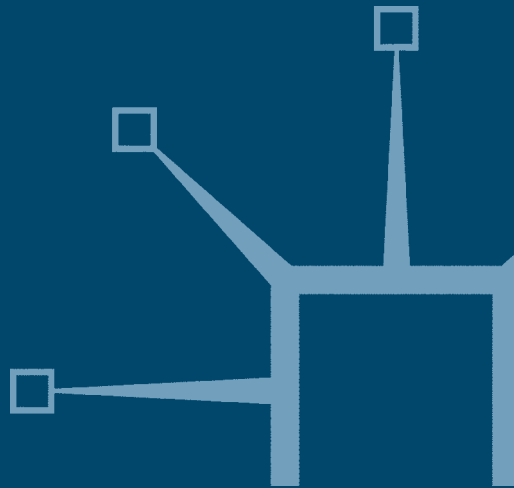


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Asset Management Standards

Corporate Governance for Asset
Management

Otto Loistl and Robert Petrag



ASSET MANAGEMENT STANDARDS

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Corporate Governance for Asset
Management

SECOND EDITION

Otto Loistl
and
Robert Petrag

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Preface to the Second English Edition

The second edition reflects the fact that pensions have become a hot issue in EU. There is now general acceptance that the pay-as-you-go (PAYG) pension scheme is no longer sufficient to take care of an ageing society. The EU has been taking measures to promote pension and investment savings by releasing the Institutions for funded Occupational Retirement Provision Directive and updating the Undertakings for Collective Investment in Transferable Securities Directive.

The directives' implementation is a key building block in the creation of a uniform common EU capital market, thus realizing the advantages of such a huge harmonized (capital) market. The directives themselves are, however, not directly applicable but have to be transposed into national laws by the individual Member States.

The different national legal systems in the EU Member States means that a single law is not sufficient for all EU states. Therefore an efficient solution has to combine knowledge of the national law systems and knowledge of how to protect against the risks affecting the (pension) investments.

Asset Management Standards provide a comprehensive overview of the risks surrounding investments from both the financial and economic aspects and of how these risks could be managed by an efficient set of rules. It is not the authors' intention to provide detailed proposals about the directives' effective transposition into national laws in order to achieve an appropriate balancing of risk and return.

The basic mechanisms leading to losses in investments have remained unchanged for centuries. They appear, however, always in the new clothes in vogue in investment products and management styles. The Asset Management Standards look behind those fashions and describe the basic risks and the know-how to manage them. First, the Standards identify investment risks (i.e., the risks

resulting from the markets' characteristics). An investor has to take these risks even when competent and careful asset management is in place. Second, the Standards identify management risks. These risks arise whenever an investor commits assets to a third party.

This second edition has updated the description of pension reforms in the main EU Member States, covering the previously widespread PAYG pension schemes and above all the EU's regulatory activities. Most of the material from the first edition had to be updated. It also deals with managing both investment risks and management risks appropriately. The law makers and directive editors have been quite busy since the first edition's publication. The comprehensive updating comprises both the European and US activities as well as the emerging importance of global bodies such as the International Organization of Securities Commissions.

Executive Summary

MARKET OPPORTUNITIES

Funded pensions have been gaining ground tremendously. Awareness has been growing that the pension payments for an aging society could not be afforded any longer by the PAYG system. Governments have to subsidize these pension systems to avoid their collapse. Coupled with greater acceptance of direct and indirect investments in financial assets as an alternative form of financial and retirement provision, the current market scenario offers the EU's financial services industry an unparalleled opportunity thanks to the profitable field of investment for financial planning and retirement provision. In the light of the tough competitive situation in the domestic market, the US financial services industry has been exploiting this tremendous growth potential in Europe for some time now and has taken a large market share.

The European financial industry will only be able to exploit the market's enormous volume and return opportunities in the face of competition from the USA if they develop guidelines reflecting European attitudes. The implementation of reliable rules to manage the risks entailed in pension funds and other investments, taking account of both ensuring efficiency and investors' confidence, is crucial to a prosperous future for Europe's financial services industry. Investment savings and retirement provisions must be viewed together because of their frequent overlaps. Charlie McCreevy, the EU's new single market commissioner, recently said for example that a revamped fund sector (in terms of its regulation) could play 'a large part in defusing Europe's pension timebomb'.¹

European standards will enable the EU's financial services industry to safeguard its own competitiveness, and will also help the industry to pre-empt any exaggerated regulation by EU or national authorities and governments.

¹ Norman (2004).

The present study aims to provide a well-established basis for developing the content of attractive asset management guidelines. It provides not only an overview of the core legal framework for financial and retirement planning in the USA and the EU (explained in particular in relation to Germany and Austria), but also analyses the underlying problems and highlights the strengths and weaknesses of the two regimes.

THE UNITED STATES OF AMERICA AS PIONEER AND COMPETITOR

Even if there is a long tradition of pension fund management in some, and of investment fund management in almost all, EU Member States, it is worth having a closer look at the relevant US rules. Fiduciary duties in the US are defined in detail in a wealth of often highly complex requirements and prohibitions. Fund board directors and pension plan trustees in the US are therefore regularly dependent on expert legal advice. Due to the differing legal systems and history, simply adopting the opaque US rules would be neither feasible nor desirable, based as they are on a highly detailed case-by-case approach and driven by what is – from a European perspective – a sometimes excessively litigious environment. The EU financial services industry has to develop its own standards. Their design can rely on both European specifics and on US ideas where appropriate.

TWO LAYERS OF EUROPEAN UNION LEGISLATION

Following an unexpectedly long process of political negotiation, the Pension Funds Directive was adopted in mid-2003, creating the basis for the EU-wide harmonized regulation of institutions for occupational retirement provision (IORP). The Member States had to transpose the Directive into national law by the end of the third quarter of 2005. In accordance with the principle of subsidiarity, the Directive is limited to generally worded minimum requirements for asset management, giving the Member States a relatively high level of latitude. The prudent person rule generally applies to investment policies. The financial services industry must now produce clear ideas and suggestions to flesh out this basic principle and pre-empt suboptimal (legislative) trends before they take root.

Similar to the IORP Directive, the UCITS Directive that governs investment funds and companies focuses more on products than on providers. Only the amendment that was adopted on 13 February 2002 (UCITS III) extended the rules in this respect, albeit to a limited extent. There are now minimum requirements for the organization of the management companies and the design of the relationship with investors.

THE KEY ISSUES

Systematic Classification

A synopsis of the EU and US standards illustrates and discusses the core problems affecting future standards. The key issues remain unchanged. The fundamental solutions are classified into four areas: *investment rules*, *separation of functions*, *disclosure requirements* and *supervision*. The objective of the rules is to manage and communicate investor risks. The detailed discussion in this volume has been updated in the light of the recent discussion.

The potential tasks facing standard setters are outlined below.

Investment rules

- 1 Qualitative investment rules based on the prudent person rule and combined with a small number of non-restrictive quantitative rules (especially single issuer and sponsor limits) should provide investment freedom to a large degree and thus the flexibility needed for the appropriate implementation of profitable passive or active portfolio management options.
- 2 Rules governing transactions by fund or pension plan management involving conflicts of interest: misuse of a position that affects or controls investment decisions by the fund or pension plan at the management company, the sponsor, or other persons (in)directly involved in asset management must be prevented. Self-dealing and personal investing must be subject to conflict of interest rules that must be monitored by compliance systems and by control and pre-approval responsibilities of the board of directors or supervisory board of the fund or plan. Disclosure requirements must also be imposed to ensure transparency. Such a structure should avoid any potential overregulation by the authorities and relieve the pressure on the regulators.

Separation of functions

- 1 Organizational separation of the management company, the sponsor, the custodian and the auditors.
- 2 Rules governing the appointment, compensation and minimum representation of independent members of boards of directors or supervisory boards.
- 3 The establishment of Chinese walls within the management company to control information flows and prevent inside information abuses.
- 4 Definition of the circumstances under which functions can be delegated, plus their effective continuous supervision.

Disclosure requirements

- 1 Transactions entailing conflicts of interests must be either prohibited or approved and monitored, and comprehensive disclosure requirements must be imposed.
- 2 Fund assets should be marked to market as a matter of principle, but standards governing fair value measurement should also be provided for justified exceptions.
- 3 Mandatory disclosure of a Statement of Investment Principles (SIP) to be adopted by the board of directors or supervisory board. The pension fund SIP is the counterpart to the investment fund prospectus.
- 4 The volume, language and graphical design of prospectuses must be tailored to the intended readers. The division into 'simplified' and 'full' prospectuses introduced by UCITS III can be used to extend the reportable information in the full prospectus, bringing the European system closer to the combination of prospectus and Statement of Additional Information (SAI) in the USA.
- 5 Established Performance Presentation Standards (PPS) as the basis for performance-related advertising.
- 6 Standardized and transparent disclosure of fees and management expenses as well as transaction costs paid from fund assets, including regulation of the related problems of soft commissions and directed fund portfolio brokerage.

Supervision

- 1 The objective should be a light, state-of-the-art supervisory regime that can respond quickly to rapid market change, so that time-consuming legislative processes and costly overregulation do not pose a risk to competitiveness. The establishment of the standards should also aim to avoid the extensive use of expensive legal advisers that is so vital in the USA.
- 2 Establishment of a fund board (board of directors or supervisory board) partly composed of independent directors which will act as a watchdog in order to directly safeguard investors' interests and will be bound by fiduciary duties. The duties and powers vested in the board should be sufficiently strong to counter any doubts about its integrity and effectiveness. However, weighing the board down with too many trivial oversight duties would be counterproductive.
- 3 Development, disclosure and oversight (by the compliance department and the fund board) of a code of ethics imposing special fiduciary duties on the employees of the management company.

List of Abbreviations

AIMR	Association for Investment Management and Research
AktG	Aktiengesetz (Austrian Stock Corporation Act)
ALM	Asset/Liability Management
Alt Eink G	Alterseinkünftegesetz (German Retirement Income Act)
Alt Zert G	Altersvorsorgeverträge – Zertifizierungsgesetz (German Pension Contract Certification Act)
AngG	Angestelltengesetz (Austrian Salaried Employees Act)
ARA	absolute risk aversion
ArEV	Arbeitsentgeltverordnung (German Employment Compensation Regulation)
ASVG	Allgemeines Sozialversicherungsgesetz (Austrian General Social Security Act)
AVmG	Altersvermögensgesetz (German Old-Age Provision Act)
BaFIN	Federal Financial Supervisory Authority
BetrAVG	Gesetz zur Verbesserung der betrieblichen Altersvorsorge (German Act on the Improvement of Occupational Pensions)
BMVG	Betriebliches Mitarbeitervorsorgegesetz (Austrian Occupational Employee Pension Act)
B-VG	Bundes-Verfassungsgesetz (Austrian Federal Constitution Law)
BssichG	Beitragsatzsicherungsgesetz (German Act on Safeguarding Statutory Health Insurance Contribution Rates)
BVerfGE	Bundesverfassungsgerichtshofentscheidung (Decisions of the German Federal Constitutional Court)
BVI	Bundesverband Deutscher Investment-Gesellschaften e.V. (German investment companies association)
CAPM	Capital Asset Pricing Model
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors

CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CFR	Code of Federal Regulations
CRRA	constant relative risk aversion
CVG	Country Version of GIPS
DARA	decreasing absolute risk aversion
DB	defined benefit
DC	defined contribution
DI	Disability Insurance
DMFR	Dynamic Minimum Funding Requirement
DRRA	decreasing relative risk aversion
DVFA	Deutsche Vereinigung für Finanzanalyse und Asset Management (Society of Investment Professionals in Germany)
EBC	European Banking Committee
EBSA	Employee Benefits Security Administration
ECJ	European Court of Justice
EEA	European Economic Area
EEE	exempt-exempt-exempt
EET	exempt-exempt-taxed
EFAMA	European Fund and Asset Management Association (formerly FEFSI)
EIOPC	European Insurance and Occupational Pensions Committee
EMH	Efficient Market Hypothesis
EMNID	Erforschung der öffentlichen Meinung, Marktforschung, Nachrichten, Informationen und Dienstleistungen (German polling firm)
ERISA	Employee Retirement Income Security Act
ESC	European Securities Commission
ESOPS	Employee Stock Ownership Plans
ESTG	Einkommenssteuergesetz (Income Tax Act)
ETT	exempt-taxed-taxed
FESCO	Forum of European Securities Commissions
FinDAG	Finanzdienstleistungsaufsichtsgesetz (German Act on Financial Services Supervision)
FinMFöG	Finanzmarktförderungsgesetz (German Financial Markets Promotion Act)
FSAP	Financial Services Action Plan
GAO	General Accounting Office
GDP	gross domestic product
GDV	Gesamtverband der Deutschen Versicherungswirtschaft e.V. (German Insurance Association)
GG	Grundgesetz (Basic Law for the Federal Republic of Germany)
GIPS	Global Investment Performance Standards
GNP	gross national product

GSiG	Gesetz über eine bedarfsorientierte Grundsicherung im Alter und bei Erwerbsminderung (German Act on Needs-Driven Basic Old Age and Disability Pensions)
HARA	hyperbolic absolute risk aversion
HZvNG	Hüttenknappschaftliches ZusatzversicherungsNeuregelungs-Gesetz (German Act on the Reform of supplementary Insurance for Steelworkers)
ICI	Investment Company Institute
InvFG	Investmentfondsgesetz (Austrian Investment Funds Act)
InvFR	Investmentfondsrichtlinien (Austrian Investment Funds Directives)
InvG	Investmentgesetz (German Investment Act)
InvStG	Investmentsteuergesetz (German Investment Tax Act)
IORPS	Institutions for Occupational Retirement Provision
IOSCO	International Organization of Securities Commissions
IPC	Investment Performance Council
IPO	initial public offering
IPS	Investment Policy Statement
IRAs	Individual Retirement Accounts
IRC	Internal Revenue Code
IRRA	increasing relative risk aversion
IRS	Internal Revenue Service
IT	information technology
KAGG	Gesetz über Kapitalanlagegesellschaften (German Investment Companies Act)
KStG	Körperschaftsteuergesetz (Austrian Corporate Income Tax Act)
KWG	Kreditwesengesetz (German Banking Act)
MDFP	Management's Discussion of Fund Performance
MEL	mean excess loss
MiFID	Markets in Financial Instruments Directive
MSCI	Morgan Stanley Capital International
NAV	net asset value
NSMIA	National Securities Markets Improvement Act
NYSE	New York Stock Exchange
OASI	Old-Age and Survivors Insurance
OECD	Organization for Economic Cooperation and Development
OeNB	Österreichische Nationalbank (Central Bank of the Republic of Austria)
OTC	over-the-counter
PAYG	pay-as-you-go
PEA	Plan d'Épargne en Actions (personal equity savings plan)
PENs	Protected Equity Notes
PFDeckRV	Pensionsfonds-Deckungsrückstellungsverordnung (German Pension Fond Technical Provisions Order)
PFKAustV	Pensionsfonds-Kapitalausstattungsverordnung (German Pension Funds Capitalisation Order)

PIFs	Pension Investment Funds
PPS	Performance Presentation Standards
RAV	Rentenanpassungsverordnung (German Pensions Adjustment Order)
REIT	real estate investment trust
RRA	relative risk aversion
S&P	Standard & Poor's
SA	supervisory authority
SAI	Statement of Additional Information
SE	shortfall expectation
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
SGB	Sozialgesetzbuch (German Social Security Code)
SIP	Statement of Investment Principles/Policy
SPD	Summary Plan Description
SRI	Socially Responsible Investing
STGG	Staatsgrundgesetz Fundamental Law of the Austrian State
TEE	taxed-exempt-exempt
TER	Total Expense Ratio
THE	time horizon effect
TIAA-CREF	Teachers Insurance and Annuity Association-College Retirement Equities Fund
TTE	taxed-taxed-exempt
UStG	Umsatzsteuergesetz (Austrian VAT Act)
VAG	Versicherungsaufsichtsgesetz (German Investment Companies Act)
VaR	value at risk
VersÄndG	Versorgungsänderungsgesetz (German Amendment of Civil Service Pensions Law)
VfGH	Verfassungsgerichtshof (Austrian constitutional court)
VfSlg	Sammlung der Erkenntnisse und wichtigsten Beschlüsse des Verfassungsgerichtshofes (Collection of Austrian constitutional-court decisions)
VstG	Versicherungssteuergesetz (Austrian Insurance Tax Act)
WCR	worst case return
WpHG	Wertpapierhandelsgesetz (German Securities Trading Act)

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Setting the Scene

Changes in the EU's demographic structures, in particular rising life expectancy and falling birth rates, represent a growing risk to the established pay-as-you-go (PAYG) state pension schemes. A clear majority of the population consequently has reservations about the long-term ability to fund this system.¹ Coupled with other current developments, such as the gradual withdrawal of the state from its social security commitments, the increasing popularity of (indirect) investment in equities and the spread of non-state pension provision, especially in the USA, this forms part of a raft of factors that represent both a challenge to, and a market opportunity for, the EU financial services industry to establish its investment funds, pension funds and retirement investment plans as a supplement to state pensions.

For several years now, there has been an ongoing political debate in Germany and Austria on further reform of the existing state pension scheme, including extending measures to promote supplementary occupational or private pensions or even make them obligatory; coupled with the EU Pension Funds Directive which finally came into force on 3 June 2003 after lengthy negotiations, this shows that policymakers too have already moved on from merely analysing the problems and are now working on implementing a three-pillar pension system.

The directives and legislative initiatives containing rules and regulations at a more general level need to be fleshed out and given more detailed substance by standards that will actually work in practice. Although the US fund industry promotes its decades-old asset management standards, in order to use these to solve the problems that Europe is facing they would require substantial modifications. Despite their very high regulatory density, the US standards have not proved to be effective at preventing scandals such as market timing and inefficient investment (as in the case of the Enron pension plans) where investment funds, pension funds,

¹ An EMNID survey showed that 53 per cent of people aged over 50 and a staggering 87 per cent of 18–50 year old Germans no longer believe that the state pension can guarantee an adequate standard of living in old age (see Tepper, 2003, pp. 23f.).

or retirement investment plans are concerned. An urgent task for the European fund industry is therefore to develop its own voluntary EU asset management standards, so that it can reinforce investor confidence in its fund products – and thus its own competitive position – and avoid legislators taking action to fill supposed gaps in the regulations. That there is certainly an awareness of these problems in the market is demonstrated by calls for ‘disclosure, transparency and corporate governance standards for all providers of life insurance’, for example.² Even though differences in the business activities of fund and life insurance companies mean that it would be pointless to try to create 100 per cent identical standards in terms of content, the underlying problems involved are very similar, not least because of the importance of unit-linked life insurance policies.

The establishment of EU-wide asset management standards is of importance for the European fund industry as a whole, and even for those countries relying primarily on funded pension schemes. The description of the situation in Germany and Austria is representative of those countries that have traditionally organized their pension provision around pay-as-you-go schemes, and aims to illustrate the growing importance of both the fund industry and asset management standards for these countries as well.

The development of standards hinges crucially on transparency in the following areas:³

- selection of the investment vehicles
- the investment strategies applied
- explicit investment rules
- defined investment objectives
- transparent incentive schemes

In addition to these areas, we will also look at issues of organization and supervision, as well as deriving proposals for the content and structure of such future EU-wide standards from a synopsis of US and European asset management standards currently in force or planned for the near future. The objective of this study is to provide both an anchor and an overview for what must surely be the next step: the elaboration of actual draft guidelines and recommendations for Europe’s own asset management standards.

This study aims to answer the following questions:

- 1 Are funded supplementary pensions a suitable response to the crisis in pay-as-you-go pension systems? This will address the following problems:
 - (a) the limits of parametric reforms of the pay-as-you-go system;
 - (b) alternatives to extending funded supplementary pensions;

² Döring (2003).

³ See Hummler (2000), p. 116.

- (c) pension reforms in German and Austria, both as indicators of growing acute funding problems in the pay-as-you-go systems, and as initial steps towards appreciable funded supplementary pensions.
- 2 What is the overall environment that demands that Europe develop its own asset management standards?
 - 3 What existing or planned statutory and voluntary rules and regulations in the EU and the USA can be used as a basis for developing European asset management standards?
 - 4 How can the objectives and rules of these standards be classified into a coherent system?
 - 5 What are the details of existing or planned rules in the USA and the EU for achieving these objectives?
 - 6 What recommendations for future European standards can be derived from a synopsis of the US and EU rules, taking account of the strengths and weaknesses in each case?

In Chapter 2, we establish the need to develop European asset management standards and list significant EU and US arrangements with the status of laws, directives and regulations, describing their structure and core content. We start by examining the legal basis for collective investment savings and funded occupational pensions in the EU, including the Undertakings for Collective Investment in Transferable Securities (UCITS) and Institutions for Occupational Retirement Provision (IORPs) Directives. Structural weaknesses of the state pay-as-you-go pension model resulting from the systemic risks posed by demographic trends are explored next. The funding principle is the most important approach to countering the foreseeable non-sustainability of PAYG schemes. Funded pension schemes are, however, met with scepticism by certain groups who favour structural reforms within the PAYG framework. We therefore discuss supposed alternatives to funded pension provisions, such as increasing the female labour force participation rate; extending pension credits for parents; immigration; and inheritance. This part of the chapter is concluded by a discussion of common objections to funded supplementary pensions, specifically the risk of asset meltdowns and the unacceptable financial burden of a wholesale change in the system.

Specifics of the legal framework for funded supplementary pensions in certain countries are also addressed. We present the main rules in Germany and Austria – representing countries with a predominantly pay-as-you-go model – and then explore those in the USA, the most important pioneer in the field of funded pensions. To enable a quantitative discussion of the dissimilar environments in Germany (as one of the countries whose pension system is almost entirely pay-as-you-go) and the USA (as a country that relies largely on funding), this is followed by a description of the different (investment) savings behaviour of people in the two countries.

This in turn is followed by a look at how capital market efficiency requirements, competitive pressure from the USA and the sort of suboptimal regulatory regime that experience shows is likely to emerge are prompting the EU fund industry to seize the initiative in establishing voluntary asset management standards.

Chapter 2 then closes with an overview of statutory asset management rules in the EU, the presentation of the Anglo–American concepts of fiduciary duty and the prudent man/prudent investor/prudent expert rule, and a summary of the two most important US funded supplementary pension concepts based on a system of defined contributions, 401(k) (occupational defined contribution plans) plans and Individual Retirement Accounts (IRAs).

Adequate asset management standards are vital for savings or retirement investment models that offer both an efficient risk/return profile and a high level of investor protection. Chapter 3 describes the structural approach used in the synopsis of existing/planned asset management rules in the EU and the USA: the primary goal of standards is to protect investors against management and investment risks. The concrete rules can be classified into the four regulatory areas of *investment rules*, *separation of functions*, *disclosure* and *oversight/implementation* (supervision). This chapter centres around the definition of the two types of risk and the four regulatory areas. Based on these findings, the individual rules are then classified into two levels: first by the type of risk to be managed by the standard, and then by the type of regulatory area. Because most of the rules affecting supervision cannot be clearly assigned to either management risk (Chapter 4) or investment risk (Chapter 5), they are covered separately in Chapter 6. Similar rules existing in both the EU and the USA are discussed together, but are treated separately if the differences are significant. Numerous rules exist in only one of the two regulatory regimes and are therefore discussed without any direct comparison.

For each of the regulatory areas, this is then followed by a summary ('The essence of future standard-setting') of the recommended relevant future EU standards for the area concerned, based on the rules outlined above. This summarizes the problems that need regulation, describes the strengths and weaknesses of existing/planned EU and US rules in the area, and then assesses their appropriateness as a basis for EU standards, either alone or in combination. Inadequacies or gaps in the rules of the regimes that make neither of them suitable are highlighted, and potential solutions are then discussed.

Chapter 4 describes the investment rules, the separation of functions and the disclosure rules for controlling management risk, and translates these rules into proposals for future standards, as described above. A particular feature of this regulatory area is the need to avoid or manage conflicts of interest between asset managers and (investment) savers.

Chapter 5 applies the same structure as Chapter 4 to investment risk. The only difference here is the omission of the separation of functions, because these serve solely to master management risk. In the area of retirement planning, standards for managing investment risk primarily address the problems surrounding (strategic) asset allocation, especially the equities versus bonds decision. Modern

risk management methods, and in particular transparency through disclosure, aim to establish equities as an efficient retirement planning instrument, even in those countries that are still dominated by pay-as-you-go systems.

Chapter 6 covers the rules for supervising and enforcing the rules explained in Chapters 4 and 5, because these are normally used for controlling both management and investment risk. Each part of the chapter then concludes with recommendations for standards in the same way as in Chapters 4 and 5. These sections differ in the institutional aspects that they address, discussing supervision by investment or pension fund boards (board of directors or fund board), regulators, compliance departments, shareholders and finally other parties, such as auditors, actuaries and custodians.

Chapter 7 concludes the study with a summary of the results and findings.

The Scenario Today

STRUCTURAL CHANGE IN THE ASSET MANAGEMENT BUSINESS IN THE EUROPEAN UNION

Harmonization of the European capital markets and the Single Currency

Advantages of harmonization

Just because the EU has a customs and currency union does not necessarily mean that there is an integrated financial market. On the contrary: the creation of such an integrated market and the associated advantages it would bring requires corresponding legal harmonization measures at EU level 'in many areas starting at a very low level'.¹ The quality of the EU as a financial centre hinges critically on the success of these measures, because they can create competitive advantages that will help prevent the loss of economic growth, employment and prosperity to locations outside the EU: 'The status quo would entrench the continuation of European financial market fragmentation [and] European savings [would be] diverted to foreign market places [because there are currently many barriers in the EU:] unnecessary bureaucracy, lack of trust, and sometimes downright protectionism' that run counter to allocational efficiency.²

The advantages of an integrated financial market are seen first at micro-economic level because companies can benefit from lower costs of capital due to significantly more pronounced market depth and liquidity, while consumers gain access to more efficient financial services and products.³ On the macro-economic level, productivity gains are possible, stimulating economic and employment growth.⁴

¹ Committee of Wise Men (2001), p. 12.

² Committee of Wise Men (2001), p. 13.

³ See Committee of Wise Men (2001), p. 14.

⁴ See Committee of Wise Men (2001), pp. 14f.

The euro itself contributes to greater efficiency in portfolio management. Exchange rate risks have been eliminated in the euro zone, transaction costs have been cut and competition between market participants has been increased. The gain in breadth and depth for the EU's capital markets offers tremendous growth potential, in particular for what is by comparison with the USA a poorly developed corporate bond sector.⁵ Driven by the expected long-term trend for a low issue volume of public-sector bonds in the wake of the Stability Pact, there is a high probability that corporate bonds will gain considerably in importance in the EU and could become a significant source of income for pension fund portfolios.

In order to meet the need for action in financial market integration more effectively, the Council of Economics and Financial Ministers of the European Union (ECOFIN) established the Committee of Wise Men chaired by Alexandre Lamfalussy on 17 June 2000 to support the Commission in the field of the regulation of European securities market. The task of the Lamfalussy Commission was to 'focus on the practical arrangements for implementation of the Community rules concerning the areas identified by the Action Plan [for financial services, see the section entitled Financial Services Action Plan on pp. 8ff.] and [to] propose various approaches to adjusting the practice of regulation and cooperation between regulatory authorities in response to current developments'. It also had to 'consider how to achieve a more effective approach towards transposition and implementation'.⁶

Over and above retirement provision, the European Commission attaches significant micro- and macro-economic importance to the harmonization intended to be achieved by the Pension Funds Directive. Opportunities for corporate investment will be improved by greater equity investment by pension funds, for example. The Commission points out that in the USA, pension funds invest 0.3 per cent of their assets in risk capital, thus providing 47 per cent of US risk capital,⁷ and forecasts that pension funds will play an important role in creating pan-European markets for risk capital.⁸ Another consequence of harmonized pension funds will be a reduction in non-wage costs because the pressure on the state pension systems will be relieved, in turn creating new jobs.⁹ Pension fund assets are forecast to grow from approximately €2,000 billion in 1999 to €3,000 billion at the end of 2005,¹⁰ and to over €11,000 billion in 2020 (see Table 2.1).

In addition, EU-wide harmonization will enhance effective worker mobility and enable large, pan-European pension fund management companies to achieve significant economies of scale¹¹ through considerable efficiency gains. If these

⁵ See European Commission, Com (1999) 134 final (1999), p. 16.

⁶ Committee of Wise Men (2001), p. 31.

⁷ See European Commission, Com (1999) 232 (1999).

⁸ See European Commission, Com (1999) 134 final (1999), p. 16.

⁹ For these positive 'side-effects' of the increased use of pension funds, see also Pragma Consulting (1999), p. II.

¹⁰ See European Commission, Com (1999) 232 (1999).

¹¹ See Pragma Consulting, (1999), p. 1.

Table 2.1 Forecast growth in EU-wide pension fund assets until 2020

Year-end	Asset volume (€bn)
1997	1,627.35
2000	2,107.47
2005	3,242.60
2010	4,989.14
2015	7,676.41
2020	11,811.10

Source: Pragma Consulting (1999), p. 2

cost advantages can be passed on (in part) to the pension fund members, they can benefit from lower contributions or higher benefits.

Financial Services Action Plan

Since 1973, the EU has been working to establish ‘a single market for financial services’.¹² This project regained momentum in 1998 from the decisions on economic and monetary union, and the EU Cardiff Summit asked the Commission to ‘present a framework for measures to improve the single market for financial services by the meeting of the European Council in Vienna’.¹³ Following this, the European Commission started to develop an action plan for financial services together with experts from the Member States and users and providers of financial services¹⁴ with the aim of counteracting the heavy segmentation of the European financial markets.

Autumn of the same year saw the first published result in the form of a Commission communication that invited the European Council and the European Parliament to adopt an amendment to the legislation governing investment funds (UCITS) on the basis of the Commission’s proposals, and that also held out the prospect of harmonization of pension funds.¹⁵ Both of these specific proposals were part of a comprehensive package of measures comprising six main goals requiring urgent action,¹⁶ to ‘secure the benefits of an optimally functioning European financial market’, in particular in view of the (then imminent) monetary union.¹⁷

¹² European Commission, Com (1999) 232 (1999), p. 3.

