structure used, it is important that all fund assets are safeguarded, not just the securities portfolio. For instance, at the time of the case study, the Kenyan CIS regime did not hold trustees responsible for safeguarding all fund assets, but instead required them only to ensure that “the custodian takes into custody all the collective investment scheme portfolio.” This language could be interpreted as the custodian being required to hold only the securities held by the fund, and not the cash, which clearly reduces investor protection. Fund assets should also be segregated from the assets of the fund’s operator, depositary, or trustee or custodian, as well as other clients of the depositary or trustee or custodian. Regulation should ensure that if the entity that holds fund assets were to become bankrupt, the fund’s assets should be clearly distinguishable and must not be part of the bankruptcy estate of the entity concerned.

IOSCO standards require the operator, custodian, depositary, and trustee to employ “fit and proper” and competent key senior personnel. “Fit and proper” implies that these personnel must have clean personal records: They have not declared bankruptcy, have no convictions for financial crime, have not been censured by a

financial regulator, and have not been refused a license or had a license withdrawn. The “fit and proper” test may be conducted by self-certification,⁴⁹ or, more commonly, the regulator may verify the suitability of key personnel through police checks or through information from other authorities. In addition, key personnel must establish competence through professional qualifications. These qualifications are usually specific to the particular role⁵⁰ and may consist of academic degrees or other qualifications and practical experience. China, for instance, requires a fund’s senior management to have a “fund practising qualification.” In Brazil, the trade association, ANBIMA, devises and administers a wide set of examination syllabuses to qualify personnel for different levels of management and administration. In Turkey the self-regulatory body, the Turkish Capital Markets Association, similarly trains fund market professionals. In the United Kingdom, the Chartered Institute of Finance and Investment, which is a parallel standard-setting, regulator-approved institute, designs a wide variety of specific qualifications. Less mature fund markets, such as Kenya, do not tend to have this level of qualification requirement.

Operators, custodians, depositaries, and trustees should be required to demonstrate continuous compliance with law and regulation. Before licensing, the applicant must usually present a business plan that shows the organizational structure and resources, including procedures and systems, such as internal audit and risk control. Regulations should require licensed entities to present regular compliance reports. The contents of such reports and of inspections of entities may be used to facilitate “risk-based supervision,” whereby the regulator categorizes regulated entities according to the perceived risk they present to the regulator’s objectives (for instance, financial stability or consumer confidence). The regulator can more effectively allocate its limited resources to paying the most attention to those entities that pose the highest risk to their objectives, because they cannot realistically check everything in detail in rapidly growing markets. For example, in

Table 2.11: Custody Arrangements for Different Legal Structures

Country	Fund Legal Structure	Supervision of Fund Operation	Safekeeping of Fund Assets
Brazil	Condominium	Administrator	Central securities depositaries for domestic assets Custodian bank for foreign assets
Kenya	Unit trust	Trustee	Trustee responsible for appointing custodian
	Investment company	Directors	Custodian
Morocco	Investment company and contractual fund	Regulator, directors (investment company), auditors	Custodian bank
Peru	Contractual fund	Regulator (no third-party supervision)	Custodian
Turkey	Contractual fund	Founder ^a Depositary ^b	Custodian ^a (usually the central securities depositary) Depositary ^b

Source: Case studies.

a. Until year end 2012.

b. Under Capital Markets Law December 2012.

Brazil, with more than 11,500 funds, the regulator has had to develop and use sophisticated IT systems that identify anomalies.

In general, operators of mutual funds should not be permitted to undertake other business activities that may pose conflict of interests. In some countries the regulatory framework may permit the operator to undertake a wide range of activities; for instance, in Kenya fund operators can be investment banks. However, if the fund operators can undertake securities brokerage or investment banking, they may risk amplifying conflict of interest with fund investors.⁵¹ Thus fund regulation usually restricts the operator's activities to only operating CIS and providing ancillary services and managing other portfolios, which allows it to diversify its revenue streams within limits that may make the business more sustainable, particularly in smaller markets. This requirement also has the effect of ensuring the operator focuses on developing the fund business.

Licenses may need to be renewed annually or may be perpetual (unless withdrawn or canceled). In some legislative systems licenses can be granted only for a year or other specified period. This was the case, for instance, in Kenya, which required annual licensing at the time of the case study. Although this allowed the regulator to withhold the license renewal in case of misbehavior, it also meant that the (often underresourced) regulator would be burdened every year with relicensing⁵² and that fund operators suffered from lack of certainty of renewal.

Enabling operators to delegate activities—but not responsibilities—may enable a wider range of entities to enter the market and facilitate competition. Although some countries' legislative systems place the responsibility for operating, managing, and marketing the fund all on one entity (commonly the fund management company), they allow delegation of many of these activities to specialist service providers. Thus, for instance, a new entrant to the mutual fund management market can reduce market entry costs by appointing a service provider instead of setting up its own registration system. Mutual fund law or regulation should therefore specify the entity responsible for an activity but permit this responsible entity to delegate the activity to another entity that meets appropriate eligibility requirements. The delegator remains responsible and must monitor that the delegate complies with all relevant regulatory requirements. Another alternative, as discussed earlier, is to permit entities such as the "administrator" in Brazil or the "responsible entity" in Australia, which may operate funds on behalf of selected investment managers, thus facilitating more market entrants and potentially greater competition.

Regulating Marketing and Fund Prospectus

Funds should be required to have a regulator-approved offering document that ensures "that there is full, accurate and timely disclosure to prospective investors providing all the information necessary for an investor to make an informed investment decision."⁵³ Regulation may also permit or require a summary, reader-friendly, document that presents information with standard content and flow to allow investors to easily compare funds. IOSCO

principles require full, accurate, and timely disclosure to prospective investors with all the information necessary to make an informed investment decision. The offering document containing this information is commonly called a prospectus, and the operator must submit this document to the regulator for registration or approval.⁵⁴ Although regulation requires a full prospectus, this can be very long and detailed and is unlikely to be easily read or understood by the average investor. Many regulators therefore now consider that a shorter version written in plain language, containing all the relevant information and consistent with the full prospectus, may serve ordinary investors better. In addition, standard content and flow can help the investor more easily compare one fund's prospectus with another. The U.S. and Canadian mutual fund regimes permit summary prospectuses, which are just a few pages long and contain key information about a fund. The Hong Kong regime also permits a simplified prospectus; in India the Key Information Memorandum serves the same purpose; and the majority of Brazilian trade association, ANBIMA's, members have agreed to a standardised short form prospectus. The Key Investor Information document required to be used by UCITS has a standardised format, with all relevant information on two sides of A4 paper. This approach is now being copied in various countries.⁵⁵

Regulating Investment, Borrowing, and Liquidity

It is extremely important that law or regulation establishes a requirement that a publicly offered mutual fund must have a diversified portfolio, and that it must invest and borrow only in conformity with limits set by law or regulation. If there is no requirement for a diversified portfolio, and only one or two investments are held, then investors are paying an annual management fee for very little reason and are not being provided with the diversification of risk that is the absolutely key function of a mutual fund. If clear limits are not placed on eligibility of investments and on amounts, types, and duration of borrowing, it is difficult for the regulator to prevent unsuitable investments being made—for instance, highly illiquid assets—or prevent excessive borrowing. Over the long term, a weakness of this type is likely to lead to loss of confidence as investors experience unexpectedly volatile or poor returns or are unable to exercise their absolute right to redeem from a fund if—at the extreme—a fund is completely hollowed out by borrowing. It is for these reasons that IOSCO principles require clear rules around types of investments, diversifying the portfolio, and restricting borrowing to "address the investment goals, the risk profile and the degree of liquidity required for a CIS to meet redemptions in all market conditions" (see box 2.2). Chapter 3 discusses this in more detail.

Regulation should establish that funds of a specified type must invest only as permitted by regulation. For instance, the key concept of a MMF is that it should have minimal risk to capital; thus if the investor puts \$1 in, he or she will get at least \$1 out (that is, the fund will seek to maintain a "constant value"). If regulation does not establish that such funds may only hold investments of a limited duration (at the time of acquisition of 365 days or less), then operators of such funds could buy longer-term instruments that may pay a higher interest rate (and so be attractive to investors)

but whose capital value is more likely to fluctuate. This, in turn, could risk the fund's ability to maintain a constant share or unit value, which investors may not understand, particularly if this is not required to be fully disclosed. The Kenyan fund market has faced this problem, because regulations at the time of the case study did not specify the investments that a MMF is required to hold, and MMFs apparently frequently hold bonds of up to five years' duration. The regulator has no power to prevent these being presented as "MMFs" because there is no definition of such funds or of the investments they are permitted to hold. IOSCO requires that a MMF be explicitly defined and that limits be set on the types of assets in which they invest and the duration and maturity of assets held⁵⁶ and recommends that where feasible such funds should be variable rather than constant net asset value.

Regulation will also need to specify those types of mutual funds that need very specific investment powers, otherwise such funds will be unable to function. This includes feeder funds that invest only in one other fund (the master fund) or cash and so would not normally be permitted to operate because funds can typically have only up to 20 percent of fund value in exposure to another fund. It also includes funds of funds (which invest only in other funds, which again, may be cumulatively limited to 20 percent of fund value), MMFs (see above), and indexed funds (which may need to invest more than 10 percent of their value in any one issuer to match the index they track, which is not usually permitted).

Typically regulations should also specify what percentage of a fund's assets may be invested in any one issuer's securities and set caps on the percentage of any one issuer's securities that the fund can hold.⁵⁷ This is, first, because mutual funds should diversify risk and, second, because they are usually tax privileged, so tax authorities are concerned that they should not be used as holding companies or as vehicles to avoid tax. For this same reason, many regimes also require that funds are owned by a diversity of investors. On the other hand, some regimes such as Brazil and Morocco permit funds to be created for a single institution or individual.

Investment in foreign assets should not be prevented by mutual fund law or regulation because this may reduce the potential for the sector to develop and its ability to compete with foreign-domiciled funds. Other barriers to foreign investment may exist in the form of exchange controls, or because of relative tax efficiency compared to investing in domestic assets, or perhaps because of cost or lack of expertise in investing in such assets, which may be better provided by foreign fund competitors. Historically, institutional investors have often invested in mutual funds partly because these funds offer a cost effective method to gain exposure to certain regions, countries, or asset classes. In Turkey, for instance, law and regulation allows mutual funds to invest abroad and Turkish pension schemes might thus find it attractive to invest in domestic mutual funds which invest in foreign assets, if it were not for the 10 percent cap on pension scheme investment in mutual funds. However, in some countries mutual fund regulation does prevent funds investing abroad: For example, Brazilian funds generally cannot invest abroad, although the "multimercado"⁵⁸ type of fund, which can invest up to 20 percent abroad, has proved successful in recent years. Moroccan mutual funds cannot invest more than 10 percent of the assets they manage in foreign currencies. At the end of 2010, less than 1 percent

of total assets under management was invested outside of Morocco, mainly in euro-denominated funds or fixed-income securities. If domestic funds do not offer international exposure, investors often buy foreign domiciled funds instead, which clearly reduces the scope for developing domestic funds. The legal and regulatory framework may also place limits on cumulative or individual fund exposure to foreign assets. For example, Securities and Exchange Board of India (SEBI) regulations in India cap foreign investment by mutual funds to a cumulative total across all mutual funds of \$7 billion, with a cap of \$300 million per mutual fund. In addition, SEBI regulations cap investment in foreign exchange-traded funds (ETFs) to a cumulative total of \$1 billion across all mutual funds, and a maximum per fund of \$50 million.⁵⁹

Regulation should allow a fund only to borrow up to about 10 percent of fund assets,⁶⁰ and only for specific purposes such as to meet redemptions and only for the short term, primarily because open-ended funds are obliged to buy back investor shares on a regular basis. If borrowing were not limited in this way, and if fund assets declined because of redemptions, the debt-to-asset ratio could increase to unsustainable levels. At year-end 2012, Turkish mutual funds were permitted to borrow up to 25 percent of asset value, which is unusually high; Kenyan regulations are silent on the subject.

Regulation should not permit mutual funds to lend in any way, other than by making deposits or buying debt securities. Here again, the danger is that the lending could, because of redemptions, become an ever higher proportion of the fund; fund investors assets could erode or lending may not be able to be repaid.

Regulation should forbid or severely limit mutual funds from investing in illiquid assets; however, in many developing countries, funds may find few liquid assets to invest. As discussed above, open-ended mutual funds give their investors the right to invest or redeem, usually on a daily basis. This, in turn, means that the fund must hold investments that are easy to buy or sell in reasonable quantity at any time without significantly affecting the market price. IOSCO, in a recent report on CIS liquidity,⁶¹ notes:

In the context of liquidity, CIS differ fundamentally from banks in that "maturity transformation"⁶² is not an inherent feature of their operation, and the majority of CIS do not engage in such transformation to the extent that banks do. For example, many CIS use investors' subscriptions to invest in highly liquid large capitalization listed company shares, which can quickly be sold if necessary to provide liquidity for meeting redemption requests from investors in the CIS. Neither does the majority of CIS provide any "promise" or guarantee that investors will get back (at least) the same amount of money as they initially invested. An investor in a CIS is a shareholder; as opposed to a depositor in a bank, who is a creditor. ... Liquidity crises are therefore less likely to cause systemic confidence problems in CIS than in banking. Nevertheless, a CIS may experience liquidity problems. Liquidity risk management in CIS is a complex area: poor liquidity can arise from many different sources, some of which are outside the control of the entity operating the CIS.⁶³

If liquid assets are lacking in a market, it may be best to enable closed-ended funds (see box 2.7), which are better suited to investing in illiquid markets and assets such as real estate and venture capital because they have no obligation to redeem their shares or units and pay out cash to investors. When creating a new legal and regulatory regime governing funds, it is best to recognize closed-ended vehicles as funds and regulate them under that regime.

The Need to Categorize and Classify Funds

Regulation typically defines types of funds to identify relevant investment limits applicable to them; however, funds also need to be categorized in more detail so that investors know what they are investing in, understand what risk they are taking, and can make effective comparisons between similar funds. Regulation requires fund offering documents to state what their investment objective is—for instance, income, growth, a mixture of these, or capital preservation—and what investment policy they will pursue to achieve this—that is, by investing in equities, bonds, money market instruments, or a mixture of these. Usually rules will require a mutual fund to invest not less than a stated percentage, often 80 percent, in the assets relating to that fund category, for instance, in emerging markets equities. When countries do not have a standard classification system for mutual funds (such as Kenya and Turkey at the time of the case study), it becomes difficult for investors to understand what they are investing in and the associated risks, and to make comparisons of performance and of cost. Kenya's regulatory regime, for instance, does not clearly define types of

funds or set investment requirements for these. Global databases⁶⁵ also broadly categorize funds into long-term funds (equity, bond, and mixed) and short-term funds (MMFs). However, this basic categorization does not cover the many gradations of objectives of funds within each broad category. In markets with a vast range of funds, investors need to know more precisely what their chosen fund is going to invest in, and what the risks are, and so funds may be further divided into subcategories: by sizes of company (e.g., midcap), by sector (e.g., energy), or by geographic focus (e.g., United States). Typically the trade association establishes more detailed categories, such as is the case in Brazil. In Peru the regulator categorizes funds into 12 types, with further subcategorizations based on the duration of bond and fixed income funds. Although the Kenyan trade association does divide funds into categories, these categories are not clearly defined and have no regulatory standing and so cannot be enforced. Some regimes go further and define a risk classification system; for instance, the Malaysian trade association (now an SRO) publishes detailed fund categories and has also developed a risk classification system based on historical volatility. In the EU, a UCIT's "synthetic risk reward indicator," calculated through a mandated risk classification system, must be shown in the key investor information document.

Regulating Fund Valuation, Pricing, and Fees

Regulators pay close attention to how a fund's assets are valued and, in turn, how each share or unit in the fund is priced, because each category of investor in a fund—whether entering, exiting, or ongoing—must be treated fairly. IOSCO principles require that the

Box 2.7: Closed-Ended Funds and U.K. Example

Closed-Ended Funds

Closed-ended funds essentially operate like an ordinary public company: They market a one-off issue of securities (similar to an initial public offering) to attract a minimum value of capital that makes the fund commercially viable. If they succeed in attracting this minimum amount, the fund is formed either with a permanent life, or a fixed life of a specified period stated in the prospectus (usually five to 50 years). The fund is then listed, adding to the range of securities available in the market. Because the fund does not have to redeem its shares or units, it does not need liquid underlying assets. Thus the fund can invest in infrastructure, real estate, and venture capital-type companies although such funds may also invest in liquid securities. If the portfolios of such funds do become liquid over time, then they can convert to open-ended form.

Before fund-specific law existed, closed-ended funds were created either using trust or corporate law. Thus in some countries (such as the United Kingdom), law and regulation do not include closed-ended funds within the definition of a collective investment scheme, and thus law relating to CIS does not apply to closed-ended funds. This is why countries that have, for historical reasons, followed the United Kingdom's approach to regulating collective investment schemes have regulatory frameworks which do not govern closed-ended funds.

Closed-Ended Funds in the United Kingdom

In the United Kingdom, closed-ended funds are known as "investment companies," that is, companies that exist to make investments, instead of creating goods or providing services. They operate under company law.

Although the market conduct regulator governs the investment management of closed-ended funds formed as investment companies, the investment companies themselves are regulated only by company law and tax and listing requirements. Tax rules require that these funds may not be a close company,⁶⁴ may not invest more than 15 percent of their value in any one issuer, and must be listed on a stock exchange. "Investment companies" are a specialist subset of listed securities that have their own listing rules because, for instance, they do not have trading histories when they are listed, unlike ordinary companies.

regulator provides a methodology to calculate a fund's net asset value (NAV) and a pricing methodology and system for entering or exiting a fund that allows fair treatment for new, exiting, and ongoing investors.⁶⁶ Essentially, the NAV is the value of the fund's assets at the most recent market price, less the debts owed by the fund.⁶⁷ NAV should be calculated as often as the fund deals in shares or units, which is typically daily,⁶⁸ and will vary as the value of fund assets varies. When an investor buys a share or unit, an entry charge may be added to the net asset value per share or unit; conversely, when the investor redeems a share or unit, an exit charge may be deducted from the NAV. When regulation does not specify a methodology for calculating NAV, investors may suffer from inconsistent pricing. In Kenya, for instance, regulation does not specify whether to value the fund's portfolio based on offer and bid or mid prices, nor does it specify whether the costs of buying and selling the fund's portfolio should be factored into the valuation. So any comparison of one fund's price per unit against another's may be misleading, because one may include a charge and another may not. One of the problems in many emerging markets is that trade in securities may not be very frequent, and prices therefore may not be formed often, which may make valuation difficult.⁶⁹ If the share or unit price derived from the NAV is wrong, an investor entering the fund may either pay too little or too much, and an investor exiting the fund may receive too much or too little. In turn, this will reduce or enhance the value for ongoing investors, so all investors will not be treated fairly. The valuation and pricing of fund shares or units of a fund is arguably the single most important aspect of mutual fund operation and of key concern to regulators.⁷⁰

One of the key roles of regulation is to define what charges may be levied on funds and on investors as they enter or exit the fund. In general, regulation allows funds to levy a charge on investors as they enter or exit a fund (although some types of funds, such as MMFs, do not levy these). Such charges, discussed in more detail in chapter 1, are usually expressed as a percentage of the net asset value of the share or unit. Regulation should also establish what charges or costs may be paid out of the fund to meet its cost of operation. This typically includes the costs of managing fund investments, administering the

fund and servicing the investors, and costs of fee-based services such as custodian, depositary, or trustee. In addition, the fund generally pays for the cost of buying and selling investments, duties or taxes, legal advice to the fund, regulatory fees, performance fees⁷¹ and producing the offering document. In some jurisdictions, the fund is permitted to pay for marketing (advertising, promotion) and distribution (sales commissions) costs. In others, the operator is instead expected to pay for these activities out of their revenues because these activities typically lead to an increase in sales, and therefore fund value, which in turn benefits the operator (because operator fees are a percentage of the value of the fund). It is important that permitted charges are not only defined, but required to be disclosed, and that regulation states that any cost that has not been disclosed cannot be levied.

Setting regulatory caps on charges has pros and cons. Some regulators may cap the level of fees that may be charged on a fund, either per charge or across all charges as a cumulative total percentage of the fund's value to protect investors' interests (see table 2.12). However, market participants may then simply charge the maximum allowable fees, restricting competition and maximizing profitability, or, if the limits are set too low, it may become unprofitable to operate mutual funds and the sector will fail to develop. For instance, in Morocco, law no. 1-93-213 requires the articles of association of open-ended corporate and contractual funds to clearly outline what fees will be charged for buying or selling fund shares or units, as well as the maximum annual management fees. The law also requires the Minister of Finance to set the maximum fees and authorize the methodology to compute management fees.⁷² In Turkey, where mutual funds are mostly operated by affiliates of banks, the regulator did not originally limit annual charges. This led to a situation where Turkish MMFs levied charges of around 5.5 percent—exorbitant for MMFs by international standards. The Turkish regulator, the Capital Markets Board, therefore capped charges on MMFs at 1.1 percent (and set other limits on equity and fixed income funds). This improved returns to investors, who were now charged 4.4 percent less. However, banks have found marketing MMFs much less profitable, and sales of such funds have fallen.

Table 2.12: Charges Limited by Regulation and General Level of Charges in Case Study Countries as at Year End 2012

Country	Entry Fee	Annual Management Charge	Exit Fee
Brazil	Not limited Sometimes charged	Not limited 0.5–4.0%	Not limited Usually not charged
Kenya	Not limited Up to 6% charged	Not limited Up to 3.5% charged	Not limited Not charged
Morocco	Not limited Up to 2.15%	Limited to 2% maximum	Not limited Up to 1.22%
Peru	Not limited 1–3%	Not limited 0.5–3%	Not limited Not charged
Turkey	Not limited Rarely charged	Limited: 1.1% money market; 2.2% for short-term bond; 3.65% for equity	Not limited Not charged

Source: Case studies.

It is useful for regulation to require disclosure of the total annual operating cost of a fund. Regulation may permit many different charges—in addition to the annual management charge paid to the operator—to be levied on funds, and so many regulatory frameworks require the fund's total annual cost of operation to be calculated, based on the previous year's audited accounts. The fund's annual report and offering document must disclose this total annual cost of operation to investors (an estimate has to be given for a new fund). This enables investors to make fair comparisons across funds. Such a requirement is more common in developed markets than in emerging markets; for example, the European Securities and Markets Authority requires the Key Investor Information document to disclose "ongoing charges."⁷³

Regulating Advertising and Promotion

Regulatory requirements that apply to securities offering, and sometimes to financial products in general, will usually apply to fund advertising, with some additional fund-specific requirements relating to performance and risk disclosure. The general regulatory principle is that advertising and promotions should be fair, clear, and not misleading. IOSCO requires that advertising be consistent with the fund's offering document (which is essentially the terms and conditions under which investment in the fund is made and not a promotional tool). Regulation should also ban forecasting performance or guaranteeing (or implying guaranteed) results. Most regulators mandate a series of standard statements (risk warnings) to be made in fund advertising materials that caution investors that fund values and income from funds can fluctuate, that investors may not get back the amount that they invested, and that past performance is not a predictor of future performance. The China Securities Regulatory Commission, for instance, forbids the use of words such as "safe," "ensure," "promise," "free of risks," "safeguard," "high yield," and "no risk"—any or all of which may lead the investors to believe there is no risk. Regulators in nascent markets may wish to approve fund publicity material before publication; however, for underresourced regulators in large markets, this activity would be unsustainable. In addition, regulators typically wish to avoid giving the impression that they have endorsed a mutual fund. Instead, a delegated trade association or SRO may monitor advertisements and other publicity material.