¹³ European Communities (1998), no. 17.

¹⁴ See European Commission, Com (1998) 625 (1998), p. 2 and p. 5.

¹⁵ See European Commission, Com (1998) 625 (1998), pp. 12–14.

¹⁶ These six primary goals are: a forward-looking EU legislative apparatus; the elimination of capital market fragmentation; making the advantages of open markets available to both users and suppliers of financial services; closer coordination by national supervisory authorities; an integrated EU infrastructure; and the reduction of barriers resulting from disparities in taxation (see European Commission, Com (1998) 625 (1998), p. 5).

¹⁷ European Commission, Com (1999) 232 (1999), p. 3.

A little later, on 11 May 1999,¹⁸ the Commission in turn presented a systematic programme of measures for the gradual implementation of a single market in financial services up to 2005¹⁹ in its Financial Services Action Plan (FSAP). In this document, the European Commission emphasized the tremendous importance of the financial markets for employment. The financial services industry generates approximately 6 per cent of EU GNP, it said, and provides jobs for 2.5 per cent of EU employees.²⁰

The Action Plan defines the objectives in the area of financial services, prioritizes them²¹ and provides a timetable for (and a description of) various mechanisms for implementation. Regular reports by the Commission to the Council on meeting deadlines are also scheduled.²² By mid-2004 the Commission declared the completion of the FSAP's regulatory initiatives. On the one hand the Commission hailed its success, but on the other hand cautioned that 'the creation of a truly European market for financial services and [the contribution to] increased European competitiveness now depends on the consistent and timely implementation of the FSAP measures at Member State level, convergence of national supervisory practices and rigorous enforcement'.²³

One of the three most urgent initiatives identified was political agreement by the end of 1999 on the two proposals on Directives amending the UCITS Directive (UCITS III).²⁴ As in the case of most of the other areas covered by the Action Plan, the UCITS amendment would serve both to increase the liquidity of the European capital markets and thus benefit both investors and issuers, and also to facilitate the cross-border marketing of financial services, above all by removing the remaining barriers to the cross-border provision of retail financial services, while retaining and improving consumer protection.²⁵ The introduction of a 'European passport', which would take the form of a standardized licence allowing financial services providers to operate EU-wide on the basis of authorization in their home country, was proposed as a suitable instrument for achieving a single market for UCITS.²⁶

Another objective announced in the Action Plan was the establishment of a 'single market framework for supplementary pension funds', covering 'authorisation, reporting, fit and proper criteria, rules on liabilities and investments ... [as well as] the coordination of the tax arrangements governing supplementary

¹⁸ See European Commission (1999b).

¹⁹ At the Lisbon European Summit in March 2000, the European Council called for the implementation of the FSAP by 2005 (see European Communities (2000), no. 21).

²⁰ See European Commission, Com (1998) 625 (1998), p. 1.

²¹ The three priority levels range from level 1 for measures to be implemented immediately, to level 3 for new work that should be set in hand (see European Commission, Com (1999) 232 (1999), p. 21).

²² See European Commission, Com (1999) 232 (1999), p. 15. All in all a total of ten progress reports were issued between October 1998 and June 2004.

²³ European Commission, Sec (2004) 659/1 (2004), p. 1.

²⁴ See European Commission, Com (1999) 232 (1999), p. 4.

²⁵ See European Commission, Com (1998) 625 (1998), p. 1.

²⁶ See European Commission, Com (1998) 625 (1998), p. 15.

pensions'.²⁷ In the same way as the objective of political agreement on the amendments to the EU investment fund directives ultimately implemented as UCITS III, the draft proposal for a Pension Funds Directive was awarded utmost priority.²⁸

The EU UCITS Directive

The European UCITS Directive²⁹ lays down the legal framework for mutual funds and investment companies.³⁰ The objective of the UCITS Directive is to harmonize in particular the differences in national fund regulation governing the *duties* imposed on funds and the *supervision measures* applied to them (these differences were considerable before the Directive came into force), so as to eliminate distortions to competition that represent a barrier to a single European capital market. Another primary objective is to establish effective, uniform investor protection. To alleviate or eliminate these barriers to the single market for investment funds, the UCITS Directive establishes 'common basic rules for the authorisation, supervision, structure and activities [of investment funds] and the information they must publish'.³¹

Figure 2.1 quantifies the volume of European investment funds. The total net assets are broken down in the two categories, UCITS and non-UCITS funds. The ratio of UCITS to non-UCITS funds has remained almost constant at 4 to 1 from 1998 to 2005. The UCITS framework has proved itself to be reliable and popular over its 20 years of existence. At the end of the first quarter of the year 2005 an asset total of €4.4 trillion³² was managed by about 30,000³³ investment funds and investment companies complying with the standards set by the UCITS Directive.

Another objective of the Directive is to facilitate the cross-border marketing of mutual funds within the EU. This saw the introduction of the principle of mutual recognition,³⁴ a breakthrough for the financial services sector. This means that UCITS domiciled in one Member State can market their funds in other Member States without the need for further authorization by the host Member State. Unfortunately, things have turned out rather differently in practice, because national law often establishes barriers, and – like all European directives – the UCITS Directive is not directly applicable and thus enforceable law. Moreover, although the number of UCITS operating on a cross-border basis has doubled over the last

²⁷ European Commission, Com (1999) 232 (1999), pp. 7–8.

²⁸ See European Commission, Com (1999) 232 (1999), p. 25.

²⁹ Directive 85/611/EEC.

³⁰ According to Article 2(1) 1st indent Directive 85/611/EEC, closed-end funds are excluded from the scope of this Directive. In Recital 6 to this Directive, however, the Commission announces its intention to harmonize types of UCITS other than open-end funds.

³¹ Preamble to Directive 85/611/EEC.

³² See EFAMA (2005), p. 2.

³³ See PwC and EFAMA (2005), p. 5.

³⁴ Art. 5, Directive 85/611/EEC.

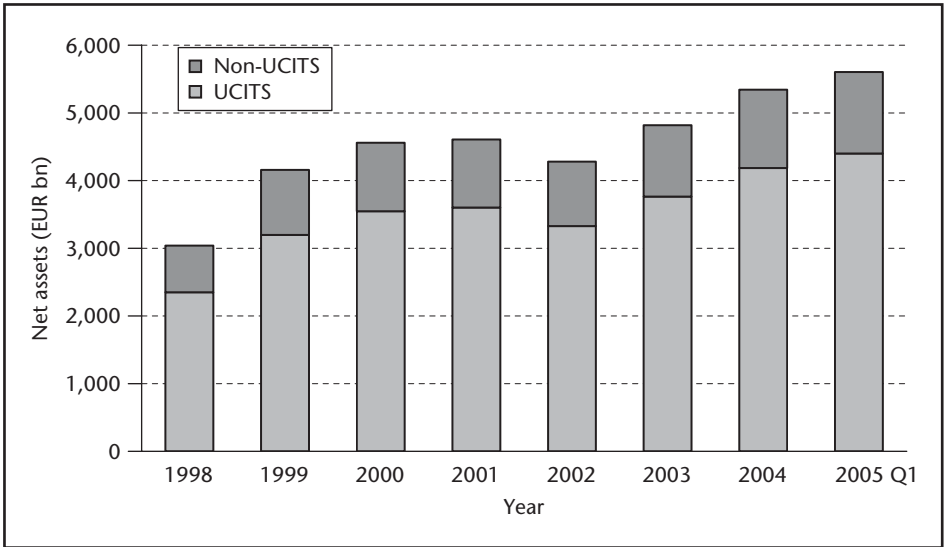


Figure 2.1 Net assets of European investment funds

Source: EFAMA (2005), p. 2

five years to 2005³⁵ they represent only a 16 per cent share of the total number of UCITS.³⁶ As a consequence of this rather modest degree of market penetration of cross-border UCITS, the EU's single market commissioner, Charlie McCreevy, recently announced the need for 'fixing the UCITS passport'.³⁷ The main measures planned to achieve an effective single market for UCITS are the standardization of UCITS notification procedures³⁸ and the clarification regarding assets eligible for investment by UCITS.³⁹

The UCITS Directive adopts a completely different approach compared with the later second-generation financial services directives,⁴⁰ which are focused on the service providers. By contrast, the UCITS Directive primarily regulates the authorized product,⁴¹ and significant rules relating to the management company were only added with the 2002 amendment (see UCITS III below). The Commission, however, as part of its UCITS Review, is currently contemplating

³⁵ See Schaub (2005).

³⁶ See PwC and EFAMA (2005), p. 5.

³⁷ McCreevy (2005a), p. 2.

³⁸ CESR, the committee of regulators responsible for UCITS (see the section on The Lamfalussy process: the Four-Level Approach, pp. 25ff), issued a consultation paper on the subject of the UCITS notification procedures in October 2005 (CESR (2005c)).

³⁹ In March and October 2005 CESR issued two consultation papers on eligible assets (CESR (2005a) and CESR (2005b)). See also McCreevy (2005a), p. 3.

⁴⁰ Second Banking Directive, Directive 90/619 EEC (amended by Directive 92/96/EEC) 'Third Life Insurance Directive', Directive 93/22/EEC 'Investment Services Directive'.

⁴¹ See European Commission, Com (1998) 451 final (1998), p. 5.

the modernization of UCITS law along the lines of a more 'principle-driven, risk-based' regulatory approach.⁴²

On 17 July 1998, the European Commission presented two draft Directives amending the UCITS Directive (known collectively as UCITS III).⁴³ Prior to this, the European Commission had already published a proposal to amend the UCITS Directive (UCITS II) on 9 February 1993,⁴⁴ the main objective of which was to expand its scope to other types of UCITS. However, this proposal met with stiff political resistance,⁴⁵ so the Commission brought new proposals into play in the form of UCITS III. UCITS III passed the final hurdle on 21 January 2002 when it was adopted by the European Parliament and the European Council and came into force on its publication on 13 February.⁴⁶

The first Directive⁴⁷ governs the 'products': UCITS are now authorized to invest in a wide variety of financial instruments. They can now invest in funds of funds,⁴⁸ derivatives funds,⁴⁹ index funds,⁵⁰ money market funds⁵¹ and bank deposit funds.⁵² The proposal in the 'Product' Directive to allow UCITS also to act as securities lenders in certain circumstances⁵³ was dropped in the final version.

The 'Product' Directive devotes a comparatively large number of provisions to the regulation of funds of funds to eliminate the specific problems associated with them that could potentially take unfair advantage of shareholders: investment in one and the same UCITS is limited to a maximum of 20 per cent.⁵⁴ To avoid cascading investment in funds of funds that in turn invest in other funds of funds (and so on), investment in subfunds that themselves invest more than 10 per cent in other UCITS is prohibited.⁵⁵ Cascading fees must be avoided or disclosed transparently: if the subfunds are linked directly or indirectly to the fund of funds,

⁴² European Commission, Com (2005) 947 (2005), p. 10.

⁴³ European Commission, Com (1998) 449 final (1998), and European Commission, Com (1998) 451 final (1998).

⁴⁴ European Commission, Com (1993) 37 final.

⁴⁵ The proposal was withdrawn by the Commission on 17 Dec. 1998.

⁴⁶ Initially, the Commission expected the proposed amendments to be adopted in 2000 (see European Commission, Com (1999) 232 (1999), p. 25) and subsequently pushed back the deadline to 2001 (see European Commission, Com (2000) 0336 final (2000)).

⁴⁷ Directive 2001/108/EC is the outcome of European Commission, Com (1998) 449 final (1998).

⁴⁸ Art. 19 (1) (e) Directive 85/611/EEC.

⁴⁹ The section on Legal basis for the use of financial derivatives by UCITS, starting on p. 265, describes the permitted structure of such derivatives funds.

⁵⁰ Art. 22a, Directive 85/611/EEC.

⁵¹ Art. 19 (1) (a) to (c) Directive 85/611/EEC.

⁵² Art. 19 (1) (f) Directive 85/611/EEC allows sight and term deposits with a maximum term of 12 months, but to avoid any excessive concentration of the counterparty risk associated with deposits, Art. 22 (1) of the Directive limits the amount of the portfolio assets that be invested in one and the same institution to a maximum of 20 per cent.

⁵³ Art. 21 (4) European Commission, Com (1998) 449 final (1998).

⁵⁴ Art. 24 (1) Directive 85/611/EEC stipulates a general 10 per cent limit, but allows the Member States to increase this to a maximum of 20 per cent.

⁵⁵ Art. 19 (1) (e) 4th indent Directive 85/611/EEC.

the purchase or sale of such subfunds may not attract any fees.⁵⁶ The prospectus must disclose the maximum intended fees of the fund of funds and its subfunds and disclose such fees actually charged in the annual report.⁵⁷ If the investment is made in funds (of funds) that are not subject to the UCITS Directive (i.e., in particular in non-EU funds), these must publish half-yearly and annual reports that meet certain minimum criteria.⁵⁸

The (more comprehensive) second Directive ('Management Directive')⁵⁹ addresses in detail the 'service providers' (the management company): on the basis of a 'European passport', management companies can market their investment funds EU-wide by virtue of their authorization in the home Member State either directly or via branches, and may offer discretionary portfolio management⁶⁰ or the management of pension funds,⁶¹ as well as investment advice⁶² and the safekeeping of UCITS shares as non-core services.⁶³

To obtain this EU-wide authorization and the related home country supervision,⁶⁴ the management company must meet certain quality standards relating to its own funds,⁶⁵ reliability⁶⁶ and internal control mechanisms.⁶⁷ For discretionary portfolio management, the management of pension fund portfolios and the non-core services, the management companies are exclusively subject

⁵⁶ Art. 24 (3) Directive 85/611/EEC defines 'linked' in greater detail.

⁵⁷ Art. 24 (3) penultimate and last sentence of Directive 85/611/EEC.

⁵⁸ Art. 19 (1) (e) 3rd indent Directive 85/611/EEC.

⁵⁹ Directive 2001/107/EC is the outcome of European Commission, Com (1998) 451 final (1998).

⁶⁰ To minimize conflicts of interest, such discretionary portfolios may only be invested wholly or partly in UCITS of the management company concerned with the prior consent of the investor (Art. 5f (2) Directive 85/611/EEC).

⁶¹ Art. 5 (3) (a) of Directive 85/611/EEC stipulates that the pension funds/discretionary portfolios under management must contain instruments as defined by Section B of the Investment Services Directive 93/22/EEC, which are: securities, UCITS, money market instruments, financial futures contracts, interest rate futures contracts, interest rate, currency and equity swaps, and options on these instruments.

⁶² Investment advice relates to the instruments given in note 61.

⁶³ Art. 5 (3) (b) Directive 85/611/EEC 'UCITS III'. Articles 5 (1) and (6) of the same Directive govern the EU-wide validity of the authorization.

⁶⁴ Art. 5d (2) Directive 85/611/EEC.

⁶⁵ Art. 5a (1) (a) 1st indent Directive 85/611/EEC requires an initial capital of €125,000 plus additional own funds of 0.02 per cent of the amount of the management company's total portfolio assets exceeding €250 million; the total capital required may not, however, exceed €10 million. Art. 5a (1) (a) 3rd indent Directive 85/611/EEC requires the management company to permanently maintain own funds in accordance with Annex IV of Directive 93/6/EEC (Capital Adequacy Directive). This states that own funds may never be less than one-quarter of the fixed overhead costs in the previous year.

⁶⁶ Art. 5a (1) (b) Directive 85/611/EEC requires at least a two-person management, as well as good reputation and sufficient experience (in UCITS management) for the individual managers. Under Art. 5b (1) Directive 85/611/EEC, the owners of the management company must be identified to the authorizing authority, and the authority must be satisfied that 'sound and prudent' management is assured.

⁶⁷ Art. 5f (1) Directive 85/611/EEC requires for this 'in particular, rules for personal transactions by [the] employees' and for self-dealing.

to the following provisions of the Markets in Financial Instruments Directive (MiFID).⁶⁸

- 1 The management company must have sufficient initial capital in accordance with the Capital Adequacy Directive⁶⁹ for it to be authorized.⁷⁰
- 2 The management company must comply with certain organizational requirements. For example, the accounting and other records, information technology (IT) security procedures and internal control mechanisms, especially those relating to proprietary trading by employees, must be 'sound'. The ownership rights of customers' securities and funds must be safeguarded, in particular to prevent their use for own account by the management company for their own account. The organizational arrangements must prevent conflicts of interest between the management company and its clients, and between different clients, wherever possible.⁷¹ In addition, the continuity of business activities must be ensured and, if functions are outsourced to third parties, their unimpaired supervision by the management company must be possible and 'undue additional operational risk' must be avoided.⁷²
- 3 Minimum content of a code of conduct.⁷³

In addition to the existing full prospectuses, the UCITS Management Directive also provides for *simplified prospectuses* that must be provided to prospective investors free of charge before they subscribe for shares.⁷⁴ The objective of this new instrument is to provide average investors with information that they can clearly and easily understand.⁷⁵

The requirements for the minimum contents of simplified prospectuses⁷⁶ are relatively abstract and leave much room for interpretation, with a resulting

⁶⁸ Art. 5 (4) Directive 85/611/EEC as amended by Art. 66 Directive 2004/39/EC subjects the management companies to the following relevant articles of the MiFID (Directive 2004/39/EC): Art. 2 (2), Art. 12, Art. 13 and Art. 19. As a general rule Art. 2 (2) (h) MiFID explicitly excludes UCITS and their custodians and management companies from the scope of the MiFID. MiFID came into force on 30 April 2004 on its publication in the Official Journal of the EU (European Union, 2004). MiFID is the replacement for the Investment Services Directive 93/22/EEC which will cease to have legal force from 30 April 2006 (Art. 69 in conjunction with Art. 72, Directive 2004/39/EC).

⁶⁹ Directive 93/6/EEC.

⁷⁰ Art. 12, Directive 2004/39/EC.

⁷¹ Provisions of Art. 13, Directive 2004/39/EC that were already contained in Art. 10, Directive 93/22/EEC.

⁷² Art. 13, Directive 2004/39/EC.

⁷³ Art. 19, Directive 2004/39/EC, corresponding to Art. 11 Directive 93/22/EEC.

⁷⁴ Art. 33 (1) Directive 85/611/EEC. A mandatory component of the simplified prospectus is a statement that the full prospectus and the (semi-)annual report may be obtained on request and free of charge before or after conclusion of the contract (see Schedule C in the Annex to Directive 85/611/EEC).

⁷⁵ Art. 28 (3) Directive 85/611/EEC.

⁷⁶ See Schedule C in the Annex to Directive 85/611/EEC.

potential for hampering the comparability of simplified prospectuses, especially between different Member States. To promote cross-border marketing of investment funds,⁷⁷ the Commission recommends harmonizing the contents of simplified prospectuses over and above the broad basic structure stipulated in the UCITS Directive (see the section entitled Prospectuses in the EU, from p. 315 on).

Pension Funds Directive: Regulation of IORPs

The objectives of the Pension Funds Directive

Until the Directive ‘on the activities and supervision of institutions for occupational retirement provision’⁷⁸ – often referred to as the ‘Pension Funds Directive’ – came into force in mid-2003, pension funds were the last key element of the financial services industry for which there were no specific rules at EU level.⁷⁹ After awarding it the highest priority level in the Financial Services Action Plan,⁸⁰ the Commission presented a relatively brief proposal for a Pension Funds Directive on 11 October 2000.⁸¹ This proposal was based on the 1997 pensions Green Paper⁸² and the resulting Communication on the same topic published in 1999.⁸³ The key proposal in the Green Paper was not to subject investment rules for pension funds to quantitative restrictions, but to apply the prudent person rule.⁸⁴ The 1999 communication of the Commission summarizing political reactions to the Green Paper noted that the proposed prudent person rule had met with broad approval by the Member States. The Commission’s understanding of the definition of the prudent person rule is also to be found in this document: those responsible for managing the pension plan must behave as careful professionals in making investment decisions and at the same time be aware of the need to earn an adequate return on investments. No ‘unnecessary risk’ may be assumed in doing so; this will be ensured primarily by adequate diversification.⁸⁵

⁷⁷ See European Commission, IP/04/547 (2004), p. 1.

⁷⁸ Directive 2003/41/EC.

⁷⁹ See European Commission, IP/98/447 (1998), p. 1.

⁸⁰ See European Commission, Com (1999) 232 (1999), p. 25.

⁸¹ European Commission, Com (2000) 507 final (2000). The proposal was originally expected for mid-2000 (see European Commission, Com (1999) 232 (1999), p. 25).

⁸² European Commission, Com (1997) 283 (1997).

⁸³ European Commission, Com (1999) 134 final (1999). This communication presents the political conclusions of the long consultation process following publication of the Green Paper, as well as the steps the Commission thought necessary to achieve a single market for supplementary pensions.

⁸⁴ For a discussion of the differences in interpretation of the prudent person rule in the EU and the USA, see the section on The prudent person rule in the Pension Funds Directive, p. 157; esp. Table 2.20. In particular, pension funds should be given freedom to invest in foreign currencies, asset classes and regions of their choice. There should be a ban on forcing them to invest, or prohibiting them from investing, in certain asset classes or assets of certain Member States (see European Commission, Com (1997) 283 (1997), p. 11).

⁸⁵ See European Commission, Com (1999) 134 final (1999), pp. 16f.

Another significant core document that paved the way for the Pension Funds Directive was the 'Rebuilding Pensions' study commissioned by the European Commission.⁸⁶ This was a report containing recommendations on a code of best practice for European supplementary funded occupational pension funds. It was based on a EU-wide survey of institutions in all segments of the pensions industry. The report called for greater efficiency and transparency to reflect the ever-growing importance of pension funds. This would require 'pension fund governance' similar to the concept of corporate governance for public companies. In turn, the implementation of this concept depends on the existence and enforcement of a 'code of best practice', whose EU-wide harmonization would be a component of the Pension Funds Directive, at that time still in the planning stage.⁸⁷ This 'code of best practice' is chiefly based on the principle of security, and also responsibility, accountability, transparency, efficiency, affordability and adequate supervision.⁸⁸ The differing regulatory and fiscal regimes in each country need to be taken into account.⁸⁹

As a result of various demands by the European Parliament to modify certain points compared with the original proposal, it was not until two-and-a-half years later, on 3 June 2003,⁹⁰ that the legislative process for the Pension Funds Directive was successfully completed and adopted by the European Parliament and the Council.⁹¹ Although the Financial Services Action Plan had envisaged accepting the proposal for the Pension Funds Directive in 2002,⁹² the process of reaching political consensus lasted longer than expected despite urging by the Commission to stick to the timetable.⁹³ Particularly contentious issues were the scope of the Directive, the concept of primarily qualitative investment rules, the premium reserves and cross-border membership.⁹⁴ The Member States had until 23 September 2005 to turn the Directive into national law.⁹⁵ As a matter of fact only a minority of the 25 EU member states embodied the rules of the Pension Funds Directive in national law on time.⁹⁶ On the eve of the implementation deadline,

⁸⁶ Pragma Consulting (1999).

⁸⁷ See Pragma Consulting (1999), p. 5.

⁸⁸ See Pragma Consulting (1999), p. II.

⁸⁹ See Pragma Consulting (1999), p. I.

⁹⁰ The original plan was for the Directive to be adopted in 2002 (see European Commission, Com (1999) 232 (1999), p. 25).

⁹¹ European Commission, Com (2000) 507 final (2000).

⁹² See European Commission, Com (1999) 232 (1999), p. 25.

⁹³ For example, in the Fifth Progress Report on the Action Plan, the Commission warned that 'real progress' is needed for the *Pension Funds Directive* (European Commission, Com (2001) 712 final (2001), p. 9).

⁹⁴ See European Commission, Com (2001) 286 final (2001), p. 7 and European Commission, Com (2001) 712 final (2001), p. 9.

⁹⁵ Art. 22 (1) Directive 2003/41/EC.

⁹⁶ As of 15 Oct. 2005 only Austria (BGBl (*Federal Gazette*) 18/2005), Germany (BGBl. (*Federal Gazette*) I 53/2005), Denmark, Estonia, Ireland and Poland were confirmed by the Commission to have fully transposed the Pension Funds Directive into national law (see European Commission (2005), p. 2).

Charlie McCreevy voiced concern that the member states might hamper the working of the Directive by having national legislation not fully compatible with the Directive's core principles, namely the prudent person investment rule and cross-border operation. As IORPs are subject to national social and labour law⁹⁷ there is the possibility of abusing this obligation as a protectionist measure and thus preventing the creation of the intended internal market for pension funds.⁹⁸

To ensure a harmonized scope, the Pension Funds Directive only covers those legal entities that are not attributable to social security funds and that use the funded method.⁹⁹ As intended,¹⁰⁰ systems using the pay-as-you-go method and pension provisions (book-reserved pension plans common in Germany and Austria) are therefore not covered by the Directive.¹⁰¹

The Pension Funds Directive aims to optimize the conflicting goals of security and efficiency and contains three major objectives to achieve this: first, strict prudential rules should protect the interests of pension fund members; second, the investment policy should be allowed a certain degree of leeway to match the long-term investment horizon of retirement provision systems; and third, cross-border pension funds should exploit the considerable potential for savings.¹⁰²

To reflect the objective of investor protection, the Pension Funds Directive stipulates that the pension fund members must be adequately informed about their retirement provision system, that defined benefits must be funded by sufficient assets, that guarantees must be matched by own funds, and that the regulators must be equipped with adequate supervisory powers.

Investor protection requires transparency for pension fund members.¹⁰³ Consequently, the Pension Funds Directive stipulates that pension scheme members must be provided with the following information on request:

- with the annual accounts and annual report¹⁰⁴
- the statement of investment policy principles¹⁰⁵
- the target level of retirement benefits (in the case of a defined benefit, or DB, scheme)¹⁰⁶

⁹⁷ Art. 20 Directive 2003/41/EC; for details, see the description of the notification process in the section on Cross-border IORPs, p. 23.

⁹⁸ McCreevy (2005b).

⁹⁹ Art. 6(a) Directive 2003/41/EC.

¹⁰⁰ See European Commission, Com (1999) 134 final (1999), p. 20.

¹⁰¹ Art. 2 (2) Directive 2003/41/EC.

¹⁰² See European Commission, Com (2003) 254 final (2003), pp. 3f.

¹⁰³ See European Commission, Com (1998) 625 (1998), p. 12.

¹⁰⁴ Art. 11 (2) Directive 2003/41/EC; where applicable, this disclosure duty may be met by alternatively providing the information in question to the representatives of the scheme members.

¹⁰⁵ Art. 11 (3) Directive 2003/41/EC; where applicable, this disclosure duty may be met by alternatively providing the information in question to the representatives of the scheme members.

¹⁰⁶ Art. 11 (4) Directive 2003/41/EC.

- the level of benefits in case of cessation of employment¹⁰⁷
- arrangements relating to the transfer of pension rights to another IORP in the event of a change of employer¹⁰⁸

Without need for request the IORP has to disclose to its members:

- information on changes to the pension fund rules within a reasonable time¹⁰⁹
- annual information about the situation of the IORP¹¹⁰
- each member has to be provided with information on the funding level of his or her accrued individual entitlements on an annual basis¹¹¹
- in the case of a defined contribution (DC) scheme the range of investment options (if there is a choice), the fund portfolio and information on risk exposure and costs¹¹²
- on commencement of the benefit phase, appropriate information on the benefits due and the corresponding payment options¹¹³

Except for the annual accounts and annual report and the statement of investment policy, the specific content and structure of the information to be given to the IORP's members and beneficiaries is not prescribed by the Pension Funds Directive apart from the general requirement to be 'detailed and substantial'.¹¹⁴ Furthermore, these disclosure requirements represent only the minimum level of information to be provided. Thus the Pension Funds Directive gives rather broad regulatory leeway to the Member States.

The second objective, that of efficient investment, will be achieved by a focus on the pension liabilities and adequate diversification of the investment portfolio that may not be hampered by excessive restrictions on investments in equities or international securities.

Finally, cross-border pension funds require mutual recognition of regulatory systems and cooperation between national regulators.¹¹⁵ In the final Directive, however, the European Parliament forced through a significant change that runs counter to the objective of cross-border IORP activity.¹¹⁶ The Pension Funds Directive now sets out that it is a matter for the Member States to decide whether pension funds must provide cover for biometric risks and issue an asset

¹⁰⁷ Art. 11 (4) Directive 2003/41/EC.

¹⁰⁸ Ibid.

¹⁰⁹ See n. 104.

¹¹⁰ See n. 106.

¹¹¹ See n. 106.

¹¹² See n. 106.

¹¹³ Art. 11 (5) Directive 2003/41/EC.

¹¹⁴ See n. 106.

¹¹⁵ See n. 102.

¹¹⁶ See European Commission, Com (2003) 254 final (2003), p. 5.

value guarantee.¹¹⁷ This political decision is likely to interfere with the single market for IORPs because pan-European pension funds must ultimately make allowances for national rules that are not necessary for efficient retirement provision. In addition to the resulting direct (administrative) costs, there could be considerable opportunity costs because of the efficiency losses associated with such compulsory guarantees.

Harmonized Exempt-Exempt-Taxed taxation of retirement provision

There are three elements of funded pension provisions that can be taxed: the contributions, the investment income and capital gains, and the retirement benefits. In the EU, tax exemption for the first two components and taxation of the benefits paid is the most common model.¹¹⁸ This is known as an EET system (Exempt-Exempt-Taxed). By contrast, some EU countries apply (either instead of EET or as an alternative to it) an ETT system (Exempt-Taxed-Taxed: tax-exempt contributions, taxation of investment income and capital gains and benefits), a TEE system (Taxed-Exempt-Exempt: contributions must be paid from net income, but investment income and capital gains, and benefits are tax-exempt)¹¹⁹ or, as in the case of the new severance pay scheme in Austria, the EEE system (i.e., full tax-exemption of all three components).

The European Commission's original plans, although these were ultimately not implemented, were to harmonize the taxation of pension fund contributions, investment income and capital gains, and benefits, over and above the regulation of investment and supervision. The Financial Services Action Plan contained the priority two objective of publishing a draft Directive 'on the coordination of the tax arrangements governing supplementary pensions' by the end of 1999 that would then be adopted (by the Council and the Parliament) in 2002.¹²⁰ The first three progress reports following the Action Plan only contained a 'Commission initiative on the taxation of supplementary pensions'¹²¹ instead of proposing a Directive. The Commission then published a communication on the elimination of tax obstacles to the cross-border provision of pillar 2 pensions in April 2001.¹²² In doing so, the Commission made clear that it did not 'intend proposing legislation to harmonise the taxation of retirement provision in the Member States' but that it would 'welcome alignment ... on the basis of the EET principle'. However, because it believed that 'it is likely that differences between Member States' systems will remain for the foreseeable future',¹²³ the Member States should use

¹¹⁷ Art. 9 (2) Directive 2003/41/EC is the outcome of an amendment requested by the European Parliament. The draft Directive did not stipulate such a requirement.

¹¹⁸ See European Commission, Com (2001) 214 final (2001), pp. 6f.

¹¹⁹ Ibid.

¹²⁰ See European Commission, Com (1999) 232 (1999), p. 30.

¹²¹ European Commission (1999a), p. 11; European Commission, Com (2000) 0336 final (2000), p. 19; European Commission, Com (2000) 692/2 final (2000), p. 27.

¹²² European Commission, Com (2001) 214 final (2001).

¹²³ European Commission, Com (2001) 214 final (2001), p. 21.

unilateral and bilateral tax treaties to prevent cross-border worker mobility leading to double taxation because entitlements are acquired in a TEE country and benefits are consumed in an EET country, or to avoid them not being taxed at all because the worker works in an EET Member State but retires in a TEE country. Such mismatches of different Member States' tax systems should be addressed in the short-term by better cross-national coordination.¹²⁴ If cross-border pension funds continue to be exposed to discriminatory tax treatment (i.e., if domestic schemes are treated as privileged), in particular by enjoying more favourable rules on deductibility of contributions or taxation of benefits,¹²⁵ or because the transfer of pension capital between two domestic funds is tax-free but is taxed if it is transferred to an IORP in another Member State, the Commission warns expressly that it will initiate Treaty infringement proceedings against the Member State concerned.¹²⁶ The European Parliament supports the Commission's approach and 'urges [it if appropriate] to institute infringement procedures quickly',¹²⁷ while the Member States are urged 'firstly to institute measures to introduce the EET system'¹²⁸ and second to 'consider a process of stronger cooperation [over and above] the bilateral and multilateral agreements on the avoidance of double or zero taxation'.¹²⁹

The European Commission launched infringement proceedings against Denmark,¹³⁰ Belgium, Spain, France, Italy, Portugal,¹³¹ the UK, Ireland¹³² and Sweden¹³³ during the years 2003 and 2004 for discriminatory tax treatment of foreign pension schemes. The Commission believes that the privileged deductibility of contribution payments to domestic pension funds allowed in those countries represents restrictions on the free movement of labour and services.¹³⁴ As three of the above-mentioned Member States (Denmark, Belgium and Spain) did not comply (in time) with the Commission's formal requests to change the tax rules

¹²⁴ See European Commission, IP/01/575 (2001), p. 2.

¹²⁵ See European Commission, IP/01/575 (2001), p. 1.

¹²⁶ See European Commission, Com (2001) 214 final (2001), p. 14.

¹²⁷ European Parliament, A5-0388/2001 (2001), No. 3.

¹²⁸ European Parliament, A5-0388/2001 (2001), No. 5.

¹²⁹ European Parliament, A5-0388/2001 (2001), No. 8.

¹³⁰ In Feb. 2003 the European Commission sent a 'reasoned opinion' to Denmark (stage 2 of infringement proceedings under Art. 226 of the EC Treaty) in response to Denmark's preceding information to the Commission detailing the national tax rules thought to be infringing the EC Treaty. Thereby the Commission formally requested Denmark to amend its tax rules to ensure equal treatment of contributions paid to domestic schemes and schemes located in another Member State (see European Commission, IP/03/179, Brussels, 2003).

¹³¹ In 'letters of formal notice' (stage 1 of infringement proceedings under Art. 226 of the EC Treaty) the Commission addressed the unequal tax treatment of contributions paid to domestic and foreign pension schemes and requested Belgium, Spain, France, Italy and Portugal to submit their observations on the subject (see European Commission, IP/03/179, 2003).

¹³² Letters of formal notice were sent by the Commission to the UK and Ireland in July 2003 (see European Commission, IP/03/965, 2003).

¹³³ In Dec. 2004 the Commission sent a 'reasoned opinion' to Sweden (see European Commission, IP/04/1500, 2004).

¹³⁴ See European Commission, IP/03/179 (2003).

in question¹³⁵ they were referred to the European Court of Justice in Luxembourg (ECJ).¹³⁶ As of December 2005 the three infringement cases are still pending in the ECJ.¹³⁷ In the past several rulings by the ECJ on cross-border tax deductibility have given priority to the internal market's freedoms.¹³⁸ The successful challenging of discriminatory tax restrictions severely limits the (ab)use of tax law for protectionism in the field of pension provisions.

The fact that mere tax coordination was given preference over harmonization is due to the normally substantial and generally insurmountable resistance to tax harmonization efforts within the EU.¹³⁹ The often considerable differences in the tax treatment of contributions to investment income, capital gains, and benefits from IORPs in the various Member States represent a considerable barrier to the freedom of movement of workers, services and capital. Tax differences are barriers first of all for workers wanting to become members of a pension fund in a Member State that is not their country of residence, and second for financial services providers wishing to offer their pension funds in other EU Member States.¹⁴⁰

If an EU-wide, uniform EET system is ultimately established, this would benefit both the tax authorities and the members. The advantages of the EET model are that the majority of the pension reserves existing when the member retires originate not from the contributions, but from the investment income and capital gains,¹⁴¹ so the tax base in the EET system is much larger than in a TTE or TEE system. TTE or TEE taxation generates relatively low tax revenue at present, while an EET system promises considerably higher tax revenue from the benefits paid from the invested pension capital in *real* terms years or decades in the future. In addition to the lower tax revenue, the first option also suffers from the increased likelihood of high future social welfare/transfer payments to those future pensioners who were unable to build up a retirement provision sufficient to assure their standard of living or even a subsistence level due to the taxation of their pension contributions. An EET system thus offers two significant advantages: that of encouraging the creation of pension capital, and that of ensuring

¹³⁵ Belgium and Spain received the Commission's reasoned opinions in Dec. 2003 (see European Commission, IP/03/1756, 2003).

¹³⁶ The Commission announced the referrals to the ECJ on the following dates: 9 July 2003 in the case of Denmark (see European Commission, IP/03/965, 2003); 8 July 2004 in the case of Spain (see European Commission, IP/04/873, 2004); and 22 Oct. 2004 in the case of Belgium (see European Commission, IP/04/1283, 2004).

¹³⁷ Actions were brought before the ECJ by the Commission against Denmark on 23 March 2004 (see Court of Justice, 2004); against Belgium on 23 Dec. 2004 (see Court of Justice, 2005a); and against Spain on 7 Feb. 2005 (see Court of Justice, 2005b).

¹³⁸ Cases of *Wielockx* (Court of Justice, 1994), *Safir* (Court of Justice, 1998), *Danner* (Court of Justice, 2002) and *Skandia/Ramstedt* (Court of Justice, 2003).

¹³⁹ Tax-related decisions must be adopted unanimously (see European Parliament, A5-0388/2001, 2001, no. 2).

¹⁴⁰ See European Commission, Com (2001) 214 final (2001), pp. 3f.

¹⁴¹ See Pragma Consulting (1999), pp. 3f.

tax revenue in the medium to long term which would otherwise tail off because of demographic change.¹⁴²

However, the strained budgetary position in many EU Member States favours measures designed to maximize short-term tax revenue. Today's budget problems may thus prevent the implementation of the more favourable EET system, or at least dilute it to the point where many citizens are prevented from ensuring adequate supplementary provision (for example, because the tax-exempt investable amounts are too low). National misgivings about an EU-wide EET tax harmonization may also be fuelled by the fear that future tax revenues will be lost to other EU countries if there is a majority of employees in the home country who invest pension capital tax-free during their working life but then consume the resulting retirement benefits abroad and tax them there.¹⁴³ The European Commission and the ECJ, however, do not accept the possible loss of revenue as a justification for tax discrimination. Then the need to preserve fiscal coherence, though, was considered by the ECJ as a legitimate reason for an exemption from equal tax treatment in a judgment dating back to the early 1990s.¹⁴⁴ This decision by the ECJ has drawn much criticism. In its more recent decisions, however, the ECJ made clear that Member States can invoke the principle of tax cohesion only if there is a direct link between the grant of a tax advantage and the offsetting of that advantage by a corresponding disadvantage (i.e., a fiscal levy). Up to now there has been no other case where the ECJ allowed a Member State to rely on the principle of fiscal coherence.¹⁴⁵ The court has not considered the plaintiffs' requests for equal tax treatment of contributions and benefits paid to and received from domestic and foreign pensions schemes in violation of the principle of tax coherence.

Cross-border IORPs

The Pension Funds Directive 'represents a first step on the way to an internal market for occupational retirement provision organised on a european scale'.¹⁴⁶ The categorization of the Directive as only 'a first step' is due to the fact that it excludes the important areas of taxation and portability. It is the intention of the Commission to deal with discriminatory national tax law by infringement proceedings and to address the issue of portability by a specific Directive.¹⁴⁷

By subjecting investment rules to the prudent person principle and by authorizing IORPs to offer their services on a cross-border basis, the Pension Funds Directive provides two important prerequisites for the establishment of an internal market for pillar 2 pensions. As the prudent person principle is

¹⁴² See European Commission, Com (2001) 214 final (2001), pp. 20f.

¹⁴³ See Bruce (2002).

¹⁴⁴ See Court of Justice (1992), paragraphs 21ff.

¹⁴⁵ See Jacobs (2003), paragraph 47.

¹⁴⁶ Recital 6 Directive 2003/41/EC.

¹⁴⁷ European Commission, Com (2005) 507 final (2005).

covered in a later chapter,¹⁴⁸ this section focuses on the cross-border authorization process.

Similar to the UCITS Directive's 'European passport' for investment funds, the Pension Funds Directive aims to provide single licence procedures for IORPs operating in several Member States. Member States are required to allow both 'their' companies to act as sponsors of IORPs located in other Member States and 'their' IORPs to accept sponsorship by employers from other Member States.¹⁴⁹

An IORP wanting to engage in cross-border activities first needs *authorization* by the competent supervisory authorities of its home Member State (home SA).¹⁵⁰ If the IORP in question is planning to operate as a 'guest IORP' in more than one host Member State, this authorization is needed only once and not for each cross-border activity.¹⁵¹

An authorized IORP then has to undergo the so-called *notification* process, whereby the IORP exclusively communicates only with its home SA, while the home SA initiates a dialogue with the competent supervisory authorities of the other Member State(s) where the IORP aims to do business ('host SA').¹⁵² This notification process is depicted in Figure 2.2: first the IORP notifies the home SA of the intended acceptance of sponsorship by (an) employer(s) located in (an) other Member State(s) [host Member State(s)]. This notification has to name the host Member State(s), the sponsor and the main characteristics of the pension scheme in question (which retirement benefits are granted under what conditions¹⁵³). If the home SA has no doubts that the IORP's administrative structure, its financial situation and the good reputation and professional qualifications or experience of the persons running the IORP are compatible with operating as a guest IORP, it has to forward the notification to the host supervisory authority within three months. If there are unresolved doubts, the IORP is not permitted to work as a guest IORP.

If there are no such doubts the host SA then has to inform the home SA about certain national regulations regarding the activities of IORPs within a further two months. The Pension Funds Directive restricts these national regulations to the social and labour law applicable to the pension scheme, special investment rules¹⁵⁴ and requirements for information to be given to an IORP's members and

¹⁴⁸ See section on The prudent person rule in the Pension Funds Directive, p. 157.

¹⁴⁹ Art. 20 (1) Directive 2003/41/EC.

¹⁵⁰ Licensing of a non-cross-border IORP does not necessarily need authorization (for details, see section on Authorization/registration and continuing oversight in the EU, p. 372).

¹⁵¹ See CEIOPS (2005), p. 9.

¹⁵² Art. 20 (1)–(7) Directive 2003/41/EC; transposed into German federal law by sections 117, 118c and 118e VAG as amended by BGBl. (*Federal Gazette*) I, no. 53/2005 Art. 1 nos 22, 24 and 26; transposed into Austrian federal law by sections 11a and 11b PKG as amended by BGBl (*Federal Gazette*) I, 8/2005 Art. 2 no. 8.

¹⁵³ Art. 6 (b) Directive 2003/41/EC.

¹⁵⁴ The host Member State may impose certain quantitative restrictions on guest IORPs if they apply equally (or more strictly) to domestic IORPs (for details, see section on The prudent person rule in the Pension Funds Directive, p. 151).

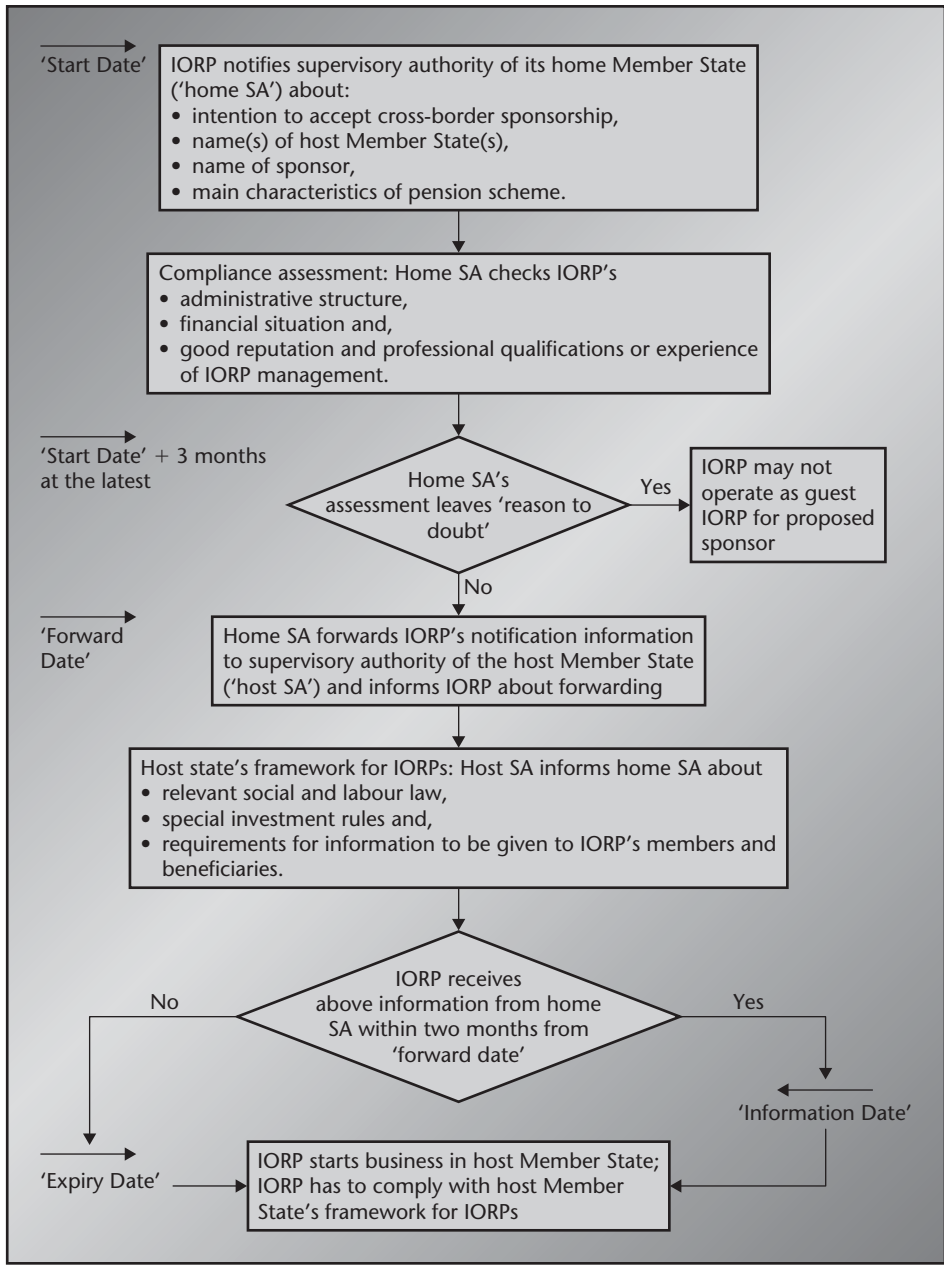


Figure 2.2 Notification procedures relating to starting cross-border IORP activities

Source: Adapted from EFRP (2005), Appendix 4

beneficiaries.¹⁵⁵ After receiving this communication the home SA forwards this information to the IORP; the date of receipt by the IORP is called the Information Date. The day immediately following the aforementioned two-month period is termed the Expiry Date.¹⁵⁶ The IORP is allowed to commence cross-border business on the earlier of these two dates. In the latter case the guest IORP has to follow the social and labour law applicable to the pension scheme, the special investment rules and the specific requirements for information to members and beneficiaries, despite not having received information on these regulations by the home SA. Therefore the need for the two-month period of waiting for the host SA to provide the information seems questionable.

The Lamfalussy process: the Four-Level Approach

A major outcome of the Lamfalussy Report was a proposal to reform the EU regulatory process in the form of a 'Four-Level Approach'. In Level 1, the European Parliament and the Council would reach agreement on the principles of a Directive or Regulation proposed by the Commission under the existing co-decision procedure. In Level 2, detailed technical implementing measures would be developed in the 'comitology procedure', while Level 3 would see strengthened cooperation by national regulators to achieve consistent implementation. Finally, Level 4 would involve stronger enforcement, primarily by the Commission.¹⁵⁷

This new concept for EU legislation aims first, to enable the rapid implementation of the Action Plan and second, to establish a more transparent and efficient regulatory structure in the field of financial services.¹⁵⁸ The arguments in favour of the Four-Level Approach are that the established legislative process does not work because it is too slow, too rigid and frequently ambiguous; and it does not distinguish between core principles and implementing rules.¹⁵⁹ In particular, 'there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential supervision'.¹⁶⁰ Distinguishing between basic instruments and implementing rules has the institutional advantage that implementing measures are no longer subject to the time-consuming co-decision procedure.

As the Lamfalussy Committee had proposed,¹⁶¹ a new EU committee structure was implemented for the securities sector in 2001, based on the EU comitology

¹⁵⁵ The minimum information requirements are described in the section on The objectives of the Pension Funds Directive, p. 15.

¹⁵⁶ CEIOPS (2005), p. 12.

¹⁵⁷ See Committee of Wise Men (2001), pp. 10 and 26ff.

¹⁵⁸ See Committee of Wise Men (2001), p. 12.

¹⁵⁹ See Committee of Wise Men (2001), pp. 19–21.

¹⁶⁰ Committee of Wise Men (2001), p. 24.

¹⁶¹ See Committee of Wise Men (2001), p. 35.

approach adopted in 1999.¹⁶² Comitology is 'the delegation of implementing powers by the Council to the Commission for the execution of EU legislation'.¹⁶³ The 'comitology committees' composed of representatives of the Member States and the Commission assist the Commission in the execution of the implementing powers conferred on it.

The 'regulatory procedure' applies to financial services.¹⁶⁴ This means that the Commission is assisted by a regulatory committee consisting of representatives of the Member States that operates on Lamfalussy Levels 1 and 2,¹⁶⁵ and also by a committee of regulators composed of representatives of the national regulatory authorities, which is located on Lamfalussy Level 3.¹⁶⁶

For the area of securities (and in future for UCITS, too), the regulatory committee is the European Securities Committee (ESC),¹⁶⁷ and the committee of regulators is the Committee of European Securities Regulators (CESR).¹⁶⁸ The first of these '[advises] the Commission on policy issues as well as on draft proposals ... in the field of securities',¹⁶⁹ while the latter has a similar function to 'advise the Commission ... [and to prepare] draft implementing measures in the field of securities'.¹⁷⁰ CESR is the successor to the Forum of European Securities Commissions, or FESCO.¹⁷¹ In November 2003, this two-tier structure of one committee that primarily exercises a regulatory function and another with primarily advisory functions was extended to IORPs and UCITS.

¹⁶² The comitology resolution (European Council, Decision 1999/468/EG, 1999) came into force on 18 June 1999 (published in OJL (Official Journal of the European Union L Series) 184 of 17 July 1999, p. 23).

¹⁶³ Committee of Wise Men (2001), Annex 5.

¹⁶⁴ The specific details of the regulatory procedure are governed by Art. 5 European Council, Decision 1999/468/EG (1999). In addition to the regulatory procedure, there are also advisory, management and safeguard procedures.

¹⁶⁵ See European Commission, Com (2003) 659 final (2003), p. 8.

¹⁶⁶ *Ibid.*

¹⁶⁷ The ESC started working on 7 June 2001 (Art. 6 European Commission, Decision 2001/528/EC, 2001). Chaired by a representative of the Commission, the ESC consists of 'high-ranking representatives of the Member States' (Art. 3 European Commission, Decision 2001/528/EC, 2001). The Lamfalussy Committee suggested 'state secretaries' as suitable high-ranking representatives (see Committee of Wise Men (2001), p. 38).

¹⁶⁸ CESR started working on 7 June 2001 (Art. 8 European Commission, Decision 2001/527/EC, 2001). It was originally going to be called the 'EU-Securities Regulators Committee' or ESRC (see Committee of Wise Men (2001), p. 35). Each Member State nominates one 'high-ranking representative of its supervisory authority', while the Commission also appoints a 'high-ranking representative' to the Committee (Art. 3 European Commission, Decision 2001/527/EC, 2001).

¹⁶⁹ Art. 2 European Commission, Decision 2001/528/EC (2001); Art. 1 European Commission, Decision 2004/8/EC (2003) extends this advisory function to UCITS.

¹⁷⁰ Art. 2 European Commission, Decision 2001/527/EC (2001); Art. 1 European Commission, Decision 2004/7/EC (2003) extends this advisory function to UCITS.

¹⁷¹ The Lamfalussy Committee recommended the FESCO structure as the (organizational) basis for CESR (see Committee of Wise Men (2001), p. 40). The CESR charter formally adopted all of FESCO's agreements, standards and obligations (see CESR (2002), Article 9).

Table 2.2 EU committee structure for the financial services sector

	Securities (incl. UCITS)	Banks	Insurers and IORPs
Regulatory committee (Lamfalussy Levels 1 and 2)	European Securities Committee (ESC)	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)
Committee of regulators (Lamfalussy Level 3)	Committee of European Securities Regulators (CESR)	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

Source: European Commission, Sec (2004) 659/1 (2004), p. 12

The European Insurance and Occupational Pensions Committee (EIOPC) was established as the regulatory committee for pension funds.¹⁷² The EIOPC advises the Commission on policy issues relating to the application of Community provisions.¹⁷³ It is the equivalent of the ESC for the insurance and pension fund sector. However, the legal instruments needed for the allocation of responsibilities were not all in force by the start of 2005. To achieve implementation, the Commission has presented a proposal for a Directive to establish a new financial services committee organizational structure.¹⁷⁴ The EIOPC can start work¹⁷⁵ as soon as this Directive comes into force.¹⁷⁶ The counterpart to CESR is the recently established Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).¹⁷⁷

Banks are the third group of financial services companies that will be covered by their own regulatory committee and committee of regulators. Table 2.2 shows an overview of the committees responsible for the three groups.

For investment funds and companies, the responsibilities of the UCITS Contact Committee will pass to the ESC in future.¹⁷⁸ Under UCITS I, the functions of the

¹⁷² EIOPC replaced the previous Insurance Committee (IC), which had been established by Council Directive 91/675/EEC.

¹⁷³ Art. 2 European Commission, Decision 2004/9/EC (2003).

¹⁷⁴ European Commission, Com (2003) 659 final (2003).

¹⁷⁵ Art. 5 European Commission, Decision 2004/9/EC (2003). Art. 5 European Commission, Com (2003) 659 final (2003) amends Art. 1 Council Directive 91/675/EEC to replace the Insurance Committee by EIOPC.

¹⁷⁶ The Council formally adopted the proposed Directive on 21 Dec. 2004.

¹⁷⁷ CEIOPS started working on 24 Nov. 2003 (Art. 8 European Commission, Decision 2004/6/EC).

¹⁷⁸ Art. 2 European Commission, Decision 2001/527/EC (2001), as amended by Art. 1 European Commission, Decision 2004/7/EC (2003), extended CESR's responsibilities to UCITS. Formally, the ESC was supposed to be the successor to the UCITS Contact Committee (see European Commission, Com (2003) 659 final (2003), S 18).

UCITS Contact Committee,¹⁷⁹ which was composed of representatives of the Member States and chaired by a Commission representative, were:

- (a) to facilitate the harmonized implementation of the UCITS Directive through regular consultations on any practical problems;¹⁸⁰
- (b) to facilitate consultation between Member States on more rigorous or additional requirements they may adopt further to those in the UCITS Directive,¹⁸¹ and on special rules for cross-border UCITS;¹⁸²
- (c) to advise the Commission on additions or amendments to the UCITS Directive;¹⁸³
- (d) and to receive regular reports from the Commission on refusals¹⁸⁴ and withdrawals¹⁸⁵ of authorizations of cross-border UCITS to which the principle of home country supervision applies.¹⁸⁶

In addition, UCITS III designated the Contact Committee as a Regulatory Committee¹⁸⁷ that assists the Commission with regard to certain technical modifications to be made to the UCITS Directive.¹⁸⁸ In the course of the transfer of responsibilities from the UCITS Contact Committee to the ESC and CESR, the duties defined in UCITS I were abolished¹⁸⁹ and the ESC was established as the advisory body to the Commission;¹⁹⁰ in future the ESC will also assist the

¹⁷⁹ Art. 53 (3) Directive 85/611/EEC.

¹⁸⁰ Art. 53 (1) Directive 85/611/EEC.

¹⁸¹ If they are generally valid and do not run counter to the provisions of the UCITS Directive, the Member States may impose stricter and additional requirements than those stipulated in the UCITS Directive on UCITS domiciled in their territory (Art. 1 (7) Directive 85/611/EEC).

¹⁸² Cross-border UCITS must comply with the provisions of the host state not contained in the UCITS Directive and may market their products subject to this condition (Art. 44 Directive 85/611/EEC). They must also ensure that the shareholders in the host state receive the payments of the UCITS and are able to surrender their shares (Art. 45 Directive 85/611/EEC). See also n. 180.

¹⁸³ See n. 180.

¹⁸⁴ If UCITS wish to establish a branch in a Member State other than their home country, they must provide the supervisory authority in their *home* country with certain documents, which are then passed on to the supervisory authority in the prospective host country, provided that there are no concerns (Art. 6a Directive 85/611/EEC).

¹⁸⁵ For information on the procedure in the case of violations by the management company, up to and including the withdrawal of authorization, see section on Enforcement, p. 376.

¹⁸⁶ Art. 6c (9) and (10) Directive 85/611/EEC.

¹⁸⁷ Art. 53a (1) Directive 85/611/EEC gives the UCITS Contact Committee the status of a regulatory committee in accordance with Art. 5 European Council, Decision 1999/468/EG (1999).

¹⁸⁸ The Contact Committee assists the Commission in matters relating to the alignment, clarification and framing of definitions and terminology to ensure uniform application of the Directive throughout the Community (Art. 53a (1) Directive 85/611/EEC).

¹⁸⁹ Art. 7 no. 1 and 2 European Commission, Com (2003) 659 final (2003).

¹⁹⁰ Art. 53b Directive 85/611/EEC inserted by Art. 7 no. 8 European Commission, Com (2003) 659 final (2003).

Commission¹⁹¹ 'on policy issues as well as on draft proposals', including on UCITS.¹⁹²

Inherent weakness in pay-as-you-go state pension schemes

Parameters of PAYG schemes

Inter-generational contract

Statutory pension schemes, which constitute 'pillar 1' of the EU pensions system, are financed by the state from current revenue on a PAYG basis. Apart from what are known as the fluctuation reserves, no capital stock is built up from the contribution payments, which instead are used to satisfy the claims of retirees; as a result, the contributions merely serve to acquire a pension entitlement whose settlement is then the responsibility of the next generation.

Since the pay-as-you-go system does not establish any ownership or contractual rights to accumulated capital, social legislation has designed the 'inter-generational contract', which is rooted in the trust that both younger and older generations have in the sustainability of the system. The generation that is active in the labour market must be confident that its own pensions will be paid by the following generation, while the generation that is already in retirement must be confident that the currently active generation will pay the contributions required for the current pension payments. This means that if such a pay-as-you-go system is abolished, the final active generation would go empty-handed, in much the same way as those who join a Ponzi scheme (too) late in the game.¹⁹³

Equation 2.1 presents a simple model of the pay-as-you-go system that does not show non-pension-related payments on the expenditure side or tax-funded subsidies on the revenue side;¹⁹⁴ it demonstrates that the level of (compulsory) contributions b_t to the pay-as-you-go system is determined first by the pension level RN , in other words the ratio of the average pension r_t to the average wage w_t , and second by the support ratio RQ , which indicates the ratio of the number of pensioners R_t to the number of contribution payers N_t . Because the support ratio is rising in almost all industrialized countries and will record even more significant growth over the next few decades, the logical consequence is – all

¹⁹¹ When the Directive to establish a new committee structure in the financial services sector (draft Directive: European Commission, Com (2003) 659 final, 2003) comes into force, the responsibilities will be automatically transferred from the UCITS Contact Committee to the ESC (Art. 2 European Commission, Decision 2004/8/EC, 2003) and CESR (Art. 2 European Commission, Decision 2004/7/EC, 2003).

¹⁹² Art. 2 European Commission, Decision 2001/528/EC (2001) as amended by Art. 1 European Commission, Decision 2004/8/EC (2003).