Regulating Sales and Distribution

Shares or units in mutual funds are commonly defined as securities, and so the securities law of a country, or a broader financial services law, typically governs the way mutual fund shares or units are distributed; that is, it dictates who is eligible to sell these units/shares or advise prospective investors. This is usually the case for an investment company, because a share in a company is a security under securities law.⁷⁴ This may not, however, be the case for a unit in a unit trust or in a contractual fund unless the law governing unit trusts or contractual funds or the securities or financial services law specifies that these are securities or specifies other provisions instead. In Morocco the law for securities offering governs the distribution of shares of open-ended corporate and

contractual funds. Similarly, in Turkey, the Capital Markets Law governs the sale of mutual fund units. Fund law or regulation should ideally permit the operator of a fund—that is, the fund management company—to sell shares or units in its funds (typically broking or dealing in securities is otherwise limited by securities law to entities with these licenses). In Turkey, law and regulation did not permit this until the new Capital Markets Law in 2012 was passed; this prevented the fund management company from making direct sales of fund units through, for instance, its own website.

Although the operator is responsible for the sales policy and distribution of a mutual fund, licensed distributors usually sell the fund(s) on the operator's behalf. In some countries, distribution is regulated by an SRO. The operator enters into contracts with distributors to sell the fund(s) on their behalf. Typically these distributors may include bank branches, insurance sales forces, specialist sales agents, securities brokers and dealers, private banks, and financial advisers. Law and regulation should make it illegal for those without appropriate license to sell or deal in shares or units in funds or to advise on buying and selling them. Licensed distributors will have to comply with the terms of their license, including conduct-of-business rules and reporting.⁷⁵ In some countries, such as Brazil, the self-regulatory body (ANBIMA) regulates distribution. ANBIMA's recent Code of Conduct⁷⁶ provides standards for distributors targeting retail investors of investment funds to ensure they provide appropriate information and deal with these investors fairly. ANBIMA also certifies professionals who market and distribute investment products to qualified investors, as well as branch managers who service high-net-worth individuals and institutional investors. In addition, ANBIMA inspects its 117 investment fund distributors.

Financial advisors who advise on investing in mutual funds are also generally regulated. As discussed earlier, increasingly regulation in developed markets requires an independent advisor to be the agent of the client, and remunerated by the client, not the operator. Even in developed markets, specialist financial advisers and regulation governing them is relatively recent; thus, this type of entity in emerging markets is correspondingly rare. Typically the entities that advise investors on mutual funds may also advise them on financial planning, mortgages, pensions, insurance, and other savings, and so regulation of these entities can be complex, covering a wide range of different financial products. Regulation usually requires the adviser to have the necessary professional qualification to give advice across the relevant range of products. A key consideration for regulation is whether the adviser is the agent of the operator of the fund (compensated by commission); or the agent of the client (and paid by the client). In developed markets, advisers were typically the agents of operators. However, increasingly, regulation requires advisers who claim to give independent advice—that is, unbiased advice across a range of product providers—to be the agent of the client and requires the remuneration of these advisers to be agreed between the client and the adviser.

To maximize distribution potential, financial regulation should not prevent the development of fund supermarkets or the listing of mutual funds on stock exchanges. Fund supermarkets are Internet-based platforms that provide information on mutual funds and dealing services and record keeping for those that wish

to buy and sell such funds. Generally such platforms provide only information and guidance (using decision trees, for instance) and do not provide advice, but they do arrange and perform transactions in securities and therefore are usually governed by securities law. In general, however, these platforms are unlikely to develop until a sufficient range of funds and investors is in place to support their operation, so these are usually seen only in more developed emerging markets. In some countries, allowing mutual fund shares or units to be listed on a specialized section of exchanges can also increase the visibility of mutual funds and assist in developing demand for funds. This will require developing special listing requirements, sometimes referred to as “technical listings” because the shares or units of the funds are still bought and sold via the fund management company. A fund that has a technical listing on an exchange may become eligible for investment to institutions that may only invest in listed or traded securities. Indeed, in some cases it may be possible to encourage exchanges to develop what is essentially a fund supermarket as a subset of their operations.

Regulating Disclosure, Reports, and Ongoing Information to Investors

Regulation should require operators to publish regular information on a fund's share or unit price in an accessible medium together with the offering document or a short form offering document. Ideally this information will be available along with statistics on other funds to allow investors to easily compare funds. Investors into a fund will need to follow the progress of their fund, and typically their first priority is the price of the share or unit of the fund, which indicates whether they are making a profit or a loss. Therefore most regulators require operators to show regular share or unit price information in an accessible medium, such as a widely circulated national newspaper, or the operator's website, or better still on a website that carries prices of all funds. Ideally the performance of the fund will be published relative to others so that investors can compare funds and make informed decisions. Trade associations or commercial providers may host websites that show such comparative data; sometimes this information must be disclosed on a special section of the regulator's website. If this type of disclosure is not required, potential investors will find it difficult to find and compare information on funds and so may be deterred from investing. Without this type of disclosure, investors may also only be able to find promotional material that may emphasize benefits but fail to highlight risks effectively. In Kenya, for instance, at the time of the case study operators' websites showed only marketing information and did not disclose prospectuses, any form of offering document, or annual reports.

Regulation should require operators to calculate and present data on fund performance consistently, accurately, fairly, and with clarity, so that investors can make meaningful comparisons across funds. Investors who do not have access to independent and comprehensive information about fund performance are more vulnerable to being sold the latest product. The regulator therefore typically mandates that performance information is disclosed on a consistent basis.⁷⁷ In Kenya, no rules specify whether to include reinvestment of income, or whether performance is given gross or net of charges, or gross or net of tax. Thus investors cannot know

if they are comparing like with like and may therefore be misled either accidentally or deliberately. External, independent providers of data, found typically in developed fund markets, often play a key role in ensuring that such critical data are analyzed and presented in a consistent, fair, and clear manner. Major global providers of fund performance information include Lipper, Morningstar, Trustnet, and Standard & Poor's. In some countries local providers of such services have developed, including CRISIL in India (now owned by Standard & Poor's).

Regulation should require operators to send fund investors annual audited financial reports. IOSCO requires that these reports should be prepared to internationally accepted standards, but at the time of the study there are no International Financial Reporting Standards specific to mutual funds, and so fund accounts are prepared using the relevant standards required in each country. In addition to the prospectus, the operator must provide investors (and file with the regulator) annual audited and half-yearly unaudited financial reports of each fund (or each subfund of an umbrella fund) on the management and operations of the CIS.⁷⁸ It is useful to require the operator to present the report in standard form and order, which makes it easier to compare one fund with another. Regulation should require reports from the fund operator and trustee or depositary stating their obligations and how they have fulfilled these. The regulator should require the auditor to report on whether the accounts give a “true and fair” view of the fund's capital and income position.

Regulation should set standard and practical disclosure requirements as much as possible. Methods used in developed markets such as postal mail may be unreliable in some markets, and other delivery methods such as couriers may be too expensive. In such circumstances, it may be better to allow reports to be sent via e-mail (not simply by display on websites, where investors may not be aware of new documents being displayed) or published in national media (although this also may be costly). Chapter 3 revisits this discussion.

Competent Supervision

In new markets lack of understanding of mutual funds is likely to be a problem. If mutual funds have not previously operated in a country, or are relatively new, policy makers and regulators are unlikely to have an understanding of why elements of law and regulation matter (which this publication seeks to address) or how funds work. This can lead to laws and regulations being poorly drafted that can lead to mutual funds not being formed or only some types of mutual fund not being formed, and it also makes enforcing compliance difficult. Regulators who do not understand funds also may not act to stop or prevent abuses because they may fail to recognize their significance. Neither of these are conducive to sector development.

Internationalization of Fund Markets

Legislation for mutual funds is typically formed at the country level; however, increasingly supranational standards are being developed to create regional fund markets and consolidate smaller mutual fund sectors. The EU is the leader in creating regional standards with respect to mutual funds. In 1985 the EU adopted the first directive

to harmonize standards on UCITS – generally, open-ended publicly offered funds that invest in transferable securities within specified limits.⁷⁹ The UCITS directive aims to achieve a single market for mutual funds across the EU. It allows shares or units of open-ended collective investment funds created in any EEA member state,⁸⁰ which comply with the directive's standards,⁸¹ to be distributed in all other EEA countries. This ability to distribute UCITS across borders has resulted in significant growth in the EU mutual industry, allowing multinational asset management companies to distribute funds across Europe. In 2012, 45 percent of assets under management in UCITS in Europe was invested in funds sold across borders, up from 21 percent in 2001.⁸² Further, many countries outside Europe accept the UCITS standard for inward sale: In 2012, an estimated 40 percent of UCITS sales were outside the EU,⁸³ including Latin America, the Middle East, and East Asia. Similar to the EU regional market, regulators in Hong Kong, China, and China are developing a platform to mutually recognize mutual funds operating in either jurisdiction.⁸⁴ The Asia-Pacific Economic Cooperation (APEC) region also plans to harmonize collective investment funds, to permit their distribution across borders, through an Asia Region Funds Passport applicable to all APEC countries.⁸⁵ Chile, Colombia, and Peru, which established the Mercado Integrado de Latin America⁸⁶ to integrate stock market transactions, could similarly agree to conform to common standards⁸⁷ to authorize and regulate mutual funds. Thus authorized mutual funds domiciled in one member country could be freely and automatically distributed in other member countries. Integrating these three mutual fund markets would consolidate relatively small domestic mutual fund industries into one larger market of roughly \$60 billion in assets under management. Another example is the East African Community, which plans to harmonize regulations to permit funds domiciled in a member country to be distributed in other member countries using the EU concept of home/host country regulation; however, the scale of mutual fund sectors in this region is very small (Kenya being the largest).

Permitting the Offering of Foreign Funds in Domestic Markets

Law can enable sales of foreign funds into a domestic market through “recognizing” foreign funds governed by jurisdictions that provide equivalent investor protection standards as domestic fund law. The law may also allow foreign funds to be sold only to professional investors. Commonly, it is illegal to publicly offer a fund that is not approved by the domestic regulator. This means it would be illegal for foreign funds without a domestic license to be sold to retail investors in that country. However, governments may wish to allow foreign funds to be sold to the public, for example, to facilitate a regional single market, as described above. Thus the law must make provisions for the regulator to “recognize” other fund jurisdictions, meaning a mutual fund that can be sold to the public in one jurisdiction would be recognized as eligible for sale to the public in another (see table 2.13).⁸⁸ In some countries, regulation may not permit foreign funds to be sold to the public, but they may be allowed to market to professional investors: Thus UCITS can be sold to pension funds in several Latin American countries such as Chile, Colombia, Mexico, and Peru. In Brazil, foreign funds cannot be offered to domestic investors, and pension funds cannot invest in

Table 2.13: Ability to Offer Foreign Mutual Funds to the Domestic Public Subject to Registration with the Regulator as at Year End 2012

Country	Ability to Offer Eligible Foreign Funds Publicly
Brazil	No
Kenya	No
Morocco	No
Peru	No
Turkey	Yes

them; however, pension funds can access foreign funds by investing in a domestic fund of funds that invests into foreign funds.

“Recognizing” foreign funds becomes more important because publicly offered funds are increasingly distributed across borders; however, regulators will also need to consider how this may affect the sales of domestic mutual funds. If foreign domiciled funds are allowed to be sold domestically, the domestic fund market may be threatened by the competition from foreign funds. As table 2.13 indicates, outside regional trading blocs, it is relatively rare for foreign funds to be permitted to be publicly offered, and statistics on such sales in emerging markets are not generally publicly available. Anecdotal evidence from Lebanon, which allows this practice, is that people invest in foreign funds largely for foreign investment, and domestic-based funds are used for domestic investment. Thus in Lebanon, the key area of competition may be between domestic funds that invest abroad and foreign funds that invest abroad.

In many countries, foreign funds may also be sold privately to investors without any regulatory recognition. In both Kenya and Peru, although foreign funds could not be publicly offered, more affluent investors could invest in foreign funds through private wealth managers and private banks. In Peru, for instance, the total value of the domestic mutual fund market in 2012 was \$6.5 billion, whereas individual Peruvian investors had invested an estimated \$10–15 billion offshore in foreign mutual funds (no exchange controls are in place in Peru). This may be because investors wish to keep money offshore or hold assets in foreign currencies, or because domestic mutual funds, which historically invest only domestically, do not offer the international diversification that some Peruvian investors seek.

Other Laws that Affect Mutual Fund Development

Although the creation and operation of mutual funds is mainly governed by financial, securities, or mutual fund law, other law can hinder the operation of mutual funds unless it is disapplied where necessary. The main difficulty is the application of company law to open-ended investment companies (see discussion above on legal structures of funds for details) because company law is usually designed for ordinary companies that have a fixed number of shares in issue, whereas open-ended investment companies constantly create and cancel shares and so have variable capital.

Some of the other operational features of mutual funds are also difficult to accommodate under normal company law, such as selling and redeeming shares at net asset value. The most common way of dealing with this is by issuing exemptions or exclusions from company law (see box 2.8). In Kenya, the Capital Markets Act exempts “mutual funds” (open-ended investment companies) from Companies Act provisions relating to sale and redemption of shares. Similarly, in Turkey, mutual funds that take the form of investment companies are governed also by corporate law with some exemptions.

The success of the mutual fund sector is often a consequence of whether the law permits these funds to play a role in retirement saving. First, when retirement-related law or employment conditions require individuals to contribute a high portion of their salary to a national pension scheme, mutual funds and other savings vehicles may be “crowded out.” In Uganda where employees of companies with more than five workers had to contribute 15 percent of salary to the National Social Security Fund, this may have “crowded out” mutual funds. In Kenya, on the other hand, mandatory contributions to the National Social Security Fund were K Sh 400 or roughly \$4, leaving space for private pension schemes and mutual funds to develop. Second, mutual funds also become less competitive when individuals are allowed to withdraw their contributions from pension schemes with limited penalty, such as in Tanzania, where individuals

have been able to withdraw contributions when they change jobs. In such cases, pension savings effectively become short term investments and can substitute for mutual fund vehicles. Third, although in some countries pension schemes are simply required to prudently diversify investment risk, with no investment limitations (and so are free to invest in mutual funds), in others pension law/regulation may establish the permitted investments of such schemes (whether defined benefit or defined contribution), which may or may not include mutual funds. Particularly when saving into a pension scheme is mandatory and represents a relatively high proportion of salary, the ability of pension schemes to invest in mutual funds can be critical to developing the mutual fund sector. In countries where mutual funds play a large role in retirement savings, significant growth in the sector can occur (see box 2.9). In other countries, such as Turkey, individual retirement schemes may not invest more than 20 percent of their assets in mutual funds. Since 2013 the Turkish government has also offered top-ups to contributors to the individual retirement system. Thus, within limits, if contributors meet certain requirements, the government contributes 25 of value for every 100 of value contributed. Contributions to mutual funds, therefore, become much less attractive, particularly because Turkish pension scheme members can withdraw their contributions, with penalties, before retirement. Hence retirement savings are relatively accessible rather than being locked away until retirement.

Box 2.8: Mutual Funds Formed as Investment Companies

Enabling mutual funds as investment companies with variable capital is often challenging, because company law will typically apply to such companies. The formation process can be both expensive and cumbersome because of added procedures required under company law. For instance, the fund will need to register with the registrar of companies, as well as seek regulatory approval.

These issues can be dealt with in various ways:

- *Add special clauses to company law or commercial codes:* This is often difficult, given the complexity of corporate law and the time taken to pass or to amend such laws.
- *Law that governs mutual funds can disapply the relevant sections of corporate law:* This is quite a common approach but needs expertise to ensure all relevant matters are considered. The disapplication must be addressed in law rather than regulation.⁸⁹
- *Exclude mutual funds from company law:* In effect, mutual funds formed as investment companies would then operate only under mutual fund law and regulation. However, in this case, investors would be vulnerable unless mutual fund law addresses the governance, creation, operation, and winding up of such funds (as it would with contractual funds).

Box 2.9: Mutual Funds and Retirement Savings

In countries where mutual funds play a large role in retirement savings, the sector has witnessed significant growth. Australia’s mutual fund market, for instance, has become one of the largest in the world, in good part due to the role these funds play in “superannuation” or retirement savings. Similarly in the United States, retirement assets held in 2012 through defined contribution pensions and IRAs amounted to 48 percent of the value of all long-term mutual funds (investing in equities, bonds, and a mixture of these) and 14 percent of the value of all MMFs.⁹⁰

In the United States, many defined contribution-type retirement plans, such as IRAs, also invest directly into mutual funds. These personal pension plans are tax-privileged “wrappers,” which are essentially an individual account owned by the contributor; the plan is the “wrapper” like an envelope within which law permits certain assets to be held. One of these assets is mutual funds. Research dating from 2013⁹¹ also showed that 92 percent of households that owned mutual funds were using them to save for retirement purposes and that 81 percent of households that owned mutual funds held those funds within employer-sponsored retirement plans, demonstrating the importance of retirement-related savings incentives.

It is important, therefore, to think through the policy implications of the design of pension systems for the development of mutual funds. Box 2.9 illustrates the importance of the role mutual funds play in developed markets.

Taxation

In general, if funds (or any form of savings on investment) suffer more tax than competing savings products, they will fail to attract investors. The tax regime of mutual funds is usually determined by the relevant tax authority and plays an important role in the competitiveness of the mutual fund sector. Taxation is a major influence on the flow of savings. No investors wish to pay tax that they do not have to pay, and conversely, investors are attracted to products that have favorable tax status. If tax treatment is unattractive, investors and funds will seek domiciles or instruments where tax liability is lower. Fund operators thus seek to minimize the tax liability of funds and maximize returns to attract investors. In some countries funds may not be able to receive favorable tax status: for instance, in Saudi Arabia, where there is no income tax at all, investors cannot receive a more favorable tax treatment of fund income. In many developing countries where significant portions of the population are in the informal economy and do not pay tax, or if tax evasion is widespread, investing in funds may be unattractive because it could draw unwanted attention to taxable capital and income. Governments thus have to achieve a delicate balance between collecting fair and timely revenues from investors, while also not impeding the ability of funds to mobilize capital by imposing unattractive tax liabilities.

Unless a fund tax framework is carefully considered, funds and their investors may suffer multiple levels of tax on the income or capital gains proceeds of a fund.⁹² The simplest way to illustrate this is diagrammatically (see table 2.14).

The basic principles of fund taxation are as follows:

a. **In general, funds should be “fiscally neutral” or “tax transparent.”**

The key principle in fund taxation is that an investor investing in assets indirectly via a mutual fund should not be at a disadvantage

compared with an investor directly buying those same assets. If it were disadvantageous to invest indirectly via a mutual fund, everyone would invest directly instead. In Morocco, for example, although mutual funds were in principle tax transparent, a quasi-tax was imposed on several mutual funds in 2011 and 2012, in the form of a special contribution to a social fund called the Fonds de Cohésion Social. This went against the principle known as “fiscal neutrality,” which is extremely important in fund taxation. In general, therefore, funds are “see-through” entities, which are not subject to tax on income and capital gains that result from their own portfolio transactions. This implies that the tax point is generally the investor and not the fund.

- b. **For a fund to avail “fiscal neutrality” status, the tax framework has to clearly define the vehicle to which this tax treatment or exemption applies.** The tax framework may simply define this vehicle by referring to a fund licensed or approved by the domestic regulator.⁹³ To avail tax transparent status, a fund may also have to meet other stated criteria. For example, publicly offered closed-ended funds may need to be listed or meet certain diversification and ownership requirements. This means, of course, that a fund that ceases to have the defined status will also cease to get the favourable tax treatment, which can, in turn, be an incentive to be regulated.
- c. **The tax framework must be clear as to whether the mutual fund or the fund investor pays tax.** If an investor is uncertain whether tax is payable by a fund or by a fund investor or both, they may find mutual funds less attractive as a savings vehicle.
- d. **The tax regime must be fair and relatively simple, and tax authorities must be consistent in their treatment of mutual funds.** Very convoluted taxation treatment will deter the mutual fund market’s development because it may make fund returns less attractive and make funds more expensive to operate and administer. Brazil and Peru’s mutual fund taxation regimes were good examples of such unnecessary complexity at the time of the case study (although Peru’s taxation regime has changed

Table 2.14: Levels at Which Tax May Have an Impact on Funds and Their Investors

	Income	Capital Gains
Withhold tax at source	Tax may be withheld on interest or dividends paid to funds	Unusual for tax to be withheld at source
Taxed at the level of the fund, whether or not distributed to shareholder	<p>Income (e.g., dividends, interest) is taxed at fund level.</p> <p><i>This is unattractive if investor must pay additional tax after receiving income from the fund.</i></p>	<p>Capital gains when the fund’s assets are sold is taxed at fund level.</p> <p><i>This is unattractive if investor must pay additional tax on receipt or when realizing profit on sale of shares or units.</i></p>
Withhold tax before payment to investor	On income or on both income and capital gains, if both are accrued and not taxed, until they are in the hands of the investor	
Taxed at level of investor	<p>Income is taxed upon receipt by the investor.</p> <p><i>This is usually the case, except dividends may be tax free, as a capital market development incentive, or if the fund shares or units are within a wrapper</i></p>	<p>Capital gains are taxed upon receipt by the investor at the time of distribution or at the time of sale of shares or units at a profit.</p> <p><i>This is usually the case except if the fund shares or units are held within a wrapper</i></p>

Box 2.10: Brazil and Peru Taxation Regime for Mutual Funds

Brazil Come Cotas System

Under Brazil's system, tax is levied from a fund, at regular intervals, on the calculated returns—both income and gains—which accumulate in the unit value. Cash is raised to pay this tax by redeeming the appropriate number of units.

Called come cotas—literally “eating units”—it sounds simple. But this tax is not levied on equity funds or on closed-ended funds and is in effect a tax on accumulated interest. The tax rate levied is between 15 and 22.5 percent and is complicated to calculate, applying differently to those who hold through the tax period versus those that redeem within it, and it may vary according to fund maturities.

Although complicated, this system does ensure that tax payment is not deferred until the unit is redeemed from the fund, which is a benefit for the tax authorities.

Peru

In Peru, each mutual fund was previously required to separately calculate the taxable income of each type of investor (corporations and individuals) and separately withhold this tax. This was because tax authorities wanted to effectively levy tax at the fund level—even though funds were not taxable—because it was easier to deal with a single fund than with hundreds or thousands of investors receiving returns.

This complicated system was made more complicated because different investor types were taxable at different rates on income and on gains, although those with an income or gains of less than S/.20,000 (around \$675) were exempt.

In addition, bank deposits were not subject to such taxes, and contributions to the mandatory pension system was tax exempt and proceeds tax free, both of which made mutual funds less attractive to investors.

This system was changed in 2013, and the mutual fund's administrative burden has reduced because now the fund is only required to deduct a flat 5 percent from profits (both income and realized gains) when an investor redeems. The new system reduces the administrative burden, as well as achieves an attractive tax rate by international standards. However, the tax treatment of bank deposits still remains more favorable.

since then; see box 2.10). If investors are uncertain about tax treatment, they may also invest in an alternate vehicle where tax treatment is clearer. In Kenya, for instance, the tax authority was inconsistent in interpreting tax law for unit trusts, which caused a lack of clarity for fund operators and investors.

- e. **The tax system should avoid requirements that impose excessive administrative burden.** For example, in Kenya, once the fund is more than six months old, investors may not own more than 12.5 percent of the fund, and the fund must have at least 25 unitholders or shareholders. This type of requirement necessitates daily monitoring and possible refusal or reversal of transactions, which is an unnecessary administrative burden.

The tax framework deals with capital gains or income in multiple ways. This chapter does not deal with every variant of fund taxation, but three of the main approaches used are summarized below. Table 2.15 also gives a general description of tax systems worldwide. Investments are either “taxable” (“T”) or “exempt” (“E”). Thus if the contribution to the investment is made pretax, the contribution is exempt; if it is made posttax, the contribution is taxable. Similarly, the money while inside the investment can be either taxable or exempt from tax, and when the investor receives proceeds of the investment—income or capital gains—these can be taxable or exempt from tax. The three key variants are the following:

1. **The fund suffers no tax. The fund distributes capital gains and income to the investor, who is then taxed on both capital gains and income, at their taxable rate.** This tax treatment is known as “pass-through” and is the tax regime in the United States. Thus U.S. mutual funds distribute all realized gains and dividends

annually, and investors are taxed for income and realized capital gains every year. The U.S. mutual fund industry has continuously complained that this is both unfair and complicated and acts as a deterrent to investing in mutual funds.⁹⁴ However, many people invest in mutual funds via retirement plans, which makes them exempt from these taxes (although they will be taxable on income taken from the scheme once in retirement).