¹⁹³ See Goldman Sachs Global (2001), p. 1. A fraudulent investment scheme in which earlier investors are entirely paid out of money paid into the scheme by subsequent investors is called a Ponzi Scheme, after Carlo Ponzi who initiated such a scheme in 1919 in the USA.

¹⁹⁴ Rürup (1998), p. 781.

else being equal – an increase in average wages and/or a reduction in average pensions and/or an increase in contribution rates.

$$b_t = \frac{r_t}{w_t} \cdot \frac{R_t}{N_t} = RN \cdot RQ \quad (2.1)$$

Because the level of (gross) average wages is largely unaffected by social security legislation, the only inherent leverage factors remaining de facto in the system are either benefit cuts (lower average pensions) and/or contribution hikes.

Increasing the female labour force participation rate

However, it can also be argued that the rise in the support ratio can at least be slowed, and is not merely dictated by demographic trends. One way of reining in the growth in the support ratio and thus the contribution rate is to increase the female labour force participation rate, which is lower than the male labour force participation rate, and not just in Germany.¹⁹⁵ Although women have a significantly higher life expectancy than men,¹⁹⁶ this is not reflected in a higher statutory pensionable age. In fact, there are still gender-specific differences in the pensionable age in Germany and Austria.¹⁹⁷ The lower standard pensionable age for women in Germany was gradually increased to 65 between 2000 and 2004, so the pensionable age for women born in and after 1945 is now identical to that for men.¹⁹⁸

In Austria, this alignment is being introduced over a relatively long period, and will only start in 2024. The planned phased increase in the standard pensionable age for women will actually only be completed in 2033. This time-frame is a good example of a totally exaggerated interpretation of the ‘principle of legitimate expectations’: the constitutional rule on harmonizing pensionable ages dates back to 1992.¹⁹⁹ At least two-thirds of the Austrian parliamentary deputies – the qualified majority needed to change the constitution – were therefore evidently of the opinion that in 1992, women aged 28 and older could not be expected to adapt their plans for the future to a longer working life for reasons of legitimate expectations. They evidently believed that only women then aged 23 and younger

¹⁹⁵ In 2000 (2001), the male labour force participation rate was 79.9 per cent (75 per cent), in Germany (Austria), while the female labour force participation rate was 57.8 per cent (64.5 per cent) (see Deutscher Bundestag (2002), pp. 94f and Federal Ministry of Economics and Labour (2002), p. 1).

¹⁹⁶ The statistical life expectancy of newborn male children is currently 75.11 (75.56) years in Germany (Austria), while that for newborn female children is 81.07 (81.46) years (see Federal Statistical Office (no date/a)) and Statistik Austria (2003b).

¹⁹⁷ The different retirement age for men and women in Austria was introduced by the *Kaiserliche Verordnung vom 25 June 1914 RGBL 138*. During the Nazi period, the then German legal position with the same retirement age for men and women was adopted. In 1948, a different retirement age was re-introduced for men (65) and women (60) (see *VfSlg 12568/1990*). However, male and female Austrian civil servants have the same normal retirement age of 65 (section 13(1) BDG and section 99 RDG).

¹⁹⁸ Section 237a(1) SGB 6; there are special rules governing justified expectations safeguards for people approaching retirement age (section 237a(3) SGB 6).

¹⁹⁹ Section 3 BGBl. (*Federal Gazette*) no. 832/1992, dated 29 Dec.

could reasonably be expected to accept an increase in the standard pensionable age to 65.

The change in the legal position was due in any case to a corresponding ruling by the Austrian constitutional court.²⁰⁰ In its reasoning, the judges argued that 'Parliament's sole substantiation for differing arrangements for the pensionable age of men and women was that the physical characteristics of women justified inability to work or exercise a profession at the age of 60 to a greater extent than those of men'. Legal doctrine also justified different age limits by the additional burden of raising children and running a household in addition to holding down a job, the judges continued.

However, 'both justifications were not totally compelling'. 'The considerably higher life expectancy of women contradicts an earlier inability to work', they argued, as did the fact that 'Parliament makes no distinction between the pensionable age of male and female civil servants'; moreover, 'no account is taken of the work that a woman has actually done, but rather all women are treated equally'. Neither did they believe that the argument that women suffered from a 'double burden from work and household' could justify a different pensionable age, first because 'a not inconsiderable number of working women are single and that therefore the burden of work and household is no different for them than for single men', and second because the concept of marriage as a partnership of equals had been anchored in law since 1975.²⁰¹

Quite apart from this judicial view of things, there are sound economic reasons that support aligning the pensionable age. Other things being equal, prolonging women's working lives not only helps cut the support ratio, but may also increase women's pension levels (because of their own contributions, not because of derivative claims). Using the state pension scheme to compensate for actual and/or alleged gender-specific social injustices is simply inefficient and preserves existing structures. However, the related debate is so ideologically overburdened that any actuarially equitable solution appears to be more or less impossible to implement. For example, the arguments vehemently advanced by German labour representatives against an actuarially equitable treatment of men and women seem almost incomprehensible. The view put forward by the labour unions that 'men are privileged in the contractual arrangements for private pensions because their lower statistical life expectancy means that they have to pay lower contributions than women for the same pension'²⁰² must be viewed as fundamentally flawed because if both sexes have the same pensionable age and the level of contributions is identical, women's pensions have

²⁰⁰ *VfSlg* 12568/1990.

²⁰¹ Section 91 Allgemeines Bürgerliches Gesetzbuch (ABGB).

²⁰² Minority vote by three trade union officials, one member of a works council and the President of the Deutscher Paritätischer Wohlfahrtsverband (German Non-Denominational Welfare Association) contained in the final report by the Rürup Commission (Federal Ministry of Health and Social Security, Berlin (2003), p. 143).

a substantially higher present value because of their statistically higher life expectancy.

The benefit principle means that higher benefits require higher contributions. By definition, profit-oriented (insurance) companies sell benefits, representing a higher (present) value, that they must themselves provide, at a higher price, unless state or intra-company (cross-)subsidies are involved. That is why the allegation that ‘to date ... private pension providers have been unable to create offerings that provide for the same amounts of contributions and payouts for men and women’ is simply irrational from both a market economy and a gender equality perspective.

Based on the apparent insight that redistribution from men to women is not a feature of companies operating in a market economy, there are consequently calls for ‘legislative measures to oblige the providers of pension products to offer unisex tariffs’. The fact that this demand for the ‘same terms and conditions when structuring pension provision contracts’²⁰³ for women and men would constitute a blatant breach of the principle of equality,²⁰⁴ which not only says that what is equal must receive equal treatment, but also that what is unequal must be treated unequally,²⁰⁵ has not occurred to these advocates at all, or else they are not willing to accept it.

Ultimately, German politicians decided against applying the principle of equality to the treatment of men and women for private retirement provision using Riester products. Since early 2005, unisex tariffs have been obligatory for all new pension contracts.²⁰⁶

Inter-generational fairness

It is not just the legal pension arrangements for male compared with female insured persons that can be seen as unjust from an actuarial perspective, as the inter-generational distribution of burdens and benefits from the state pension system also exhibits blatant deficits in this respect. The seven million pensioners at the time profited disproportionately from the 1957 German pension reform, which established the pay-as-you-go system funded by income from dependent employment, because they received approximately 70 per cent of their final net wage as a pension without having paid in matching contributions to the pension insurance system.²⁰⁷ By contrast today’s employees, especially those born after around 1970, will have to expect falling pension levels²⁰⁸ despite a growing

²⁰³ Ibid.

²⁰⁴ Art. 3 GG (Germany); Art. 7(1) B-VG and Art. 2 StGG (Austria).

²⁰⁵ According to rulings by the Federal Constitutional Court, what is materially unequal may not arbitrarily be treated equally (BVerfGE 1, 52).

²⁰⁶ Section 1(1) no. 2 AltZertG as amended by Art. 7 no. 1 AltEinkG.

²⁰⁷ See Steingart (2004a), p. 53.

²⁰⁸ The same cohorts also have to expect a longer working life. For example, the Rürup Commission recommends raising the retirement age to 67 for those born in 1969 and thereafter (see Federal Ministry of Health and Social Security, Berlin (2003), p. 31).

burden from direct and tax-financed indirect pension contributions.²⁰⁹ The notional rate of return on pension contributions develops 'in line with population growth and wage growth'.²¹⁰ Because we can expect that the substitution of domestic labour by foreign labour as a consequence of globalization and also by domestic and foreign capital will continue, it is unlikely that future wage increases will be able to fully offset a shrinking population, with the result that the notional rate of return, and thus the pension level, will decline.

It will be necessary to cut existing pensions and/or curb the annual increases so as to limit the one-sided redistribution from the generation born in and after 1970 to the older generations to at least a sustainably tolerable level. The ostensibly plausible argument that the net pension adjustments that were standard in Germany until the 2001 pension reform already mean that the burdens are shared fairly between the generations does not stand up to closer examination. Because the ratio of people in work to pensioners is dropping all the time, working people actually bear the larger burden,²¹¹ which contradicts the principle of inter-generational fairness.²¹²

Inter-generational fairness means that 'the ratio of contributions to benefit entitlements does not change between the generations'. But because such a change without countermeasures 'is normally the case in an ageing society', any 'reform of the pension system [that is fair to both generations] ... must mean reducing the burden on the younger generation and thus increasing the burden on the older generation'.²¹³ Inter-generational fairness can be captured quantitatively²¹⁴ and is thus not merely the sort of qualitative measure that normally shatters against the ideological barriers of political rivalry.

Those factions trying to preserve the existing system will have to substantially rethink their approach. The awareness that 'a spending machine that distributes its entitlements without being sufficiently anchored in the economic basis'²¹⁵ – in other words a pay-as-you-go system whose benefits are permanently well above the economic performance of its contributors – cannot be stabilized in the medium to long term needs to be at the forefront of everybody's minds. This is linked to the insight that it is de facto not the 'vested rights' but rather the value added by working people that represents the economic basis of the pay-as-you-go system.

²⁰⁹ Unless there are far-reaching structural reforms, it is foreseeable that those aged around 30 today 'will have to pay around three quarters of their income in taxes and contributions at the end of their working lives' (Sauga, Anwar, Berg and Tietz, 2003).

²¹⁰ Rürup (1998), p. 782.

²¹¹ See Rürup (1998), p. 790.

²¹² For example, one of the primary objectives elaborated by the Rürup Commission was 'to increase the sustainability of funding the statutory pension insurance system for reasons of inter-generational fairness', which would require 'the growing costs of social security in an ageing society to be spread more evenly across all generations' (Federal Ministry of Health and Social Security, Berlin (2003), pp. 3 and 5).

²¹³ Sozialbeirat (2001), p. 9.

²¹⁴ The available methods for quantifying inter-generational fairness are generational accounting, implicit income tax and the internal rate of return (for details, see Sozialbeirat (2001), p. 10).

²¹⁵ Steingart (2004a), p. 52.

Ultimately, a more equal sharing of burdens by the generations will also benefit a majority of today's pensioners because this can help prevent the risk that the inter-generational contract will be terminated by the younger generation. One should not ignore the fact that there is a growing incentive for the younger generations to opt out of the compulsory insurance system through migration, bogus self-employment, or moonlighting. The rationale behind this sort of flight from the labour market is the combination of growing pension insurance contributions and the prospect that 'benefit entitlements that are fairly earned through today's contributions ... cannot be realised'.²¹⁶

Principle of legitimate expectations makes inter-generational contract rigid

However, the legal basis of the trust that underlies the inter-generational contract is still not a satisfactory guarantee that entitlements will actually be settled, because even a constitution can be amended if there is a sufficiently large majority. In Germany²¹⁷ and Austria at least, though, the 'principle of legitimate expectations' sets limits on such amendments. According to a ruling by the German Constitutional Court, pensions are protected by the property protection guarantee enshrined in the Basic Law.²¹⁸ However, the constitutional judges do not view this as meaning the absolute unassailability of pension arrangements because they allow Parliament 'a fundamentally far-reaching latitude' in pensions legislation, particularly

where this serves to maintain the proper functioning and efficiency of the state pension insurance systems, to improve them, or to adapt them to changing economic conditions in the interests of all concerned ... Where this serves the purpose of the common good and complies with the principle of reasonableness, Parliament cannot be prevented from cutting benefits, reducing the scope of entitlements or benefits, or restructuring them.²¹⁹

According to rulings by the Austrian Constitutional Court, the constitutional principle of equality²²⁰ binds Parliament to the principles of objectivity and the prohibition on arbitrariness, among other things. Parliament 'must take corresponding account of the aspect of legitimate expectations when changing legal

²¹⁶ Steingart (2004b), p. 80.

²¹⁷ Pension insurance entitlements are afforded special legal protection in Germany (see von Maydell (1998), p. 898).

²¹⁸ 'As assets, pension rights and vested benefits have the key characteristics of property that is protected by the constitution.' (BVerfGE 53, 257, 290).

²¹⁹ BVerfGE 53, 257, 293. The principle of reasonableness means that the evaluation of the admissibility of a certain action that cuts benefits must be measured by the extent to which the rights affected 'are characterized by the personal relationship to the proportion of own contributions by the insured person' (BVerfGE 53, 257, 293). A consequence of this, for example, is that surviving dependents' pensions are afforded less protection than individual old-age pensions, because the former are derivative rights not resulting from the individual's own contributions.

²²⁰ Art. 7(1) B-VG; Art. 2 StGG.

positions'.²²¹ Laws that abolish or amend rights that Parliament has already granted are only constitutional if they can be objectively substantiated. This means that an objectively justified encroachment on existing rights is indeed possible because there is no constitutional protection for vested rights.²²²

However, the Constitutional Court does award 'particular importance' to the principle of legitimate expectations in pensions law. As a rule, the principle of legitimate expectations prohibits 'sudden and far-reaching interference with vested legal positions'.²²³ Specifically in the case of pensions, the principle of legitimate expectations requires meeting the expectation

that retirement will not entail any substantial drop in living standards achieved during working life ... This expectation may not be affected by sudden legislative measures affecting living standards. Any disregard for this expectation will affect pensioners particularly seriously because, as a rule, they cannot adapt after the event to the new circumstances.²²⁴

A strict interpretation of the principle of legitimate expectations that aims to preserve existing structures in the form of a prohibition on any interference with existing pension arrangements whatsoever would rob policymakers of much of the latitude they need for reforms to strengthen the sustainability of the pay-as-you-go system. Trade unions²²⁵ and other employee representative organizations, opposition parties and even parts of the government employed just this rigid interpretation of what is indeed for a constitutional state the indispensable principle of legitimate expectations in their fight against the pension reform presented by the Austrian federal government in the spring of 2003. This pension reform proposed abolishing the early retirement pension due to unemployment²²⁶ or a long period of insurance contributions,²²⁷ increasing the deductions for early retirement,²²⁸ eliminating the first pension adjustment after reaching pensionable age,²²⁹ reducing the extent of pension increases²³⁰ and above all a gradual,²³¹ and in the final stage drastic, increase in the reference period for calculating pension benefits (*Durchrechnungszeitraum*).²³²

²²¹ VfSlg 11288/1987.

²²² See VfSlg 11665/1988.

²²³ VfSlg 12568/1990.

²²⁴ VfSlg 11665/1988.

²²⁵ See Luger (2003), p. 7.

²²⁶ Section 253a ASVG rescinded by Art. 73, Part 2 Z 17 *Budgetbegleitgesetz* 2003.

²²⁷ Section 253b ASVG rescinded by Art. 73, Part 2 Z 18 *Budgetbegleitgesetz* 2003.

²²⁸ Section 261(4) ASVG as amended by Art. 73 Z 22, Part 2 *Budgetbegleitgesetz* 2003.

²²⁹ Section 108h(1) ASVG as amended by Art. 73 Z 4, Part 2 *Budgetbegleitgesetz* 2003.

²³⁰ Section 261(2) ASVG as amended by Art. 73, Part 2 Z 21 *Budgetbegleitgesetz* 2003; the replacement rate for the pension is the same as the percentage that results as the total increase points acquired.

²³¹ Section 607(4) ASVG as amended by Art. 73, Part 2 Z 44 *Budgetbegleitgesetz* 2003.

²³² Section 238(1) ASVG as amended by Art. 73, Part 2 Z 11 *Budgetbegleitgesetz* 2003. The European Commission has expressly praised Austria for prolonging the reference period and cutting the amount of pension increases, but does not address inter-generational allocative effects and contributory equivalence at all, and the time horizon only marginally (see European Commission, Com (2004) 20 final (2004), pp. 52f).

Table 2.3 Pension adjustment indices versus real value maintenance in Austria for 1990–2002

Year	Adjustment index ^a	Contribution base reduction factor ^b	Product of adjustment index and contribution base reduction factor	Inflation rate (%) ^c	Inflation factor based on 2002 ^d
1990	1.288	1	1.29	3.3	1.36
1991	1.231	1	1.23	3.3	1.31
1992	1.182	1	1.18	4.1	1.27
1993	1.136	0.9978	1.13	3.6	1.22
1994	1.109	0.99382	1.10	3	1.18
1995	1.079	0.99385	1.07	2.2	1.15
1996	1.053	0.99495	1.05	1.9	1.12
1997	1.053	0.99652	1.05	1.3	1.10
1998	1.04	0.99653	1.04	0.9	1.09
1999	1.025	0.99656	1.02	0.6	1.08
2000	1.019	0.9966	1.02	2.3	1.07
2001	1.011	0.99662	1.01	2.7	1.05
2002	1	0.99666	1.00	1.8	1.02

^a Section 1 no. 3 Art. I 479. Verordnung, BGBl. II No. 479/2002, 17 December 2002.

^b Section 108(8) ASVG.

^c Consumer price index (see Statistik Austria, 2003a).

^d If 2002 is taken as the benchmark, the inflation factor is the value by which an amount arising in the year in question must be multiplied to preserve the real value.

Increasing this reference period (to what in the final stage will effectively be the entire working life) will by itself have the greatest effect on the pension level due to the low pension adjustment indices,²³³ and, compared with a calculation limited to a certain period of the working life,²³⁴ it is also fairer from the perspective of contributory equivalence. Table 2.3 shows that the pension adjustment indices do not offset the loss in real value due to inflation, and most certainly do not provide for any real rate of return. For example, if an employee retires in 2003, his or her income from 1990 is only adjusted by a factor of 1.29, while accounting

²³³ The historical contribution bases are multiplied by the adjustment index and, for years after 1993, additionally by the contribution base reduction factor. The latter results in a further reduction (increase) if in the calendar year in question, the social security contributions were higher (lower) than in 1992 (see section 108d(4) ASVG).

²³⁴ Section 238 ASVG, in the version of the 'Pre-Budget Support Act 2003', stipulated a calculation limited to the highest 180 contribution months for the standard retirement age, and to the 216 highest contribution months for early retirement. In most cases, this meant that the normally lower starting salaries (compared to final salaries) were ignored, which in turn meant that the low adjustment indices compared with inflation, and particularly compared with capital investments, hardly had any effect at all.

for inflation alone would require a factor of 1.36. This means that younger age groups are going to suffer massive shortfalls because their contribution bases in the first years of their working lives will be practically worthless, since the pension adjustment indices applied to calculating the pension level will be lower than the rate of inflation.

The prime accusations hurled by the above-mentioned interest groups and parties lobbying hard against this pension reform were those of social injustice and breach of the principle of legitimate expectations. In the face of extremely strong trade union resistance by Austrian standards, the government modified its reform plans so that the cuts would not take full effect until 2028. This saw the younger generation (again) shouldering the main burden of the cuts. The 2003 government pension reform bill even envisaged a more pronounced inter-generational unfairness by providing for a diminishing cap on potential pension losses staggered by retirement date.²³⁵ The losses for older workers retiring before the end of 2007 would have been limited to a maximum of 3.5 per cent compared with the former statutory arrangements. For people retiring after 2007 and up to the end of 2015, the losses, to be calculated by a comparative calculation, would have been limited to a maximum of 7 per cent, and for those retiring between 2015 and the end of 2027, to a maximum of 10 per cent. For employees retiring in 2028 and thereafter, the cap would have been abolished in its entirety in one fell swoop, meaning that today's younger employees would have had to expect losses of between 30 per cent and 50 per cent.²³⁶ In the end, though, a general 10 per cent cap was codified in 2003.²³⁷ However, the term of this cap was significantly limited and it was replaced by a diminishing staggered cap as part of a further round of pension reform at the end of 2004; although this did not feature any blatantly discriminatory stages, it did put the older generations in a better position than the 2003 reform. Starting with 5 per cent in 2004, the maximum loss to be established by means of a comparative calculation rises by 0.25 percentage points each year to 10 per cent in 2024.²³⁸

The 2003 pension reform is thus certainly not sustainable and not suited to securing for the long term the willingness of the younger generation to continue paying contributions under the notional inter-generational contract because it represents a massive breach of inter-generational fairness. This reform exacerbated the inherent inter-generational distribution problem to the point where it became an inter-generational conflict that is inherent in the pay-as-you-go system faced with a shrinking or ageing population structure. The allocative decision on scarce financial resources was clearly taken in favour of the older generations. The younger generation will have to pay for it both while that generation is working and when it has retired: first, through higher tax and social security

²³⁵ Section 606(5) ASVG as amended by Art. 74, Part 2 Z 44 *Regierungsvorlage des Budgetbegleitgesetzes* 2003.

²³⁶ See Wolschlagner (2003), p. 70.

²³⁷ Section 607(2)3 ASVG as amended by Art. 73, Part 2 Z 44 *Budgetbegleitgesetz* 2003.

²³⁸ Section 607(2)3 ASVG as amended by Art. 2, Z 99 *Pensionsharmonisierungsgesetz*.

contribution rates, which will hit working people in particular under the present tax and social security system, and second, through significantly lower future state pay-as-you-go pensions compared with the current pension level. There can therefore certainly be no talk of sustainable funding for the reform because this would require

the growing costs of social security in an ageing society being distributed more equally between the generations ... To achieve this means ensuring that the contribution/benefit ratio of the systems does not experience a one-sided shift to the detriment of younger people. A policy that aims to ensure inter-generational equality will only be able to manage the demographic shifts through inter-generational reallocation, i.e. by shifting it in favour of younger people.²³⁹

In the light of these considerations, the European Commission's view that the Austrian reform represents 'an important step towards securing [a] more sustainable pension system'²⁴⁰ seems to have missed the point.

The decision to dispense with short- to medium-term consolidation measures for the state pension system to a large extent means that further cuts can be expected within the foreseeable future. The European Commission, for example, believes that 'the downside ... of the Austrian ... reforms [is that] a long time will be needed before they produce a full positive impact on public finances and labour market performance'.²⁴¹ Appealing to the principle of legitimate expectations will probably become less effective because the picture of the responsible citizen often held up as an ideal cannot be accommodated with a policy that continues to ignore demographically driven structural changes that jeopardize the system. People who have been confronted with a series of (comparatively modest) pension reforms for many years now (and most recently in 1997 and 2000) that increase contributions or cut benefits, and who are also aware of (or at least ought to be aware of) the demographic trends, but who at the same time still have trust in the sustainability of the state pension scheme in its present structure, can hardly expect to be classed as responsible citizens.

Changes in demographic structures

Overview of the problem

In the EU, the first pension pillar is still by far the most common because, on average, EU state pension benefits accounted for well over 80 per cent of pension payments at the turn of the millennium,²⁴² while the figure for Germany was

²³⁹ Federal Ministry of Health and Social Security, Berlin (2003), pp. 5f.

²⁴⁰ European Commission, Com (2004) 20 final (2004), p. 52.

²⁴¹ European Commission, Com (2004) 20 final (2004), pp. 53f.

²⁴² See Pragma Consulting (1999), p. II; European Commission, Com (1997) 283 (1997), p. I, concurs.

between 75 per cent²⁴³ and 85 per cent²⁴⁴ (depending on the source consulted). The long-term goal of many efforts to reform pensions is to expand the second and third pillars of the pension system so as to relieve pressure on pillar one (see Table 2.13, p. 70).

The 'Law on Invalidity and Old-Age Insurance' that came into force on 1 January 1891, under the aegis of Otto von Bismarck, is frequently incorrectly cited as the original model for a pension system designed on a pay-as-you-go basis. In fact, the German pension insurance was originally funded, and was only gradually restructured as a pay-as-you-go system in the wake of the hyperinflation in the 1920s.²⁴⁵ Historically, the way the US social security system – introduced almost half a century later – is financed evolved from funding to pay-as-you-go in much the same way as the German system.

The numerous advantages of the pay-as-you-go method, such as ease of introduction, flexible adaptability either upwards²⁴⁶ or in response to sudden changes, such as a higher-than-expected rise in unemployment²⁴⁷ or, as in the German case, to unification,²⁴⁸ and not least the general inflation-proofing through the linking of pensions to nominal pay increases,²⁴⁹ are offset by serious drawbacks. These are becoming increasingly important²⁵⁰ now that the ability of the pay-as-you-go systems to continue functioning properly is jeopardized by two long-term demographic trends: first, *falling birth rates*,²⁵¹ and second, *rising life expectancy* in the industrialized countries.

Rising life expectancy

Table 2.4 shows that male (female) EU citizens born in 2001 could expect to live for an average of 75.3 (81.4) years. Japan can be seen as a clear indicator that the increase in life expectancy in Europe is far from reaching its limits, as people born there in 2001 were expected to live two and three years longer than in the EU, at 77.6 and 84.2 years.

²⁴³ See BVI (2000d), p. 45.

²⁴⁴ '[M]ore than 80 per cent' (see Börsch-Supan (2000), p. 3); 81 per cent (see Müller (2002), p. 1); 85 per cent (see Goldman Sachs Global (2001), p. 1).

²⁴⁵ See Brunner (2001), pp. 6–8.

²⁴⁶ In practice, the pay-as-you-go system is only really flexible in terms of benefit improvements and enhancements. In Germany at least, and especially in Austria, laws and their interpretation by influential lobby pensioner groups prevent *short-term* benefit cuts. However, the rising old-age dependency ratio makes such cuts increasingly necessary, first to stop inter-generational fairness becoming too lopsided, and second to curb the growth-restraining effect of (in any case already high) rising social security contributions.

²⁴⁷ See Wagner (1998), p. 806.

²⁴⁸ See Rürup (1998), p. 784.

²⁴⁹ Ibid; See also Bulthaupt *et al.* (2001), p. 6.

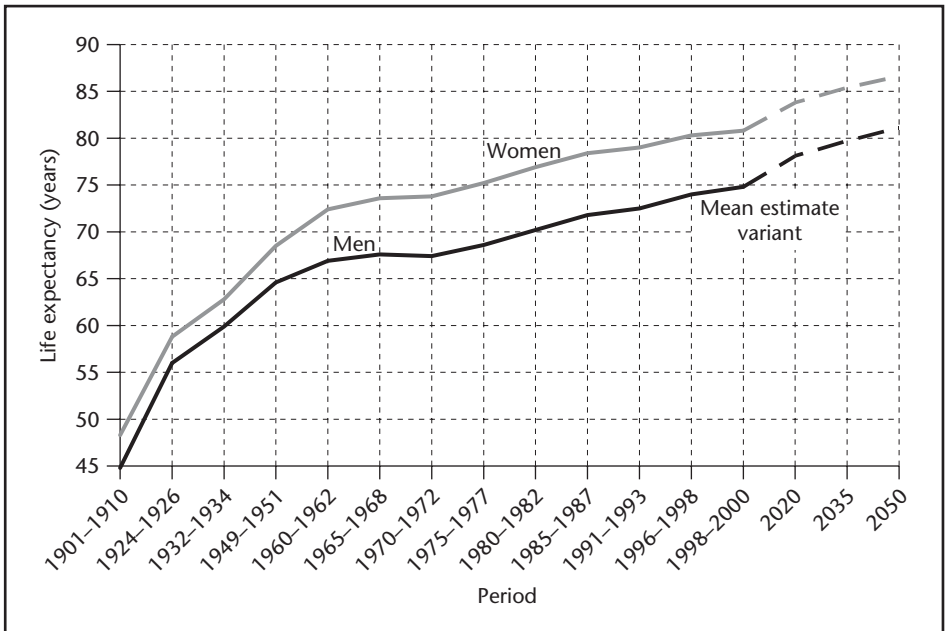
²⁵⁰ See European Commission, Com (1997) 283, 1997, p. 3; or Buttler and Stegmann (1997), p. 21.

²⁵¹ The normal measure used is the composite birth rate, which 'states the average number of children a woman would have during her life if the conditions in the year under analysis were to apply from her 15th to her 49th birthday' (Federal Statistical Office (2003), p. 10).

Table 2.4 Life expectancy at birth in selected countries and the EU in 2001

Country or Region	Men	Women
France	75.5	83.0
Germany	74.8	80.8
Italy	76.7	82.9
Japan	77.6	84.2
Austria	75.4	81.2
UK	75.7	80.4
USA	74.4	80.0
EU 15	75.3	81.4

Source: Federal Statistical Office (2003), p. 17

**Figure 2.3** Development of statistical life expectancy in Germany between 1901 and 2050

Source: Federal Statistical Office (2003), p. 15

A historical analysis of the related trends in Germany is impressive testimony to the positive effects of prosperity and medical progress on statistical life expectancy (see Figure 2.3): at the beginning of the twentieth century, men (women) could only expect to live to the age of 44.8 (48.3), but in the period

immediately following the Second World War, statistical life expectancy had risen by 20 years. In the following 50 years until the new millennium, a further increase by a good 10 years to 74.8 (80.8) was recorded. In its median estimate, the German Federal Statistical Office assumes that the life expectancy of men and women will grow by a further six years in the period up to 2050 compared with 2000, to 81.1 and 86.8 years.

Figure 2.3 indicates the extent of the medium- to long-term pension funding problem. A clear increase in life expectancy that is not accompanied by an increase in the pensionable age (in fact, the retirement age has actually fallen) results in significantly longer pension payments that – all else being equal – could only be met by higher financial resources if the support ratio were actually to *drop*. In reality, of course, the support ratio will actually *increase* significantly.

The changes in life expectancy presented Figure 2.3 are based on ‘period mortality tables’, whose projections are based in turn on present mortality probabilities. However, because diminishing mortality probabilities over time were observed in the past, period mortality tables significantly underestimate actual trends. By contrast, cohort mortality tables claim a higher accuracy of prediction. Instead of being based on present mortality probabilities, cohort mortality tables model future mortality probabilities and thus reach significantly higher results. For Germany, for example, statistical life expectancy for men (women) born in 2000 is 4–5 (5–6) years higher, at 78.3–79.3 (85.6–86.7) years, than the estimates based on traditional period mortality tables.²⁵² In consequence, the projections commonly based on period mortality tables should be seen as conservative estimates of life expectancy. As a result, policymakers and the population should not be misled into thinking that it is more than theoretically conceivable that (period mortality table) estimation tolerances allow any scope for a let-up in the reforms, or even their reversal. In fact, an appreciable increase in the pressure for reform is almost inevitable: that is, contribution hikes, benefit cuts and a growing need for supplementary personal retirement planning will continue in the next few decades. There is some leeway, however, in terms of the extent to which the three reform parameters will change.

The age structure of a population is normally represented graphically by population or age pyramids. This term is misleading in that this form of representation has not resulted in the shape of a pyramid for decades now (although it was at the beginning of the twentieth century), but rather recalls a Christmas tree. For example, the population tree for Germany in 1950 can still be imagined as a pyramid if the age cohorts that were decimated in the Second World War are added back (see Figure 2.4).

The Christmas-tree age pyramid for 2001 clearly shows the sudden drop in birth rates due to the Pill that emerged in the mid-1960s in the cohort of the thirty-somethings (see Figure 2.5). Ultimately, this resulted in the age groups of those born starting in the early 1970s being far smaller than those of the older

²⁵² See Deutscher Bundestag (2002), p. 20.

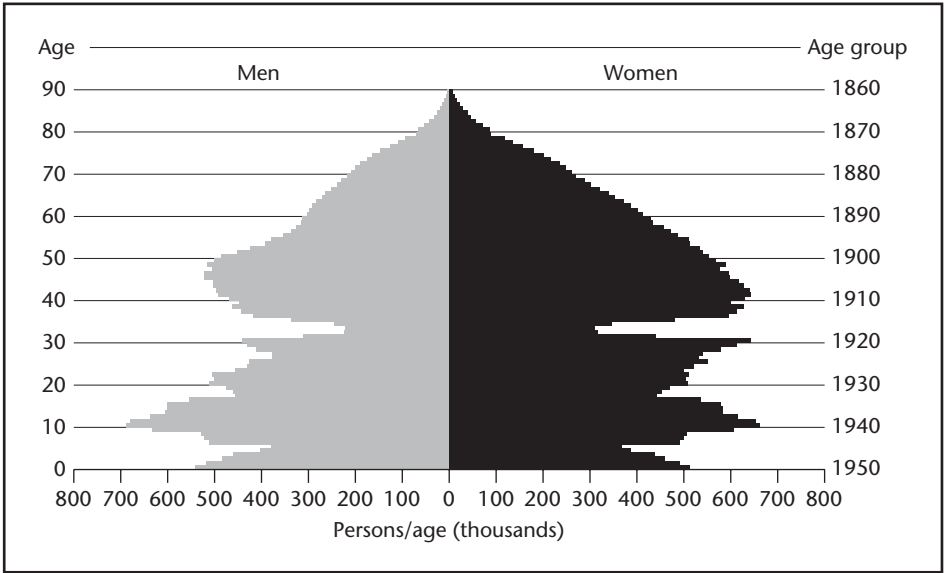


Figure 2.4 Age structure of the German population in 1950

Note: Data extracted from underlying Javascript file for Federal Statistical Office (no date/b)

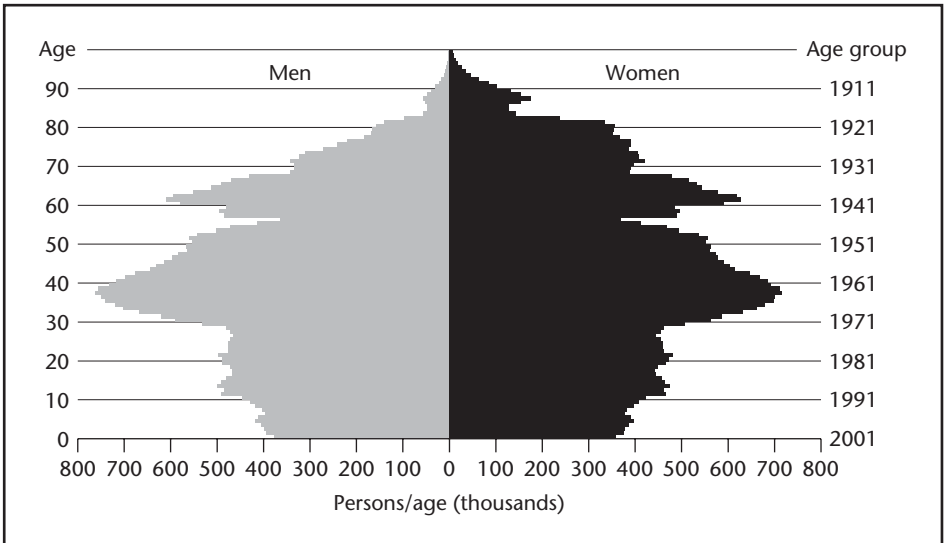


Figure 2.5 Age structure of the German population in 2001

Note: Data extracted from underlying Javascript file for Federal Statistical Office (no date/b)

cohorts for whose retirement provision they (will) have to pay. The projected age pyramid for 2025 (see Figure 2.6) illustrates the predictable crisis: the cohorts in retirement age will mostly be far larger in 2025 than the successor generations still working who are financing their pensions.

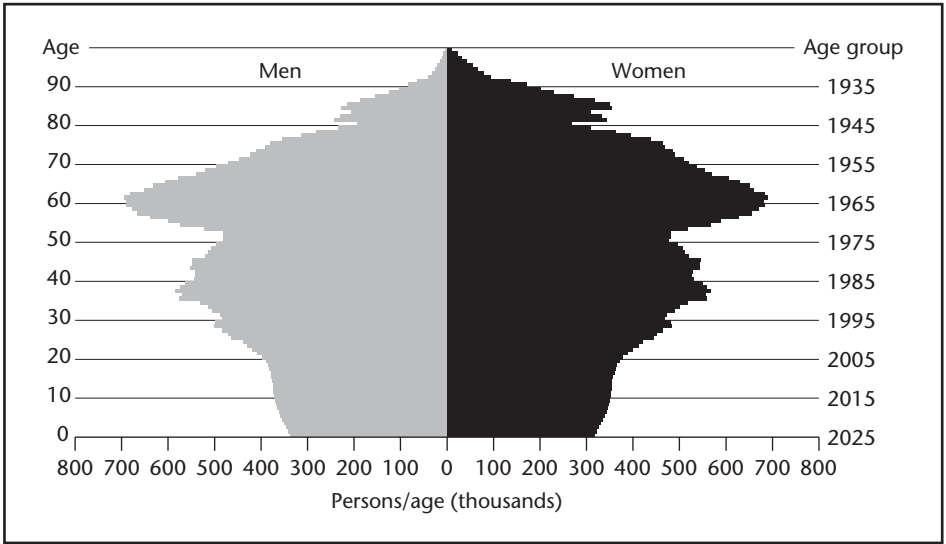


Figure 2.6 Projected age structure of the German population in 2025

Note: Data extracted from underlying Javascript file for Federal Statistical Office (no date/b)



Figure 2.7 Projected age structure of the German population in 2050

Note: Data extracted from underlying Javascript file for Federal Statistical Office (no date/b)

Finally, the age pyramid in 2050 will probably look like a mushroom (see Figure 2.7). The age groups born in 1990 and thereafter are almost all smaller than the corresponding older age groups. Starting at around the cohort of those then aged 30, a further clear acceleration in population shrinkage is evident.

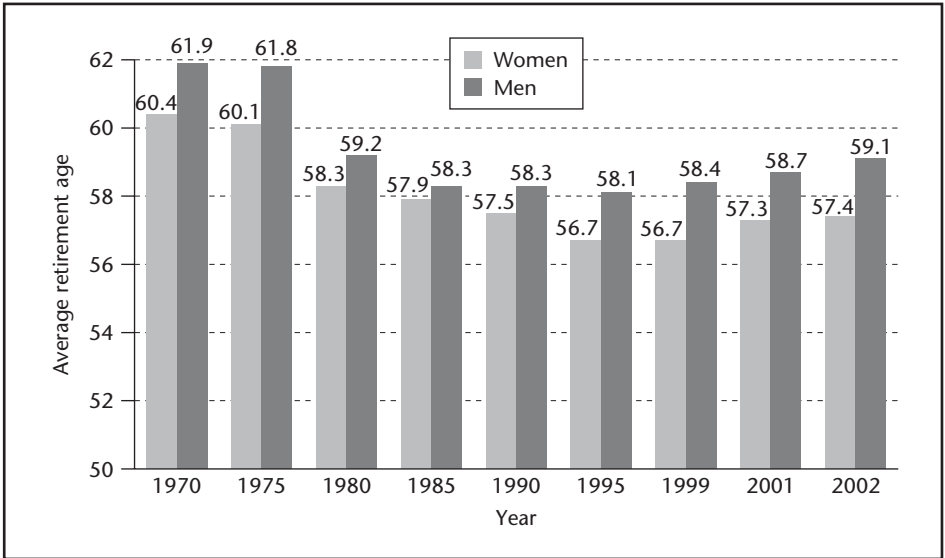


Figure 2.8 Average retirement age of Austrian men and women (excluding civil servants) between 1970 and 2002

Sources: Data for 1970–99: see Wöss (2000), p. 1,002; data for 2001: see Hauptverband der österreichischen Sozialversicherungsträger (2003), p. 23; data for 2002: see Hauptverband der österreichischen Sozialversicherungsträger (no date).

Early retirement

The existing and impending inequalities in the pay-as-you-go system will pose a threat in the long term to social peace and the continuation of the inter-generational contract because the principle of equivalence in contributions and benefits in the social security system will increasingly not apply. For example, today's pensioners enjoy relatively high retirement benefits compared with the contributions they paid, while if the current situation continues, today's contributors will be faced with exactly the opposite situation.²⁵³ This means that it is no longer possible to say that the principle of inter-generational fairness is being observed.

The demographic effects are being amplified by early retirement, which is often sanctioned for short-term employment policy reasons. In Austria, for example, the average retirement age (excluding civil service pensions) for men (women) fell from 61.9 (60.4) to 58.1 (56.7) between 1970 and 1995. There has been a slight rise since then, and in 2002, men retired at an average age of 59.1 and women at 57.4 (see Figure 2.8). The most likely cause of this increase is the rise in the actuarial deductions for early retirement or the premiums if people retire later.²⁵⁴

²⁵³ See Buttler and Stegmann (1997), p. 21.

²⁵⁴ See Federal Ministry of Finance (2001).

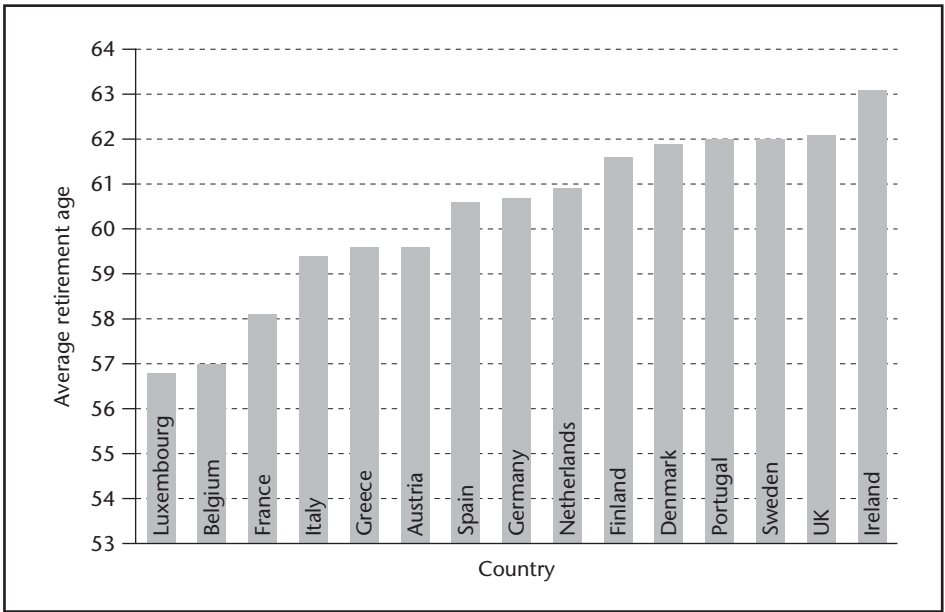


Figure 2.9 Average retirement age in the 15 EU Member States in 2002

Source: European Commission, Com (2004) 24 (2004), p. 92

The European Commission's classification of the average Austrian retirement age of 59.6 in 2002 (see Figure 2.9), which is higher than that of the *Hauptverband der Sozialversicherungsträger Österreichs* (Austrian Association of Social Security Providers: see Figure 2.8), is evidently due to the non-inclusion of civil service pensions by the *Hauptverband*. With an average retirement age of 59.6, Austria is in the lower half of the EU league table and is thus a good year lower than Germany (60.7).

Numerous experts and institutions offer a wide range of differing proposals to solve the problem of an excessively low (effective) retirement age due to continuously rising life expectancies. A selection of these proposals is presented below.

- 1 Joseph Stiglitz (Nobel Prize for Economics) proposed indexing the pensionable age on the basis of (rising) longevity.²⁵⁵
- 2 Klaus Zimmermann, Director of the Institute for the Study of Labour (IZAS) in Bonn and also President of the German Institute for Economic Research (DIW), advocates changing the financial incentives to encourage a longer working life. If this is insufficient, he thinks that it may be necessary to extend the statutory retirement age.²⁵⁶

²⁵⁵ See Hahne (2001).

²⁵⁶ Ibid.

Table 2.5 Retirement age that would be necessary in 2050 in the case of zero immigration between 1995 and 2050 to maintain the same old-age dependency ratio as in 1995 (by country or region)

Country or Region	Retirement age (years)
France	73.9
Germany	77.2
Italy	77.3
Japan	77.0
UK	72.3
USA	74.3
EU	75.7

Source: United Nations Population Division (2000), p. 27

- 3 By contrast, Friedrich Breyer, an economist based in Constance, favours the immediate elimination of all state subsidies that encourage early retirement.²⁵⁷
- 4 A UN study comes to the conclusion that without immigration, the retirement age would have to be lifted to about 75 by 2050 to stabilize the old-age dependency ratio at the level of 1995 (see Table 2.5).
- 5 The Rürup Commission²⁵⁸ 'advocates raising the statutory pensionable age from currently 65 to 67' and believes that the 'awareness that early retirement tends to promote unemployment rather than reduce it because of the associated increase in non-wage costs' is important.²⁵⁹
- 6 The 'Demographic Change' parliamentary commission of inquiry established by the German Federal Parliament at the end of 1999 holds the view that it 'will be necessary in the interests of the long-term ability to fund the statutory pension insurance system to increase the effective and the statutory retirement age'.²⁶⁰

The EU Barcelona Summit makes clear that there is also awareness at European level of the need for urgent action in this respect. During the course of this summit, the EU announced its intention to increase the effective retirement age by 5 years in the period up to 2010.²⁶¹

²⁵⁷ Ibid.

²⁵⁸ The Rürup Commission was established by the Federal Minister of Health and Social Security on 12 Nov. 2002 to 'develop proposals for the sustainable financing and further development of the social insurance system' (Federal Ministry of Health and Social Security, Berlin (2003), p. 23).

²⁵⁹ Federal Ministry of Health and Social Security, Berlin (2003), pp. 7f.

²⁶⁰ Deutscher Bundestag (2002), p. 169.

²⁶¹ See Presidency of the EU Council (2002).

Table 2.6 Actual and forecast birth rates (children per woman) between 1950 and 2050 by country or region

Country or Region	1950–1955	1965–1970	1995–2000	2020–2025	2045–2050
France	2.73	2.61	1.71	1.96	1.96
Germany	2.16	2.32	1.30	1.58	1.64
Italy	2.32	2.49	1.20	1.47	1.66
Japan	2.75	2.00	1.43	1.73	1.75
South Korea	5.40	4.71	1.65	1.90	1.90
Russian Federation	2.51	2.02	1.35	1.70	1.70
UK	2.18	2.52	1.72	1.90	1.90
USA	3.45	2.55	1.99	1.90	1.90
Europe	2.56	2.35	1.42	1.67	1.78
EU	2.39	2.52	1.44	1.45	1.80

Source: United Nations Population Division (2000), p. 23

Low birth rates and increases in support ratio and old-age dependency ratio

Both the UN and the Organization for Economic Cooperation and Development (OECD) believe that the unfavourable birth rate trend will improve in future.²⁶² However, these predictions should not be understood as any all-clear. The German Federal Office of Statistics, for example, adopts a more pessimistic estimate of future fertility when it forecasts a largely constant birth rate in Germany, at 1.4, for the first half of the twenty-first century.²⁶³

Even if there is a trend reversal in the birth rate (as shown in Table 2.6), the pay-as-you-go system will remain at risk: because the birth rate in the EU and Europe has hovered around only 1.4 for a good 30 years now, the pension insurance contribution burden on the age cohort of those currently aged up to just over 30 would not drop even if there were an immediate jump in the birth rate to a value above the reproduction level of 2.1.

Relying on any jump in fertility as a consequence of state support for families to lift the pay-as-you-go system out of its crisis will therefore also be ineffective, at least for the next 30 years or so. At the same time, there are no indicators that would point towards any significant slowdown in the rise of life expectancy. Apart from the resulting pension funding problem, this trend is certainly desirable. This rising life expectancy is also linked to greater personal fitness with age than in the past, which not only makes a large proportion of early retirement cases appear to be increasingly unsustainable, but also makes an increase in the standard pensionable age a reasonable and fair proposition. In the EU, for example,

²⁶² See Taverne (2000), p. 9.

²⁶³ See Federal Statistical Office (2003), pp. 10f.

life expectancy has risen by 8 to 10 years since the 1950s, while the percentage of 60–64 year old men working has dropped over the same period from 80 per cent to 30 per cent.²⁶⁴

A few striking facts from widely differing periods may help demonstrate the extent of these demographic changes: at the start of the Bismarckian pension system in the German Reich in the last quarter of the nineteenth century, only one in six people survived to reach pensionable age. Immediately after the Second World War, British men died on average one year after reaching pensionable age, but today they enjoy 19 years of retirement.²⁶⁵ While there were still four to five working people per pensioner in the EU average at the end of the 1990s, there will only be two in 2040.²⁶⁶

The support ratio (see equation 2.1, p. 30) is a significant measure of the funding status of a pay-as-you-go pension system. In addition to the labour force participation rate, the age when people start work and the pensionable age, the old-age dependency ratio is a significant determinant of the support ratio. Sometimes referred to as the ‘age dependency ratio of the old’, it is calculated as the number of persons of retirement age divided by the number of persons of working age. In the debate on the ability to fund the pension systems, no adequate distinction is often made between the terms old-age dependency ratio and support ratio. What is important is the fact that a rise in the old-age dependency ratio also results in a rise in the support ratio only if all other things are equal.

One of the reasons why the old-age dependency and support ratios do not necessarily develop in parallel²⁶⁷ is that some working age people do not actually work, and that people of pensionable age do not necessarily draw a single pension; some older people have no pension, and others have multiple pensions.²⁶⁸ This opportunity for diverging development of the old-age dependency and support ratios supports the hypothesis that an increase in the labour force participation rate, in particular of women, coupled with a reduction in unemployment, could achieve the sustainable stabilization of the pay-as-you-go system because, all else being equal, a higher labour force participation rate and/or a higher employment rate will cut the support ratio. This would thus avoid more painful parametric reforms, and in particular an increase in the pensionable age and a partial switch to a funded pension system.

However, the historical development of the old-age dependency and support ratios in Austria in the last three decades of the twentieth century can serve as a good example of why such a scenario should be seen more as wishful thinking than as a forecast with a high probability of realization. Between 1970 and 1999, a slight fall in the old-age dependency ratio was accompanied by a strong rise in

²⁶⁴ See Taverne (2000), p. 10.

²⁶⁵ See Pragma Consulting (1999), p. 3.

²⁶⁶ See European Commission, Com (1997) 283 (1997), p. I.

²⁶⁷ See Wöss (2000), p. 1,000.

²⁶⁸ See Guger and Mayrhuber (2001), p. 6.

the support ratio.²⁶⁹ In the light of this, the theory that if the old-age dependency ratio rises sharply in the future, there will then be a strong probability that a drop in the support ratio can be expected, seems rather weak. In the same way, the argument that 'part of the rise in the support ratio could be offset by economic growth coupled with employment growth'²⁷⁰ is not necessarily logical, because the pension lobby can force through pension adjustments linked to economic growth on a more or less regular basis. In the past, economic growth mainly resulted in higher pensions, and not in stable or even falling contribution rates.

In addition to distinguishing between the old-age dependency and support ratios, the distinction between various old-age dependency ratios is important. Because both retirement age and working age (as effective factors) cannot be clearly distinguished, old-age dependency ratios with different age groups appear in the literature. Common ones are the 65/25 (i.e., the ratio of those aged 65 and older to those aged between 25 and 64) and 60/20 old-age dependency ratios. If the old-age dependency ratio is used as an indicator of the long-term ability to fund the pay-as-you-go system, it makes sense to orient the age boundaries on the effective age when people start work and the effective retirement age. Because these age boundaries shift over time – in recent years, people have started working later and taking retirement earlier – the analysis of old-age dependency ratios using a variety of selected age limits appears to be expedient.

Table 2.7 shows the development of the 65/15 old-age dependency ratio for the period 1950 to 2050. It can be seen that, in principle, the demographic trend that is so critical for the pay-as-you-go model also applies to the USA²⁷¹ and Japan.²⁷² Another factor is the persistent high level of unemployment since the mid-1970s, not only in Germany, but across almost all of Europe; this not only reduces contribution income but also increases the pressures on the benefits side, because the number of people taking early retirement due to unemployment has risen sharply.²⁷³ On the other hand, the demographic trends forecast by the UN for the USA over the next few decades differ appreciably from its projections for the EU, with the US population expected to *grow* by 82 million and the EU population expected to *decline* by 41 million.²⁷⁴

²⁶⁹ The reasons given for this trend are a drop in the average retirement age combined with rising longevity, and thus an increase in the average pension discontinuation age (see Wöss (2000), p. 1,001).

²⁷⁰ Guger and Mayrhuber (2001), p. 4.

²⁷¹ There have also been contribution hikes in the US in recent years, but these will not be sufficient to ensure the long-term stability of the system: even if the contributions were to be further increased to 12 per cent of gross earnings, the system would collapse by 2029. In particular the fact that the baby boomers – the largest single group of individuals in US history – will start retiring in the next ten years will put massive strains on the social security system. A number of reforms are under discussion, such as the (partial) conversion of the PAYG system towards a funded system, or the (partial) privatization of the social security system (see GDV, 1998).

²⁷² See European Commission, Com (1997) 283 (1997), p. 1.

²⁷³ See Buttler and Stegmann (1997), p. 4.

²⁷⁴ See United Nations Population Division (2000), Table IV.11, p. 27.

Table 2.7 Old-age dependency ratio^a (for assumed zero immigration after 1995) between 1950 and 2050 by country or region

Country or Region	1950–1955	1965–1970	1995–2000	2020–2025	2045–2050
France	0.17	0.22	0.24	0.35	0.44
Germany	0.14	0.23	0.24	0.41	0.57
Italy	0.13	0.19	0.27	0.42	0.66
Japan	0.08	0.12	0.25	0.45	0.58
South Korea	0.06	0.06	0.09	0.23	0.42
Russian Federation	0.10	0.13	0.18	0.28	0.41
UK	0.16	0.22	0.25	0.34	0.42
USA	0.13	0.16	0.19	0.32	0.39
Europe	0.13	0.18	0.22	0.33	0.49
EU	0.14	0.21	0.25	0.38	0.53

^a Ratio of over 64-year olds to the 15–64-year olds.

Source: United Nations Population Division (2000), p. 23

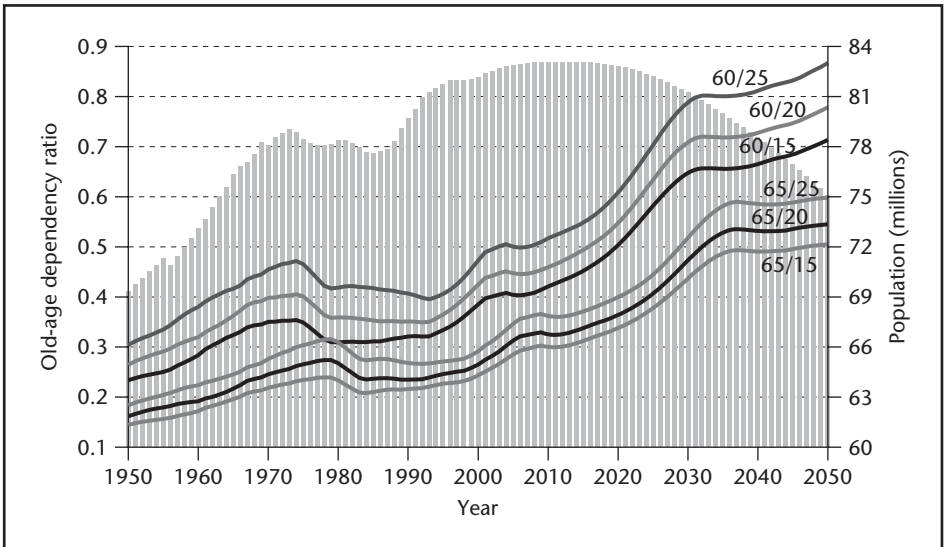


Figure 2.10 Development in Germany of old-age dependency ratios when different parameters are applied and of the population as a whole between 1950 and 2050

Source: Own calculations based on the data extracted from the Javascript file of the Federal Statistical Office (no date/b)

Figure 2.10 shows both the historical and (as a continuation) the forecast development of old-age dependency ratios for Germany when different parameters are applied. The 65/15 old-age dependency ratio corresponds to the one used in Table 2.7 in terms of the selected age limits. What is clearly evident is that all

of the old-age dependency ratios relevant for the ability to fund the pay-as-you-go method display the same trend. Depending on whether the retirement age is assumed to be 60 or 65, the negative trend starts five years earlier or later. Because the statutory or effective pensionable age²⁷⁵ is likely to rise in the future, but an increase in the average vocational training period is also expected, the 65/20 old-age dependency ratio is more suited to assessing the future situation, although the 60/15 old-age dependency ratio is likely to be more relevant at present. The 65/20 old-age dependency ratio rises from 0.16 in 1950 through 0.30 in 2004 to 0.53 in 2035, and then increases again slightly to 0.55 by 2050. Because of the lower underlying pensionable age, the 60/15 old-age dependency ratio is higher across all periods. It was 0.23 in 1950, and rose to 0.41 by 2004. It is expected to climb to 0.66 in 2032, before rising again slowly starting in 2040 to reach 0.71 in 2050.

This prediction is based on the following progression in the population development: the current overall German population level of 83 million or so will remain stable until around 2015, and will then decline continuously to approximately 75 million in 2050.²⁷⁶ The temporary plateauing of the old-age dependency ratio just before the turn of the millennium in Figure 2.10 is particularly striking. Depending on the retirement age used, the old-age dependency ratio between around 2000 and 2010 or 2005 and 2015 remains stable at a level of approximately 0.45 or 0.35. This 10-year phase is termed the 'demographic pause' because there is no direct exacerbation of the age structure relevant to pension insurance in this time window. This temporary stabilization of the situation certainly represents a political challenge in this respect because there will be a temptation to suspend reforms perceived to be unpopular, or to dilute them to the point of ineffectiveness. The demographic pause is then followed by a significant rise in the old-age dependency ratio, which will climb by more than 60 per cent over the following 20 years.

Benefit cuts and contribution hikes

Equation 2.1 (p. 30), which illustrates the connection between the level of the contribution rate, the old-age dependency ratio and the pension level, shows that if the pay-as-you-go system is retained in a scenario in which the old-age dependency ratio²⁷⁷ is on the up, there are essentially only two – both unpleasant – future

²⁷⁵ The successive bringing forward of the effective retirement age since the 1970s, termed 'deprofessionalization of old age' (see Deutscher Bundestag (2002), p. 48) must be stopped and ultimately reversed.

²⁷⁶ This development is based on the median assumptions on longevity trends and net immigration (average 200,000 persons/year); see Federal Statistical Office (2003), pp. 25f.

²⁷⁷ The support ratio is determined primarily by the old-age dependency ratio; provided that the labour force participation rate remains unchanged, the support ratio and old-age dependency ratio change proportionally.

prospects, namely either *contribution hikes*²⁷⁸ or *benefit cuts*.²⁷⁹ Lower benefits take the form of either lower pension payouts or a later pensionable age.²⁸⁰ Contributions have already been increased in many EU countries, so there is now an increasing trend towards cutting back benefits. However, 'international comparisons show that encroaching on pension rights almost always hits those who have built up pension entitlements, and only rarely means cutting existing benefits'.²⁸¹ As a result, the burdens associated with reforming the pension systems have so far been imposed only on those generations still working – and in particular on the young age groups – although one of the major causes of the crisis in the pay-as-you-go model, the low birth rate (since around the mid-1960s), is attributable to a significant extent to age groups that have already retired or are about to do so.