2. **The fund suffers no tax. The fund distributes income to the investor, which is subject to tax at the relevant tax rate; the fund accrues capital gains, and the investor pays capital gains tax when they sell units/shares.** This regime is found in many European and other countries, where income must be distributed and is subject to tax in the hands of the investor at their relevant tax rate when distributed. But capital gains are not permitted to be distributed and must instead accrue in the fund. The investor pays capital gains tax when they sell the units or shares at a profit, because the price of the units/shares by that stage will include all accrued gains.⁹⁵

3. **The fund suffers no tax. The fund accrues both capital gains and income. When the investor sells units or shares, the difference between purchase price and sale price per unit or share indicates the gain that is taxable at the level of the investor.**⁹⁶ This is the case, for example, in Peru and Turkey where tax is withheld at a standard modest rate: 5 percent in Peru and 10 percent in Turkey.⁹⁷ This tax approach is easier and less expensive for the tax authority because it collects tax at an easily identifiable point, instead of seeking to claim small amounts of tax from thousands of (possibly recalcitrant) individuals.

Table 2.15: Description of Taxation Systems of Funds in Selected Countries as at Year End 2012

Country	Income	Capital Gains	Differentiation between Short and Long Term	Who Pays the Tax
Brazil	Retained in fund	Retained in fund	Yes, depending on type of fund	Fund investor twice yearly on total return or at redemption for certain funds
Kenya	Distributed and taxable	Not taxed	No	Fund investor on redemption
Morocco	Distributed to shareholders	Retained in fund	No	Fund investor in year of receipt of income; at time of redemption or sale if capital gain
Peru ^a	Retained in fund	Retained in fund	No	Fund investor upon redemption
Turkey	Retained in fund	Retained in fund	No	Fund investor on redemption
United Kingdom and some European countries	Distributed to shareholders	Retained in fund	No	Fund investor in year of receipt of income; shareholder at time of redemption if capital gain
United States and certain other countries	Distributed to shareholders	Distributed to shareholders	Yes	Fund investor in year of receipt

Source: World Bank study.

a. Under new system.

It is important to note in the above cases that if funds are structured as companies or as trusts, they would potentially need to be exempted from tax applied to normal corporations.

As discussed earlier in the chapter, funds formed as companies or unit trusts could be potentially liable for tax. Thus these funds will need to be specifically exempted or else should be allowed to offset or reclaim any tax payable.

Investors can also hold shares or units in a fund through a range of tax-incentivized ways, such as pension schemes or retirement plans or other tax-incentivized “wrappers,” which allows them to be exempt from capital gains tax, if applicable, or to receive income tax-free, or be able to reclaim tax paid. For instance, tax-efficient wrappers, such as those used for retirement accounts (e.g., IRAs or the 401(k) in the United States) provide tax protection from income and capital gains tax. Thus investors do not get taxed in the current year for their interest/dividends received but instead are taxed when they remove the money from the tax-deferred account as ordinary income.⁹⁸ Governments have recently attempted to reinvigorate capital markets and mobilize savings in several countries through tax incentives for wrappers such as Japan’s Nippon Individual Savings Account, South Africa’s Tax Preferred Savings Account, Canada’s Tax Free Savings Account, and the United Kingdom’s Individual Savings Account.

Government often use tax frameworks to influence investor behavior, for example, to encourage investment in long-term assets. In some cases, if competing savings vehicles have a more favorable tax treatment than funds, mutual fund asset growth may diminish; however, in many cases it can also result in growth of mutual fund assets because funds may be used as the underlying investment vehicle for other forms of savings. Favorable tax treatment can amplify the attractiveness of products that

are considered mutual fund substitutes, such as short-term bank deposits compared with MMFs, or pension fund investment compared with longer term mutual funds. For instance, given that the predominant savings vehicle is typically a bank deposit or savings account, if bank interest is tax-free whereas dividends or proceeds on sale of funds are taxed (as is the case in Peru), investors will find MMFs relatively unattractive. The reverse is the case in China, where bank interest is taxable and dividends (including dividends from MMFs) are tax free. In addition, in China, bank interest rates are capped but MMFs can offer much higher rates. These factors combined account for the phenomenal growth of MMFs in China. Similarly, long-term savings such as pensions are usually granted a favorable tax status. Pension funds are usually tax exempt, and contributions to a pension fund are tax deductible, allowing investors to reduce taxable income. If, in addition, pension contributions are compulsory, as they are in many countries such as in Latin America, mutual fund growth can be stunted (although if pension schemes can and do invest in mutual funds, the impact of this may be reduced). In Turkey, longer-term mutual funds compete with individual retirement savings accounts to attract voluntary savings; the latter, which offer a government incentive of a contribution of a free 25% of value for every 100 contributed, are clearly rather more attractive.

Tax policy considerations in an early emerging market where mutual funds are just developing will require careful consideration. Overly strong incentives, designed to encourage the market, may be exploited by those who are more sophisticated and more affluent and may be perceived as unfair to those who cannot afford to save; they may also lead to unacceptably high reduction of tax revenues. Very strong incentives may also have the effect of redirecting savings flows in a way that may, at an extreme, threaten financial stability (for instance, a mass shift from bank deposits to

MMFs); it may also create an unsustainably high level of demand for a limited supply of assets that could result in asset bubbles. Lack of incentives may result in failure to mobilize savings out of bank deposits and into capital markets, with reduced potential for economic development.

A key policy consideration is also the capacity of the taxation system. As noted above, many governments structure tax treatments so that tax is taken at the fund level, for ease of collection. Many tax systems lack the capacity to deal with tens or hundreds of thousands of individual tax accounts and tax returns; in such cases, creating tax treatments for individual accounts may be too complex and expensive. Where few people in a country pay income tax, it may be necessary to offer incentives other than taxation such as matched contributions to pension schemes or savings plans or bonus allocations.

In Summary

- 1. A mutual fund sector will not expand strongly unless people are confident that mutual funds are worthy of their trust.** Much of this confidence is instilled by a belief that fund investors' interests are adequately protected by law and regulation and that any failure in this respect will be effectively addressed by a government or regulator. A weak legal and regulatory environment can negatively affect the mutual fund industry. When investors are not confident in the market, they either do not invest or pull out of mutual funds.
- 2. The key objective of regulating publicly offered mutual funds is to protect the interests of the individuals who buy, hold, and sell shares or units of such funds.** Law and regulation seek to ensure that action can be taken against unregulated vehicles that may defraud investors. Legal and regulatory regimes for mutual funds seek to maximize confidence in mutual funds by addressing asymmetries of information and conflicts of interest between operator and investor and preventing the possibility of the fund operator (or its affiliates) stealing or misusing fund assets by requiring a third party to safeguard the assets.
- 3. However, overregulation can be costly, deter market entrants, and push investors toward other investment vehicles, thus preventing—or slowing—market development.** Regulatory frameworks also need to align with the stage of market development. When designing fund frameworks, policy makers must take into account the practical implications of operating funds in a domestic market and, where necessary, disapply international practices where they are not practical. This requires knowledge both of how mutual funds typically work and of how the domestic market functions.
- 4. Primary legislation defines the nature of a mutual fund and protects investors by requiring that only a fund that has met legal and regulatory requirements for publicly offered open-ended funds may be offered to the general public.** Primary legislation should create a sound legal basis for mutual funds to be established, licensed, supervised, operated, and wound up. Secondary legislation, called regulations or rules, would then

set out more detailed requirements such as aspects of fund operation or standards applicable to operators and supervisors of funds.

- 5. The regulator, empowered by primary legislation, enforces the legal and regulatory framework governing mutual funds and their service providers.** It is vital that regulation is applied fairly, evenly, and consistently, otherwise neither investors nor market participants will have sufficient confidence to commit their resources to the market. It is important to have a legal and regulatory framework of good quality, but this will not encourage mutual fund development if failure to comply with it goes unpunished. The regulator must have adequate resources to conduct its duties and the power to enforce compliance and impose and enforce sanctions when market participants misbehave.
- 6. The legal and regulatory framework must also define the legal structures in which mutual funds can be created.** The most common legal structures are the trust, corporate, and contractual types. Despite the prevalence of different legal structures, the operational characteristics of mutual fund structures are becoming increasingly similar, as regulatory frameworks cohere around the IOSCO principles and, increasingly, regional standards.
- 7. Legal and regulatory frameworks for mutual funds may also permit additional structural options to allow the mutual fund sector to benefit from economies of scale; these include umbrella funds, multishare or unit classes, and the master-feeder structures.**
- 8. It is extremely important that law or regulation establishes a requirement that a publicly offered mutual fund must have a diversified portfolio, and that it must invest and borrow only in conformity with its specified type (equity, bond, mixed asset funds, etc.) and within limits set by law or regulation.** Regulations should also specify what percentage of a fund's assets may be invested in any one issuer's securities and set caps on the percentage of any one issuer's securities that the fund can hold.
- 9. A mutual fund legal and regulatory framework can allow foreign funds to be publicly sold in a country by “recognizing” foreign funds as being governed by a jurisdiction that provides equivalent investor protection standards as domestic fund law.** This “recognition” of foreign funds is becoming more important as publicly offered funds are increasingly distributed across borders; however, regulators will also need to consider how this may affect the sales of domestic mutual funds.
- 10. Although the creation and operation of mutual funds is mainly governed by financial, securities, or mutual fund law, other laws can affect the operation of mutual funds.** For instance, the success of the mutual fund industry is often linked to the size and nature of the pension fund industry. Particularly when saving into a pension scheme is mandatory and represents a relatively high proportion of salary, the ability of these schemes

to invest in mutual funds can be critical to developing the mutual fund sector. In countries where mutual funds play a large role in retirement savings, significant growth in the sector can occur. Thus laws governing pension schemes, insurance companies, and other entities—specifically pertaining to their ability to offer competing savings products or to invest in mutual funds—can also affect the competitive positioning of the mutual fund sector.

11. In general, if funds (or any form of savings on investment) suffer more tax than competing savings products, they will fail to attract investors. The tax regime of mutual funds is usually determined by the relevant tax authority and plays an important role in the competitiveness of the mutual fund sector. Unless a fund tax framework is carefully considered, funds and their investors may suffer multiple levels of tax on the income or capital gains proceeds of a fund.

12. The next chapter discusses the market-related drivers and impediments for mutual fund sectors. In some cases these drivers and impediments are related very closely to the legal and regulatory environment; hence some of the discussion above is revisited in the next chapter from a different angle.

Endnotes

1. A classic example of this arose in the United States during the Credit Crunch when there was a run on a money market mutual fund—Reserve Primary Fund on Tuesday, September 16, 2008—which held Lehman paper, which became valueless; investors feared that similar funds would also be affected, and a “run” on that fund and on all MMFs started to develop. MMFs at that time were estimated to provide a third of short-term corporate financing in America, so such a run had systemic implications. The government was forced to step in and guarantee repayment of investors’ money for a period, which achieved the desired result and put an end to the run (no claims were made against this guarantee).
2. Named after Charles Ponzi, who promoted such schemes in America in the 1920s.
3. OECD, “White Paper on Collective Investment Scheme Governance,” 2005.
4. See Clifford E. Kirsch and Sutherland Bibb L. Strench, *An Introduction to Mutual Funds*, chapter 6, http://www.lodpdf.net/preview/0BNcUiVUZFpj9dS14g9JY7dYw_FPsH1PBLadtQqfRVM/An-Introduction-to-Mutual-Funds-Practising-Law-Institute.html?query=Types-of-Income-Funds.
5. “Collective investment scheme” in the IOSCO context generally refers to open-ended publicly offered funds (the mutual funds covered by this study) and to listed and traded closed-ended funds (which are not the subject of this study).
6. This chapter does not discuss the judicial system’s role, but if enforcement of legal requirements through the courts is weak, it is likely that confidence in mutual funds will be lower than it might otherwise be.
7. “White Paper on Governance of Collective Investment Schemes,” 2005.
8. The United Kingdom has moved to a “twin peaks” model with separate prudential and market conduct regulators.
9. It should be noted that such legislation may enable funds other than mutual funds, for instance, closed-ended investment companies.
10. Note that subsequently IOSCO has passed a large number of other standard-setting documents for collective investment schemes; the Principles referred to underlie these.
11. Morningstar, “Global Fund Investor Experience 2013 Report.”
12. India issues an annual consolidated update, however.
13. Morningstar, “Global Fund Investor Experience 2013 Report.”
14. Note that the regulator identified in the table may report to a ministry or may be a government agency.
15. IOSCO, “Objectives and Principles of Securities Regulation,” June 2010.
16. Investment Company Act of 1940 Section 2 (c).
17. For perspective, at the end of 2012 there were about 73,000 investment funds globally, and the United States, which represented roughly half of total assets under management of some \$23 trillion, had around 7,600 funds.
18. In legal, accounting and operational terms.
19. This will apply even if there is a multifunctional or megaregulator.
20. Despite its name this is a self-regulatory organization and not a trade association.
21. Despite its name, this association is for managers of mutual funds.
22. As an example, some of the data used in this study are collected by trade associations worldwide and published through the International Investment Funds Association, which has 41 members which are fund-related trade associations around the world.
23. This may not be an effective deterrent and would deprive the trade association of membership fees, and so may be against the interests of the association.
24. Morningstar, “Global Fund Investor Experience 2013 Report.”
25. In the case of ANBIMA and many other SROs members contract to obey the rules as a condition of membership of the SRO, which makes them subject to the SRO’s disciplinary procedures for any breach of that contract.
26. Sometimes termed “the Duck Clause,” that is, if it looks like a duck, swims like a duck, and quacks like a duck, it is a duck regardless of what it is called; so if it looks and acts like a collective investment scheme, it is a collective investment scheme. This gives the regulator or courts clear power to act against unlicensed schemes, requiring them to become licensed or to cease and desist from such activity.
27. These are identified in the IOSCO Principles in section 1. To a lesser extent, this is based on policy decisions about mutual fund laws and their content.

28. Also in Korea before it adopted trust law.
29. However, in some cases, the United Kingdom, for example, investment companies are not required to have annual general meetings, so shareholders in these funds have rights only to vote at extraordinary general meetings that are called only to vote on fundamental changes to the fund, again, typically, changes to investment objectives or policy and increases in costs.
30. Good practice set by the Investment Company Institute, the trade association of U.S. mutual funds, is two-thirds.
31. Functional independence means the operator and the depositary can be subsidiaries of the same company, but must be completely operationally separate (systems, people, offices, etc.). Proponents of functional independence believe being subsidiaries of the same company fosters strong vested interest in the reputation of the group and could possibly be more effective than requiring full independence. On the other hand, being part of the same company could lead to cover ups to preserve reputations.
32. Also adopted in Uganda.
33. In this case, it is usually a requirement that a minimum period of notice is given before any such change is made, so that investors who do not like the change have the option to redeem their units without penalty before the change is implemented. While pragmatic, this approach means that the investor may have to make a choice between incurring a tax liability upon redemption of units and accepting a change they do not like.
34. As part of the quality of regulation on securities markets.
35. "White Paper on Governance of Collective Investment Schemes," 2005.
36. The draft Securities Bill (Collective Investment Schemes) Regulations in Kenya has sought to make more provisions for these funds.
37. This structure resembles the handle and frame of the umbrella; the subfunds are the different colored fabric panels of the golf umbrella.
38. Most, but not all (in Canada for example) taxation authorities, however, will regard this move from one subfund to another, even though it is within the same umbrella structure, as a "crystallization" of such gains for tax purposes (if such taxes are levied). One of the risks of the umbrella structure is that a subfund within the umbrella may become liable for the debts of another subfund since they are all part of a single overall fund. "Protected cell" regimes seek to deal with this risk.
39. Within the voluntary condominiums under the Brazilian civil code, owners of fractions can partake in the profits of the condominium according to the fraction they own.
40. The feeder fund may also hold cash for liquidity and derivatives for risk management.
41. For this reason, master funds are often created in the contractual form; indeed the United Kingdom recently introduced this form of fund specifically for this purpose.
42. There were 35 administrators in Brazil at the time of writing of the case study.
43. The administrator remains primarily responsible for compliance even if it subcontracts an independent investment manager to manage the investments.
44. Even very high capital requirements, unless they are so high as to deter any entrants at all, would be insufficient to compensate investors in the event of a major loss that was caused by deliberate action or complete failure of an operator.
45. This will require a law enabling a nominee function that may or may not exist.
46. Morningstar, "Global Fund Investor Experience 2013 Report."
47. Kenya Case Study.
48. From the banking regulatory perspective, it also isolates potential risks from bank capital.
49. On the understanding that if a lie is subsequently detected their employer will be obliged to dismiss them.
50. For instance, the Chartered Financial Analyst suite of qualifications is regarded as the globally recognized standard for investment professionals.
51. An operator may still be the member of a group, within which similar conflicts may arise.
52. Other means can be used to correct misbehavior. For instance, regulators receive reports and inspect entities during the period between licensing renewal years and can take steps to require correction if needed. In addition, the threat not to renew a license could also be used for the wrong reasons.
53. IOSCO Principles for Collective Investment Schemes (1994).
54. Alternatively, to save regulatory resources, an attestation by a lawyer that the prospectus is fully compliant may be sufficient to allow the regulator to approve the prospectus. In either case, the prospectus may be required to state that registration or approval of the prospectus by the regulator does not constitute approval or endorsement of that fund by the regulator.
55. Of course, the full prospectus still needs to be prepared and made available to prospective investors on request.
56. IOSCO, "Policy Recommendations for Money Market Funds," October 2012.
57. This may be cumulative across all the funds managed by any one operator.
58. A multiasset class fund that can change allocations from one asset class to another.
59. Securities and Exchange Board of India, "Master Circular for Mutual Funds to March 31, 2013."
60. In Brazil some multimercado funds are permitted to leverage using derivatives. Regulations normally limit derivative use to "efficient portfolio management" or insurance to reduce, but not increase, risk.
61. IOSCO, "Principles of Liquidity Risk Management for Collective Investment Schemes," March 2013.

- 62. At its simplest, using short-term liabilities to invest in long-term assets (taking in short-term deposits and making longer term loans).
- 63. For instance, closure of a market in which a CIS is invested because of extreme weather or power failure.
- 64. A company under the control of five or fewer participants or any number of participants if they are directors.
- 65. Such as that published by the U.S. Investment Company Institute and that used in the IOSCO survey.
- 66. IOSCO requires that the regulation must “provide a system for valuation of CIS assets based on market value and for pricing of shares or units and procedures for entering or exiting a CIS which are fair to entering, existing and ongoing investors. CIS must redeem upon request and only suspend such redemption in certain stated circumstances and follow certain procedures; for sale and redemption of shares or units which must be at net asset value plus or minus a charge as appropriate; and for distribution or reinvestment of income.”
- 67. Therefore the NAV per share or unit is the market value of assets of a scheme, less its debts, divided by the total number of shares or units of the scheme on any particular date.
- 68. Generally the price has to be calculated on any day on which trading in shares or units is allowed. One key issue is the valuation of unlisted or irregularly traded assets for which reliable prices are not available.
- 69. In the case of shares, it may be necessary to permit pricing by reference to recent prices of similar assets by what is called fair value pricing. In the case of bonds this may be done through the mandatory use of agencies whose job it is to calculate “prices” based on a standardized approach based on coupon, credit rating, and duration (these “prices” may not be correct, but every fund is then incorrect to the same degree).
- 70. The generally accepted key principles based on IOSCO’s 2013 more detailed report, “Principles for the Valuation of Collective Investment Schemes,” are the following: there should be comprehensive, documented policies that should seek to address conflicts of interest and be consistent, and there should be appropriate procedures for review upon detection of error.
- 71. An extra fee paid to the investment manager if the fund outperforms its benchmark, usually an index, by a stated percentage, which is expressed as a percentage of the total value of that outperformance.
- 72. Order no. 1872-04 of the Minister of Finance dated October 25, 2004 (11 ramadan 1425).
- 73. <http://www.esma.europa.eu/node/49059>.
- 74. So its sale and advice upon investing in such shares is therefore governed by securities law unless otherwise stated.
- 75. Another key issue will be whether such entities are permitted to hold client money, in which case ring-fenced client accounts will be required, or hold client assets in their own name, in which case the regulations for holding as nominees will need to be clear.
- 76. For retail distribution of 12 categories of financial instruments, including mutual funds.
- 77. Among key issues identified by another IOSCO report, “Performance Presentation Standards for Collective Investment Schemes” (2004), are standardized time periods for presenting performance information, performance benchmarks to compare performance of one fund with another or an objective benchmark such as interest rates or inflation.
- 78. The report and accounts will also contain a report from the operator explaining what has been done with the portfolio and why during the period and also some general comments on the immediate outlook.
- 79. The EU has amended this directive subsequently several times as the market evolved; at the time of the study UCITS V is in the process of implementation.
- 80. The 28 members of the EU plus Iceland, Lichtenstein, and Norway.
- 81. Eligibility requirements for cross-border distribution include for investment diversification, type of allowed investments, allowed borrowing, the use of derivatives for leverage, etc.
- 82. Lipper, “European Fund Market Review 2013 Edition,” http://share.thomsonreuters.com/PR/Lipper/European_Fund_Market_Review_2013.pdf.
- 83. UCITS Fund Distribution 2012, PwC.
- 84. Chinese domestic mutual funds and funds approved for marketing in Hong Kong, China.
- 85. Australia, China, Taiwan, China, Hong Kong, China, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and Vietnam. This will, of course, take time, just as UCITS took more than 10 years to have a significant impact and not all members of APEC will initially open their markets.
- 86. MILA’s objective is to create economies of scale and scope for equities trading on the exchanges and firms operating within the region.
- 87. These provide equal protection to investors in each member country.
- 88. Of course, a fund that can be sold only to professional investors in one jurisdiction should not be permitted to be sold to the public in another.
- 89. If done in regulation, a court is likely to opine that provisions of a law will dominate over the provisions of a regulation.
- 90. Other data in this paragraph are from the 2013 Investment Company Fact Book.
- 91. Michael Bogdan and Daniel Schrass. “Profile of Mutual Fund Shareholders, 2013,” ICI Research Report (February) (Washington, DC: Investment Company Institute, 2014).
- 92. In contrast, when an individual directly invests in a security, there are only two levels of taxation possibly applicable: at the company level and at the individual level. Situations in which the investor ends up paying taxes twice for his or her investment, both through taxes withheld by the investee company on dividends paid to fund and taxes withheld by fund on dividends paid to the investor, are termed “double taxation.”

93. Example: “A fund licensed by ...”
94. Investors do not have control over when the portfolio manager decides to realize capital gains, and they do not have control over when they are taxed. See Robert Pogen and Theresa Hamacher, *The Fund Industry: How Your Money Is Managed* (New York: Wiley, 2011).
95. However, common numerous incentives or exemptions may eliminate or minimize the impact of any tax due, including holding fund shares or units through retirement plans.
96. Indexation against inflation may be permitted.
97. In Turkey, however, if a fund invests 75 percent or more in domestic equities, there is no withholding tax to make such funds competitive with direct investment in equities, which is also exempt from the 10 percent withholding tax; also corporates will have to pay the difference between the 10 percent withheld and the 20 percent corporate tax rate.
98. Conrad S. Ciccotello, “The Nature of Mutual Funds,” in *Mutual Funds: Structures, Analysis, Management, and Stewardship*, ed. John A. Haslem (New York: Wiley, 2010), pp. 3–15

3. Market Drivers and Impediments to Mutual Fund Development

Introduction

This chapter explores the nature and significance of market, or nonlegal/regulatory, drivers and impediments in developing the domestic mutual fund sector. These impediments are divided into three categories. The first type of impediment is the *level of demand for mutual funds*; that is, whether the number of investors in a country that are aware of mutual funds and have the resources to invest in them is sufficient. These investors may be institutional—such as pension schemes, insurance companies, and other mutual funds—or they may be corporate entities.¹ They may also be individuals, who are saving to meet short- or long-term needs. A second type of impediment is the *nature and quality of investable assets* for mutual funds, that is, whether the range of investable assets is sufficient for funds to spread risk adequately and whether those assets are liquid enough to facilitate the operation of open-ended funds. These assets are typically money market instruments, government and corporate bonds, equities, and sometimes derivatives and real estate. The third type of impediment is the *market structure of the mutual fund sector and the market infrastructure of the country* within which it operates. This market structure or infrastructure may restrict the potential for development of the sector, for instance, by restricting access to distribution channels or posing barriers to entry. Each of these factors is explored in the following sections.

Demand

Countries differ in whether mutual fund ownership derives predominantly from institutional or retail investors, which are the two primary sources of mutual fund demand. Although in theory the distinction between the two is simple, in practice the difference is difficult to classify (see box 3.1). Per available statistics in the case study countries, in some countries, such as Turkey, the mutual fund sector, at the end of 2012, was virtually 100 percent retail owned.² In Peru, at the time of the case study, the mutual fund sector was also almost 100 percent individual investor owned.

In these countries, retail demand is clearly strong and institutional investor demand weak. Although Kenya had no published data on ownership, its mutual funds were also thought mostly to be owned by individuals through insurance-linked products. At the other end of the spectrum, in Brazil, retail ownership was around 18 percent, and the rest was owned by a combination of institutional investors.³ Similarly, in Morocco institutional investors owned 91 percent of assets under management in mutual funds. Clearly in these last two cases retail demand is relatively weaker than institutional demand.

Box 3.1: Distinction between Retail and Institutional Demand

In a retail transaction, the individual chooses which fund to buy (whether that choice is advised or not). The individual may buy the units or shares directly from the fund or within a wrapper such as a defined contribution pension scheme.

In an institutional transaction, the manager of an institutional portfolio (insurance, pension, or another mutual fund) decides to invest in a fund, without reference to the wishes of the individual scheme member or policy holder. (See chapter 1 for more on this.)

The differentiation between the two types of transactions is simple when dealing with mutual fund sales made to defined benefit pension schemes or insurance companies or to other mutual funds, which are clearly institutions.

However, in practice this classification is not consistent or may not hold true in all markets. In some countries, such as Kenya, statistics on the mutual fund sector simply do not differentiate between institutional and retail sales. In some countries, sales classified as retail may be classified as institutional in other countries. For example, in the United States, sales made through defined contribution pension schemes are categorized as retail, whereas in France they are categorized as institutional. When demand for mutual funds derives from unit-linked insurance products, this may be treated statistically as deriving from an institution (the insurer) or from the individual who takes out the unit-linked plan.

Of course, all demand eventually derives from individuals because it is individual money that contributes to pension schemes, pays for insurance policies, and takes ownership stakes in companies, including those companies that offer pension schemes and insurance policies.

Institutional Demand

In countries where institutional investors—pension schemes, insurance schemes,⁴ and corporates—are not very well developed or are divesting assets, demand for mutual funds can be low. For instance, in Kenya, although no official figures were available, institutional demand for mutual funds was thought to be low, partly because both the life insurance and pension sectors were not well developed. Similarly, in Turkey, where institutional ownership of mutual funds is low (1 percent in 2012),⁵ pension and insurance vehicles represented only around 1 percent and 3 percent of GDP, respectively, in 2011.⁶ In contrast, where institutional investors are more developed, such as in developed markets in Europe, there is potentially higher institutional ownership of mutual funds. For example, in Europe, more than 34 percent of mutual funds were owned by insurance and pension vehicles at the end of 2011 and just over 8% were owned by nonfinancial corporations.⁷ In addition, as in several developed markets, if pension funds are divesting assets (for example, as “baby boomers” draw on their retirement), demand for mutual funds may decrease if they are the underlying assets. For instance, in the United States, 10,000 baby boomers will turn 65 every day until the year 2030,⁸ which may lead to sale of pension assets, including mutual funds. A similar phenomenon may arise in some emerging markets; for instance, it is anticipated in Morocco by 2026.⁹

Where institutional investors are instead a significant presence and if such investors receive better fiscal treatment than mutual funds, the mutual fund sector is likely to grow to the extent such schemes are allowed to invest in mutual funds. As discussed in chapter 2, if pension schemes or insurance companies’ products benefit from better tax treatment than mutual funds, savings are likely to flow to those contractual savings schemes rather than to mutual funds. Particularly if, in the case of pensions, contributions also are mandatory and represent a substantial proportion of salaries, demand for mutual funds will likely be low if regulation does not permit or restricts pension schemes’ and insurance companies’ investment into mutual funds.

Even if regulation allows pension schemes and insurance companies to invest into mutual funds, institutional demand for mutual funds may not develop unless mutual fund investment portfolios are aligned to the investment objectives of institutional investors. As noted, in both Peru and Turkey, institutional investment in mutual funds was virtually nonexistent. In both countries, pension schemes could invest in mutual funds but mostly do not do so.¹⁰ In Peru, for instance, because domestic mutual funds invest predominantly in the local market, potential buyers may not perceive them to offer any particular advantage to pension schemes and insurance companies who already have in house expertise in domestic asset management. In Turkey, on the other hand, mutual funds predominantly invested in short-term instruments (see figure 1.7 on asset exposure in chapter 1, where Turkish mutual funds are shown to have only around 3 percent exposure to equities) and may not have been able to meet the longer-term investment needs of Turkish pension funds. The most popular Turkish mutual fund, the MMF, was predominantly sold by banks to retail clients rather than institutional clients. In countries where mutual funds are more commonly used for retirement savings, these funds typically have much higher equity exposures, such as 45 percent exposure to equity in the United States.¹¹

In addition, institutional investors may not invest in domestic mutual funds if such funds do not offer exposure to international assets, either because of lack of capacity or regulatory constraints. Investing abroad via a collective investment scheme typically is attractive to institutional investors because it would be more expensive for them to hire their own in-house team of experts in international investments than to invest through a professionally managed mutual fund investing internationally. In developed markets it is typical for such international diversification to be offered to domestic institutional investors via domestically based mutual funds rather than by foreign-based mutual funds. At the time of the case studies, neither Peruvian nor Turkish domestic mutual funds invested abroad to any great extent, perhaps because

fund operators felt that they did not have established expertise in such investment. However, in Peru, the 10 percent of funds under management that pension schemes invested in mutual funds, at the time of the case study, were made in foreign mutual funds that invested outside Peru.¹² This presented a missed opportunity for domestic mutual funds. However, even if domestic mutual funds are not barred from making foreign investments, other legal, regulatory, or tax barriers to foreign investment may exist (see chapter 2).

Corporate demand for mutual funds, particularly for cash management, may help expand the mutual fund sector. Corporations are typically characterized as institutional investors. They use mutual funds, specifically MMFs, for cash management. In fact, MMFs are a large component of the mutual fund sector in some developed markets, such as the United States, partly because of this demand from corporates. In the United States, 20 percent of the cash assets of nonfinancial businesses were invested into MMFs in 2012 (although this percentage had declined from its peak of 37 percent in 2008).¹³ In Brazil, 8 percent of collective investment schemes were owned by corporates.¹⁴ Nonfinancial companies owned 26 percent of mutual funds in Morocco, where MMFs also represented 26 percent of total funds under management. High levels of ownership of MMFs by corporates can lead to very large amounts of money flowing into and out of MMFs daily, in turn requiring highly liquid underlying investments that may be a problem in emerging markets (as discussed later in this chapter).

Overall, institutional demand has benefits for mutual funds in general in that it can generate large inflows that can build assets under management rapidly. Where it derives from long-term investors such as pension funds and insurance companies, these flows can be more stable and fund choices more discriminating because they are made by expert investors; where it relates to corporate demand for MMFs, large daily inflows and outflows may be involved, which may be difficult to accommodate in less liquid markets. Institutional flows have the benefit that they are usually cheaper to attract than retail flows, which usually involve

more expensive brand awareness building and promotional activity. Institutional investors also tend to exert pressure on costs and demand good performance to a greater extent than retail investors, which may in turn make mutual funds more competitive. Ensuring that institutional investors can use mutual funds as underlying investments, and that mutual funds can invest abroad, is therefore important.

Retail Demand

Mutual funds tend to be more successful in countries with a larger number of smaller savers, that is, a larger middle class. Mutual funds are essentially designed to diversify risk for smaller savers who do not have enough money to achieve diversification themselves; thus, they tend to be a middle class savings vehicle. An OECD study¹⁵ estimated that the global middle class totaled 1.8 billion people in 2009, of which Europe had 664 million (or 36 percent) versus Sub-Saharan Africa with 32 million people (or 2 percent).¹⁶ Correspondingly, assets under management invested in mutual funds in Europe at the end of 2012 were \$6.2 trillion, whereas in Sub-Saharan Africa it was \$69 billion. Although a range of other factors explored in this study may also have an impact on availability of savings, essentially, other things being equal, the greater the income of households in a country, the more likely it is that the mutual fund sector will develop more strongly. This tendency is shown to some extent in the sample of emerging markets shown in table 3.1, where some mutual fund markets that represent a larger proportion of GDP also tend to be in countries where the gross national income per capita is higher. A more detailed discussion of this relationship between fund use and per capita income can be found in a March 2014 ICI study.¹⁷

Consumers who have higher levels of education, higher levels of income, more disposable income, and reside in, or close to, urban areas are more likely to invest in mutual funds or to be open to doing so. A 2011 study on household savings in India¹⁸ noted that savers with 11 or more years of education were more likely to invest in securities

Table 3.1: Selected Emerging Markets Categorized by Gross National Income per Capita: Value of Mutual Funds as a Percentage of GDP, Year End 2011

Low (\$1,045 or less)		Lower Middle (\$1,046–4,125)		Upper Middle (\$4,126–12,745)		High (\$12,426 or More)	
Country	Mutual Funds as % GDP	Country	Mutual Funds as % GDP	Country	Mutual Funds as % GDP	Country	Mutual Funds as % GDP
Kenya	0.80	India	4.61	Brazil	46.87	Korea	34.12
		Indonesia	2.19	China	4.65	Russia	0.16
		Morocco	26.92	Costa Rica	3.09	Saudi Arabia	4.50
		Nigeria	0.20	Hungary	11.7	Slovenia	5.00
		Pakistan	1.43	Malaysia	28.31		
				Mexico	8.00		
				Peru	2.79		
				South Africa	30.61		
				Turkey	2.33		

Sources: IOSCO survey, World Bank, case studies.

markets and mutual funds. People living near urban areas were more likely to make such investments than those in rural areas. In fact, 87 percent of mutual fund assets under management in India derived from the top 15 cities by size, with the top five cities accounting for 74 percent of the value of the sector.¹⁹ The 2011 study in India further showed that those with higher income levels were less likely to be risk averse and therefore more open to investing in securities and mutual funds. The survey also found that one of the main reasons people did not invest in securities markets was inadequate financial resources. The lack of disposable income is a widespread barrier to savings. A global survey on consumer attitudes to savings in the period 2004–2008²⁰ showed that the largest barrier to saving was lack of disposable income: Almost 50 percent of people did not save simply because they could not afford to. Finally, low levels of participation in the formal economy may reduce potential for mutual fund development because those in the informal economy may not risk investing their money where it may be noticed by the tax authorities.

However, consumers may also feel that they have sufficient savings through contractual savings schemes and therefore do not need to invest in mutual funds, and cultural factors may dictate investor preference for other types of investments. As discussed in chapter 2, individuals who are required to make pension contributions to a first and/or second pillar system by law, or by their employment contract, may feel that they have already made adequate savings. A global consumer attitudes survey²¹ found that 12 to 15 percent of those participating in 13 of the emerging and developed markets felt that they already saved enough. The survey also found that reliance on governments to provide an adequate level of pension is higher in emerging versus developed markets; for instance, 49 percent of those surveyed in India thought that government would provide adequate pension, and the average across all survey countries (developed and emerging) was 24 percent. In emerging markets retail investors also tend to prefer other investment choices such as gold or real estate. For example, Turkey's Capital Markets Board undertook a study that showed that retail investors preferred investing in gold, real estate, and bank deposits, in that order of preference.²²

Overall, retail demand also has benefits for mutual funds. Although such flows tend to be smaller, take longer to build, and be more expensive to attract (because they involve building brand awareness and promotional activity), they may be more remunerative because such clients may be less sensitive to cost and to periods of indifferent performance than institutional clients. However, retail investors may be less familiar with the risks entailed in mutual fund investing and so may redeem in large numbers if markets fall sharply (this tendency should reduce over time as such risks become better understood). Incentivization of retail saving through mutual funds needs to be carefully considered, however; if it is overdone, too much money may flow into such funds that may not be able to be accommodated because of the level of capital market development. If it is underdone, mutual funds may fail to develop.

Lack of Awareness

In emerging markets, both governments and individuals may also lack awareness and understanding of mutual funds. The lack of

government awareness and understanding of mutual funds may mean that mutual funds do not receive attention in financial sector strategies or may suffer in comparative fiscal treatment with other savings schemes. Regulators may also lack understanding and awareness of mutual funds, which may mean that they are less willing or able to participate in educating the public on the benefits that mutual funds can provide. As chapter 2 points out, this lack of understanding may also lead to funds being less effectively regulated and supervised, which in turn may damage the potential for market development, because confidence in these funds is less likely to develop. The vast majority of the public may also not be familiar with mutual funds or understand how they function, although this may be equally true in developed countries as well.²³ In India, an income and savings survey²⁴ indicated that fewer than 2 percent of the population invested in mutual funds and 90 percent of savers were unaware of the existence of mutual funds. In fact, a survey²⁵ of Indian mutual fund operators showed that they thought the inadequacy of consumers' knowledge of mutual funds was the greatest impediment to greater mutual fund market penetration. Similarly, in South Africa, which has the largest fund market in Sub-Saharan Africa, and where mutual funds have been sold since 1965, a survey on financial literacy²⁶ showed that only 2 percent of the sample held mutual funds and only 33 percent had heard of such funds.

In these markets, the lack of public and standardized information on mutual funds and the lack of specialist independent data providers may limit awareness and, therefore, demand for mutual funds. In developed markets, independent media cover mutual funds extensively. However, in early emerging markets, such media coverage is usually not present. For instance, in Kenya, national newspapers generally do not have personal financial pages or supplements, and no websites or magazines feature comprehensive fund information on a regular basis.²⁷ The scale of developed markets can also sustain the cost of specialist independent fund information providers such as Lipper, Morningstar, and Standard & Poor's, who measure and compare factors such as fund investment performance and cost.²⁸ Some of these features of developed markets may, of course, also be prevalent in more developed emerging markets and help with building understanding and awareness on mutual funds. For example, in India and Malaysia, coverage of mutual funds is similar to that seen in mature markets with well-developed statistical and information services from trade associations and specialist data providers. However, in smaller fund markets, independent data providers are uncommon, so sources of unbiased information about funds may be nonexistent, as in Kenya, or limited, as in Turkey. This lack of independent mutual fund performance and cost data may also reduce competition pressures on the sector. In addition, developed fund markets have standardized requirements for disclosure of information about funds, which help investors effectively compare funds, as discussed in chapter 2. However, in several emerging markets, such as Peru and Kenya, mutual fund disclosure is nonstandardized, which can reduce demand because investors cannot rely on data being given on the same basis and therefore being comparable.²⁹ This general lack of awareness and understanding of mutual funds is exacerbated because in countries where mutual funds are relatively

small, their operators may not be able to fund the advertising and promotion that larger and more mainstream financial services, such as banking and insurance, can afford. Thus unless the mutual funds being sold are part of the range of services provided by a major financial institution, such as a bank or insurer, the brand name of the mutual fund operator is unlikely to be widely known. One solution may be for government or the regulator to finance and undertake financial literacy campaigns to educate people as to financial choices and their implications if the market cannot afford to do this.

Emerging market retail investors also need sources of independent financial advice, and this is typically uncommon in such markets.

In emerging markets, given people's inexperience of dealing with investments such as mutual funds and the large number of funds that may be available in many countries, a common need is for sources of information and advice as to which fund best suits a client's needs. For example, in markets where there is a proliferation of mutual funds, as in Brazil (around 11,500), investors who lack financial knowledge may find it difficult to decide which one to buy. Although standardized categorization of such funds can help, investors may still be confronted by a choice of 50 to 100 funds of a similar type, and where there is a lack of comprehensive unbiased information in the marketplace, this can deter people from investing. In emerging markets, the financial advisory industry, which covers a wide range of financial services and could assist in developing retail demand for mutual funds, is typically not well developed. For instance, South African financial literacy research³⁰ showed that a source of independent advice, such as a broker, ranked far below other sources of advice (4 percent, compared with almost 80 percent of advice derived from family or friends), whereas this is a more significant source of advice in the United Kingdom (14 percent).³¹ In general, sources of independent financial advice will tend to develop only once entrepreneurs perceive that a demand for such advice exists and that money can be made providing this service. Thus, the better the incentivization for investing in mutual funds, the greater the demand and the resulting need for advice.

Lack of Confidence

Investors may simply lack confidence in the financial sector and/or mutual funds or be deterred by market volatility or the potential loss of capital. In countries with long histories of financial crises, ordinary investors may lack confidence in the financial system in general. Economic and financial instability can either deter investors from investing or influence their investment strategy. Mutual funds in emerging markets are also more likely to experience problems with buying or selling fund assets quickly and easily because of illiquidity in the market (see discussion below). This can engender fear in investors who have experienced or witnessed the inability of others to withdraw their money from a mutual fund upon demand.³² As discussed in chapter 2, investors may also lack confidence in mutual funds because of prior Ponzi schemes. In addition, market volatility may also deter investors because it implies uncertain investment outcomes. In Brazil, for instance, a history of economic turbulence, with periods of high interest rates and high inflation, has made investors highly

sensitive to inflation and to the possibility of future interest rate changes that could reduce the value of the capital invested in bond funds.³³ They are thus reluctant to invest in financial instruments with long durations and/or fixed interest rates in case the capital value of their investments plummets (see box 3.2). Investors in some markets may also be more sensitive to loss of capital than to the potential of making gains. For instance, in Turkey more than 60 percent of those surveyed in a capital markets awareness study³⁴ preferred a lower (but safer) or guaranteed rate of return, whereas only just more than 20 percent wanted best market performance or competitive rates.

Box 3.2: Brazilian Fund Market Response to Investor Fear of Inflation and Interest Rate Volatility

In Brazil where investors are worried about interest rate volatility, fund managers have effectively converted longer-term "fixed-income" funds to MMFs.

In Brazil, including the assets of multimercado³⁵ funds and FAPI³⁶ funds, fixed-income and money market instruments accounted for 75 percent of total assets under management.³⁷ Almost 70 percent of bonds held had a duration of three years or less. However, even though the bonds held by such funds may not mature for three or five years, the interest rate on 70 percent of bonds held was indexed to a reference interest rate or floating rate. Thus, when market interest rates change, the rates payable by the bonds held by funds change too, which implies no impact on the capital value of the bonds concerned. Thus in Brazil such bonds are more like money market instruments whose capital value is not likely to fluctuate. Funds investing in these instruments can therefore offer a more stable capital value and less volatility to investors.

The availability of MMFs may improve investor confidence, but in some markets these may entail greater risks than are apparent. As discussed in chapter 1, MMFs are mutual funds that invest primarily in short-term debt of corporates, banks, and governments, such as commercial paper, treasury bills, and certificates of deposit. The popularity of MMFs in many markets—both developed and emerging—often derives from their net asset value per unit being either constant, so there is no potential for loss of capital, or variable, but relatively little potential for loss of capital (see box 3.3). These funds are also popular because they can access wholesale money market rates and therefore usually offer higher interest rates than investors receive with retail deposits. This difference in interest return was a key element in the genesis of such funds in France and the United States and, more recently, in China. However, in some emerging markets, there may be no definition of what a MMF is, and the investment may in fact be riskier for investors than would be typical. For instance, almost 50 percent of Kenyan mutual fund assets under management were invested in what are referred to as "MMFs." However, many of these funds actually invest in bonds with a life of anywhere up to five

Box 3.3: Money Market Funds and the Risks of Constant Value MMFs in Volatile Interest Rate Environments

Money market funds are popular when they offer higher returns through their access to wholesale money market interest rates together with diversification of risk. In competing with bank deposits, these funds may also encourage banks to provide better rates of interest. Such funds can become systemically significant providers of finance to corporates. For instance, in the United States, MMFs at the time of the credit crunch were estimated to own around 40 percent of commercial paper in issue.³⁸

However, a possible downside is that investors may be misled into investing into money market or other funds, thinking that their capital is safer than it is. If the funds underperform, disillusion could set in and confidence in funds may be damaged as a result. This is why brief, clear, comprehensible disclosure of risk is important.

Constant value MMFs, in particular, may be inadvisable in environments with volatile interest rates.³⁹ In Kenya, for example, Central Bank benchmark interest rates between 2000 and 2012 had abrupt movements with relative frequency, ranging roughly between 1 percent and 20 percent. Unless constant value MMFs hold very short-term paper, it is probable that such interest rate volatility would cause capital loss sooner or later, and such funds would “break the buck” and damage market confidence.

years on acquisition, which would ordinarily be categorized as “fixed income,”⁴⁰ so their unit values are likely to be volatile (see chapter 2).

Mixed asset class funds or fund of funds, which reduce volatility of returns, may also improve confidence. However, in some countries regulatory frameworks governing funds either do not envisage mixed asset class funds that can shift their asset allocation to equities, bonds, and cash over time, or do not envisage funds of funds, which can shift asset allocation through their underlying mutual funds. Where this is the case, fund managers will be less able to reduce volatility of returns and to offer “target absolute return funds,” which are usually funds of funds that aim to give a positive return in every year. Although these types of fund may be difficult to operate in newly developing capital markets, which lack the range of liquid investments needed to operate them, providing for such funds to exist gives flexibility as markets develop.