Benefit cuts have been pioneered by the United Kingdom. After the election of Margaret Thatcher as Prime Minister in 1979, Westminster passed a large number of laws cutting benefits over the following years: for example, the Social Security Act 1980 pegged pension increases to inflation rather than wages. A decision was also taken to align the retirement age for women with that of men by 2020. The Social Security Act 1986 featured a bundle of measures – including cutting the state supplementary pension from 25 per cent to 20 per cent of the calculation basis,²⁸² a lifetime income calculation starting in 2009, and a 2 per cent reduction in top-up factors – that reduced state supplementary pension benefit levels by two-thirds.²⁸³

Contribution rates cannot be further increased arbitrarily because, all else being equal, a higher contribution burden adversely affects employment and economic growth. Each increase in pension insurance contributions pushes up non-wage costs and thus amplifies the incentive to substitute capital for labour. From the perspective of working people, each increase in contributions and taxes reduces the incentive for (additional) work and thus boosts the shadow economy and (official) unemployment. In turn, the resulting deterioration in the old-age dependency ratio snowballs, prompting further contribution hikes by reducing the number of contribution payers.

²⁷⁸ In Germany, the pension provision burden was increased dramatically not only by contribution increases, but also by increases in the income threshold for contribution assessment. The threshold was still only €39,881 in 1991 (see Buttler and Stegmann (1997), pp. 2f), but had risen to €54,000 by 2002 (see von Rosen (2001), p. 79).

²⁷⁹ In recent years, effective pension cuts were made in Germany (but these were reversed by the Old-Age Income Supplementary Act in early 2001) and in Italy by pegging the level of pensions to price rather than wage inflation, by changing the pension calculation basis as in France and Italy, or by changing the reference period (see Taverne (2000), p. 15).

²⁸⁰ For measures increasing the de facto pensionable age in Germany, Italy, the Netherlands and France, see Taverne (2000), pp. 14f.

²⁸¹ Grünwald, Url, Zeilhofer, Hoskovec, Schiendl and Bittner (2003), p. 41.

²⁸² The calculation basis is the band of earnings between the lower earnings limit (LEL) and the upper earnings limit (UEL) for the state supplementary pension insurance. For 2002/2003, the LEL and UEL were £75 and £585 per week.

²⁸³ See Blake (2003), p. 3.

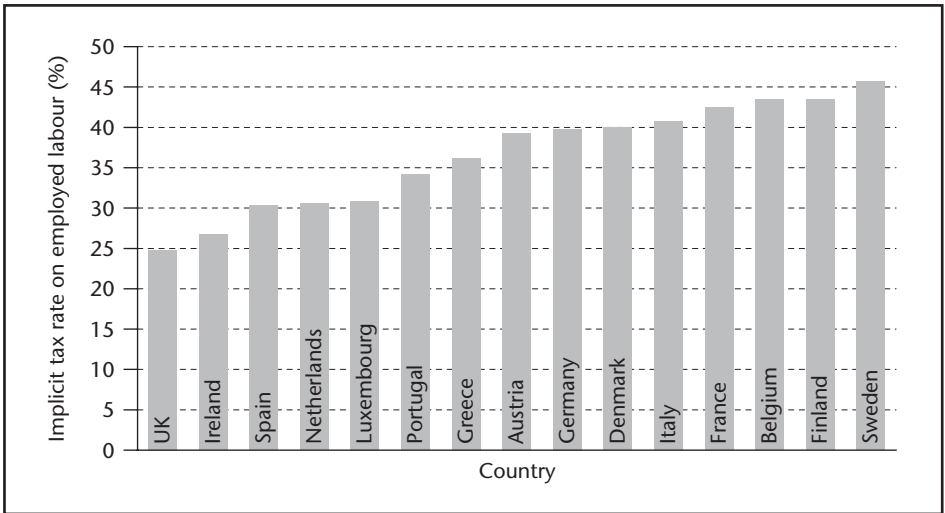


Figure 2.11 Implicit tax rate on employed labour in the 15 EU countries in 2002

Source: European Commission, Com (2004) 24 (2004), p. 97

The implicit tax rate on employed labour, measured as the 'ratio of total taxes on employed labour (personal income taxes plus employees' and employers' social security contributions plus payroll taxes) divided by the total compensation of employees plus payroll taxes',²⁸⁴ has now reached such a high level in a good half of EU Member States that cuts in the burden appear to be urgently needed to increase structural employment. With an implicit tax rate of 39.3 per cent, Austria is slightly better off than Germany, where it is 39.8 per cent. The range of implicit tax rates in the EU 15 is quite impressive: the UK has the lowest at 24.8 per cent, while Sweden holds pole position with 45.7 per cent (see Figure 2.11).

Developments in both Germany and Austria show that during the post-war period, successive increases in the pension contribution rate have resulted in a significant increase in the retirement provision burden. Table 2.8 shows that the German contribution rate for the state pension scheme introduced in 1957 on a pay-as-you-go basis has risen from 14 per cent to 19.5 per cent in 2003; in other words by just on 40 per cent. However, this does not adequately reflect the burden on the population, because this direct contribution rate is accompanied by an indirect contribution rate in the form of the taxes hypothecated for pension insurance (part of value added tax revenue and, since April 1999, the eco-tax). Because the contributions to the statutory pension insurance are not sufficient by themselves to cover the corresponding pension entitlements (the percentage cover was only 75.4 per cent in 2001, 76 per cent in 1999, and 76.5 per cent in 2000²⁸⁵), the difference has to be met from tax revenue by what is known as the

²⁸⁴ European Commission, Com (2004) 24 (2004), p. 115.

²⁸⁵ See Federal Government of the Federal Republic of Germany (2002), p. 60.

Table 2.8 Changes in contribution rates to the statutory pension scheme^a as a percentage of gross wages/salaries in Germany^b

Year(s)	Contribution rate	Year(s)	Contribution rate
1957–67	14.0	1993	17.5
1968	15.0	1994	19.2
1969	16.0	1995	18.6
1970–72	17.0	1996	19.2
1973–80	18.0	1997–31 March 1999	20.3
1981	18.5	From 1 April 1999	19.5
1982–31 August 1983	18.0	2000	19.3
1 Nov. 1983–84	18.5	2001	19.1
1985	18.7	2003	19.5
1 June 1985–86	19.2	2015	19.0–27.0 ^c
1987–31 March 1991	18.7	2030	22.1–36.6 ^c
1 April 1991–92	17.7		

^a As a percentage of gross earnings, with employee and employer each paying half.

^b In 1998, an increase to 21 per cent was only avoided by an increase in value added tax that was used to increase the federal subsidy paid to the social security funds (see Buttler and Stegmann (1997), p. 2).

^c Bandwidth from four estimation models (see GDV (1997), p. 183).

Source: See GDV (1997), pp. 182f and Martin Hentrich Software, (2003)

‘federal subsidy’.²⁸⁶ Measured by the aggregate of the direct and the indirect contribution rate, the ‘implied contribution rate’, there was actually an increase of approximately 50 per cent between 1957 and 2000.²⁸⁷

Contribution rate growth in Austria mirrored that in Germany to a large extent, although the burden was generally 2 to 3 percentage points higher than in Germany. Table 2.9 shows that, based on a contribution rate of 11 per cent in 1955, it grew successively until it had doubled to 22.8 per cent. In contrast to Germany, the 50 per cent contribution split between employer and employee changed at the end of 1977, when it increasingly became largely employer-financed, so that at present, 55 per cent of the contribution rate of 22.8 per cent is paid by the employer and 45 per cent by the employee.

A remarkable feature of the Germany/Austria comparison is that the German contribution level of just short of 20 per cent produced (and continues to produce) much fiercer political controversy than the Austrian contribution level, which is some 15 per cent higher. A contribution rate of 22.8 per cent would be illegal in Germany because, as part of the Riester pension reform, the German Parliament

²⁸⁶ However, the federal subsidy is not so much a benefit paid to regular pensioners, but rather compensation paid to the state pension insurance system for making non-pension payments.

²⁸⁷ See Börsch-Supan (2000), p. 1.

Table 2.9 Change in the contribution rate to the state pension insurance scheme for salaried employees as a percentage of total gross compensation^a plus special payments^b in Austria

Year(s)	Contribution rate	Year(s)	Contribution rate
from 1955	11.0 ^c	1 Jan. 1980–31 Dec. 1980	20.5 ^d
1 Jan. 1967–30 June 1968	16.0 ^e	1 Jan. 1981–31 Dec. 1983	21.1 ^f
1 July 1968–30 June 1970	16.5 ^e	1 Jan. 1984–31 Dec. 1984	21.7 ^g
1 July 1970–31 Dec. 1976	17.0 ^e	1 Jan. 1985–31 Dec. 1987	22.7 ^h
1 Jan. 1977–31 Dec. 1977	17.5 ⁱ	Since 1 Jan. 1988	22.8 ^j
1 Jan. 1978–31 Dec. 1979	19.5 ^k		

^a Section 49(1) ASVG.

^b Social security contributions are also payable on special payments, normally in the form of Christmas and holiday bonuses (section 49(2) in conjunction with section 54(1) ASVG).

^c Section 51(1) no. 3 (b) ASVG in the version BGBl. (Federal Gazette) no. 189/1955; payable 50/50 by employer and employee (section 51(3) no. 3 (b) ASVG in the version BGBl. (Federal Gazette) no. 189/1955).

^d Increase in the supplementary pension insurance contribution rate to 3 per cent (1 percentage point employee, 2 percentage points employer; section 51a(1) ASVG in the version Art. I no. 13 BGBl. (Federal Gazette) no. 530/1979), with the general contribution rate remaining unchanged.

^e See Federal Ministry of Labour, Health and Social Affairs (1998).

^f Increase in the supplementary pension insurance contribution rate to 3.6 per cent (1 percentage point employee, 2.6 percentage points employer; section 51a(1) ASVG in the version Art. I no. 16 BGBl. (Federal Gazette) no. 585/1980), with the general contribution rate remaining unchanged.

^g Increase in the supplementary pension insurance contribution rate to 4.2 per cent (1 percentage point employee, 3.2 percentage points employer; section 51a(1) ASVG in the version Art. I no. 2 BGBl. (Federal Gazette) no. 590/1983), with the general contribution rate remaining unchanged.

^h Increase in the general pension insurance contribution rate from 17.5 per cent to 18.5 per cent (section 51(1) no. 3(b) ASVG in the version Art. I no. 6 BGBl. (Federal Gazette) no. 484/1984), with the supplementary contribution rate remaining unchanged.

ⁱ Section 51(1) no. 3(b) ASVG in the version BGBl. (Federal Gazette) no. 704/1976; payable 50/50 by employer and employee (section 51(3) no. 3(b) ASVG).

^j Increase in the supplementary pension insurance contribution rate to 4.3 per cent (1 percentage point employee, 3.3 percentage points employer; section 51a(1) ASVG in the version Art. I no. 17 BGBl. (Federal Gazette) no. 609/1987), with the general contribution rate remaining unchanged.

^k Introduction of the 'supplementary pension insurance contribution': the general pension insurance contribution rate of 17.5 per cent has not been increased since then except in 1984 (to 18.5 per cent). Instead, successive increases in the supplementary contribution led to an increase in the effective contribution rate. The general contribution rate is paid 50/50 by employee and employer, but the majority of the supplementary contribution must be paid by the employer. 19.5 per cent results from 17.5 per cent general contribution rate plus 2 per cent supplementary contribution (0.5 percentage points employee, 1.5 percentage points employer; section 51a(1) ASVG in the version Art. I no. 2 BGBl. (Federal Gazette) no. 648/1977).

introduced a 20 per cent (22 per cent) cap until 2020 (2030: see remarks on the Riestler pension products, p. 82). This means that since 1988, the Austrian contribution rate has been at a level German politicians think is only acceptable for the period after 2030. Because Austrian and German demographic trends are largely similar, this allows the conclusion to be drawn that the Austrian contribution rate will continue to be significantly higher than the German rate in the future; similarly, an unacceptably high contribution burden, especially on the younger generation, will be reached several years, or even decades, sooner in Austria than

in Germany. Because this means that additional contribution hikes will produce an unsustainable level more quickly in Austria than in Germany, the probability of further significant benefit cuts in the Austrian pay-as-you-go system is higher than in its German counterpart, because the pay-as-you-go model can only be managed through the two parameters of the contribution rate and the level of benefits.

Impact of an ageing society on the labour market

One line of argument against extending funded supplementary pension systems is based on the hypothesis that starting in around 2020, the demographic ageing process means that there will be a labour shortage, producing a return to full employment and thus an opportunity for restoring funding for the social security systems to a sustainable basis.

There are indeed grounds for hoping that pressure on the labour market may well be eased in the future. In Germany, the number of working-age people (considered to be the age group between 20 and under 60) will be 1²⁸⁸ to 4²⁸⁹ million lower in Germany in 2020, and 10²⁹⁰ to 18²⁹¹ million lower in 2050, than in 2002, when this age group numbered 45.35²⁹² million. Although such predictions 'on the development of the labour supply are relatively well-founded',²⁹³ the figures shown above highlight the fact that the simulation outcomes of different models or of identical models with different parameters may produce considerable variations. Of the various determinants of the labour supply, only the birth rate is predictable with a high degree of accuracy, while the predictions on migration and labour force participation are subject to considerably greater uncertainties.²⁹⁴ This makes the fact that 'demand for labour is considerably more variable because it depends on such shifting factors as the level and structure of consumer demand, technological progress, labour force productivity, the cost of capital (interest rates) and labour costs (wage costs, non-wage costs, regulatory costs)'²⁹⁵ all the more significant. This makes a scenario conceivable in which a sharply rising support ratio results in a significant increase in non-wage costs, and an increase in the average age of the working population leads to higher wage costs because of the principle of seniority, and/or demand for capital falls because part of the capital stock has become obsolete due to population shrinkage,²⁹⁶ which in turn (all else being equal) would see interest rates drop, making substitution of labour by

²⁸⁸ Own calculations based on the records from: Javascript file for Federal Statistical Office (no date/b).

²⁸⁹ Forecast by German Institute for Economic Research (DIW), scenario with lower immigration (average 140,000 net additions p.a.) and increase in labour force participation rate up to 2020 by around 2 percentage points, and then remaining constant until 2050 (see Deutscher Bundestag (2002), pp. 68f).

²⁹⁰ See n. 288.

²⁹¹ See n. 289.

²⁹² See n. 288.

²⁹³ Deutscher Bundestag (2002), p. 81.

²⁹⁴ See Deutscher Bundestag (2002), p. 75.

²⁹⁵ Deutscher Bundestag (2002), p. 82.

²⁹⁶ See Deutscher Bundestag (2002), p. 76.

capital more attractive. As a result, the supply-side effect would be largely eroded by a demand-side effect tending in the same direction.

This illustrates that the foreseeable decline in the labour supply will not necessarily be accompanied by largely unchanged demand for labour. For this reason, corresponding simulations should document these naturally occurring underlying restrictions sufficiently clearly instead of asserting some sort of dogmatic truths, even though there are fundamental stochastic parameters that entail a considerable degree of uncertainty.

In the light of the miserable employment situation in recent years, the prediction for Austria by Guger and Mayrhuber, for example, of 'surplus demand on the labour market'²⁹⁷ and the associated dampening effect on the rise in the support ratio appears to be highly optimistic at present. A successive drop in unemployment to 3.5 per cent in 2015 and then to as low as 1.3 per cent in 2030,²⁹⁸ accompanied by a simultaneous rise in labour force participation,²⁹⁹ should therefore be viewed with scepticism. The authors themselves, for example, point to the considerably more pessimistic forecast in the report by Rürup and Schröter³⁰⁰ commissioned by the Federal Ministry of Labour, Health and Social Affairs, which assumes 4 per cent unemployment for 2030, but view its results as 'considerably underestimating the employment dynamics',³⁰¹ albeit without any more detailed examination of the problem of uncertain stochastic parameters.

Apart from the fact that the effects of demand for labour are ignored, even the sort of full employment scenario that lies at the heart of the Guger and Mayrhuber simulation model is not able to give the all-clear for the pay-as-you-go system because all it can do is reduce the rise in the support ratio, rather than stop it. Even if there is a clear increase in the employment and labour force participation rate, the support ratio will rise by just on 20 per cent between 1999 and 2015, and by a good 42 per cent by 2030.³⁰²

Old-age provisions and parenting

As the low birth rate is a major cause of the long-term funding problems for state pension schemes, there are often calls to stagger pension insurance contributions depending on the number of children per insured person. An argument in favour of cutting contributions for workers with many children is that as potential future contribution payers, these children always benefit all future pensioners, including those without children, whereas the substantial costs of bringing up children largely have to be borne by the parents. To a certain extent, the costs associated with children are privatized, while their (future) benefits are socialized.

²⁹⁷ Guger and Mayrhuber (2001), p. 1.

²⁹⁸ See *ibid.*, p.11.

²⁹⁹ See *ibid.*, p. 14.

³⁰⁰ Rürup and Schröter (1997).

³⁰¹ Guger and Mayrhuber (2001), p. 19.

³⁰² See *ibid.*, p. 14.

However, there are many arguments against staggering contributions by the number of children. In particular, the implication that children are conceived primarily to maintain social security systems and that the parents should somehow be compensated financially to a significant extent for something that mainly benefits society as a whole seems to ignore social reality. In fact, in those industrialized countries that have been hit by the pay-as-you-go pensions crisis, the desire to have children is generally linked to other motives that have nothing to do with pensions insurance. After all, there is more to parenthood than merely burdens, as it also serves above all to fulfil emotional needs. Leaving aside such considerations, which are in any case almost impossible to quantify, there is also a range of much sounder arguments against discriminating against people with no or few children in terms of pension insurance contributions, and these were advanced by the Rürup Commission when it gave the following grounds for its rejection of staggering contributions by the number of children.³⁰³

- 1 Pension insurance is just one of many social areas – albeit an important one – that is being hit by an ageing population. Measures to encourage people to have children should therefore be funded primarily from tax revenue, otherwise individuals who are not members of compulsory pension insurance schemes and who have few or no children do not share the burden of population ageing, while those with many children are hit excessively hard.
- 2 Statutory pension insurance is generally based on the principle of participatory equivalence.³⁰⁴ If people with few or no children were to receive lower state pension benefits than people with many children, although they paid the same contributions, this principle would be violated. There would then be no fair relation between the benefits and the contributions paid to acquire those benefits. Based on the constitutional rulings on the property protection guarantee for pensions (and pension entitlements), the rights of people with many children would be less protected in future because their personal contributions would be relatively lower. Ultimately, such a sliding scale for contributions could actually prove to be disadvantageous for those intended to benefit from it if any need to make savings in future were again to result in cuts in benefit entitlements.³⁰⁵
- 3 Staggering contributions by the number of children would lead to redistribution from lower to higher incomes – something that would certainly lead

³⁰³ See Federal Ministry of Health and Social Security, Berlin (2003), pp. 114–16.

³⁰⁴ There are exceptions to the underlying principal of participatory equivalence, for example in the case of minimum pensions, which provide a disproportionately high pension benefit compared with the contributions paid. There is no contributory equivalence, because the same benefit does not necessarily result from the same contributions. However, the system of earnings points (see equation 2.2, p. 84) ensures that identical benefit entitlements are acquired for contributions paid at the same time. ‘Contributory and participatory equivalence diverge whenever, all else being equal, there is a change in the contribution rate’ (Köhler-Rama (2003), p. 3).

³⁰⁵ For the justification behind the different levels of property protection, see n. 219, p. 34.

to acceptance problems in the population – because the contribution rate is a percentage of income up to the income threshold for contribution assessment. Any percentage reduction in the contribution therefore has a greater effect in absolute terms on people with many children in higher income brackets than on low-income earners. The principle that each child should be worth the same to the state would therefore be impossible to satisfy.

In addition, the family tax credit (*Familienlastenausgleich*) is already an element of both the social security and tax system, and of the system of transfer payments, with the result that somewhere between one-third and one-half of childcare costs are subsidized by the (German) state.³⁰⁶

- 1 The social security system enables earnings points to be credited for child-raising periods,³⁰⁷ state subsidies for Riester pension products are governed by the number of children, among other factors, and children are generally co-insured free in the statutory health insurance system.³⁰⁸
- 2 In addition to a choice between child benefit³⁰⁹ or child tax allowance,³¹⁰ there are other tax breaks for families with children.³¹¹
- 3 As part of the system of real transfers, childcare facilities are funded in some cases, but at any event schools and universities are funded by tax revenue. Monetary transfers by the various local, regional and national authorities generally provide for premiums for children.³¹²

Impact of retirement provision on national budgets

Another conceivable option for solving the funding problem for the pay-as-you-go system is to increase government spending, but public spending in the EU is

³⁰⁶ Family support measures amounted to an estimated almost €181 billion in 2001. This produces a support ratio for childcare costs of just on 47 per cent. Factoring in parents' own contributions to the support measures, the support ratio is around one third. (Rosenschon (2001), pp. 42–5.)

³⁰⁷ Section 70(2) SGB 6.

³⁰⁸ Section 10 SGB 5.

³⁰⁹ Section 25 SGB 1.

³¹⁰ The question of whether a child allowance can be claimed in addition to the child benefit is decided by the tax authorities, who assess what would be most advantageous to the taxpayer (section 31 EStG).

³¹¹ Rosenschon (2001), pp. 2–9, describes the following as additional privileges for people raising children: education allowances, household allowance, child component of homebuyers' allowance, maintenance allowance, allowance for employing a domestic help, or for placing the child in a children's home and reduced reasonable costs.

³¹² *Ibid.*, pp. 29–41, lists, among other things, the child components of secondary unemployment benefit, social security benefit and the housing allowance, as well as the education allowances paid by the *Länder* and the family allowances paid to public service workers. Expenditure on schools, kindergartens, transport for schoolchildren and reduced prices and fees are also classified in this category.

already very high³¹³ and the Maastricht Treaty and the subsequent Growth and Stability Pact demand strict budgetary discipline. Any Member State breaching these agreements because of excessive budgetary deficits would trigger higher inflation which would then be 'exported' to other Member States in the euro zone, making intervention by the European Central Bank inevitable in the form of a higher discount rate. Long-term interest rates would also rise on the back of a risk premium on euro-denominated bonds. Higher interest rates depress capital investment and consumer spending, thus reducing economic growth and increasing unemployment across the entire euro zone, including those countries that pursue a responsible fiscal policy.³¹⁴

Immigration

Higher immigration is sometimes cited as a more or less painless alternative to restructuring the financial burdens of the pay-as-you-go system. As an alternative to both extending pillar 2 and pillar 3 pensions and to increasing contributions and/or cutting benefits, there are calls to liberalize the highly restrictive immigration laws in most EU Member States. There is a suggestion that immigrants will rejuvenate the age structure, restoring the old-age dependency ratio to a level that will sustain the ability to finance old-age pensions.

Models developed for a UN study on replacement migration examined the question of the extent to which immigration represents a workable solution up to 2050 for the (pay-as-you-go) pension system in industrialized countries threatened by adverse demographic trends.³¹⁵ The key findings of this study (shown below) indicate that immigration cannot by itself solve the crisis of the pay-as-you-go system.³¹⁶

- 1 During the first half of the twenty-first century, the populations of most of the countries and regions surveyed will shrink and get older (Table 2.10 shows that the percentage population decline in the individual EU countries will be up to 28 per cent, in the case of Italy, between 2000 and 2050) because of 'below-replacement fertility' (i.e., fewer than 2.1 children per woman,³¹⁷ see Table 2.6) and increased longevity (Table 2.10 also shows that the number of people aged 65 and above in the individual EU countries will rise by between 53 per cent in Sweden and 117 per cent in Spain by 2050). The notion of using immigration

³¹³ According to a study by the European Commission, the ratio of pension payments to GDP will grow to 15 per cent to 20 per cent in a number of Member States, including Germany, from the average of 10 per cent at the end of the 1990s (see European Commission, Com (1997) 283 (1997), p. 1).

³¹⁴ See Taverne (2000), pp. 18f.

³¹⁵ The study covered the following countries and regions: France, Germany, Italy, Japan, South Korea, Russia, UK, USA, Europe and the EU.

³¹⁶ See United Nations Population Division (2000), p. 4.

³¹⁷ See United Nations Population Division (2000), pp. 6f.

Table 2.10 Change in population and in the proportion of the total population aged 65 years or older for the EU countries that must expect a shrinking population between 2000 and 2050

Country	Population (in thousands)		Population decline		Proportion 65 years or older		Increase in persons aged 65 years or older (%)
	2000	2050	in thousands	%	2000	2050	
Austria	8,211	7,094	-1,117	-14	15	30	106
Belgium	10,161	8,918	-1,243	-12	17	28	65
Denmark	5,293	4,793	-500	-9	15	24	59
Finland	5,176	4,898	-278	-5	15	26	72
Germany	82,220	73,303	-8,917	-11	16	28	73
Greece	10,645	8,233	-2,412	-23	18	34	92
Italy	57,298	41,197	-16,101	-28	18	35	92
Luxembourg	431	430	-1	0	14	27	84
Netherlands	15,786	14,156	-1,629	-10	14	28	104
Portugal	9,875	8,137	-1,738	-18	16	31	99
Spain	39,630	30,226	-9,404	-24	17	37	117
Sweden	8,910	8,661	-249	-3	17	27	53
UK	58,830	56,667	-2,163	-4	16	25	56

to rejuvenate a population centres around the belief that the age structure of immigrants tends to be younger than the population of the host country. However, research for the USA comes to the conclusion that the 'rejuvenating' effect of immigration on the population there is only minimal.³¹⁸

- 2 Although birth rates may pick up again in the coming decades, it is highly unlikely that they will return to replacement levels. Moreover, measures to increase fertility in the short to medium term (roughly in the 20 years following the introduction of the measures) have no effect on the old-age dependency ratio.
- 3 The USA and the EU will be able to maintain stable populations during the period under review with a level of immigration comparable³¹⁹ to that of recent years.³²⁰ For the EU, this prediction applies in particular to France and the UK. In the case of Germany, it should be noted that immigration levels in recent years cannot be seen as being representative of the long-term trend because

³¹⁸ See United Nations Population Division (2000), pp. 10f.

³¹⁹ For details of immigration between 1990 and 1998, see Table A1 in the Appendix to this chapter.

³²⁰ See Scenario A in Table A2 (for cumulative net migration up to 2050) and Table A3 (for average annual net migration up to 2050) in the Appendix to this chapter.

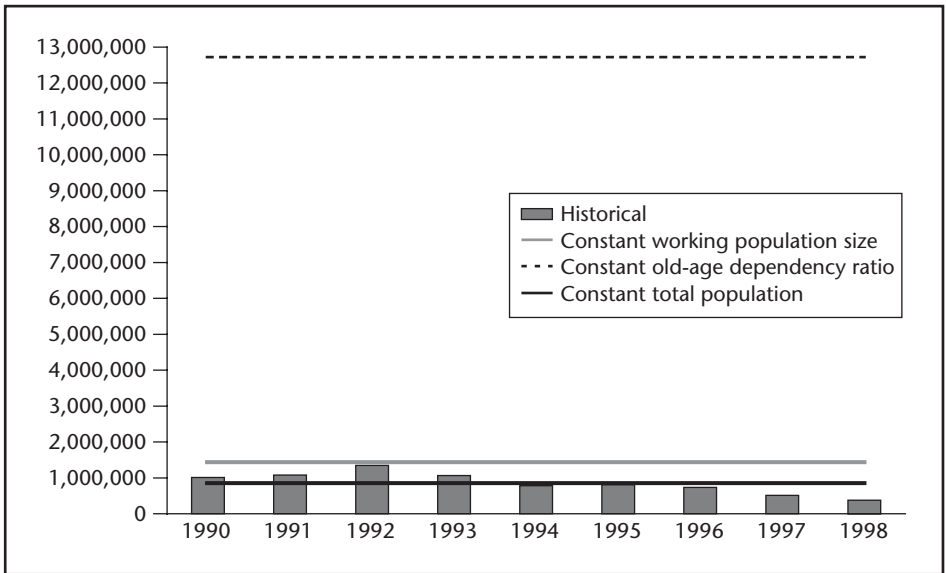


Figure 2.12 Historical net migration to the EU between 1990 and 1998 compared with the three major future immigration scenarios for the EU for 1995 to 2050

special circumstances pushed them well above long-term levels. The other countries and regions studied would need a level of immigration much higher than historical migration levels to stabilize their populations.

- 4 If immigration is to be used to prevent a decline in the *active* population, the numbers of migrants will have to be significantly larger than those needed to offset total population decline. The EU would need an annual average of almost 1.5 million new immigrants, for example, with Germany alone accounting for around 450,000.³²¹ Estimates put the cumulative total migration needed for the EU between 1995 and 2050 at almost 80 million immigrants, with more than 25 million going just to Germany.³²² The practical difficulties that would be involved in dealing with such high immigration levels mean that this strategy could be no more than a short- to medium-term solution to the pensions problem.
- 5 The immigration levels needed to maintain the old-age dependency ratio at its current level would be so high that they would be unfeasible, both politically and socially: around 700 million people would have to migrate to the EU by 2050 (or almost 13 million per year), and more than 188 million to Germany

³²¹ See Scenario B in Table A3 in the Appendix.

³²² See Scenario B in A2 in the Appendix.