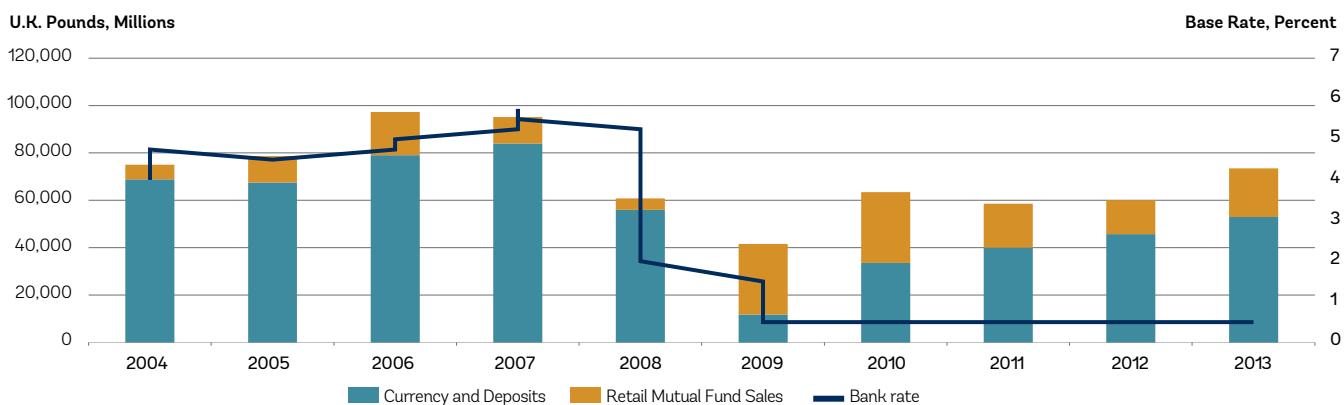
Impact of Competing Saving Methods on Demand for Mutual Funds

In general, mutual funds may be crowded out by other savings mechanisms in the market that are mandatory or offer advantages such as ease of access, more competitive returns, more security, or greater tax efficiency. As already mentioned, where retirement provision is mandatory, and contributions are high, people may see no further need to save. Other savings mechanisms may also crowd out mutual funds because of relative tax advantages as noted in chapter 2. As discussed in chapter 2, in Peru, for instance, mutual funds had to withhold tax when distributing income or gains to investors, but banks did not have to do the same for deposits.⁴¹ This crowding-out effect may be compounded if other long-term savings mechanisms are also easily accessed; that is, in some countries, retirement contributions can be withdrawn before retirement with relatively low, or no, penalties, which reduces the need to invest through mutual funds, which are valued for their liquidity (because they are obliged to redeem upon request).⁴² Mutual funds also compete with bank deposits. When interest rates are high, ordinary investors will typically leave their money on deposit in banks, where their capital is usually subject to deposit guarantees, rather than take higher levels of risk in equity or bond mutual funds. In addition, as at the time of the case study

in Turkey, for instance, when loan spreads were higher than mutual fund-related fees, banks that controlled mutual funds had less incentive to promote mutual funds versus deposits. Similarly mutual fund demand declines when government savings instruments offer high real rates of return⁴³ to retail investors, with security of capital with which mutual funds cannot compete. In Pakistan, for instance, in the early 2000s, national savings vehicles available only to retail investors provided interest rates of 15 percent; unsurprisingly, mutual funds were crowded out. Similarly, at the time of the case study in Kenya, the Central Bank had reduced the minimum subscription for treasury bills to the equivalent approximately of \$250, enabling direct retail participation. T-bills are a more secure investment, and so this could channel retail investor money away from money market mutual funds. Last, investors may also simply prefer to invest directly into equities or bonds instead of seeking to diversify risk through mutual funds. For instance, in Kenya at the end of 2012, local individuals owned just more than 23 percent of shares⁴⁴ listed on the Nairobi Stock Exchange⁴⁵ and accounted for nearly 19 percent of market turnover in the last quarter of that year.⁴⁶ Similarly, in Turkey, direct equity investment appeared to be more popular than investing indirectly via equity mutual funds: Borsa Istanbul held more than a million individual accounts, although fewer than 10 percent were thought to be active.⁴⁷

Conversely, when returns on other savings products are low, capped, or limited, or when the underlying investments in mutual funds perform well, mutual funds may flourish. When interest rates on deposits (and MMFs) are low, as they have been in many countries since the credit crunch, investors will tend to look elsewhere to improve their returns. Demand for bond funds and equity income funds typically increase in these circumstances. Figure 3.1 illustrates this point. It shows the impact of interest rates on inflow of savings into funds versus bank deposits in the United Kingdom: Basically, as interest rates fall, net retail sales of funds increase. Mutual funds may also benefit from limits or caps placed on other savings instruments. In Turkey, where current accounts did not pay interest, banks offered MMFs to their clients with excess cash in current accounts and in turn levied charges of 5.5 percent per annum on the funds (until these charges became capped at 1.1 percent).⁴⁸ More recently, Chinese MMFs have seen success mainly because they could offer interest rates of around 6 percent whereas ordinary individuals could get only around 0.3 percent on demand

Figure 3.1: Net Acquisition of Deposits and Currency and Net Retail Sales of Mutual Funds by U.K. Households versus Bank of England Base Rate, 2004–2013

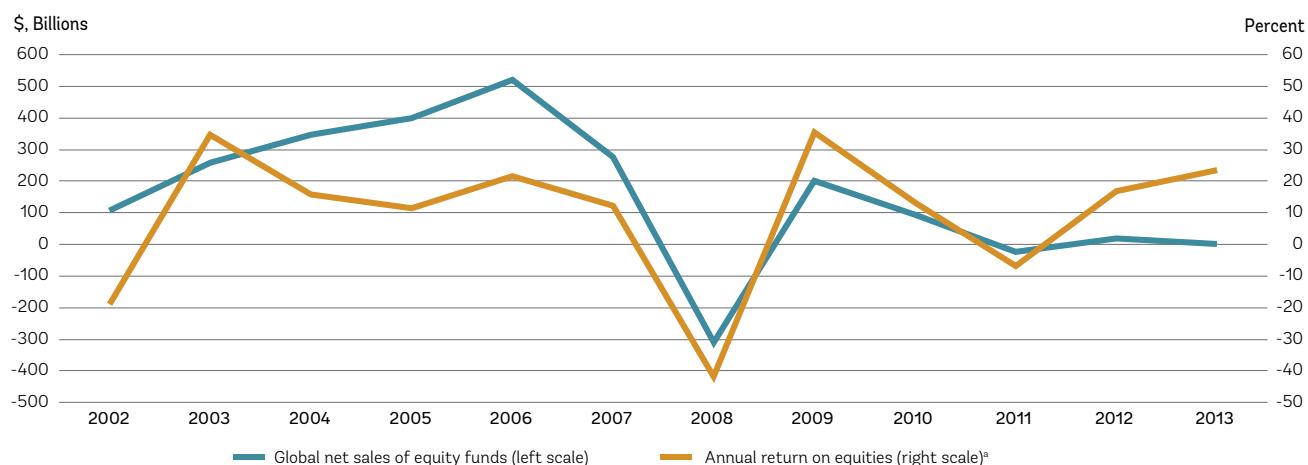


Source: Bank of England, Investment Management Association, and ONS.

deposits, and the government capped one-year deposit rates at 3.3 percent.⁴⁹ Also, as mentioned in chapter 2, income distributed by Chinese MMFs was free of withholding tax, whereas interest on deposits was not.⁵⁰ The entry of MMFs can disadvantage banks such as in the United States in the 1970s, when Federal Reserve regulation Q capped interest rates on bank deposit rates and MMFs were able to offer investors access to market interest rates, which were higher. In France in the 1980s, government did not permit interest payment on retail deposits,⁵¹ thus making MMFs more attractive. On the other hand, in the United Kingdom, bank savings deposit rates have habitually been competitive with wholesale money market rates; thus MMFs have never developed to any great extent. Last, mutual fund demand may also be strongly influenced by the market performance of their underlying investments; for example, figure 3.2 illustrates that net sales of equity funds tends to correspond with equity market performance.

Domestic mutual funds may also be crowded out if foreign mutual funds can be publicly offered and are more competitive than domestic funds. The development of a domestic mutual fund market may be impeded if there are no exchange controls and authorities permit foreign mutual funds that prove to be more competitive than domestic mutual funds to be sold into a country. Foreign funds may have advantages over domestic funds. For instance, they may have lower charges because of economies of scale. Their managers may have wider and deeper investment knowledge of international markets, well-established brands, and deeper pockets to pay for promotion and commissions to distributors. They may therefore potentially be more attractive to domestic investors than domestic funds. For example, a 2012 study⁵³ of distribution of UCITS in Asia noted that in Hong Kong, China, offshore funds represented 94 percent of total market value. As discussed in chapter 2, some countries' regulatory systems, such as the United States, make it

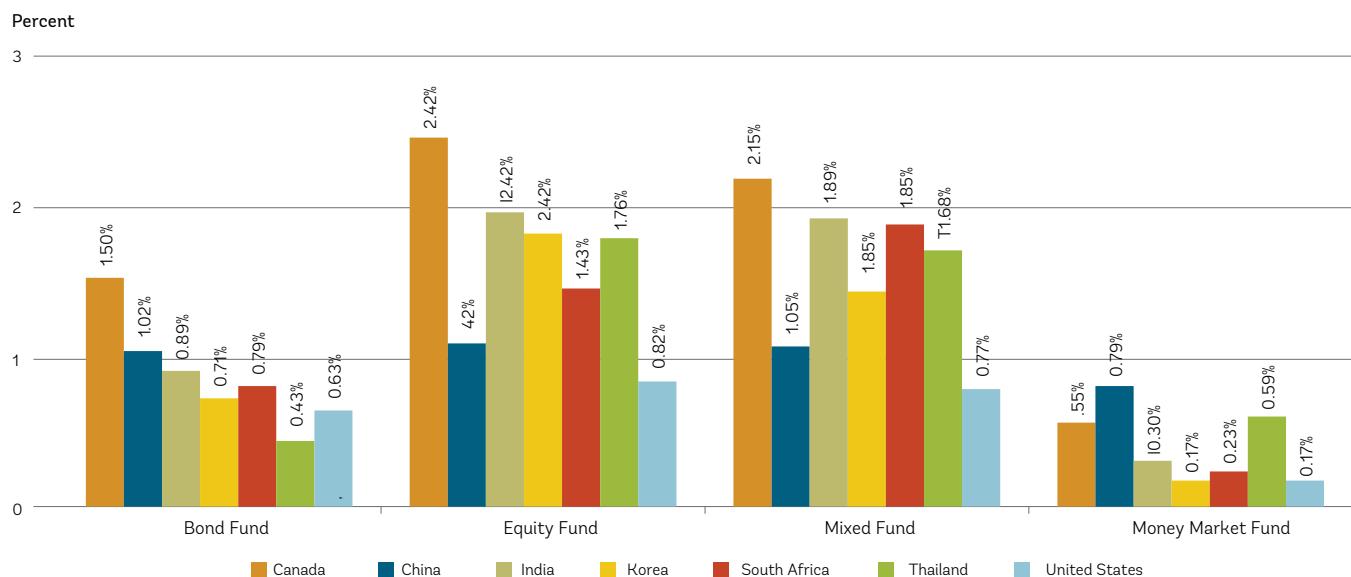
Figure 3.2: Global Net Sales of Equity Funds versus Annual Return on Equities, 2002–2013⁵²



Sources: Bloomberg, ICI Global Perspective, March 2014, International Investment Funds Association, and Morgan Stanley Capital International.

a. December to December percent change in MSCI All Country World Daily Total Return Index.

Figure 3.3: Total Expense Ratios in Select Emerging and Developed Markets



Source: Morningstar Fund Research 2013.

illegal to offer a mutual fund unless it is a domestically based fund approved by the regulator. However, other countries, such as Turkey, have regimes that “recognize” foreign funds for public offer or allow foreign funds to be privately offered to professional or rich investors. But in Turkey, although numerous foreign funds have been approved for offer, they have not been successful in attracting investors, probably because their method of taxation is more cumbersome than for investors in domestic funds.⁵⁴

Although mutual fund-related costs in emerging markets are not necessarily higher than those in developed markets, where these costs are high relative to direct investment, they may deter demand. A mutual fund’s total expense ratio is its total annual operating expenses expressed as a ratio of its average net assets. Total operating expenses include the annual management charge paid to the fund operator as well as various charges, such as for legal, audit, and trustee, depositary, or custody services. Although higher annual management charges may make the business of operating funds more viable, they can also deter investors, especially in comparison with other competing investment products. In addition, when the total costs of a fund, as measured by the total annual operating expense ratio, are high, the return to the investor is correspondingly lower. Figure 3.3 shows the range of total expense ratios⁵⁵ of mutual funds in a selection of emerging and developed markets derived from a Morningstar study of global investor experience.⁵⁶ It shows the United States as one of the lowest cost developed markets globally and Canada as one of the most expensive, implying that such costs are not uniformly lower in developed markets versus emerging markets. In Kenya, for example, investing in equities via a fund resulted in annual charges of up to 3.5 percent (in addition to entry charges of up to 6 percent). This was clearly expensive compared with investing directly in equities through a broker with as little as \$1,000 and once-off brokerage fees of 2 percent or less. However, this level of cost was clearly not

a complete deterrent because equity mutual funds constituted 30 percent of assets under management in Kenyan mutual funds at the time of the case study.

Supply

One of the inherent contradictions of developing mutual funds in emerging markets is that the key requirement for mutual funds to function is a sufficient range of adequately liquid, diversified investments that are easily valued and transferable; however, emerging markets often do not fulfill this requirement. Little purpose is seen in introducing laws and regulations to facilitate the introduction of mutual funds if these funds are unable to function properly. As mentioned in chapter 1, mutual funds are typically an outcome, and not a cause, of capital markets development. It was only when capital markets in the United Kingdom and the United States became sufficiently liquid that these funds could start to function and thus came into existence. Mutual funds need a sufficient range of investments to diversify risk. They also need markets with adequate liquidity to invest new inflows to the fund promptly and to be able to sell assets to raise cash and meet redemptions. Funds must also be able to accurately price their portfolios of assets to accurately value fund shares or units for sale or redemption.⁵⁷ In addition, for assets to be easily bought and sold they usually need to be transferable⁵⁸ and to be traded on a market that functions frequently, reliably, and transparently. Without such conditions, a strong possibility exists that one or more funds may fail either to diversify risk, or to redeem upon request, which will damage confidence in such funds and possibly damage confidence in wider capital markets.

Ability to Diversify Investments

If only a very limited range of investments—money market instruments, equities, or bonds—is available, mutual funds

cannot satisfy diversification requirements or differentiate their performance from other funds in the market. In such cases, the legal framework should ideally enable mixed asset funds, which can invest in shares, bonds, and money market instruments. Mutual funds typically are not allowed to invest more than 5 percent or 10 percent of their value in any one issue of securities and cannot have more than 20 percent cumulative exposure to the deposits, money market instruments, and issuance of any one issuer (with the exception of government).⁵⁹ These limits ensure that a fund provides diversification and that fund operators earn their charges for portfolio selection and management (which they would not do if a fund had only two or three investments). In developed markets, mutual funds may have hundreds of different holdings, which is relatively easy to achieve in markets such as the London Stock Exchange (around 2,500 listed companies) or the New York Stock Exchange, which is part of the Intercontinental Exchange network constituting 11 different exchanges trading 12,000 securities and contracts globally. However, as a recent IOSCO survey⁶⁰ found, even in emerging markets that are wider and deeper, such as South Africa, achieving required levels of diversification could be difficult.

Emerging markets generally have less developed stock markets, and countries with smaller stock market capitalization to GDP ratios tend to also have smaller mutual fund assets under management to GDP ratios (see figure 3.4). Exposure to equities is often low in emerging markets (for instance, 3 percent in Peru), often because supply of liquid equities is low.⁶¹ For instance, in Peru, despite 241 issuers with a market capitalization of around \$153 billion at the end of 2012, monthly stock market turnover in December 2012 was only \$2.2 billion, indicating a lack of liquidity.⁶² Kenya had around 50 listed companies at the time of the study, only 20 of which were reasonably liquid, and Morocco had around 77, with liquidity concentrated in the largest 15 companies. A mutual fund in such circumstances is more likely to be able to achieve effective diversification if it is permitted to be a mixed fund,

holding both equities and bonds, than if it is a “pure” equity fund (see box 3.4).

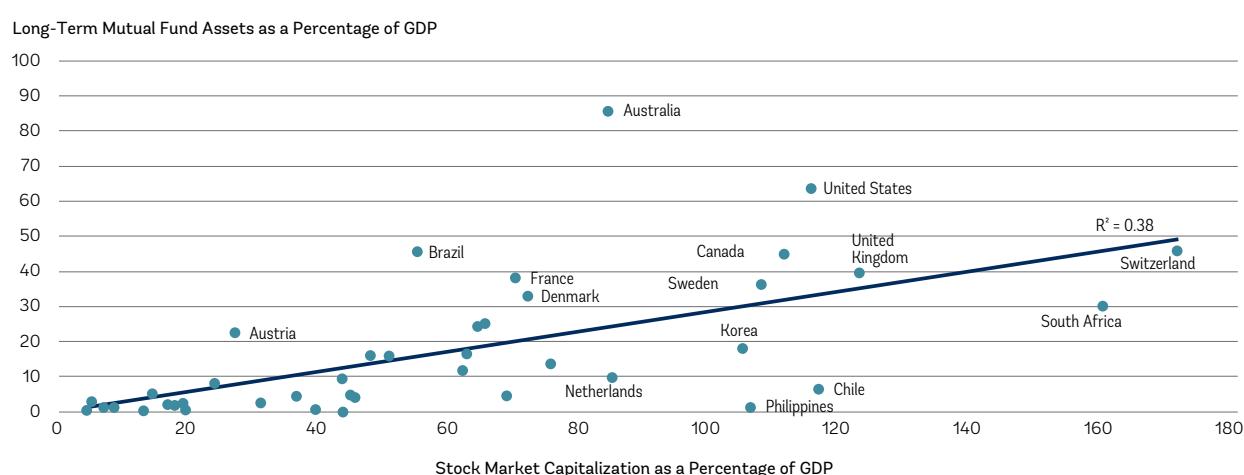
Emerging markets may also have limited supply of government bonds or a limited supply of government bonds of varying durations. In Saudi Arabia, where government borrowing needs are minimal, no government bonds are available to buy; government issuance in other countries may be limited because of relative cost versus other forms of borrowing or other factors. In yet other countries, government bonds may have limited duration, which leads to the absence of a yield curve against which to rate corporate issuance, which may in turn limit the supply of corporate bonds.

Similarly, the supply of money market instruments in emerging markets may be insufficient, as fund managers in Kenya, for instance, asserted. IOSCO’s recommendation⁶⁴ is that a conservative MMF’s portfolio should have a weighted average maturity of up to 60 days and a weighted average life of 120 days, which means a sufficient supply of such money market instruments is needed for such funds to operate.

Need for Liquidity

In illiquid markets, where trading is infrequent and assets cannot be easily bought or sold, valuing mutual funds is difficult; moreover, new inflows may not be able to be invested promptly, and open-ended funds may not be able to promptly honor investor redemption requests. Mutual funds ideally need to access current prices for their investments daily to value fund assets and calculate the price per share or unit at which investors can enter or exit the fund that day. This means that the prices of the underlying assets must be formed daily, which may not happen in emerging markets where few transactions take place (moreover when prices are formed, they may be volatile and easy to manipulate) and where institutional investors such as pension funds tend to “buy

Figure 3.4: 2012 Mutual Fund Assets/GDP versus Stock Market Capitalization/GDP⁶³



Sources: International Investment Funds Association and World Bank.

Note: Total net asset data for Russia are as of 2011. Data is included for Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, China, Costa Rica, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, India, Italy, Japan, Korea, Rep. of Mexico, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Trinidad and Tobago, Turkey, United Kingdom, and the United States.

Box 3.4: Achieving Investment Diversification in Ugandan Equity Mutual Funds

Uganda, which has had a mutual funds law since 2003,⁶⁵ had underlying regulations requiring a fund to have a minimum of 16 holdings (four investments capped at 10 percent of fund value and 12 investments capped at 5 percent). However, the Ugandan Securities Exchange had only eight listed domestic securities and seven cross-listings. Turnover on the exchange was around \$6 million in the last quarter of 2012.

This made it virtually impossible for an equity mutual fund to operate effectively; simply not enough different equities were available for an equity fund to achieve the diversification required by the regulations. It was also very unlikely that an equity fund that raised \$5 million could get invested within a three-month period.

and hold" because assets are hard to come by. In Morocco, for instance, given stock market illiquidity, historical prices disclosed by the Casablanca Stock Exchange may not automatically reflect the actual value of shares or give a good indication of the price that would result from future transactions.⁶⁶ In illiquid markets, mutual fund inflows from investors therefore are also at risk of being kept in cash instead of being invested because assets are difficult to buy. This means investors are not achieving the exposure to the asset classes and entities described in the fund's investment policy and objectives. On the flip side, if mutual funds fail to meet their fundamental obligation to investors to redeem upon request because assets cannot be sold quickly to raise cash, then again investors again are being deprived of their right as stated in the fund's prospectus. Another problem is that stock exchanges may not trade every day, so prices cannot be formed every day. In this case funds in emerging markets may be permitted by regulation to value and deal less frequently: only once every two weeks or even once a month.⁶⁷ This was the case in Uganda at the time the Collective Investment Schemes Act was passed in 2003. Trading on the Uganda Securities Exchange was twice weekly for a few hours (it subsequently started to trade five days a week and open for normal business hours). In this case, prices could be formed only twice weekly also, so daily valuation and pricing of funds could not be required. Infrequent trading of bonds is also a problem in many emerging (and developed) markets. In Brazil, where bond funds are more like MMFs (see discussion above), a wide range of government bonds are found (with fixed, floating, and index-linked rates of interest). However, illiquidity is still a problem because secondary markets in bonds are very limited. In Brazil this is because if the interest rate on a bond floats or moves with an interest rate index, the market value of the bond held does not change, and therefore there is no need to sell the bond if bonds with higher rates come onto the market. In countries with no exchange controls, such as Peru, illiquidity may drive investors in search of liquid assets toward foreign assets.

Indexed funds may also not be able to operate in illiquid markets. Index funds aim to replicate the performance of a stated index (less management charges) by using inflows to buy the components of the relevant equity or bond index in the same proportions as the constituents of the index. However, if an index fund cannot buy and sell the underlying assets every day as money enters and leaves the fund, it will diverge from the performance of the index. Many exchange-traded funds operate in this way, although in some cases

they synthetically replicate the performance of an index using swaps, but this is feasible only in markets where there are financial institutions able and willing to enter into such transactions.

Closed-ended funds may be better suited to illiquid markets. In illiquid markets where the range of equities or bonds available is limited and these instruments are infrequently traded, the development of closed-ended funds should be encouraged before open-ended funds. In countries where funds developed organically, closed-ended funds usually developed first, because they did not need liquid securities markets. Because such funds do not have to redeem their shares or units, the fund does not need liquid underlying assets. Thus these funds can also be used for investment in infrastructure, real estate, and venture capital-type companies (see box 2.7 for more on closed-end funds).

Ability to Hedge Risks

In emerging markets, mutual funds may not have access to instruments to hedge risks. In markets such as Kenya or Morocco, because underlying assets (such as shares or bonds) are not typically well developed, derivatives (contracts whose value depends on the value of an underlying asset) are correspondingly not well developed or available. This means that derivatives cannot be used in such countries (as they are in others) to reduce risk. In addition, mutual funds investing in foreign assets might wish to hedge the currency risk involved, but this will not be possible if currency forward contracts or swaps are not available, as is generally the case in early emerging markets. It is very important, therefore, to recognize that developing mutual funds and developing capital markets are interdependent; mutual funds can function effectively only where capital markets provide sufficient diversification and liquidity.

Market Structure and Infrastructure

Market structure impediments can restrict competition between mutual fund operators, create barriers to entry, and limit product development.

Dominance of Bank Ownership of Fund Operators

Banks and insurers dominate ownership of fund operators in many emerging and developed markets, both in terms of number

of operators and by value of assets under management in funds.

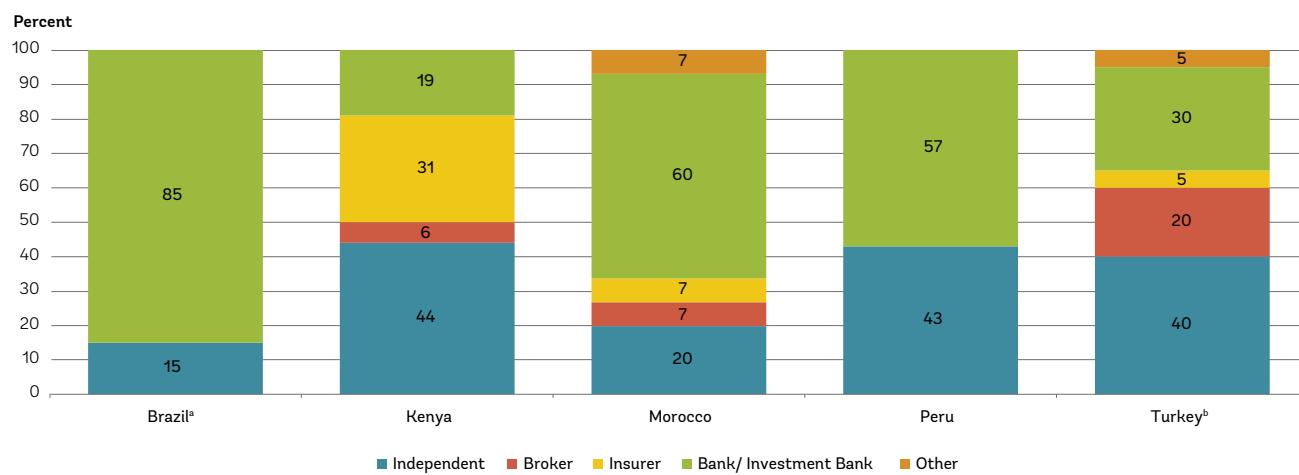
Figure 3.5 shows this domination of bank ownership in terms of number of operators in the case study countries. However, bank dominance is even stronger in the same countries when analyzed in terms of assets under management. In Brazil, 17 of the top 20 operators (accounting for 85 percent of assets under management) were bank owned. Similarly, in Morocco, seven of the top eight asset management companies were owned by banks and controlled 87 percent of assets under management, and in Peru banks controlled 95 percent of assets under management. In Kenya, the top eight operators in terms of assets under management were banks and insurers and controlled 50 percent of the market. In Turkey only 30 percent of assets under management were controlled by banks.⁶⁸

Although mutual fund operators owned by a larger financial services firm may have certain advantages, this type of ownership also leads to less exclusive focus on developing the mutual fund management business and may deter growth and competition within the sector. If a dedicated firm operates funds, the firm would focus exclusively on developing and growing the mutual fund business. However, when banks are the fund operators, or dominantly own mutual fund operators, the business priority may not always be mutual fund sector growth (the same will also be true of insurance ownership). For instance, in Kenya and in Turkey (until the end of 2012), the operator of the fund, which created the mutual fund and was legally responsible for its operation, did not have to hold a fund management license. Instead, an operator could simply appoint an investment management company to manage the assets of the fund. Thus entities that covered a broad range of financial services, such as investment banks in Kenya and banks in Turkey, could create and operate funds. In this case, fund operation is simply one activity within a wider-ranging business whose commercial priorities will vary over time. In contrast, in Brazil, regulation required a specialist administrator company to

operate funds, whereas in Morocco, Peru, and Turkey (since 2013), a specifically licensed fund management company is required to operate funds. Although these fund management companies may often be a subsidiary of a bank, insurance company, or other financial sector business, their focus is exclusively fund management, and they are invested in the success of the mutual fund business and the development of the sector. Banks and insurer domination may also reduce competition in the mutual fund sector. In Peru, for example, to buy units in a fund operated by a bank-controlled fund operator, the client would have to open an account with the bank that owned that operator. Subscription into the fund was then made through this account, and investment proceeds were also received through this account. This potentially deterred bank clients from investing in funds offered by other operators, thus reducing competition between operators.

Bank or insurer domination may also influence the type of mutual fund products developed in the market. Fund operators dominated by banks and insurers will tend to create the product range that can be sold most effectively by their parent organization to its client base. It is possible, therefore, that the relatively low percentage of assets under management invested into equities in many emerging markets (as shown in chapter 1), in markets where banks dominate ownership of operators, may also be related to these banks being more able to sell money market and fixed-income products to their client base rather than equities. Banks would be more incentivized to offer MMFs because these funds have less volatile returns, therefore being more acceptable to clients and presenting less reputational risk to banks. For example, the domination of MMFs in Turkey could possibly have resulted from banks seeking to retain their clients through an interest-bearing investment at a time when current accounts paid no interest and term deposits locked clients in for periods when interest rates were likely to fluctuate. Thus the bank's clients received interest and quick access to their money.

Figure 3.5: Bank Domination of Mutual Fund Operators by Number of Operators



Source: World Bank case studies.

a. In Brazil, the figure refers to the top 20 administrators/managers of funds in Brazil only, but there are 92 administrators.

b. In Turkey, the figure refers to ownership of portfolio management companies (only entities permitted to create funds at year end 2012).

and the banks got 5.5 percent annual charges (until the regulator limited these). In addition, banks that own mutual fund operators may also not necessarily market mutual funds on an ongoing basis, because other activities may be more profitable. For instance, as referred to earlier, in Turkey, banks were incentivized to offer MMFs when they could charge 5.5 percent annual charges on such funds; however, when charges were capped at 1.1 percent, it made more sense to channel such clients to deposits instead, thus contracting assets under management in such funds. Turkish MMF assets declined from 78 percent of total assets at the end of 2011 to 58 percent by the end of 2012.

In sum, bank or insurance domination of ownership of fund operators has both positive and negative effects. Banks and insurance companies are typically well placed to develop such business because they have known brand names, established distribution networks, large client bases and are generally able to finance such businesses and can take a long-term view of their development. These institutions do not need to achieve early profitability, unlike independent operators who are likely to come under more pressure to make early profits and, therefore, may not enter the business in small nascent markets. However, as noted above, from the sector development perspective, such institutions may give lower priority to developing a mutual fund business if it is only one business activity among many and if it is not as profitable as some other activities (as would generally be expected in the early stages of mutual fund development).

Ability to Access Distribution

Access to distribution channels can have a major effect on the fund operator's profitability and ability to conduct business; it can also impact household penetration of mutual funds. If a fund operator cannot sell units in its funds directly to investors (for example, through its own website), this may both limit the operator's ability to develop their business and reduce potential distribution channels. In Turkey, for instance, until 2012, if a fund management firm was the operator of a mutual fund, it could sell units in its funds only through intermediary institutions (banks and brokerages). Thus such firms were captive to distribution channels over which they had no control. Fund operators may also in effect be forced to use particular distribution channels because of regulatory requirements for minimum fund sizes. For example, in China circa 2006, mutual funds could be licensed to operate only if they attained a certain minimum size (approximating to \$26 million). The only way to gather this level of investment at the time was to distribute the fund through one of the four banks that dominated 80 percent of mutual fund distribution:⁶⁹ If this could not be achieved, the fund could not be formed.

Fund operators' ability to build their own distribution channels is often limited. If mutual fund operators were to incur the expense of building their own "captive" distribution, such as a sales force or branch network, this would likely increase the costs of mutual funds and in turn make them less attractive to investors. Thus mutual fund operators linked to or owned by entities that already have substantial distribution networks may be best placed to make

sales. From the perspective of the banks or insurance companies, such a link helps derive another revenue stream from an existing cost base.

Banks and insurance companies have a large existing client base to distribute funds, but if they dominate retail distribution, they can restrict independent fund operators from entering the market (if institutional investors are not significant owners of mutual funds). Enabling "funds of funds" can help independent fund managers to enter the market in such circumstances. Mutual funds, like other financial products, tend to be sold rather than bought. Banks and insurers have sales networks that have existing customers who are already in the formal financial sector. Thus, as shown in chapter 1, banks in particular often play a dominant role in distributing mutual funds in both developed and emerging markets. Where banks or insurers dominate fund distribution, they are unlikely to recommend or distribute products offered by competing fund operators. The typical entry route for a new fund market entrant that is not owned by a major financial institution is to first attract institutional clients (which do not require distribution networks), establish a reputation for performance, build assets under management and fee revenue, and then expand into retail markets. Thus, if as in Peru there is little institutional mutual fund business, bank domination of retail distribution may make it difficult for nonbank entrants to distribute their funds and build mutual fund businesses. In Brazil, bank domination of distribution has been offset partly because institutional investors are a significant presence (as in Morocco), but also because independent fund management companies can sell their funds to bank clients through "funds of funds" offered by the bank.⁷⁰ However, in some regulatory regimes, such as Kenya at the time of the case study, it is not possible to operate funds of funds, because the rules do not allow a fund to invest 100 percent in other funds. This may shut off one route through which independent fund management companies can enter the market. It may also reduce the potential for creating funds of funds that invest abroad, which is typically a cost-effective way for ordinary individuals and institutional investors to invest abroad.

Developing a wider range of distribution channels, including financial advisers (which are generally absent in early emerging markets) and Internet-based platforms to sell funds, may increase household penetration of mutual funds and help new fund operators enter the market, thus supporting sector development. Some emerging markets have a wider range of distribution channels, which reduces bank and insurance domination of fund sales and enables independent fund operators to build alternative distribution channels. In most countries stockbrokers or private wealth management divisions of banks may offer advisory services, although private wealth management tends to focus on higher-net-worth individuals. In developed markets, financial advisors may distribute mutual funds and other financial products. These advisers may be remunerated by commissions agreed by them with mutual fund operators and therefore act as agent of that operator.⁷¹ Independent financial advisers, on the other hand, are increasingly being required to act as the agent of the client and be remunerated only as agreed between the client and the adviser. In either case, if

the operator of the mutual fund pays a commission, they do so only when a sale is made. This is less of a financial burden than hiring a salesforce, or creating a branch or agency network, and therefore offers a better opportunity for independent fund operators to enter the sector. However, financial advisers are largely absent in early emerging markets, although they are developing in countries such as Brazil and India. This is almost certainly because, in early emerging markets, demand is insufficient for such advice to make a pure financial advisory business sustainable; where such businesses do exist they are likely to be adjuncts of and complementary to an existing business such as banking or private banking or sometimes legal and accountancy firms (see box 3.5). In India, a recent study concluded that the presence of financial advisors had the highest correlation to penetration of mutual funds in Indian districts, indicating the importance of this distribution channel for Indian mutual fund operators.⁷² In addition, Internet-based platforms may target distributors of mutual funds ("business to business"), offering a wide range of mutual funds, and often other products, from different providers. They also allow the distributor to deal online for all their clients. Other such platforms may offer a similar service directly to members of the public ("business to consumer"). Such a service may be provided in several countries; one fund supermarket, for instance, operates in Hong Kong, China; India; Malaysia; and Singapore. Again, this is a relatively low cost way of a mutual fund operator to access a wide variety of potential clients through a single outlet, with commissions payable only when a sale is made.⁷³

In many developed and emerging markets, the competence of distributors—whether in banks, financial advisory firms, or elsewhere—and the ability to adequately explain mutual funds to their clients can also affect mutual fund penetration. In India, for example, nearly 62 percent of mutual fund operators reported that the quality of mutual fund distributors was a key impediment to improving mutual fund penetration.⁷⁴ Internationally there has been a trend to professionalize financial advice; regulators are increasingly requiring advisers to have certain qualifications or a required level of experience as discussed in chapter 2 (for example, see box 3.5).

Incentivizing Distribution

Where banks dominate fund operation and distribution, their charging structures may also make it difficult for independent, nonbank affiliated players to enter the market and hence potentially restrict competition. When mutual funds operated by bank or insurance subsidiaries are offered through their own branch or agency networks, the distribution costs incurred are internal to the bank or insurance company, which may choose to pass these on by applying entry or exit charges or may choose to absorb them. But entrants that do not have access to such a distribution channel will need to incur costs to provide commissions to intermediaries and to recover these by levying entry or exit charges on their clients. This may make funds of these players uncompetitive with those bank or insurance offerings that have no entry or exit charges. Thus any such new entrant is likely to need sufficient initial capital to sustain some years of up-front costs as they build up distribution. A new independent start-up fund operator will find this a barrier to entering the market.

The relative attractiveness of mutual funds compared with other products, and the limits placed on mutual fund charges and commissions, may also place mutual funds at a disadvantage compared with other savings products being distributed. Sales persons who deal with competing savings products are naturally influenced by the relative incentives these products offer their customers and themselves. Simply put, sales persons will tend to sell the most attractive product to the client, because that is the easiest sell and therefore most remunerative to the distributor. For example, in Turkey, mutual fund distribution was noncompetitive compared to pension savings because of a couple of factors: First, the government added 25 units to every 100 units of value contributed to the individual pension system, making mutual funds less attractive in comparison; second, pensions salespersons were paid commissions up front, amounting to up to a total of seven years of the applicable annual charges (compared with much lower annual commissions paid for mutual funds sales). Kenya provides a similar example. Commission for a life insurance policy was 40 percent of the first year's premiums, falling to 10 percent in each of the next two years. By comparison, the maximum commission for a unit trust was up to 6 percent of the value of the initial charge. Most regulatory regimes also limit the charges that can be made to funds and require that these are clearly disclosed (see chapter

Box 3.5: Nontraditional Distribution Channels for Mutual Funds in India

Almost three-quarters of mutual fund assets under management in India is derived from the four big metropolitan areas—Chennai, Delhi, Kolkata, and Mumbai—and the top 35 metropolitan cities accounted for around 90 percent of assets under management as at year end September 2013.⁷⁵

The Indian government has been focused on the need to expand the distribution of mutual funds beyond the major cities. It has sought to expand distribution channels for funds by allowing sales through independent financial advisers remunerated by fees from their clients.

The government has also allowed "simple and performing" mutual fund schemes to be sold through postal agents (India Post has branches all across India), retired government and semigovernment officials, retired bank officers with service of at least 10 years, and other similar persons such as bank correspondents and persons who sell other financial products. In response to this expansion in permitted distributors, the mutual funds trade association has developed a special Mutual Fund Foundation Certification and one-day Mutual Fund Foundation Certification training program for these groups.

2). For example, in many countries the operator cannot charge the cost of marketing and selling a fund to the fund; instead the operator has to pay this out of the entry, annual or exit charges. In comparison, bank, pension, and insurance products may not face such requirements and can therefore pay higher commissions than mutual funds can, which again incentivizes the distributor to sell competing products rather than mutual funds.

Charges as a Barrier to Entry and a Basis of Competition (versus Performance)

Charges are typically one of the factors driving competition in the mutual fund sector; however, in some markets, charges can be the primary basis of competition rather than performance. The fund prospectus usually establishes the nature and scale of charges, which may be limited by regulation (as in the case in Morocco and in Turkey). In some countries, although entry charges are allowed, fund management companies choose not to levy them (exit charges are generally rare). This, in turn, may enable fund operators (or their parent companies) with more capital to deter less well-financed competitors from entering the market.⁷⁶ Funds with lower charges are also more likely to provide better performance because charges reduce returns; this may also give fund operators with deeper pockets an advantage. In such cases, it would be key for independent fund operators to differentiate themselves by their performance; this will most likely be assisted by developing wider and deeper capital markets as well as public awareness of funds.

When institutional investors, which typically pay lower annual management fees, predominate, new mutual fund operators may find that these low charges make it difficult to enter the market or to create viable businesses. Internationally, annual management charges levied on institutional investment into mutual funds are generally lower than the charges made on retail investment, partly because the cost of attracting and servicing large numbers of small transactions in the retail market is much higher than the cost of attracting and servicing small numbers of large transactions in the institutional market. Also, to attract retail business, the operator typically has to pay promotional costs and commissions to distributors, or fees to platforms, out of annual management charges. In Morocco competition for institutional business at the time of the study was such that mutual funds sold to institutional clients (who have large capital and higher negotiation power) levied very low annual management charges. Some firms indicated as low as between one and five basis points, whereas charges on retail investors were in the range of roughly 150 to 190 basis points.⁷⁷ Although established mutual fund operators may be able to sustain these lower charging levels because they have larger pools of assets under management on which to levy such charges, new entrants may not be able to build their business on such charging levels, particularly if they are not part of a larger organization (such as a bank) that may be able to subsidize costs for some years. This potentially could impede new independent fund operators from entering the market and developing a viable business. In addition, given the lack of liquidity and depth in the securities markets, and the resulting constraint on differentiation and performance, Moroccan funds thus competed heavily on fees rather than performance. Where institutional demand is dominant,

it may be useful to additionally encourage retail demand to counter some of these effects.

Supply of Service Providers

In the early phases of market development, because of the lack of economies of scale, the mutual fund sector may be dominated by a few service providers, thus concentrating risk. As discussed in chapter 2, mutual funds need service providers other than the operator to operate effectively. This includes trustees or depositaries responsible for safekeeping assets and supervising fund operation or custodians responsible for safekeeping fund assets.⁷⁸ Most commonly, this role is taken by banks or their subsidiaries. However, in nascent markets, few entities may be prepared to take on the custodian, trustee, or depositary role. This may be because the sector is too small to provide acceptable revenues for a diverse range of providers and, in turn, may lead to small numbers of service providers who dominate the market and thus concentrate risk. In Kenya, for instance, the mutual fund market had 16 mutual fund operators and only two trustees (both banks), with one trustee being the predominant provider of such services. New service providers may be encouraged to enter this business as the scale of their other key business (for example, as custodians to pension fund assets) expands.

Where there is a lack of custodians or depositaries, central securities depositories may provide these services. In some countries, such as Brazil and Turkey, the central securities depository provides custody services to funds, although another entity – such as the fund's administrator in Brazil or the fund's founder in Turkey – would supervise fund operation. In other countries, such as Lebanon, the central securities depository may also supervise fund operation. This has the advantage of creating economies of scale that could result in lower costs to funds; however, it can also result in a monopoly position. The central securities depository can play a useful role where legal frameworks require that the depositary to a fund must be legally and functionally independent of the operator. However, many developed and emerging countries permit the depositary of a fund to be part of the same parent group as the fund operator, provided that the depositary and the fund operator are functionally independent.

Third-party administrators that offer specialized services to mutual fund operators can be valuable for fund operators trying to enter the market. These administrators may offer a number of services, such as registering holders, servicing investors, and fund accounting and valuation. As discussed in chapter 2, to enable third-party administration, mutual fund legislation or regulation must specify that operators can delegate activities to other parties. IOSCO principles require that the responsibility for the activity still lies with the operator, and both the operator and regulator can oversee the delegate effectively. If the fund operator cannot delegate to a third party, new mutual fund operators entering the market would have to buy or develop the systems and expertise needed to administer its mutual funds. This would make entering the market more expensive. Specialized third-party administrators who service a number of clients can also lead to economies of scale that could reduce mutual fund costs. Although the other case study

countries did not have third-party administrators, Brazil's slightly unusual market structure offered similar benefits to the ability to delegate to a third party (although the legal responsibilities were somewhat different). In Brazil, an administrator was responsible for operating a mutual fund but could appoint an external and independent fund manager to manage the fund's assets. In effect a fund manager could enter the market at relatively low cost as long as it could find an administrator to provide services to it to establish and service its funds. In turn, this could assist increase the number of independent fund managers and competition in the market.

In nascent mutual fund markets, it may be hard to find domestic legal and audit firms with experience in mutual funds. A solution in such cases is to draw on expertise available from neighboring countries (within the same language group) that have more advanced mutual fund sectors. For instance, Kenyan lawyers and accountants have worked with mutual funds for some years and so could provide expertise to other countries in the East African Community as they develop their markets. In addition, the quality of auditors and their oversight of audits may not meet the standards of "internationally acceptable quality" required by IOSCO. Given that bank regulation often requires a specified standard for bank audits, one option is for regulation to require that only auditors that are eligible to undertake bank audits may undertake mutual fund audits.

Market Infrastructure

In early emerging markets, market infrastructure to facilitate a mutual fund sector may be only starting to develop, which can impede the mutual fund's ability to operate. Market infrastructure typically refers to stock exchanges or trading platforms on which

Box 3.6: Market Infrastructure Supporting Mutual Funds

Historically, such market infrastructure consisted of physical trading floors where securities were bought and sold.⁷⁹ This included paper-based systems for confirming and undertaking transactions. Registers of ownership of holdings and processing of settlement of transactions (delivery of securities or of payment for them) were also paper based, taking several weeks and conducted through checks.

Securities (and fund shares or units) were either in bearer form (a document of ownership of a holding that gives details of the holding but does not state the name of the owner) or in registered form (a document of ownership where the name and address of the holder are given as well as details of the holding). Selling such securities meant renouncing ownership of them, again via a paper-based system.

Most securities markets today display information and undertake trades electronically and confirm, clear, and settle transactions electronically. Registers are "dematerialized" and are also electronic and frequently held by central securities depositories.

to buy and sell fund assets or trade fund shares or units, central depositories to maintain records of securities ownership, and clearing and settlement organizations to clear and settle securities markets transactions (see box 3.6). In early emerging markets, such infrastructure will be nascent; their scale and nature will tend to adjust over time as market needs evolve. Of course, all institutional investors in a particular market will deal on the same exchange and experience the same registration and clearing and settlement procedures, so the mutual fund sector will not suffer a greater or lesser impediment than other institutional investors in that market.

Early markets present several challenges to operating mutual funds; namely, these markets often have limited listings, infrequent trading, slow and unreliable settlement systems, and slow registration of ownership of securities. As discussed earlier in this chapter, an early emerging stock market is likely to have a limited number of listings and more sporadic trading. This would make it difficult to develop stock or bond market indices against which fund performance can be measured or to use such indices as the basis for developing passively managed index funds. In addition, in some countries stock markets may operate only on two or three days a week for limited periods, so it would not be possible for mutual funds to buy and sell underlying assets daily. Mutual funds also need reliable trade and settlement cycles⁸⁰ so that investments can be bought and sold with daily inflow and outflows of money. In nascent stock markets, counterparties for guaranteed settlement may not be available, so funds in emerging markets are more likely to be at risk of failed trades. In addition, if company shares are registered by individual corporate registrars (as in Uganda in 2003), once the transaction has been executed on the exchange, the change in ownership of company shares will need to be confirmed through a company's registrar, which may take weeks and can impede fund operations as well as the ability to exercise shareholder rights (through voting shares owned by the fund) and to sell assets. Similarly, if dividends are payable by check, it may be necessary to physically collect the check and bank it, which will take time and possibly delay receipt of income by a fund. These problems are usually eliminated with the entry of an electronic central securities depository with links to clearing and settlement systems. However, more unique challenges may also exist in certain markets. For instance, in Vietnam in 2007, a fund operator was permitted to have only a single trading account to undertake any trading on behalf of clients including funds and the firm's own account trading. This also meant that a fund operator could deal only through the one brokerage with which it held the single trading account, restricting the operator's ability to choose different brokers for different transactions.

Other challenges may also exist to impede mutual fund operations, such as slow, costly, or unreliable communications and money transmission. Funds need prompt online, electronic price feeds⁸¹ from exchanges or data providers to value fund holdings and price fund shares or units, but these may not be available in nascent markets. Historically fund regulatory systems required communications, such as confirmations of transactions and annual and semiannual reports, to be sent to all investors by post. However, in many emerging markets postal systems have poor

national coverage and sometimes are insufficiently reliable, and couriers would generally be prohibitively expensive. The alternative would be for the regulator to allow summaries of reports in national newspapers (potentially expensive also), with information included on how to get the full report. Another alternative is for regulation to permit such communication to be electronic, although this is feasible only where Internet access is reasonably widespread and services reasonably reliable. In some emerging markets money transmission may be slow and expensive across different bank networks and across regions, which would add to the cost of investing in a mutual fund, particularly if contributions are small.⁸² Also, the longer the money transfer takes, the greater delay in getting the money into the fund and invested, possibly missing out on market rises. Distributing fund income and/or gains to investors would also be affected by money transmission costs, especially where the cost is high relative to the value of the payment. In this case, enabling the “rolling up” or reinvestment of these dividends can provide a solution, with the investor selling the required value of shares or units where needed.

In Summary

1. Ideally both institutional (including corporate) and retail demand for mutual funds should be actively developed.

Institutional investors can contribute strongly to expanding the mutual fund sector if they are permitted to use mutual funds as underlying assets. Pension fund-related demand can grow if contributions to pension schemes that can invest in mutual funds are mandatory and/or tax or otherwise incentivized. Institutional demand for mutual funds will also grow if mutual funds offer an advantage such as cost-effective investment in foreign assets without adverse tax consequences, or if MMFs offer institutional, corporate, and retail customers competitive returns because they have access to wholesale market rates.