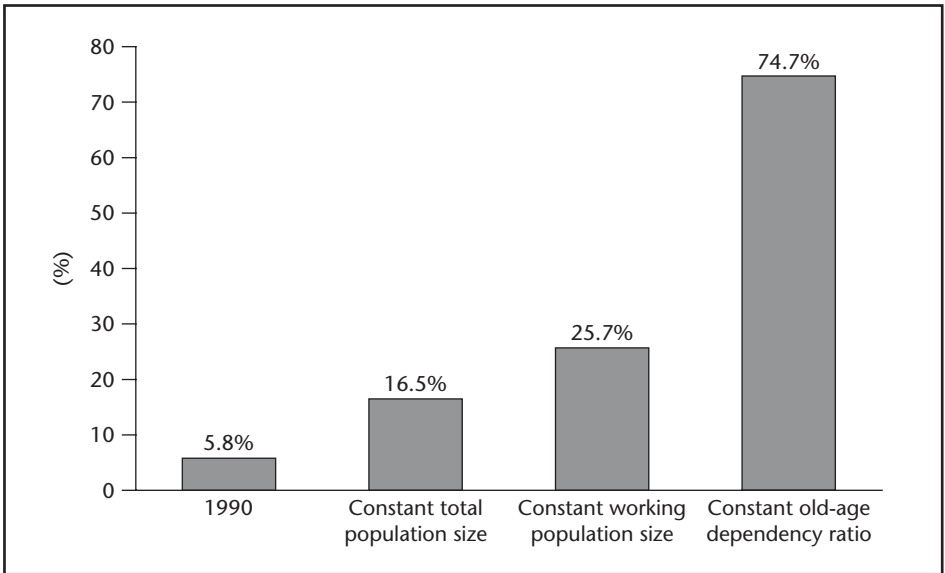


Figure 2.13 Proportion of migrants to total population in 1990, and projected to 2050 for scenarios A to C (EU)

Note: Scenarios A and B relate to immigrants and their descendants

(almost 3.5 million per year).³²³ Figure 2.12 compares historical immigration to the EU in the 1990s with the future immigration needed in the EU using the three scenarios – constant total population (scenario A), constant active population (scenario B) and constant old-age dependency ratio (scenario C) – and shows on the one hand that the scenario maintaining a constant total population largely matches the historical migration figures and that the scenario maintaining a constant active population is not too far out of reach, but that on the other, the immigration needed to maintain the old-age dependency ratio demands immigration that is 10–30 times historical levels. Especially for scenario C, not only the absolute figures but also the ratio of immigrants (and their descendants) to the local population reveals a number of migrants that far exceeds what is politically possible: Germany, for example, would see migrants and their descendants accounting for 80 per cent of its population in 2050³²⁴ (1990: 6.4 per cent³²⁵). With a ratio of just under 70 per cent³²⁶ (1990: 10.4 per cent³²⁷), France would not be far behind. Even the relatively low immigration

³²³ See Scenario C in Table A2 (for cumulative net migration up to 2050) and Table A3 (for average annual net migration up to 2050).

³²⁴ See Table A5 in the Appendix.

³²⁵ See Table A4 in the Appendix.

³²⁶ See n. 324.

³²⁷ See n. 325.

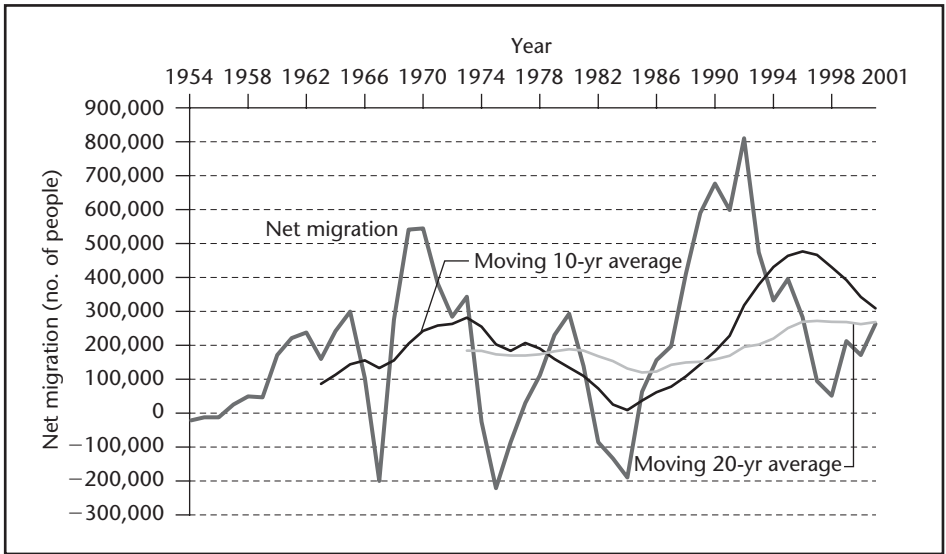


Figure 2.14 Net migration in Germany between 1954 and 2001

Source: Federal Statistical Office (2003), p. 21

ratio – measured against the other large EU countries – of just short of 60 per cent³²⁸ for the UK would be an unrealistic prospect. Figure 2.13 shows a direct graphical comparison of historical and projected immigration levels for the EU, contrasting the 1990 figure with the projections for scenarios A to C: the figure of around 75 per cent migrants in 2050 as a consequence of net immigration of around 700 million people between 1995 to 2050 (see above) for scenario C speaks for itself.

- 6 The demographic trends demand reform not only of the pension systems, but also of the healthcare system (insurance contribution levels, quality of benefits), as well as an increase in the labour force participation rate.

The UN's demographic calculations appear to be more suited to estimating theoretically possible trends. However, pension reforms also need forecasts based mainly on historical migration flows as an additional basis. An analysis of the situation in Germany shows that average annual net migration in the second half of the twentieth century was around 200,000 (see 20-year moving average in Figure 2.14).³²⁹ In its median population estimate, the Federal Statistical Office assumes that – no doubt extrapolating from this historical trend – given average annual net immigration of 200,000, the German population will be around four

³²⁸ See n. 324.

³²⁹ Deutscher Bundestag (2002), p. 16, gives average annual (positive) net migration of 165,000 for the period 1960 to 2000.

Table 2.11 Old-age dependency ratio in Germany in 2050 by assumed migration

Migration scenario for mid-range life expectancy model	Old-age dependency ratio in 2050	
	Age limit 65	Age limit 60
Low migration (100,000 per annum)	0.59	0.85
Medium migration (200,000 per annum)	0.55	0.78
High migration (300,000 per annum)	0.51	0.74

Source: Federal Statistical Office (2003), p. 34

million lower in 2040 than it is today,³³⁰ and that in the following ten years it will shrink by around three million to 75 million (see Figure 2.10, p. 50). More pessimistic assumptions forecast a significantly more pronounced population decline to between 65³³¹ and 67³³² million.

The fact that immigration cannot help stabilize the pay-as-you-go system as a stand-alone reform measure is also evident from the low impact of immigrants on the development of the old-age dependency ratio in Germany. The primary reason behind this lack of any significant effect is that 'based on experience to date, immigrants too have a relatively low birth rate, so although immigration may lessen ageing for a number of years, it does not represent any long-term solution.'³³³ In realistic immigration scenarios, there is no sustained stabilization in the supply of labour; in fact, the supply of labour starts declining some years earlier or later, depending on the underlying assumptions on migration. Even for an assumed annual net immigration of 260,000, 'a sharp decline in the number of working-age people can be expected after 2020'.³³⁴ Even higher annual immigration of 300,000 per year only results in an insignificant decline in the old-age dependency ratio: Table 2.11 shows that, depending on how the upper age limit for the old-age dependency ratio is defined, the level in 2050 can be reduced by around 5 per cent to 8 per cent per 100,000 immigrants. Table 2.11 again highlights the relatively pronounced effect of lifting the pensionable age: if the average retirement age increases by five years (starting from the age of 60), this reduces the old-age dependency ratio by some 30 per cent.

³³⁰ See Federal Ministry of Health and Social Security, Berlin (2003), pp. 54f.

³³¹ See Deutscher Bundestag (2002), p. 31.

³³² The model assumptions of the Federal Statistical Office on population trends are based on a 3 × 3 matrix (i.e., there are three differently quantified assumptions on longevity and immigration, producing a total of nine different scenarios). A population of 75 million is the outcome of the median of these nine variants, with 67 million representing the lowest variant (see Federal Ministry of Health and Social Security, Berlin (2003), pp. 25f and pp. 54f).

³³³ Federal Statistical Office (2003), p. 34.

³³⁴ Deutscher Bundestag (2002), p. 67.

The 'generation of heirs'

When talking about the state pay-as-you-go pension systems, some commentators accuse the older generation of a lack of inter-generational solidarity with the younger generation. One of the responses to this is that there are considerable financial and other non-monetary (especially childcare) transfers within families by older people to younger people.³³⁵ As well as ongoing transfers, there are also financially significant transfers of assets during the lifetime of older people or by way of inheritance.³³⁶

That such transfers, some of which can be substantial, do actually occur is beyond dispute. However, transfers within families should not be overestimated because (in Germany and Austria at least) there is no legal entitlement other than the statutory portion in inheritance law, and in particular only a minority receives this sort of financial support to an extent that may (more than) offset the shortfalls from higher contributions or tax rates and the expected lower pension level.

Inheritances cannot be a substitute for pension reforms that ensure fairness to all generations because the amount and timing of an inheritance are highly uncertain, and because a large proportion of the population cannot expect any appreciable inheritance in any case because they do not have wealthy bequeathers, or there is a (weak) positive relationship between the income of the potential heir and the amount of the legacy.³³⁷ This means that those income classes that are able themselves to finance an adequate retirement income tend to benefit from the largest inheritances.

According to estimates by the Deutsches Institut für Altersvorsorge (DIA Pensions Institute), 40 per cent of German households will inherit between 2001 and 2010, corresponding to 15 million inheritances. However, an appreciable number of these legacies will have little or no value. First, 53 per cent of the inheritances involving monetary assets will not exceed €25,000 (see Figure 2.15), while second, almost two-thirds of all estates will not include any property of real value (see Figure 2.16).

Supplementary funded pension systems

The funding principle

In a funded pension system, the contribution payments are invested rather than being passed on directly to the generation in retirement. The capital stock accumulated over the working life from the contributions and the investment income generated from them is then used to fund the pension. As a rule, the pension

³³⁵ See Deutscher Bundestag (2002), p. 39.

³³⁶ See Deutscher Bundestag (2002), p. 51.

³³⁷ See Pfeiffer and Braun (2002), p. 8.

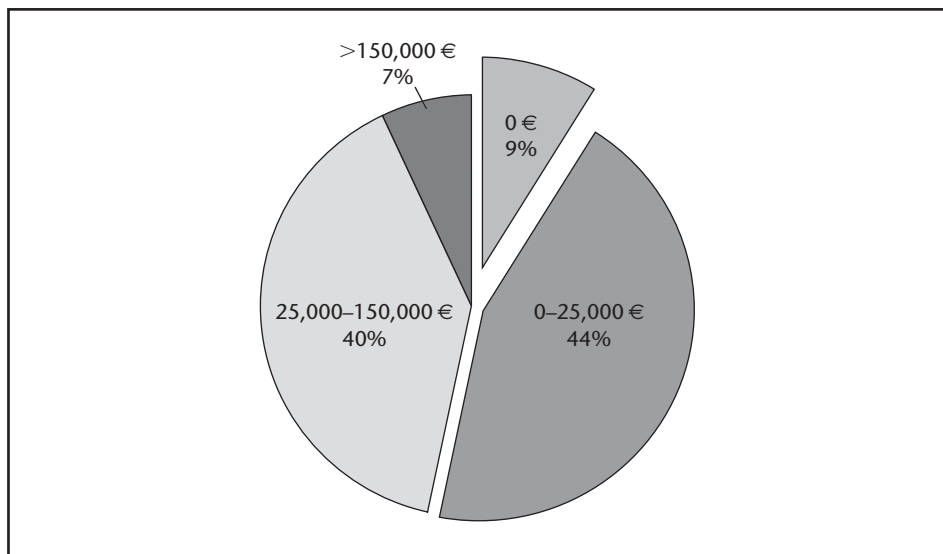


Figure 2.15 Distribution of cross-generational monetary asset inheritances between 2001 and 2010 in €

Source: Pfeiffer and Braun (2002), p. 5

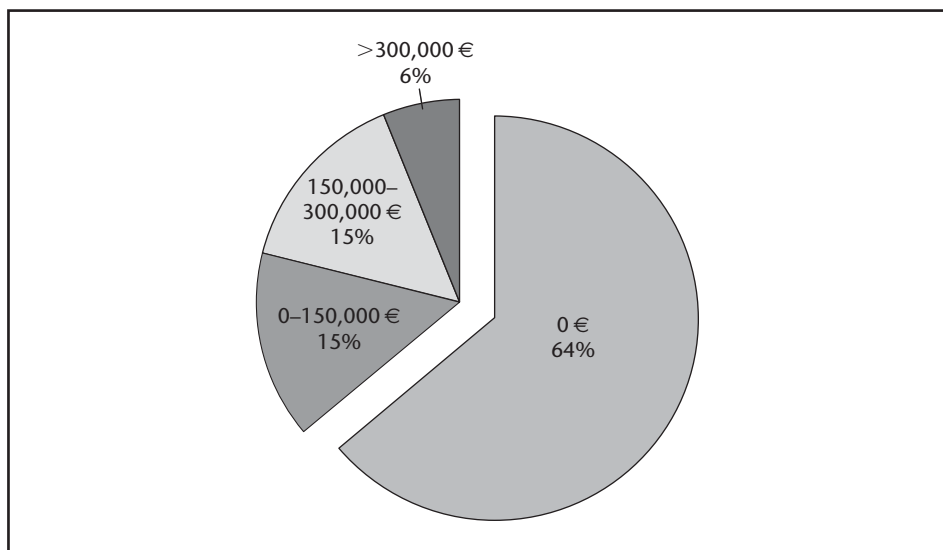


Figure 2.16 Distribution of cross-generational real property inheritances between 2001 and 2010 in €

Source: Pfeiffer and Braun (2002), p. 5

is paid successively from the capital stock, which thus gradually diminishes. Generally, all or most of the capital stock is contributed for this purpose to a private pension insurance on retirement. Depending on how the funded pension scheme is structured, lump-sum payments may be made on retirement in some cases, cutting the regular pension payments. Various forms of annuitization are also possible, first as regards the payout period and the payout arrangements, and second, in terms of heritability and biometric risks. For the payout period, the normal arrangement agreed is that payouts start immediately on retirement and continue for life, thus covering the longevity risk. Provided there are no legal restrictions, the pension payout is also possible for a specific period before or after reaching pensionable age, or the payout term itself may be limited. If the insured person dies while still working or during retirement, the invested capital stock, or that capital stock that has not already been reduced, may be reduced in part or by subsequent taxation, it may lapse, or it may be forfeited to the community of contributors or pensioners. Biometric risks (i.e., the risk of disability/incapacity for work, the longevity risk and even survivors' benefits) may be covered in full or in part by an insurance component.³³⁸

Critics of the funded pension model who prefer the pay-as-you-go system sometimes apply the 'Mackenroth theory': the way that pensions are funded is ultimately irrelevant because 'all social spending always has to be covered by the national income for the current period. There is no other source, there is no accumulation from period to period, no 'saving' in the private-sector sense.'³³⁹ Any (partial) switch from the pay-as-you-go to the funded model would therefore make no sense. This criticism falls short of its target in that it demands the assumption of a closed economy and the independence of the national product from the type of pension funding. That the first assumption does not apply to Germany, the world's number one exporter, or to Austria, a small but open economy, does not need any further discussion, while the theory that the funded pension model encourages a higher savings rate, which in turn increases investment and thus ultimately promotes growth, is somewhat controversial.³⁴⁰

Indeed, the fact that the funded pension model is not as suitable as the pay-as-you-go system for redistribution is likely to be an affront to the ideology espoused by most advocates of the pay-as-you-go system as a monopoly pensions system, as the pension payments are normally made solely from the contributions paid and the investment gains generated from these contributions. In addition, past experience shows that the effective return on securities investments (i.e., the factor that determines the level of benefits from a funded pension scheme) grew almost one-and-a-half times faster than real gross earned income between 1970 and 1995,

³³⁸ This is the case for the Riester pension, for example (section 1(1) no. 7 final sentence AltZertG).

³³⁹ See Mackenroth (1952), p. 41.

³⁴⁰ See Rürup (1998), pp. 785ff.

Table 2.12 The ‘three-pillar model’: sources of retirement income in the EU

Pillar	Type of pension and financing
Pillar 1	Flat-rate benefits, social security pensions (pay-as-you-go/funded)
Pillar 2	Occupational pension schemes (funded)
Pillar 3	Private pensions, predominantly life insurance

Source: European Commission, Com (1997) 283 (1997), p. 2

the factor³⁴¹ that determines pension payouts under the pay-as-you-go system,³⁴² and this is a further argument in favour of funded pension schemes. The response to the popular objection that the funded pension model is less secure than the pay-as-you-go system is that even worst-case scenarios of prolonged stagnation or even recession – situations that are expected to recur both because of past experience and because of various economic cycle theories – are likely to produce long-term (albeit modest) growth which at any rate will be higher than the return on the pay-as-you system, which experience shows tends to be close to zero.³⁴³

The three-pillar model

The concept behind the three-pillar model

An alternative to benefit cuts and contribution hikes to remedy the impending pensions shortfall (i.e., the fact that it will not be possible to maintain in the future the standards of living that people have become used to with statutory pensions alone³⁴⁴), would be to supplement the existing pay-as-you-go system by funded schemes, which is the thinking behind the ‘three-pillar model’ (see Table 2.12).

In an occupational pension scheme (pillar 2), the contributions are paid either by the employee or the employer or – more frequently – by both. Contributions to private pensions – the third pillar – are made solely by the beneficiary. Apart from the common tax breaks and the related mandatory product features (investment rules, minimum terms, etc.), private pensions are similar to other savings products and are thus not linked to any employment. The resulting advantage of

³⁴¹ In the pay-as-you-go system, real wage growth corresponds to the real rate of return in the funded system, provided that the population remains constant. As a rule, the annual statutory pension adjustments are tied to gross or (increasingly) net wage and salary increases. As explained in the section on Parameters of PAYG schemes, p. 29, population growth is the second factor that determines the rate of return in the pay-as-you-go system.

³⁴² Estimates of the nominal return on securities investments assume 9 per cent per annum between 2000 and 2020, which could see the total assets of pension funds in the EU rising by a factor of seven, from around ECU 1,627 bn at the end of 1997 to €11,811 bn at the end of 2020 (see Pragma Consulting (1999), p. II).

³⁴³ See Porwollik (2001).

³⁴⁴ See BVI (2000d), p. 45.

Table 2.13 Change in the share of sources of retirement provision in total EU pension benefits between 1994 and 2020

	1994 level (%)	1998 level (%)	Target level for 2020 (%)
Pillar 1	88.8	83.5	64.0
Pillar 2	7.0	11.6	28.5
Pillar 3	0.9	1.5	4.5
Means-tested welfare benefits	3.3	3.4	3.0

Source: See Pragma Consulting (1999), p. II; and European Commission, Com (1997) 283 (1997), p. 2

the third pillar (that it is thus aimed at a larger number of people, including the self-employed and inactive persons) is offset by the disadvantage of generally higher administrative costs. In large companies in particular, the administrative expense attributable to the individual employee is lower than for private pension products because of the collective nature of occupational pension plans.

The three-pillar model in the EU

It is still the case that the first pillar accounts for by far the greatest share of pension benefits in the EU, but this will no longer be possible in the future (for the reasons outlined above) so private-sector providers of pillar 2 and 3 products will become increasingly involved. The European Commission has emphasized repeatedly that the pillar 2 and 3 pension systems should not replace pillar 1, but should supplement it,³⁴⁵ and that it is a matter for the Member States to decide which share of the overall pension burden should be borne by each of the pillars.³⁴⁶

Pillars 2 and 3 could well increase their current share of around 13 per cent of total retirement provision to 33 per cent in 2020, with the second pillar accounting for 28.5 per cent and the third pillar 4.5 per cent (see Table 2.13). A condition for this is that participation in the largely voluntary³⁴⁷ second pillar practically triples from its current 23 per cent or so to 60 per cent.³⁴⁸

A number of EU Member States have already reached or even exceeded this level of supplementary pensions. In the Netherlands, the second pillar now accounts for around one-third of all retirement income.³⁴⁹ The UK, Denmark and Ireland are also playing a leading role in the EU in the establishment of funded

³⁴⁵ See European Commission, Com (1999) 134 final (1999), p. 2; Pragma Consulting (1999), p. II, concurs.

³⁴⁶ See European Commission, Com (1999) 134 final (1999), p. 15.

³⁴⁷ There were also suggestions to introduce compulsory occupational pensions (see below).

³⁴⁸ See Pragma Consulting (1999), p. II.

³⁴⁹ See European Commission, Com (1997) 283 (1997), p. 3.

Table 2.14 Share of pension fund assets of the 15 EU Member States in total assets of all pension funds in the EU at end-1997 (total volume €1,627.35 billion)

Country	Share (%)	Country	Share (%)
UK	53.4	Spain	1.29
Netherlands	20.15	Finland	1.04
Germany	7.81	Belgium	0.59
Sweden	4.79	Portugal	0.59
France	3.95	Greece	0.2
Denmark	2.21	Austria	0.185
Ireland	1.91	Luxembourg	0.005
Italy	1.88		

Source: Pragma Consulting (1999), p. 4

Table 2.15 Structure of retirement income in Germany in 1999

Income type	Share of aggregate income of people aged 65 and over (in %)
State pensions	83.8
Company pensions	2.2
Employee compensation	3
Investment income	6
Other income	4

Source: Deutscher Bundestag (2001), pp. 209 and 211

pension schemes.³⁵⁰ Taken together, the British, Irish and Dutch pension funds currently account for more than 75 per cent of the total assets of all pension funds in the EU (see Table 2.14).³⁵¹

The second pillar is relatively underdeveloped in Germany. In 1999 company pensions accounted for no more than some 2 per cent of the aggregate income of people aged 65 and above. If investment income that does not result expressly from retirement planning and therefore does not attract the related tax breaks is included in pillar 3, the picture even before the launch of the Riester pension products is comparatively favourable. Such investment income from rental, leasing and capital assets accounts for 6 per cent of the aggregate income of retired people in Germany (see Table 2.15).

³⁵⁰ See European Commission, Com (1997) 283 (1997), p. 6.

³⁵¹ See Pragma Consulting (1999), p. II.

In 2002, the volume of European pension funds totalled approximately €4,000 billion.³⁵² The volume of EU pension assets is expected to rise to €6,000 billion by 2010, because European countries are extending opportunities for funded supplementary pensions. In Germany alone, pension assets under management could grow to €900 billion over the same period in the wake of the subsidies resulting from the Riester pension reform.³⁵³

Pillars 2 and 3 have much in common, but are not (yet³⁵⁴) subject to the same rules because of the differences between pension funds (pillar 2) and life insurance products (pillar 3).³⁵⁵

- 1 Pension fund liabilities are more long term because of their longer maturities, the general impossibility of early surrender and because loans cannot be extended, in contrast to life insurance policies (with the life insurance policy serving as collateral). They therefore invest in longer-term assets.
- 2 Pension fund liabilities are often tied to salary developments (DB), while life insurance policies are oriented on a nominal value.
- 3 DB pension funds will pursue an investment policy so that they can fulfil their 'benefit guarantee' whatever the actual investment return. Life insurance companies rarely offer this sort of guarantee, but normally a (low) minimum return.

The three-pillar model in the USA

The social security system in the USA does not provide a retirement pension that maintains the pensioner's standard of living. The contribution rate of 12.4 per cent is split equally between the employer and the employee,³⁵⁶ and the income threshold for contribution assessment for the year 2005 was US\$90,000 per year.³⁵⁷ In 2004 the average pension (due to own contributions, not including pensions based on derivative claims) was US\$955 per month.³⁵⁸ The US social security system accounts for only 40 per cent of pensions in the USA.³⁵⁹ The consequences of the social security contribution and benefit levels are a high effective retirement age (42 per cent of people in the USA work beyond the age of 65³⁶⁰) and the primacy of funded occupational and private pensions.

³⁵² See Gimbel (2002b).

³⁵³ See Bulthaupt *et al.* (2001), p. 1

³⁵⁴ For the European Commission's thoughts on imposing uniform EU-wide rules on pillar 2 and 3 institutions for retirement provision see European Commission, Com (1997) 283 (1997), p. 15f.

³⁵⁵ See European Commission, Com (1997) 283 (1997), Table XIII.

³⁵⁶ In case of self-employment the full 12.4 per cent has to be borne by the insured person.

³⁵⁷ See Social Security Administration (2005a), p. 1.

³⁵⁸ See Social Security Administration (2005b), Table 5A.1.

³⁵⁹ See Tepper (2003), pp. 167f; Smetters (2002), p. 11.

³⁶⁰ *Ibid.*

Although they are as a rule highly sceptical about the notion of state welfare, even the Americans have no desire to abolish their social security system and replace it by occupational and private pensions. They mirror the predominant view in the EU that the state pension system should be retained as the first of three retirement provision pillars and that its long-term stability should be secured. What is quite clear, however, is the belief that the second and third pillars should be expanded to reduce the growing strains on social security due to demographic shifts.³⁶¹

A striking feature of the pillar 1 US social security is that (at least formally) it is a partly funded system: originally structured as a fully funded system in 1935, massive political pressure saw it evolve as early as 1939 into a hybrid system that is primarily financed on a pay-as-you-go basis. However, funding was not completely abandoned, but limited to the amount of three annual payments.³⁶² This capital consists of special interest-bearing US government securities³⁶³ and is administered by the Department of the Treasury in the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds. Because of the asset allocation, the social security assets can be treated as part of US government debt. For this reason, the claim by the US government at the end of the 1990s that it had generated substantial budget surpluses is open to the criticism that it is based on an accounting trick that jeopardizes the solvency of the state pension system: surpluses generated by the trust funds – mainly the social security funds – were disbursed for purposes that violated the statutory objectives of the funds and were replaced by the ‘special issues’ mentioned above. At the end of fiscal year 2002, for example, almost 44 per cent of the US\$6.2 trillion government debt is alleged to have consisted of such liabilities to various trust funds (including liabilities of US\$1.2 trillion to the social security system).³⁶⁴

For this reason, the capital growth of the social security trust funds, which certainly looks impressive at first sight – the volume climbed by a factor of almost five to US\$1,329 billion from the beginning of the 1990s to the end of 2002 – should rather be seen as an alarming expansion of US government debt (see Figure 2.17).

In the USA, the second pillar consists, first, of traditional defined benefit pension funds and, second, of a growing number of defined contribution 401(k) plans,³⁶⁵ while pillar 3 is covered mainly by IRAs.³⁶⁶

Occupational pension plans can be transferred independently of the employer.³⁶⁷ Just like IRAs, they are normally taxed on an EET basis, and can

³⁶¹ See Investment Company Institute (np, 2000), p. 31.

³⁶² See Feldstein and Liebman (2001), p. 6.

³⁶³ These are almost entirely ‘special issues’: government bonds that can be redeemed at any time at face value but are not traded on the capital markets (see Social Security Online, 2003a).

³⁶⁴ See Hodges (no date).

³⁶⁵ See section on Defined contribution occupational pensions: 401(k) plans, p. 160.

³⁶⁶ See section on Defined contribution private pensions plans: IRAs, p. 163.

³⁶⁷ Portability means that the retirement provision already saved does not expire when the employee switches to a new employer, but can be ‘ported’ to the new job.

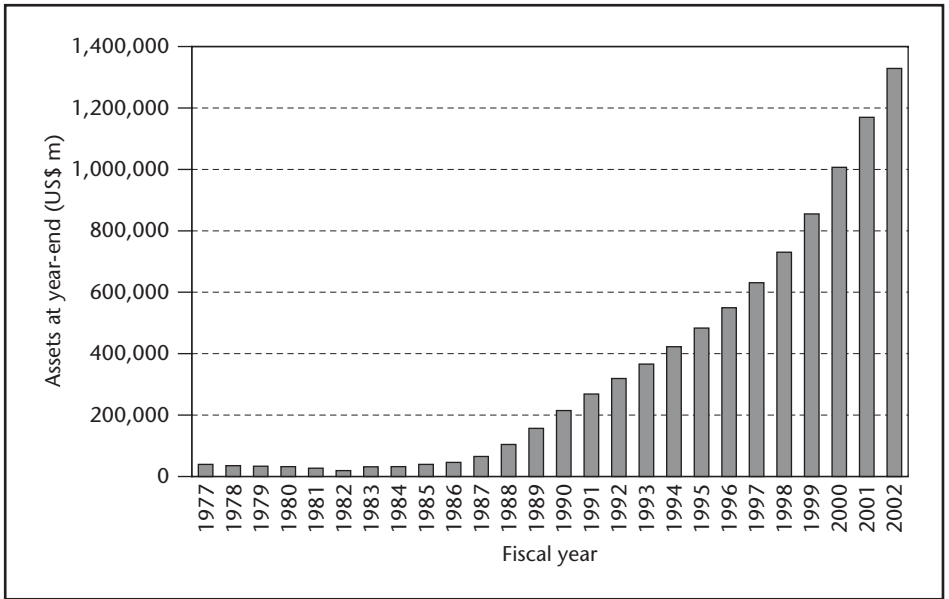


Figure 2.17 Social security trust fund volumes between 1977 and 2002

Source: Social Security Online (2003b)

be paid out either as an annuity or in a lump sum. Biometric risks may also optionally be covered.³⁶⁸

Defined benefit versus defined contribution

Especially in English-speaking countries, but also in Germany since the Riester pension reform, pillar 2 supplementary pension systems are financed by pension funds,³⁶⁹ which are divided into defined benefit and defined contribution schemes.

In *defined benefit systems*, the pension entitlement of the members is based on a specific pension formula and is not linked to the investment return on the savings capital. As a rule, the calculation is determined primarily by the number of years of service and the development of income over that period or on final salary. The investment risk and the risk of having to compensate for any shortfall are borne by the plan sponsor, which is normally the employer (except for pillar 1 schemes).

In *defined contribution systems*, the pension entitlement equals the cumulative contributions plus the investment income and capital gains from these contributions. There is no guaranteed minimum return in pure-play defined contribution plans, so the beneficiaries have to bear the benefit risk: the solidarity or insurance principles do not apply here. However, the employee may also benefit from higher

³⁶⁸ See BVI (2000d), pp. 45f.

³⁶⁹ See European Commission, Com (1997) 283 (1997), p. 3.

than expected capital market returns whereas, in defined benefit systems, any growth over and above the guaranteed pension level normally accrues solely to the sponsor.