2. Retail demand is strongly influenced by interest rate policy and taxation as well as economic cycles.

Experience from developed markets indicates that participant-directed defined contribution pension systems (which can invest in mutual funds) can contribute greatly to demand for domestic mutual funds. Awareness and education programs to develop retail demand are a long-term and expensive exercise, which a nascent sector may not be able to undertake, so government or regulatory support may be needed. In the early stages of market development, awareness programs are more likely to be most effective if targeted at relatively well-educated and affluent populations in major population centers (mass market advertising, on the other hand, is unlikely to be effective). In nascent markets, a single, well-publicized source, such as a trade association or regulator, for free, comprehensive, consistent, and factual information on funds is likely to be very useful. Developing a financial advisory sector may also help develop retail demand for mutual funds, because many people prefer to get face-to-face-financial guidance. However, this is a complex area to develop and regulate, because such advice should cover a wider range of financial services than mutual funds, and in the early

stages of market development, demand may not be sufficient for such services to make them viable.

3. Banks are always likely to play a major part in mutual fund markets, either as operators, administrators, and/or distributors of funds, and/or as trustees, depositaries, and custodians. To allow independent operators to thrive and increase competition, bank dominance of distribution should be offset by enabling other forms of distribution to develop and encouraging a third-party administrator to provide basic services to independent investment managers (as in Australia and Brazil). A central securities depository that can play custodian or depositary may help address the lack of custody, depositary, and trustee services in emerging markets. Alternately, regulation may permit a functionally separate custody/depositary subsidiary of a bank to provide services to a fund operator subsidiary.

4. There is no one “right” way of sequencing mutual fund sector development. Mutual funds develop only if a conjunction of factors is found: a reasonably sized and liquid capital market, clear but not excessive regulation, strong institutional investment notably from pension funds, availability of operators and service providers, tax neutrality or incentivization, and a middle class with disposable income to save. Without some or all of those in place, attempts to grow a mutual fund sector may prove fruitless. In general, mutual funds will be most successful where they exploit particular advantages, which may be an unintentional consequence of government policy in other areas. In some countries, MMFs have such advantages and are earliest to develop; in others it may be fixed-income funds or equity funds.

5. Encouraging mutual fund demand is inadvisable if the supply of liquid tradable securities and money market instruments is insufficient to enable mutual funds to accommodate this demand. Capital markets development therefore needs to be considered in parallel with mutual fund development. A strong mutual fund industry can not only mobilize savings cost effectively and offer investors a wide range of choices for worldwide investment in a variety of short- or long-term instruments but also contribute to further growth in an existing capital market. In capital markets that are likely to remain illiquid for some time, policy makers should encourage and actively focus on developing closed-ended funds and the domestic capital markets instead of mutual funds.

6. To kick-start a mutual fund sector, government could possibly create a publicly offered fund (e.g., the Unit Trust of India and Unit Trust of Tanzania) into which some government holdings are allocated. Although this concept has the advantage of familiarizing investors with mutual funds and mobilizing savings, and providing a training ground for employees in the sector, it may also have disadvantages. Investors may perceive such funds to have an implicit government guarantee and such funds may succeed only where they offer incentives that nonstate-

sponsored funds cannot offer, which may disadvantage private sector entrants to the market. An alternative is for state-owned banks or insurers to take the lead in developing the mutual fund business.

7. **Market infrastructure in emerging markets is more likely to present challenges to the operation of mutual funds than in developed markets.** When designing fund frameworks, policy makers must take into account the practical implications of operating funds in a domestic market and, where necessary, disapply international practices where they are not practicable. This requires knowledge both of how mutual funds typically work and of how the domestic market functions.
8. **The lack of independent information providers in nascent markets may be offset by the regulator requiring standardized disclosure of information on a central website and, if necessary, hosting such a website.** This information could also be disclosed through a trade association, or alternatively through the websites of a stock exchange or a central securities depository which provides services to all mutual funds.

Endnotes

1. Corporate entities quite often invest in mutual funds for treasury management purposes and may be included within the institutional investor category in data in some countries
2. European Fund and Asset Management Association, "Asset Management in Europe," June 2014.
3. Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA).
4. In Kenya demand from unit-linked insurance products was thought to be the main impetus for mutual fund sales, but it was not regarded as a significant factor in the other case study countries, possibly because such products may not be very developed in those markets.
5. European Fund and Asset Management Association, "Asset Management in Europe," 2014 (exhibit 25 for reference), <https://www.efama.org/Pages/EFAMA-Published-its-6th-Annual-Review---Asset-Management-in-Europe---Facts-and-Figures.aspx>. This is very low when compared to France (69 percent) or Germany (54 percent) where workplace pensions and special investment funds for institutional investors are significant owners of mutual funds, and even in comparison with Hungary (6 percent) and Romania (4 percent). These figures derived from the same report.
6. World Bank Financial Sector Indicators.
7. EFAMA Annual Report 2012, http://www.efama.org/Publications/Public/Annual%20Reports/AnnualReport_2012.pdf.
8. Pew Research Center.
9. Morocco case study.
10. In Turkey although there was a limit (20 percent) on how much pension schemes could invest in mutual funds, it appeared that this permission was rarely used.
11. Worldwide Mutual Fund Market Data, Investment Company Institute, year end 2012.
12. Mutual funds based in foreign countries, often in Ireland or Luxembourg.
13. Investment Company Institute, "2014 Investment Company Fact Book," http://www.ici.org/pdf/2014_factbook.pdf.
14. ANBIMA. These schemes invest predominantly in money market instruments or bonds that have floating rates or whose rates are indexed, making them in effect money market instruments because their interest rates move in line with current market rates.
15. Homi Kharas, "The Emerging Middle Class in Developing Countries," OECD Development Centre Working Paper No. 285, <http://www.oecd.org/dev/44457738.pdf>.
16. The study defined the middle class as households with daily expenditures of between \$10 and \$100 per person in purchasing power parity terms.
17. L. Christopher Plantier. "Globalisation and the Global Growth of Long-Term Mutual Funds," ICI Research Report (March) (Washington, DC: Investment Company Institute, 2014).
18. "How Households Save and Invest: Evidence from NCAER," NCAER, July 2011, http://www.ncaer.org/publication_details.php?plID=165.
19. "Penetration of Mutual Funds in India: Opportunities and Challenges," 2014.
20. "Understanding Consumer Attitudes to Saving," Aviva, 2004–8. This study surveyed more than 100,000 people in 25 countries around half of which were emerging markets.
21. "Understanding Consumer Attitudes to Saving," Aviva, 2004–2008.
22. Capital Markets Awareness and Knowledge Survey 2011.
23. Mutual funds have existed in the United Kingdom since 1931, but in a survey conducted in 2006 ("Levels of Financial Literacy in the UK: Results of a Baseline Survey" by the Financial Services Authority), 16 percent of those who owned mutual funds in the sample thought that they entailed no risk and 82 percent only low to moderate risk, even though mutual funds in the United Kingdom invest predominantly in equities and bonds.
24. Invest India Incomes and Savings Survey 2007.
25. Rajesh Chakrabarti, Sarat Malik, Sudhakar Khairnar, and Aadhaar Verma, "Penetration of Mutual Funds in India: Opportunities and Challenges," http://www.sebi.gov.in/cms/sebi_data/DRG_Study/OpportunitiesChallenges.pdf.
26. Financial Services Board, "Financial Literacy in South Africa: Results of a National Baseline Survey" (2012), <https://www.fsb.co.za/Departments/communications/Documents/FSB%20Annual%20Report%202013.pdf>.
27. The regulator in Kenya identifies those funds which are licensed on its site.
28. These providers can advertise and promote their services and operate on a global scale.

29. Nonstandardization of application forms was also cited as a deterrent to investors in the study on the penetration of mutual funds in India; see Chakrabarti et al., "Penetration of Mutual Funds in India: Opportunities and Challenges."
30. Financial Services Board, "Financial Literacy in South Africa: Results of a National Baseline Survey" (2012).
31. Financial Services Authority, "Levels of Financial Literacy in the UK: Results of a Baseline Survey" (2006).
32. A "run" on a fund, when investors flock to redeem their units and the fund has difficulty in raising cash to meet this, is what every fund operator and regulator dreads; such loss of confidence can be contagious and lead to a run across a sector, as nearly occurred with U.S. MMFs after the Federal Reserve Primary Fund "broke the buck" (became unable to pay back the \$1 invested) in September 2008 following the bankruptcy of Lehman Brothers. The government stepped in to offer a temporary guarantee that stemmed the flow. See <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489510#.VD-ubPlWoM>.
33. This contrasts with what generally happens with bond prices in liquid bond markets. Bonds are issued in standard blocks of value (for example, in the United Kingdom of £100 of nominal value or 100 percent), so if interest rates rise to 6 percent from 5 percent, the price of an existing £100 bond with five years left to maturity paying 5 percent will fall to £83.30 ($100 \times 5/6$); paying this will give the investor the 6 percent they would otherwise get for buying the new bond with a five-year maturity at £100.
34. European Union and Capital Markets Board of Turkey, "Capital Markets Awareness and Knowledge Survey 2011," <http://www.cmb.gov.tr/duyurugoster.aspx?aid=2012118&subid=1&ct=f>.
35. The multimercado fund is often described as a Brazilian domestic hedge fund. Certainly the regulations permit a very wide range of investment powers for this kind of fund, which can borrow, go short, and make extensive use of derivatives both to leverage and reduce risk. The degree to which this freedom is used will vary greatly from fund to fund, but extremes are rare, with most funds using their freedom to try to enhance returns while minimising risk. The increasing popularity of such funds may be due to their better recent record in delivering higher real returns to their investors at a time when real returns on other types of fund are falling.
36. Fundo de Aposentadoria Programada Individual (FAPI), which are defined as investment funds into which individuals may invest and exclusive funds that are held by open pension funds.
37. Only about 12 percent of assets under management in Brazilian mutual funds were invested in equities.
38. <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489510#.VD-ubPlWoM>.
39. It also would not align with IOSCO recommendations; see chapter 2.
40. In general, the maximum permitted maturity or residual maturity of instruments held by MMFs is around one year. This helps maintain the constant value of the unit. Assets of a short-term MMF would be expected to have an average weighted life of six months or less. Some are restricted to an average weighted maturity of 90 days.
41. Recently the process of deducting such tax has been made much simpler, which is a step in the right direction.
42. This is discussed in chapter 2. For instance, in Turkey the average holding period in a pension scheme at the time of the study was only three years (admittedly the pension system has been operating only since 2003).
43. That is, returns above inflation, so buying power is preserved.
44. Capital Markets Authority Statistical Bulletin, Q4 2012.
45. Worth \$3.25 billion, mutual funds having a total value of \$270 million.
46. In Kenya 840,000 retail investor accounts in the central depositary owned 23 percent of shares held in the system.
47. However, the average duration of a domestic investment in equity was 36 days in 2011, suggesting that such investment is typically speculative, in turn implying that mutual funds would be unsuited to such investors' needs.
48. Turkey case study. At some points in the last 15 years interest rates in Turkey were over 50 percent. Despite the Capital Markets Board bringing in a charging limit of 1.1 percent on such funds, MMFs still represented 77 percent of mutual fund assets under management at the end of 2011; however, the figures for 2012 showed a drop to 58 percent of assets, with bond funds becoming more popular, rising from 7 percent of assets in 2011 to nearly 26 percent of assets in 2012. See Investment Company Institute, "Worldwide Mutual Fund Assets and Flows," www.ici.org.
49. Financial Times, March 10, 2014.
50. This is an outcome of giving a tax advantage to dividends paid out by mutual funds in China, to mobilize savings to increase availability of financing for companies and government. This together with the fact that funds can offer returns much higher than bank savings accounts by investing in privately placed instruments has accounted for the explosion in MMFs in China.
51. Treasury Management International, "Money Market Funds: A Global Story" (2011), <http://www.treasury-management.com/article/4/216/1867/money-market-funds-a-global-story.html>.
52. The authors have received permission from ICI to use this graph, which was printed in the March 2014 ICI Global Perspective authored by L. Christopher Plantier. "Globalisation and the Global Growth of Long-Term Mutual Funds," ICI Research Report (March) (Washington, DC: Investment Company Institute, 2014).
53. BNP Paribas, "Distribution of UCITS in Asia" (2012), <http://securities.bnpparibas.com/quintessence/hot-topics/ucits-iv/distribution-of-ucits-in-asia.html#.VWCi3fIViko>.
54. Whereas domestic investors in domestic funds suffer an automatic 10 percent withholding tax, which is a final tax, investors in foreign funds have to declare tax payable, which is due at their marginal rate, which is typically higher than 10 percent, so investing in foreign funds is less tax efficient and more administratively burdensome.
55. Annual cost of operating a fund, which includes annual management charges but excludes portfolio transaction costs and taxes.
56. Morningstar Fund Research, "Global Fund Investor Experience 2013."

57. Otherwise incoming or outgoing investors may pay, or be paid, too much or too little, and ongoing investors will experience concentration (increase in the value of their shares or units) or dilution (decrease in value of the same).
58. That is, the consent of a third party is not required before they can be bought or sold.
59. Deposits with any one deposit taker are also limited typically to 10 percent or 20 percent of fund value. In more sophisticated emerging markets, exposures to a counterparty through derivatives contracts are usually limited to 5 percent or 10 percent. Funds are typically permitted to have higher exposures to domestic government bonds because these are the lowest risk domestic investments. Even then, a fund should not invest more than 30 percent of its value in any one government issue.
60. IOSCO/World Bank Survey.
61. But this is not necessarily the case in all countries. In Turkey, exposure to equities is also low (3 percent), but there is more liquidity in the Turkish stock market. Borsa Istanbul had 395 listed companies with a market capitalization of around \$307 billion and daily trade volume of around \$385 million in 2012. See <http://www.borsaistanbul.com/docs/default-source/yay%C4%B1nlar/borsa-istanbul-2012-annual-report.pdf?sfvrsn=4>.
62. MILA News, January 2013, No. 15
63. The authors have received permission from ICI to use this graph, which was printed in the March 2014 ICI Global Perspective authored by L. Christopher Plantier. "Globalisation and the Global Growth of Long-Term Mutual Funds," ICI Research Report (March) (Washington, DC: Investment Company Institute, 2014)..
64. IOSCO, "Policy Recommendations for Money Market Funds," October 2012.
65. Technically the Collective Investment Schemes Act of 2003.
66. In some cases valuation by reference may be possible. This entails using the price movement of another share (in another oil company, for instance) or the price movement of another bond that has the same duration and credit rating as a proxy. However, the latter may also be difficult if there is no credit rating of bonds (to ensure relevant comparisons) and no standardized approach to pricing of bonds of different maturities, as is also the case in Morocco and elsewhere.
67. Whether monthly redemption can truly qualify a fund as open ended is a matter for debate; a minimum redemption period of once every two weeks is the European standard.
68. The figures relate to those entities permitted to found funds and responsible for their operation at the time of the case studies. In Brazil, Kenya, and Turkey at the time of the case studies the operator commonly contracted out investment management to an external fund management company. In the case of both Kenya and Turkey the numbers and levels of bank dominance of ownership of these were similar to that given for fund operators above. However, in the case of Brazil, there were some 470 investment managers, and although the top 20 of these manage around 85 percent of total assets under management and many were bank owned, there are a further 449 managers, some of which were independently owned, that managed the remaining 15 percent, worth around \$150 billion.
69. This resulted in sales staff in the bank branches concerned being incentivized to sell the new fund to attain sales targets, but as soon as another new fund came along, branch staff were incentivized to sell that instead. In such circumstances, funds may not be recommended because they met client needs, or because they are a good investment, but because sales targets had to be met; as a consequence, fund investors firstly could lose money either through being churned from one fund to another or from poor performance of their fund as attention switched from the old to the new fund.
70. This is what is known as a "best of breed" sale through the bank distribution channel: That is, instead of offering only mutual funds operated by the bank's affiliated fund manager, the affiliated fund manager creates a "fund of funds" that invests in the leading funds of other managers (the best of the rest of the market). This may achieve more sales, because the investor is being offered something different, but with the reassurance of the bank brand attached to it.
71. Financial advisers are generally required to have a license or register with a regulator or a trade association. For example, the Association of Mutual Funds of India registers both corporate and individual distributors.
72. See Chakrabarti et al., "Penetration of Mutual Funds in India: Opportunities and Challenges." Other factors were levels of literacy, levels of savings, use of bank branches,
73. The mutual fund operator (or the mutual fund) may have to pay a fee to be on the platform concerned; commonly an annual commission will be paid by the operator to the platform that is a percentage of the value of the amount invested in that operator's fund on that platform.
74. Chakrabarti et al., "Penetration of Mutual Funds in India: Opportunities and Challenges."
75. KMPG, "Indian Mutual Fund Industry: Distribution Continuum: Key to Success," <http://www.kpmg.com/IN/en/IssuesAndInsights/ArticlesPublications/Documents/Indian-Mutual-Fund-Industry.pdf>.
76. Because these entrants would need entry charges to survive financially.
77. Morocco case study.
78. Depending on the legal structure of the fund and regulatory requirements.
79. The New York Stock Exchange still has this form of trading, although electronic trading is also undertaken.
80. Expressed typically as $T + x$, where T is the trade day and x the number of days within which settlement must be achieved.
81. Or if necessary through data given on storage sticks/flash drives.
82. For example, in Vietnam in 2007, the difference was between same day transfer and a cost of around \$35 cents within the same bank and a transfer taking up to three days and costing up to \$3.50 with another bank. If investors are making only small contributions to funds, for example, \$100, this cost, on top of an entry charge of 5 percent, might reduce the \$100 invested to \$91.5.

Appendix 1: Country Case Studies*

Brazil

History

The first investment fund in Brazil was created in 1957; by 1970 only 11 such funds were in existence. Regulation was originally by the Banco Central do Brasil. From the early 1990s responsibility for regulation of funds moved across to the Comissão de Valores Mobiliários (CVM), the capital markets regulator. After several crises in the fund sector in the 1990s and early 2000s, the CVM issued Instrução 409 in 2004, covering all types of investment funds, which remains applicable today.

Legal Environment

In 1959 the Ministry of Finance issued the first official document to address mutual funds, Portaria no. 309. In 1970 the Banco Central do Brasil issued Resolution no. 145, which was the first government regulation to establish broad guidelines regarding the constitution, functioning, and management of mutual funds in Brazil. The government instituted new regulations (Resolutions 1787 in 1991, and 1912 in 1992), which created the Fundo de Aplicação Financeira (FAF), the Fundo de Renda Fixa (FRF), the Fundo de Renda Fixa-Curto Prazo (FRF-CP), and the Fundo de Commodities, all of which absorbed the Fixed Income Fund and the Short Term Investment Fund that had been created in 1984 and 1986. These resolutions also transferred the supervision and regulation of equity funds from the BCB to the CVM. In November 1997 the Central Bank forced the separation of asset management activity from financial institutions' banking activities by Resolution 2451.

Regulation

The regulatory body is the Comissão de Valores Mobiliários (CVM). The CVM was established by Law no. 6.385 of December 7, 1976. At the time of the study the CVM had specific responsibility for the licensing, regulation, and supervision of investment funds and their administrators, fund managers, custodians, and distributors. The Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA), the trade association of funds (and other securities activities), acts as a self-regulatory organization that publishes voluntary codes and standards for its members. Although ANBIMA is not a statutory regulator, its contract with its members allows it to discipline and even fine its members.

* Note that these country case studies were conducted mostly in 2012, and although the discussion is in the present tense, the information is as of the time of the case studies and therefore may not be the most current.

Legal Structures

The only fund structure provided for in law and used is the condominium, in either open-ended or closed-ended form. Although the legal structure of Brazilian investment funds, as condominiums, is unusual, its governance meets best international standards.

Size of MF Industry

Brasil's investment funds market is the fourth largest domestic funds market in the world (after Australia, France, and the United States), worth \$1.07 trillion at the end of 2012. It has an unusually large number of funds, totaling around 7,500 (only three other domestic markets worldwide have more than 5,000 funds). It also has a large number of firms that manage fund assets, around 450.

MF Categories/Product Offerings

Types of Fund	Equity Funds	Bond Funds	Money Market	Hybrid Funds	Other
AUM in 2012 \$, millions	104,255	600,507	44,403	234,101	87,731

Founders/Promoters

In Brazil, investment funds are created by administrators, which are major financial institutions such as banks, which are responsible for the operation of the fund and are responsible to the regulator for compliance. At the time of the study there were 92 administrators: the top 10 administrators account for 75 percent of assets under management. The administrator may manage its own funds, but it may also create funds at the request of independent investment managers if it considers the investment manager to be fit and proper. Investment managers number 469. The administrator remains primarily responsible for compliance even if it subcontracts an independent investment manager to manage the investments. The administrator appoints both the custodian and the investment manager. These may or may not be part of the same financial group as the administrator. It is not unusual for all these functions to be carried out within the same financial group. These entities are usually parts of banking conglomerates that also act as distributors of fund shares or units to their own customer bases.

Ownership

Retail investors represent only 18 percent of ownership of Brazilian investment funds. A further 15 percent is categorized as “privately” owned, which includes individuals with high net worth. Public authorities corporate and other own 8 percent each. Five percent is owned by foreign entities and 32 percent by pension funds.

Custodial Services and Depositories

A custodian must be appointed to a fund by the administrator. It has a fiduciary duty to supervise the operation of the fund by the administrator and to safekeep and record fund of assets.

Distribution

Distribution in the retail market in Brazil is largely in the hands of banks, which are also usually administrators and managers of the funds they offer. Thus their revenues arise from annual administration charges, there being no need to remunerate sales outlets with initial commissions. Independent distributors of funds in Brazil are remunerated instead by means of a share in the ongoing annual administration charge, sometimes called a “trail” commission.

Fees

Subscription fees	Not levied
Redemption fees	Not levied
Annual management fees	0.25–4%

Accounting Standards

Investment funds are required to prepare annual financial statements, tables, and supplementary statements, standardized in accordance with the models established by the rules in force including the chart of accounts established in the Accounting Plan for Investment Funds (COFI) established by CVM Instruction 438 and 489 and the CVM rules. There are model accounts for guidance including notes to the financial statements. The administrator is responsible for preparing the financial statements. All funds should have their financial statements audited by an independent auditor registered at the CVM. They must include the notes required by the legal and regulatory statutes in force.

Taxation

In general, investment funds, as legal entities, are not subject to taxation in Brazil. They are considered fiscally transparent (“see-through”) entities for tax purposes. That means that investment funds are not subject to taxation on income and capital gains arising from their own transactions (at the portfolio level). The investors in the funds pay from 15 to 22.5 percent tax on the increase in the unit value in the six-month taxable period, which may derive from income or from realized or unrealized gains, with the level of tax payable depending on maturity of the portfolio and on the type of assets the fund holds, unless they are exempt from paying tax, for instance, if they are domestic pension funds. For corporate investors, income from fund is treated as taxable profit for corporate tax but allowed to offset tax already paid. For individuals, accumulated tax already paid can be deducted from final tax due at the time of redemption. The tax is payable by redemption of a matching value of units for the amount of tax due and is known as come cotas or “eating units.”

Trade Association

The Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA) is the trade association of funds and other capital markets participants.

Kenya

History

The first law that defined collective investment schemes in Kenya was the Unit Trusts Act of 1965; this remained applicable until 2000. It was not until the late 1990s that the first unit trusts were created.

Legal Environment

The Capital Markets Act of 2000 and underlying Capital Markets (Collective Investment Schemes) Regulation 2001 constituted the main law and regulation governing collective investment schemes in Kenya at the time of the case study.

Regulation

The Capital Markets Act empowered the Capital Markets Authority, which regulates unit trusts, fund managers, CIS promoters, unit trust trustees, and custodians.

Legal Structures

The only form of open-ended fund that was publicly offered at the time of the case study was the unit trust, although the current Capital Markets Act and Collective Investment Scheme Regulations also permit collective investment schemes to take the form of open ended companies (referred to as "mutual funds" in the act, which are investment companies with variable capital) or closed-ended companies (referred to as "investment companies" or "registered venture capital companies" in the act, which are investment companies of fixed capital).

Size of MF Industry

Fifty-eight funds had a total value of KSh 24 billion or approximately \$275 million at the end of June 2012.

MF Categories/Product Offerings

Types of Funds	Equity Funds	Bond (Debt) Funds	Money Market Funds	Hybrid	Other	Total
Number of funds 2012	13	11	15	14	5	58
AUM in 2012 \$, millions	82.84	10.76	130.47	39.67	11.58	275.3

Founders/Promoters

In Kenya, at the time of the case study, unit trusts had to be formed by a "promoter" of which 16 were registered with the regulator, the Capital Markets Authority of Kenya. A "promoter" must have either a license as a fund manager or as a stockbroker or as an investment bank. The promoter typically distributes the fund and appoints service providers to the fund, such as the fund manager, where the promoter is not itself a fund manager. The Capital Markets Act requires that unit trust assets may be managed only by an entity holding a fund manager license

Ownership

No statistics are published on ownership of unit trusts in Kenya. Anecdotal indications are that the bulk of the money invested into unit trusts is from retail investors.

Custodial Services and Depositaries

The Capital Markets Act requires that a corporate trustee must be appointed to a unit trust and that the trustee must ensure that a custodian is appointed to hold fund assets. Trustee and custodian activity is undertaken by banks. Unusually, the trustee and the fund manager to a unit trust are not required to be completely independent of each other; 10 percent common ownership is permitted.

Distribution

Although no statistics on this are published, sales of unit trusts are made mainly through insurance companies with fund managers, as well as through investment advisers, stockbrokers, banks, and insurance brokers and agents.

Fees

Average fees across all funds

Subscription fees	0–6%
Redemption fees	Not levied
Annual management fees	1–3.5%

Accounting Standards

Annual audited reports and accounts are required. No accounting standard is applicable to unit trusts or other collective investment schemes in Kenya. A sample review of reports and accounts indicates that they seek to comply with International Financial Reporting Standards. Although the regulations require certain information to be stated, they do not establish an accounting basis or state that any particular standard should apply.

Taxation

Under the Income Tax Act, unit trusts may be registered or unregistered. Only unit trusts registered with the regulator can be publicly offered. Registered unit trusts are not tax disadvantaged for exempt investors (such as pension funds) and are tax neutral for nonexempt investors to the degree that they pay no more tax than if they had invested directly into bonds, equity, or cash.

Trade Association

There are two trade associations: the Fund Managers Association and the Association of Collective Investment Schemes. Neither of these is formally a self-regulatory body, although some elements of voluntary self-regulation were undertaken.

Morocco

History

The Moroccan mutual funds market was born in the mid-1990s in the context of privatizations and global reform of the capital market. Morocco designed a privatization program in the early 1990s, following the implementation of a structural adjustment program. In parallel, and as from 1993, the Casablanca Stock Exchange (CSE) was computerized to allow electronic trading, a central depository company was created, and the Conseil Déontologique des Valeurs Mobilières (CDVM) was set up to supervise and regulate the market. In this context, a legal framework was set up in 1993 to allow the creation of open-ended mutual funds, in the form of collective investments vehicles to be managed by finance professionals.

Legal Environment

The main law governing Moroccan mutual funds is law no. 1-93-213 dated September 21, 1993, dealing with undertakings of collective investments in transferable securities (OPCVM). In addition, law no. 1-93-212 of September 21, 1993, concerning the CDVM and the information required from entities offering securities to the public contains a number of provisions concerning mutual funds. These provisions deal with (1) the control of mutual funds, asset management companies, and mutual fund custodians by the CDVM, (2) the inclusion of mutual funds in the list of qualified investors, (3) the appointment of new auditors by the commercial court upon request of the CDVM, and (4) the payment of commissions to the CDVM by mutual funds. Finally, mutual funds organized as Société d'Investissement à Capital Variable (SICAV), that is investment companies, are subject to the provisions of the law on corporations. In case of conflict, the provisions of law no. 1-93-213 should prevail.

Regulation

The mutual fund industry is mainly regulated by the CDVM and, to a lesser degree, by the Ministry of Finance. As is generally the case for subsectors of the Moroccan financial market, the mutual fund sector is under the dual supervision of the Ministry of Finance and of a separate regulatory agency, the CDVM.

Legal Structures

It is contractual and corporate both by law and in practice. The number of mutual funds in activity has more than doubled during the last decade. Although mutual funds are initially created in the form of investment companies (SICAV) and can still be set up under this form, market participants have since then overwhelmingly elected for collective investment funds (FCP) because of the flexibility they provide.

Size of MF Industry

333 mutual funds with DH 230 billion (~\$26.65 billion) of assets under management at the end of 2011.

MF Categories/Product Offerings

Types of Funds	Equity Funds	Bond (Debt) Funds	Money Market Funds	Other	Total
Number of funds 2011	79	153	40	61	333
AUM in 2012 \$, billions	2.58	15.77	7.04	1.26	26.65

Note: Exchange-traded funds and real-estate investment funds are not available yet in Morocco.

Founders/Promoters

Collective investment funds must be founded jointly by an asset management firm and a depository bank. However, the market is promoted by approximately 65 institutions, most of which belong to the financial sector. By virtue of the law, mutual funds must be founded jointly by an asset management company and a depository bank. However, the notion of founder does not reflect the reality of the genesis of funds in Morocco, and professionals therefore make a distinction between the legal founders of a fund and its initiator, usually referred to as its promoters. The vast majority of Moroccan mutual funds have been initiated by a single promoter, most of the time by the asset management company itself, a commercial or investment bank, or an insurance company.

Ownership

The Moroccan mutual funds industry is dominated by Moroccan institutional investors, which own more than 90 percent of total assets under management. The number of dedicated funds has surged during the last decade, and they now represent more than 40 percent total assets under management. Fewer than 20,000 retail investors own shares or units of mutual funds, and these investors have recently been leaving the market. Foreign investors are almost absent.

Custodial Services and Depositaries

The activity of mutual funds custody is reserved by law to banks and is therefore highly concentrated. In practice, only nine custodians are found in Morocco. All leading asset management companies are using their parent company for the custody of the funds they have under management.

Distribution

In the absence of any specific legislation on financial solicitation, the sale of shares or units of mutual funds by means of publicity or solicitation or through a brokerage firm, a bank, or other establishment whose purpose is the placing of securities, management, or advising in financial matters falls under the legislation applicable to securities offerings. In practice, the distribution of mutual funds is carried out by banks and asset management companies. More marginally, the distribution is carried out by brokerage firms.

Fees

Fees are shown for all types of mutual funds as weighted average by net asset value of funds (as of December 31, 2011).

Subscription fees	1.39%
Redemption fees	0.68%
Annual management fees	1.47%

Accounting Standards

Because of inconsistencies in Moroccan generally accepted accounting principles (GAAP), some large institutional investors make arbitrage between direct investments in fixed-income securities and indirect investments in the same class of assets through dedicated funds for accounting or tax purposes. The valuation of securities in the balance sheet of Moroccan companies differs between Moroccan GAAP and international financial reporting standards (IFRS). In particular, debt securities are valued at their nominal value under Moroccan GAAP, whereas shares or units of fixed income funds are valued at their net value (mark to market) as calculated and published weekly (or daily) by asset management companies. In this context, some institutional investors such as insurance companies can monitor their taxable income for a given year depending on how they invest their technical provisions, either directly in fixed income securities or indirectly through dedicated fixed income funds. Accounting standards—and tax rules—should therefore be reviewed to converge toward IFRS and prevent such arbitrages.

Taxation

Moroccan mutual funds are in principle tax transparent. This means that funds as such are not subject to any tax but that holders of shares or units of mutual funds are subject to tax depending on the capital gains (or loss) or the revenues resulting from their investment in mutual funds. However, the introduction of a special contribution to a social fund called the Fonds de Cohésion Social in 2011 resulted in the direct taxation of several Moroccan mutual funds in 2012, for the first time since the creation of the industry. This provision was apparently renewed in 2012, and some mutual funds will have to pay this contribution in 2013. This has been corrected in the 2013 budget law, which excluded mutual funds from contributing to the Fonds de Cohésion Social, but the principle of tax transparency of mutual funds should be reinstated and guaranteed in the future.

Trade Association

Association des Sociétés de gestion et des Fonds d'Investissement Marocains (ASFIM)—Association of Management Companies and Investment Funds of Morocco.

Peru

History

The mutual funds industry began its establishment in 1995 and grew substantially from assets under management of \$5 million in 1995 to \$6,771 million in 2012, with volatility during the financial crisis.

Legal Environment

Fondos Mutuos are enabled by the Ley de Mercado de Valores Decreto Legislativo no. 861 of 1996 as amended, but more specifically in detail by the Reglamento de Fondos Mutuos de Inversión en Valores y sus Sociedades Administradoras Resolución CONASEV no. 0068-2010. This was quite extensively amended and updated in 2010.

Regulation

The Superintendencia de Mercado de Valores (SMV) (formerly CONASEV) supervises securities markets and mutual funds and their fund management companies and custodians.

Legal Structures

Peruvian law permits only the operation of investment funds in contractual form. Fondos mutuos are open-ended funds of the contractual type, similar to those found in Spain and other European countries. The fondo mutuo is the principal form of collective investment scheme available to the general public in Peru, although wealthier investors can find advisory services that lead them to be able to invest in a wide range of foreign investment funds. Fondos de Inversión, which are also contractual funds but of an interval type that may be privately offered or publicly offered, are enabled under a different law, no. 18.815 of 1989.

Size of MF Industry

As at 2012 Q3 Peru had 61 mutual funds with AUM of \$6.1 billion.

MF Categories/Product Offerings

Types of Funds	Equity Funds	Bond (Debt) Funds	Money Market Funds	Hybrid Funds (Balanced)	Total
AUM in 2012 \$, billions	0.15	3.27	2.14	0.53	6.1

Founders/Promoters

Fondos mutuos are founded by fund management companies, which must be licensed by the SMV. Ninety-six percent of assets under management in fondos mutuos are managed by fund management companies owned by banks.

Ownership

Around 118,000 mutual fund accounts were in existence at the time of study. Although no publicly available research on this is available, it is thought that ownership of Peruvian mutual funds is predominantly retail.

Custodial Services and Depositaries

In Peru at the time of the study a fund management company was required to appoint a custodian to a fund to safekeep its assets; however, the custodian carries out “bare” custodial duties and has no supervisory role other than refusing to undertake portfolio transactions that are not permitted or illegal. The custodian may be a part of the same group as the fund management company.

Distribution

Banks also control distribution of funds. Because they distribute to their own customers through their own branches, there is no initial charge (front-end load) and no commission payable to sales agents.

Fees

Subscription fees	Not levied
Redemption fees	0–3%
Annual management fees	0.3–5%

Source: IOSCO Survey Data.

Accounting Standards

Annex L to the regulations contains a description of the minimum content of the annual report of a mutual fund that must be audited by an approved auditor and signed by the duly authorized representative of the management company.

Taxation

Until 2013 the fund management company had to calculate what tax should be payable by each investor on gains made in a fund, with rates of tax due varying between individuals and companies. This was complex and expensive. Since 2013 taxation has been much simpler: fund management companies in effect have to withhold 5 percent tax from the profit made on redemption of fund units. This is favorable by international standards but higher than tax payable on returns from bank deposits. Profits taken from investment in foreign funds will under the new system remain taxable at 30 percent, which is less attractive than domestic funds, but such profits may be undeclared or may be made offshore.

Trade Association

An Association of Mutual Funds was dormant at the time of the study.

Turkey

History

Investment funds in Turkey have developed since the introduction of the Capital Markets Law in 1981. The regulator of capital markets (including funds), the Capital Markets Board (CMB) of Turkey, was created in 1982. This was followed by the establishment of the Istanbul Stock Exchange (ISE) in 1985. It was not until 1987 that the first fund defined as a “mutual fund” in Turkey was created.

Legal Environment

At the time of the case study, investment funds were governed by Capital Markets Law 2499. Two distinct legal structures of investment fund envisaged in this law: “investment companies” with fixed capital (closed-ended corporate funds) in Articles 35 and 36 on “investment companies” and contractual funds (known as “mutual funds”) in Articles 37 and 38. CMB Communiques set out more detailed requirements for both types of funds. A new Capital Markets Law No 6362 was adopted in December 2012. This law envisaged investment companies with fixed capital and introduced investment companies with variable capital (open-ended corporate funds) and enabled contractual funds as before. In addition to these, the new law brought significant changes in the legal environment of funds such that investment funds can be founded only by portfolio management companies that are licensed by CMB, and portfolio management companies are obliged to appoint a depositary for funds.

Regulation

The CMB is the regulator of capital markets, including funds, their founders, and custodians. Articles 88–135 of the Law 6362 set out the principal duties and functions of the board, which include determining the principles of establishment, operation, liquidation, and termination of capital markets institutions and their supervision and the power to issue regulatory procedures. Under Law 6362 it is mandatory for all institutions authorized to perform investment services or activities to join the Capital Markets Association, a self-regulatory organization, whose objectives under the law include “to establish professional rules aimed at providing that the members of the Association work in solidarity with due care and discipline required by the capital markets, take necessary measures in order to prevent unfair competition; made regulations on issues assigned to it by legislation and determined by the Board, execute and supervise them; impose disciplinary penalties on behalf of member institutions.” At the end of 2011 the association had 143 members: 101 brokerage firms, one derivatives exchange, and 41 banks.

Legal Structures

Law 6362 enables funds as investment companies with fixed capital and investment companies with variable capital and contractual open-ended funds. Both investment companies with fixed capital and open-ended contractual funds were in operation at the time of the study, but regulations governing investment companies with variable capital had not been issued so this type of fund was not functioning.

MF Categories/Product Offerings

Types of Funds	Equity Funds	Bond (Debt) Funds	Money Market Funds	Mixed Fund	Variable Fund	Other	Total
Number of funds 2012	54	53	49	22	132	282	592
AUM, in 2012 \$ thousands	316,652	1,245,975	10,025,029	235,100	1,427,256	3,628,143	16,878,154

Source: ICI.

a. Dollar values converted from historical data at www.oanda.com.

Founders/Promoters

Under the Capital Markets Law 6362 only an entity holding a license from the Capital Markets Board as a portfolio management company is permitted to found a contractual fund (previously such funds could be founded only by a bank, insurance company, brokerage firm, pension, or charitable fund). The portfolio management company is responsible for operating and distributing the fund and for appointing a depositary.

Ownership

Ninety-nine percent of assets under management in mutual funds in Turkey is thought to be retail.

Custodial Services and Depositaries

Under Law 6362 the portfolio management company of a fund must appoint a depositary that has both safekeeping and supervisory duties. Previously the founder was responsible for safekeeping fund assets, although it may appoint a custodian to do this, and therefore no provision is in place for an oversight role to be undertaken by the custodian. Takasbank, the depositary and clearing and settlement institution to Borsa Istanbul, is the custodian to all funds.

Distribution

Historically only intermediary institutions have been permitted to distribute mutual funds in Turkey, which are banks and brokerage firms; portfolio management companies are also enabled to do so under Law 6362. One hundred other intermediary institutions are brokerages: Banks own 27 brokerage firms and dominate fund distribution. Turkey has 44 banks, which have nearly 10,000 branches. On the other hand, as a recent development, the units of all mutual funds (with the exclusion of specific types of mutual funds) operating in Turkish capital markets are being traded through an electronic trading platform called the "Turkey Electronic Fund Distribution Platform" (TEFAS) since September 1, 2015, which was established with the authorization of CMB and is operated by Takasbank. All banks, intermediary institutions, and portfolio management companies are members of this platform. It provides investors with access to all funds operating in Turkish capital markets (with the exclusion of specific types of mutual funds) through a single investment account.

Fees

At the time of the study in 2012, the CMB had capped total expense ratios of funds to 1.28 percent for money market funds, 2.19 percent for short-term bond funds, gold and other precious metal funds, index funds, capital protected and guaranteed funds, 4.38 percent for funds of funds, and 3.65 percent for other types of funds (equity funds, bond funds, etc.). Subscription and redemption fees are permitted but are not usually charged.

Range for total expense ratios	1.28–4.38%
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Accounting Standards

Mutual funds were required by the CMB to have an independent auditor and to have annual financial reports and accounts that are audited and semiannual reports that are unaudited. An internal audit function is also required.

Taxation

Mutual funds are exempt from corporation tax and income tax, so income and profits received by the fund are not taxable at the fund level. A 10 percent withholding tax is levied on any increase in the value of a unit (which may result from capital gain or from income, which is not distributed) over its purchase price when the unit is redeemed, unless the recipient is not taxable (for instance, a pension fund); this is a final tax (corporate investors can offset this against their corporation tax liability). If a fund is "equity intensive," it invests more than 75 percent in equities (the required equity investment level increased to 80 percent with the secondary legislation under Law 6362). Investors are not subject to this withholding tax upon redemption because otherwise funds would suffer a disadvantage relative to direct equity investment, which is not subject to such a withholding tax.

Trade Association

A trade association of portfolio managers, the Turkish Institutional Investment Managers Association (TKYD), has been in existence since 2000. At the end of 2011 it had 25 corporate and 30 individual members.

Appendix 2: Glossary

Administrator—In Brazil, the operator of a mutual fund that is legally responsible for creating and operating the mutual fund and appointing a fund manager to manage the fund's assets; fund assets are held by a custodian (this is different from a “third-party administrator” [see below] but similar to a “responsible entity” in Australia [see below]).

Annual management charge—The charge payable to the fund operator per annum for the operation and management of a fund, usually expressed as a percentage of the value of the fund.

Capital gain (or loss)—The profit (or loss) made upon the sale of an asset (including a fund share or unit) when it is sold for a price higher (or lower) than its cost of acquisition.

Capital growth—In relation to a fund, increase in the value of fund shares or units resulting from an increase in the value of the assets held by the fund.

Central securities depository—A specialist financial organization that holds and administers securities and processes securities transactions and may also clear and settle securities transactions.

Closed-ended fund—A fund that has no obligation to redeem its shares or units from holders and that therefore has a fixed number of shares or units in issue (also known as a fund with fixed capital).

Collective investment scheme—A generic legal description of a vehicle that attracts money from a range of investors into a single pool and professionally manages that pool: In some countries the term refers only to open-ended funds, and in others it refers to both open-ended funds and closed-ended funds. In IOSCO terminology, “collective investment scheme” generally refers to open-ended funds but may sometimes cover closed-ended funds also.

Contractual fund—Fund formed under the law of contract.

Contractual savings—Savings that must be made as required under a contract, for instance, the contract between a sponsor of a defined benefit pension scheme (employer) and a member of the scheme (employee).

Corporate fund—Fund formed under company law (see also “investment company”).

Custodian—In respect of an investment fund, a service provider that undertakes safekeeping of fund assets and securities administration services (such as receipt of dividends or interest and dealing with exercising rights of ownership of securities such as voting at general meetings); it does not have a supervisory role (see “depositary” and “trustee”).

Defined benefit pension scheme—A pension scheme whose sponsor (usually the employer but sometimes an insurance company) in effect underwrites the payment to a member of the scheme (provided they have met their contractual obligations) of a pension usually expressed as a percentage of salary that is payable irrespective of the performance of the investments of the scheme.

Defined contribution pension scheme—A pension scheme whereby the value held by the account holder in their account at the date of retirement to pay a pension is the sum of the contributions made to the scheme and any gains and income earned by those contributions.

Depositary—With respect to a mutual fund, a company that is responsible for safekeeping of fund assets and supervision of operation of the fund and its compliance with regulation and the founding document and prospectus of the fund. It may sometimes also provide third-party administration.

Entry charge—Charge payable by an investor when they buy shares or units in a fund, which is payable to the fund operator; usually expressed as a percentage of net asset value per share or unit.

Exchange-traded fund (ETF)—Marketable security that tracks an index of shares, commodities, bonds, or a basket of assets such as an index fund. Unlike mutual funds, an ETF trades like a security on a stock exchange.

Exit charge—Charge payable by an investor when they sell shares or units in a fund, which is payable to the fund operator, usually expressed as a percentage of net asset value per share or unit.

Externally managed fund—A fund that is managed and operated by another entity, typically a fund management company, which is remunerated by an annual management charge paid out of the fund that is based on a percentage of the value of the assets of the fund.

Fixed capital—See “closed-ended fund.”

Fund management company—In many but not all countries, the entity that is legally responsible for creating and operating a mutual fund, usually responsible for managing its portfolio and administering and marketing the fund.

Fund manager—An entity that manages the assets of mutual funds but does not operate mutual funds.

Hedge fund—A type of fund that does not meet legal and regulatory requirements for publicly offered funds whose investment and borrowing powers are limited only by its founding documents; usually such funds may be offered only to expert or professional investors. Also known as an alternative fund or sometimes an alternative investment fund.

Income—Revenue earned by fund assets usually interest on bonds or on deposits, dividends from equities, and sometimes rental from real estate.

Index fund—A fund whose portfolio replicates a named index, either physically (by investing in the relevant securities) or synthetically (usually by means of swaps). Also known as a “passively managed” fund because investments simply track an index and are not actively selected.

Institutional investors—Vehicles that pool capital from a number of investors and invest it on their behalf: typically pension schemes, insurance companies, and investment funds and sometimes corporates.

Internally managed fund—A fund that employs its own staff that operate the fund within policy set by the fund's board and therefore bears the full cost of its operation.

Investment company—A fund formed under corporate law, whether in open- or closed-ended form. An American fund formed under the Investment Company Act 1940 is colloquially known as a “mutual fund.”

Investment fund—Used generally in this study to mean an open- or closed-ended fund of any legal structure.

Money market fund—Very generally a fund that invests in money market instruments that have a duration of a year or less; this may be a constant value (or conservative) money market fund that seeks to maintain the value of the \$1 invested and pay interest, or a variable value money market fund where the value of the \$1 invested may fluctuate.

Mutual fund—An open-ended publicly offered investment fund; the name is used generically as a convenient description of all such funds but has no legal significance.

“No-load” fund or share or unit class—A fund or share or unit class in a fund that has no entry charge and no exit charge.

Open-ended fund—A fund that is required to redeem its shares or units from holders typically on any business day upon their request and that therefore has a variable number of shares or units in issue (also known as a fund with variable capital).

Operator—In relation to a mutual fund, the term is used in this study for the entity that is legally responsible for creating and operating the fund (IOSCO uses the same term in the same way). Different legislative frameworks may permit or require different entities to do this, typically a licensed fund management company (Morocco and Peru), a licensed administrator (Brazil), a licensed responsible entity (Australia), a licensed founder (which is a bank, broker, insurance company, pension, or charitable fund; Turkey), or a promoter (which is an investment bank, fund management company, or broker; Kenya), or in the case of a corporate fund this sometimes may be the board of the fund.

Passively managed—See “index fund.”

Responsible entity—In Australia, the firm that is responsible both for acting as the operator of the mutual fund (which takes the form of a trust) and as the trustee of the mutual fund; fund assets may be held by a custodian.

Share—An equal proportionate holding in a corporate fund that has an equal proportionate right to income and capital gains generated by that fund.

Settlement bank—A bank that is responsible for financial settlement of transactions in the securities markets.

Third-party administrator—A firm that is appointed by the operator of the fund to administer the fund (broadly, operate the register, service shareholders, and undertake fund accounting; sometimes also undertake valuation and pricing). The operator delegates this activity to the third-party administrator but remains responsible for the activity.

Trustee—In respect of a fund formed as a trust, a company (or more rarely a board of individual trustees) that is responsible to the beneficiaries of the trust (the owners of fund units) for the safekeeping of fund assets and supervision of operation of the fund by the fund management company, which is also party to the deed that is the formation document for the fund.

Undertaking for Collective Investment in Transferable Securities (UCITS)—An open-ended publicly offered fund created in a European Economic Area country that invests in conformity with the UCITS Directive and is therefore able to be offered across borders within that area.

Unit—An equal proportionate holding in a unit trust or contractual fund that has an equal proportionate right to income and capital gains generated by that fund.

Unit trust—Fund formed under trust law or precedent.

Variable capital—See “open-ended fund.”

Wrapper—Term for a tax-privileged account belonging to a named individual within which certain permitted assets such as shares or units in mutual funds can be held.

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