Another advantage of DC plans is that they allow small and medium-sized companies unwilling to shoulder the risk of defined benefits an opportunity to offer occupational pensions in the first place.³⁷⁰ In the USA at least, however, the benefit risk may exceptionally also pass to the sponsor as a result of damages claims if the sponsor does not comply with its implicit duty to educate the beneficiary about investing for retirement.³⁷¹

A defined contribution pension account is inherently always funded, but purely DC-based pension funds are relatively rare in Europe.³⁷² Asset allocation is a matter either for the sponsor/employer, although this is increasingly unattractive because of fears of claims for damages on the grounds of poor performance, or the beneficiary participates in asset allocation by choosing asset classes or even by specifying certain investment funds. In the last case, the advantage of being able to adjust asset allocation to the individual preferences of the beneficiary is offset by the possibility of increased risk due to lack of expertise.³⁷³

In the USA, there are also various hybrid forms in addition to these two 'pure-play' types of pension savings plans:³⁷⁴

- 1 Combined plans consist of a guaranteed minimum pension (the 'floor'), supplemented by a pension savings plan with defined contributions. Many employees in the USA have this sort of pension savings plan, with 401(k) plans mostly used for the DC component.
- 2 Cash balance plans are technically DB plans, but also incorporate some of the features of DC plans, such as a lump-sum payout instead of a regular pension, with the beneficiary bearing the longevity risk.
- 3 The benefit payout of pension equity plans depends on the age and final salary of the beneficiary.
- 4 Target benefit plans are DC plans that emulate the payout arrangements of DB plans, although the actual benefit may be higher or lower than the target benefit.

In the USA, there has been a 'dramatic' shift in pension fund assets away from DB³⁷⁵ and towards DC plans since the late 1990s.³⁷⁶ A similar trend has been

³⁷⁰ See Bulthaupt *et al.* (2001), p. 22.

³⁷¹ See Louge and Rader (1998), p. 22.

³⁷² See Pragma Consulting (1999), p. 13.

³⁷³ See Louge and Rader (1998), p. 19.

³⁷⁴ See *Ibid.*, pp. 26–30.

³⁷⁵ In early 2003, approximately 40 million Americans (still) had a traditional defined benefit pension plan (see McNickle and Wechsler, 2003).

³⁷⁶ See Roye (1999c).

evident in recent years in the UK, too. In rather the same way that the state delegated much of its formerly comprehensive responsibility for pension provision to companies, the companies are now passing on this responsibility to their employees. There is a clear trend towards defined contribution occupational pensions supplemented by private pensions; in the USA, private pensions are often heavily dependent on capital market performance, because equity-heavy IRAs are the standard private retirement planning instrument there, rather than life insurance policies.

Asset meltdown theory

Although funded pension systems are not immune to the effects of demographic structural changes, they are far more resistant than pay-as-you-go systems. A major reason why funded systems are far more independent of demographic trends lies in their ability to diversify internationally, so that 'differences between labour and capital market productivity associated with diverse demographic developments [in the various countries]' can be exploited.³⁷⁷

Nevertheless, the 'asset meltdown theory' has found supporters, especially among the opponents of funded pensions. The underlying assumption in this theory is that disinvestment of the invested pension assets by the baby boom generations will result in surplus supply on the capital markets and consequently in an asset meltdown: in other words 'financial market collapse'.³⁷⁸ The decline in the active population would necessarily lead to a shortfall in the labour supply, making labour more expensive than capital, which would be equivalent to a cut in the real rate of return on capital.³⁷⁹

What makes the occurrence of this asset meltdown unlikely is that a simple link between a declining labour supply and a falling rate of return on capital applies only if all other things are equal. In fact, 'the process of adjustment in an open economy is far more complicated', because 'in reality, there are many adjustment, structural and feedback effects'.³⁸⁰ A further factor is that the process of disinvestment during the pension payout phase of funded plans does not take the form of a shock, but is 'more or less continuous over time'.³⁸¹

Double burden from switching to another system (from PAYG to funded pensions)

Any plans for a system switch to a funded pension model from an established pay-as-you-go system that offers a level of benefits that maintains the standard of living (as in the case in Germany and Austria), rather than merely guaranteeing

³⁷⁷ Zimmermann and Bubb (2002), p. 11.

³⁷⁸ *Ibid.*, p. 10.

³⁷⁹ *Ibid.*

³⁸⁰ *Ibid.*

³⁸¹ *Ibid.*, p. 12.

a subsistence pension, appear impossible because of the tremendous volume of capital that would have to be accumulated by the transition generation.³⁸² In practice, therefore, there is no wholesale system switch under these circumstances; rather, the objective is to establish the three-pillar system over the period of one generation. Facilities for pillar 2 and 3 funded pension options are expanded and generally combined with a successive reduction in pillar 1 benefits, normally over a (very) long period of adjustment.

This kind of partial system switch reduces the extent of the double financial burden on the transition generation. On the one hand, this generation must continue to pay possibly even rising contributions into the pay-as-you-go system to cater for the pensioner generation and, on the other, it must build up a funded supplementary pension to safeguard its own standard of living after retirement. The extent of this financing burden on the transition generation increases the more the implementation of an adequate three-pillar system is delayed, because an almost constant and overall very pronounced rise in the old-age dependency ratio is expected in the first half of the twenty-first century. All else being equal, the associated increase in pension contributions reduces what is for average earners in any case a very narrow financial leeway for building up their own funded supplementary pension. The theoretical alternative or supplementary measure of sharing the burden with the pensioner generation normally ends in political failure because governments and Parliaments do not appear to be willing to demand that the older generation should also participate in the frequently evoked inter-generational solidarity. Under the stated conditions, a Pareto optimal solution to this problem³⁸³ is thus impossible.

The Demographic Change parliamentary commission of inquiry established by the German Federal Parliament even goes as far as denying the existence of this evident inter-generational conflict. Based on undisputed facts (e.g., that 'there are no irreconcilable differences [between the age groups]' and that 'welfare state distribution problems are not due solely to demographic change'), it gradually introduces more one-sided arguments so as to 'counter the dramatization of the inter-generational conflict'. The stated goal of 'ensuring a more differentiated public picture of the relationships and tensions between the generations'³⁸⁴ must clearly be understood to mean that the accomplishments of the older generation should be presented as mainly benefiting the younger generation, while the growing financial burdens on the younger generation should be marginalized by ignoring them to a large extent during the drafting process. For example, the argument that

during the course of their lives older people have made a large contribution to society and thus also for younger people ... that as contribution payers they financed the pensions of

³⁸² See Ruland (1998), p. 969; Rürup (1998), p. 795.

³⁸³ See Rürup (1998), p. 795.

³⁸⁴ Deutscher Bundestag (2002), p. 38.

the previous generation and thus acquired their own pension entitlements ... that they also continue to be economically active by themselves caring for others, by being consumers and taxpayers and finally ... by creating the enormous volume of real capital that is available to the younger people today,³⁸⁵

in combination with the vague formulation that 'the question thus arises of whether older people can and must make their own contribution to easing the shifts in the inter-generational burden structure caused by demographic change',³⁸⁶ gives the impression that the reader should come to the conclusion that 'the solidarity between the generations necessary for the continued existence of society'³⁸⁷ must primarily be a debt to be discharged by the younger generation.

This conclusion imposes itself because it is self-evident that the creation and expansion of tangible and monetary assets is something that does not only benefit one's own generation. In exactly the same way that every generation pays taxes and consumes from its income, this fact applies – all else being equal – to every generation, so it cannot be seen as a striking achievement by the older generation in favour of the younger generation.

In addition, the younger generation also earns its own pension entitlements through its contribution payments; however, these entitlements will effectively result only in very low pensions, even though the contribution payments are considerably higher than those made by older generations. In particular, a legal entitlement is insufficient to safeguard an effective (monetary) payment if the debtor (i.e., the pension insurance agency or the national budget) does not have (or no longer has) the capability to pay it. Moreover, the 'enormous volume of real capital' that the older people have created is owned largely by themselves and is thus not 'available' to the younger generation without some sort of consideration.

Supplementary funded pensions in Germany

Germany's (historic) pension reforms from the perspective of sustainable affordability

The risk to the pay-as-you-go model from structural demographic changes has been known in Germany since the system was launched in 1957³⁸⁸ and has been the subject of concentrated debate at the latest since the early 1980s. The objective

³⁸⁵ Ibid.

³⁸⁶ Deutscher Bundestag (2002), p. 48.

³⁸⁷ Ibid.

³⁸⁸ Equipping the pay-as-you-go system with a demographic factor that would provide for a quasi-automatic adjustment of the pension level as a factor of demographic trends had been proposed unsuccessfully as a component of the 1957 pension reform (see Tepper (2003), p. 61). However, the demographic factor that was actually introduced by the 1999 Pension Reform Act of 3 Nov. 1997 was then suspended following the change in government (see *ibid.*, p. 76 and p. 109).

Table 2.16 Change in the fluctuation reserve for the state pension system in Germany between 1969 and 2004

	1969–1976 ^a	1977–2001	2002 ^b	2003 ^c	2004 ^d	2004
Lower threshold in months	3	1 ^a	0.8	0.5	0.2	0.2
Upper threshold in months		1.5	1.2	0.7	0.7	1.5 ^e

^a See Tepper (2003), pp. 35f and p. 42.

^b Section 158(1) SGB 6 as amended by Art. 1 no. 1 *Gesetz zur Bestimmung der Schwankungsreserve in der Rentenversicherung der Arbeiter und Angestellten*.

^c Section 158(1) SGB 6 as amended by Art. 2 no. 2 BSSichG.

^d Section 158(1) SGB 6 as amended by Art. 1 no. 5 *Zweites Gesetz zur Änderung des Sechsten Buches Sozialgesetzbuch und anderer Gesetze*.

^e See section 158(1) SGB 6 as amended by Art. 1 no 25 *RV-Nachhaltigkeitsgesetz*.

of pension reforms since as far back as the 1970s was to cut benefits and increase contributions.³⁸⁹

Together with deductions for early retirement, fewer credits for training, education and similar periods, the successive dilution of what was already a no more than meagre funding in the form of the ‘fluctuation reserve’ exemplifies this trend. The fluctuation reserve was introduced in 1969 as a minimum reserve amounting to the average expected three-month payout. Up to 2004, the minimum threshold was successively reduced to only one-fifth of a monthly payout (see Table 2.16), so the fluctuation reserve by itself can no longer be seen as an adequate instrument for managing the volatile income and expenditure fluctuations. In the light of the potentially destabilizing effect on timely benefit settlement of the almost annual cuts in the fluctuation reserve, the increase in mid-2004 in the *upper* threshold of what has now been renamed the ‘sustainability reserve’, although the lower threshold of 0.2 monthly payouts was retained, looks like nothing more than an attempt to mislead.³⁹⁰ Whether the federal government can in all honesty claim to be responding to a proposal by the Rürup Commission³⁹¹ looks more than questionable on closer inspection: in fact, the Rürup Commission assumed a higher minimum threshold (valid at the time the report was produced) for the fluctuation reserve of half a month’s payout,³⁹² rather than the government’s subsequent 0.2 monthly payouts, and most certainly did not recommend merely lifting the *maximum* threshold, but rather the corridor as a whole.³⁹³

The development of the fluctuation reserve must surely be a clear example for everybody in Germany to see that when it comes to the long-term project of retirement planning, they cannot reasonably rely primarily on the state, whose representatives make what are generally emergency inroads into the system

³⁸⁹ See Ruland (no date), p. 2.

³⁹⁰ See section 158(1) SGB 6 as amended by Art. 1 no. 25 *RV-Nachhaltigkeitsgesetz*.

³⁹¹ See German Federal Government, *Entwurf eines RV-Nachhaltigkeitsgesetzes*, p. 50.

³⁹² See Federal Ministry of Health and Social Security, Berlin (2003), p. 127.

³⁹³ *Ibid.*

at ever shorter intervals. Another example of this lack of statutory pensions consistency and of the political courage to push through what have long been understood to be necessary reforms is provided by the 'demographic factor'.

By curbing the rise in pension levels, the 1992 pension reform³⁹⁴ also reined in the rise in the contribution rate by switching from gross to net adjustments. A 70 per cent net pension level was the goal.³⁹⁵ This measure proved to be insufficient to safeguard the sustainable affordability of the pay-as-you-go system, and a demographic or sustainability factor was introduced in the 1999 pension reform. This aimed to introduce half of the change in the life expectancy of 65-year olds as a further factor in the pension formula.³⁹⁶ A pension safeguard clause agreed at the same time prevented the sustainability factor from cutting pensions year-on-year or a drop in pension levels to below 64 per cent.³⁹⁷

There was a change in government before this sustainability factor came into force. The new government fast-tracked a bill to suspend the sustainability factor³⁹⁸ and the subsequent 2001 pension reform killed it off.³⁹⁹ But because the 2001 pension reform was also unsuccessful in ensuring sustainability,⁴⁰⁰ the pension reform bill at the end of 2003 revived the idea of a demographic factor in accordance with the recommendation by the Rürup Commission,⁴⁰¹ albeit in modified form. Instead of being based on the life expectancy of 65-year olds, the new sustainability factor is based on the support ratio: one-quarter of the change in this ratio flows into the new pension formula.⁴⁰² This rule implies that the financial burdens resulting from the other three-quarters of the change in the support ratio will be borne by the active contribution payers. Another burden for the active population may result from a pension safeguard clause which sets out that the sustainability factor and the factor for the change in the average pension insurance

³⁹⁴ RRG 1992.

³⁹⁵ See Ruland (no date), p. 3.

³⁹⁶ Precisely, this is half the ratio of the life expectancy of 65-year olds in the ninth preceding calendar year to the eighth preceding calendar year (section 68(4) SGB 6 as amended by Art. 1 RRG, 1999).

³⁹⁷ Section 68(6) SGB 6 as amended by Art. 1 RRG 1999.

³⁹⁸ Art. 1 section 1 *Gesetz über Korrekturen in der Sozialversicherung und zur Sicherung der Arbeitnehmerrechte* (German Act on Adjustments to Social Security and to Safeguard Employee Rights), 19 Dec. 1998, BGBl. (*Federal Gazette*) I/1998, no. 85, pp. 3843ff modifies Art. 33 RRG 1999, which governs the date that the sustainability factor comes into force to the effect that the sustainability factor only comes into force on 1 Jan. 2001, and then only if no law to the contrary has been adopted by then.

³⁹⁹ Section 68 SGB 6 as amended by Art. 1 no. 16 of the Old-Age Provision Extension Act (AVmEG) no longer contains a demographic factor.

⁴⁰⁰ In the new draft bill, the federal government admits that 'the measures introduced in the 2001 reform to safeguard pension funding in the long term can no longer be seen as adequate' (German Federal Government, *Entwurf eines RV-Nachhaltigkeitgesetzes*, p. 1).

⁴⁰¹ Based on its own calculations, the Rürup Commission comes to the conclusion that the sustainability factor as proposed in the Pension Insurance Sustainability Act would stop the pension insurance contribution rate from exceeding 22 per cent up to 2030 because, on average, pensions will rise around half a percentage point lower than without the sustainability factor (see Federal Ministry of Health and Social Security (2003), p. 9).

⁴⁰² Section 68(4) SGB 6 as amended by Art. 1 no. 11 *RV-Nachhaltigkeitgesetz*.

contributions⁴⁰³ can only be applied if they do not result in any (further) year-on-year drop in the pension level.⁴⁰⁴ This means that the programmatic goal frequently asserted by the federal government – that the ‘benchmark for these reform measures must be the principle of inter-generational fairness’⁴⁰⁵ and ‘that younger people should not be crushed by the contributions’⁴⁰⁶ – is nothing more than empty words.

The 2001 German pension reform, in particular the Riester pension products

Key features of the 2001 pension reform

Mid-1999 saw German policymakers mulling over the introduction of a system of *obligatory* funded occupational pensions to supplement the state pension system, whose contributions and benefits could then be reduced appropriately.⁴⁰⁷ Political backing slipped away, however, following public attacks on the compulsory nature of the proposals.⁴⁰⁸

On 31 May 2000, the German labour minister, Walter Riester, put forward a new reform strategy that proposed a *voluntary*, state-subsidized top-up pension.⁴⁰⁹ The aim of this supplementary pension model was to stabilize the contribution rate to the state pension scheme. The funded model is expected to produce a higher return than the pay-as-you-go system (see Table 2.17), so that to reach a certain pension level, the sum of the contributions to the state pension scheme and those to the supplementary pension would be lower than a contribution paid solely to the state pension scheme.⁴¹⁰

The *Altersvermögensgesetz* (AVmG, or German Old-Age Provision Act)⁴¹¹ passed by the Bundestag on 26 January 2001, was initially rejected by the Bundesrat, the upper house of the German Parliament, on 16 February 2001; following

⁴⁰³ Since the 2001 pension reform, the annual pension adjustment is no longer based on net wage increases (net adjustment), but on gross wages reduced by the change in the pension insurance contribution rate change and the pension savings component (see modified gross adjustment, p. 79).

⁴⁰⁴ Section 68(6) SGB 6 as amended by Art. 1 no. 11 *RV-Nachhaltigkeitgesetz*.

⁴⁰⁵ German Federal Government, *Entwurf eines RV-Nachhaltigkeitgesetzes*, p. 2 and with a similar wording p. 43. This objective was also part of the health ministry’s brief to the Rürup Commission (see Federal Ministry of Health and Social Security, Berlin (2003), p. 23).

⁴⁰⁶ German Federal Government, *Entwurf eines RV-Nachhaltigkeitgesetzes*, p. 43.

⁴⁰⁷ See FAZ.NET (2001f).

⁴⁰⁸ See Pauly, Reiermann and Sauga (2001), p. 96.

⁴⁰⁹ See FAZ.NET (2001f).

⁴¹⁰ See Buttler and Stegmann (1997), p. 13.

⁴¹¹ The AVmEG also passed by the Bundestag contains those parts of the reform that do not require the consent of the Bundesrat: the modified gross wage adjustment replaced the previous net wage adjustment to pensions, the pension level was redefined, surviving dependents’ pensions were reduced, pension splitting for spouses was introduced (sections 120a to 120c SGB 6 as amended by Art. 1 no. 34 AVmEG) and the status of young insured persons with irregular working patterns due to child raising and childcare (section 70 SGB 6 as amended by Art. 1 no. 17 AVmEG), long illnesses (section 58(1) no. 1a SGB 6 as amended by Art. 1 no. 12(aa) AVmEG) or unemployment between the age of 17 and 26, as well as school education, was improved.

Table 2.17 Real interest rates and real wage growth in Germany between 1970 and 1995

Year	Effective return on securities investments	Growth in real gross earned income
1970–94	4.1	2.4
1970–79	3.2	3.9
1980–89	4.7	1.3
1990–94	3.9	1.8
1990–95	4.5	1.6

Source: Buttler and Stegmann (1997), pp. 9f

negotiations in the Mediation Committee,⁴¹² though, it was finally enacted on 11 May 2001⁴¹³ and most of it came into force on 1 January 2002.⁴¹⁴ One of the stated objectives of this reform is to cap increases in the pension insurance contribution rate, with a ceiling of under 20 per cent until 2020 and a maximum of 22 per cent by 2030. The Act obliges the German government to intervene if these levels are exceeded.⁴¹⁵ The main points of this legislation are:⁴¹⁶

- extension of supplementary funded pensions (pillar 3)
- extension of (funded) supplementary occupational pensions through employee entitlement to an occupational pension financed by a deferred compensation model with immediate statutory vesting (pillar 2)
- introduction of a needs-driven basic provision⁴¹⁷
- pension insurance institutions must inform policyholders once a year about the status of their pension rights
- long-term cut in the pension level from 70 per cent to a minimum of 67 per cent⁴¹⁸

A result of the change to the methodology used to calculate the pension level made at the same time is that the pension level calculated using the old formula would

⁴¹² The changes following the negotiations in the mediation committee related, among other things, to the inclusion of residential property in the state subsidy programme and improvements to widows' pensions (see FAZ.NET (2001a)).

⁴¹³ See Porwollik (2001).

⁴¹⁴ Art. 35(1) AVmG.

⁴¹⁵ Section 154(3) no. 1 SGB 6 as amended by Art. 1 no. 36 AVmEG.

⁴¹⁶ See Federal Ministry of Labour and Social Policy, Berlin (2001).

⁴¹⁷ GSiG came into force on 1 Jan. 2003 (Art 35(6) AVmG).

⁴¹⁸ A compulsory component of the pension insurance report to be prepared every year by the government is a 15-year forecast, in particular on the development of income and expenditures of the statutory pension insurance system. If this report forecasts a drop in the pension level to below 67 per cent, the government 'must propose suitable measures to the legislative bodies' (section 154(3) no. 1 SGB 6 as amended by Art. 1 no. 36 AVmEG).

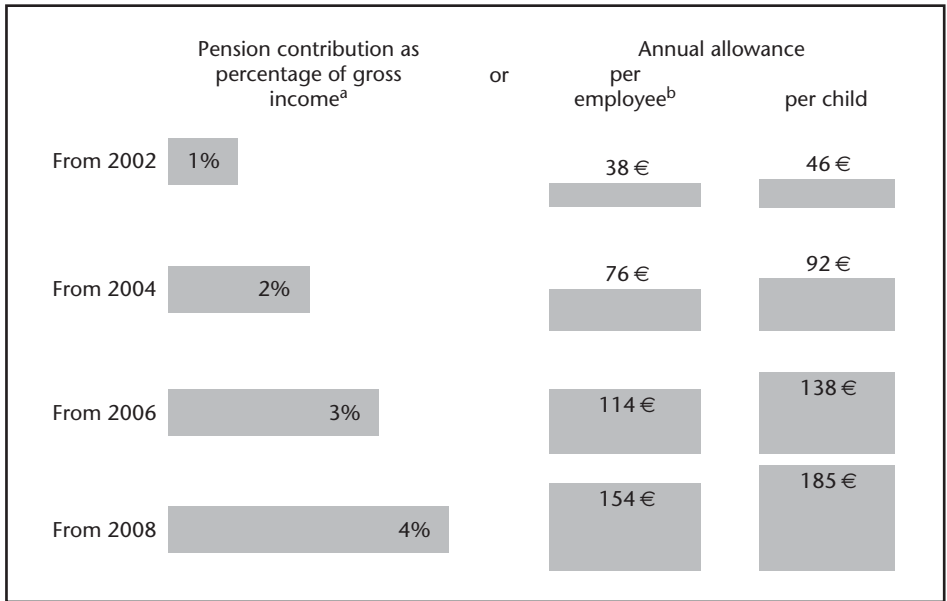


Figure 2.18 State support under the German Old-Age Provision Act

^a Up to about the maximum income threshold for contribution assessment of the year 2000 (see n. 439).

^b Double this amount for married couples (i.e., each spouse is entitled to the amount shown).

be a further three or so percentage points lower.⁴¹⁹ While the net pension level was previously calculated as the net standard pension divided by the average net employment income, a 'pension savings component' is now deducted from the average net employment income,⁴²⁰ so that – all else being equal – the pension level increases, at least in theory. The level of the pension savings component is oriented on the pension savings allowance eligible for tax deduction as a special expense under the Riester pension system (see Figure 2.18), because 'Parliament expects insured persons to incur expenses for their supplementary pension in at least the amount necessary to achieve the maximum tax break for the supplementary pension'.⁴²¹ In contrast to this deduction, however, the pension savings component will increase each year by half of a percentage point, based on 0.5 per cent of the average net employment income in 2002, up to the year 2010, when a level of 4 per cent will apply.⁴²²

⁴¹⁹ See Allianz AG/Dresdner Bank AG (2001), p. 9 and Arbeiterkammer Bremen (June 2001), p. 3.

⁴²⁰ Section 154(3) no. 2 SGB 6 as amended by Art. 1 no. 36 AVmEG.

⁴²¹ German Federal Government, *Entwurf eines RV-Nachhaltigkeitgesetzes*, p. 45.

⁴²² The 2001 pension reform provided for this 4 per cent level to be reached in 2009 (section 255e(3) SGB 6 as amended by Art. 1 no. 52 AVmEG). Because of the suspension of pension adjustments for 2004 decided in 2003 (*Gesetz über die Aussetzung der Anpassung der Renten zum 1 July*), the final level of the pension savings component was also postponed until 2010, so that a pension savings component of 0.5 per cent now applies to 2002 and 2003 (section 255e(3) SGB 6 as amended by Art. 1 no. 52 RV-Nachhaltigkeitgesetz).

Moreover, the annual pension adjustment is no longer driven by the development of average net employment income and the ratio of net to gross pensions⁴²³ (net adjustment), but since 1 July 2002 by the average gross employment income modified by two factors relevant to retirement planning (modified gross adjustment). The first of these factors is the change in the contribution rate to the state pension scheme, while the second is the change in the pension savings component. If the pension insurance contribution rises (falls) year-on-year, the pension adjustment is lower (higher) than the rise in the average gross employment income.

This means that changes in the tax burden on employees and/or pensioners as well as other social security burdens not related to pension contributions no longer affect the annual pension adjustments. In formal terms, this measure is structured as a change in the German pension formula (see equation 2.2).⁴²⁴ The calculation of the current pension value that serves as a parameter for the pension formula was modified accordingly.⁴²⁵

$$\begin{aligned} \text{Monthly pension}_{\text{gross}} &= \text{Personal earnings points} \\ &\quad \times \text{Pension type factor} \\ &\quad \times \text{Current pension value} \end{aligned} \quad (2.2)$$

where:

- an *earnings point* is essentially acquired from the contribution payments for one year resulting from the average income. If the personal income threshold for contribution assessment is higher (lower) than the average income, a corresponding multiple (fraction) of an earnings point is acquired.⁴²⁶ Earnings points can also be acquired for child-raising, education or training, etc.⁴²⁷
- the *pension type factor* governs the provision objective of the pension type under consideration (i.e., the extent to which the pension concerned is designed to replace a salary).⁴²⁸ For example, old-age pensions and occupational disability pensions designed to replace salary in full have a pension type factor of 1.

⁴²³ The net pension ratio is calculated as the net standard pension divided by the gross standard pension. Its inclusion in the pension adjustment formula serves to reflect changes in the tax burden of pensioners.

⁴²⁴ Section 64 SGB 6.

⁴²⁵ Section 255e(4) SGB 6 as amended by Art. 1 no. 52 AVmEG.

⁴²⁶ Section 70 SGB 6.

⁴²⁷ Sections 70ff SGB 6.

⁴²⁸ Section 67 SGB 6.

- the *current pension value* is the monthly old-age pension corresponding to the pension insurance contributions for an average annual income.⁴²⁹ For the year starting 1 July 2003, the current pension value in West Germany is €26.13, and €22.97 in East Germany.⁴³⁰ Since the 2001 pension reform, the annual adjustment to the current pension value has taken the form of modified gross adjustments.

Third pillar: supplementary funded private pensions

Riester pension products or contracts have offered a new opportunity for private funded pension provision in Germany since early 2002.⁴³¹ Payments to these products qualify for subsidies up to certain annual contribution limits. The pension itself is taxable during the benefit phase. The main rules relate to state support in the form of allowances or tax privileges, as well as to the structuring of the investment products.

With regard to *state support*; the monthly payments to the selected Riester pension product are a combination of contributions by the employee and state allowances⁴³² that depend on marital status and the number of children (see Figure 2.18):

- (a) the basic allowance will rise from €38 in 2002 and 2003 gradually to €154 with effect from 2008;⁴³³
- (b) the child allowance will rise from €46 per child in 2002 and 2003 gradually to €185 per child with effect from 2008.⁴³⁴

The full amount of these allowances can only be earned if the sum of the own contributions and allowances of the pension saver reaches or exceeds the 'minimum personal contribution'. This minimum personal contribution starts at 1 per cent of the previous year's income subject to statutory pension insurance contributions in 2002 and rises gradually to 4 per cent by 2008 by one percentage point every two years.⁴³⁵

⁴²⁹ Section 68(1) SGB 6.

⁴³⁰ Section 1(1) and (2) RAV 2003; the adjustments in recent years did not always keep pace with inflation. In 2001, the pension values were €25.31 (West) and €22.06 (East) [section 1(1) and (2) RAV 2001] and 2002 €25.86 (West) and €22.7 (East) [section 1(1) and (2) RAV 2002], giving percentage increases in the last two years of 2.16 per cent and 2.89 per cent (West and East 2001 to 2002) and 1.04 per cent and 1.19 per cent (West and East 2002 to 2003).

⁴³¹ As compensation for public sector pensions benefit cuts the German Income Tax Act was amended in 2001 to expand the eligibility for Riester pension state subsidies to public sector employees (section 10a(1) sentence 1 no. 1 EStG as amended by Art. 11 no. 1(a) VersÄndG 2001).

⁴³² Section 83 EStG as amended by Art. 6 no. 15 AVmG.

⁴³³ Section 84 EStG as amended by Art. 6 no. 15 AVmG.

⁴³⁴ Section 85(1) EStG as amended by Art. 6 no. 15 AVmG.

⁴³⁵ Section 86(1) EStG as amended by Art. 6 no. 15 AVmG.

To ensure the requirement for a personal financial contribution even in cases of low income and/or high allowances due to marriage or (several) children where the minimum personal contribution can be reached without any appreciable effective personal contribution, but merely due to the allowances themselves, a 'core amount' is used to stipulate an absolute lower threshold for the personal contribution.⁴³⁶ Conversely, there is also a maximum personal contribution⁴³⁷ arrangement under which the sum of the personal contribution and allowances may not exceed €525 in 2002–2003, €1,050 in 2004–2005, €1,575 in 2006–2007 and €2,100 starting in 2008.⁴³⁸ In the same way as the occupational pensions discussed below, this ensures orientation on the income threshold for contribution assessment, although this is not index-linked (i.e., the basis is always the income threshold for contribution assessment for 2000).⁴³⁹

An alternative to simple state support by means of allowances is the tax-deductibility of the contributions as a special personal allowance. The relevant tax office must examine whether it would be more favourable for the retirement saver to claim a corresponding tax allowance instead of state support ('best treatment comparison'). If the tax savings then exceed the amount of the state support entitlement because of the deductibility of the personal contributions paid and the allowances that can be claimed, this is added to the income tax liability.⁴⁴⁰

Another tax incentive relates to the tax-exemption of the investment income and capital gains. However, the pension payouts must be taxed,⁴⁴¹ producing an EET system.

A model calculation based on an annual income of €40,900 and three different scenarios for marital status and children reflects both the effects of the allowances and the alternative tax savings from deducting the retirement provision expense (see Figure 2.19). At 41 per cent, the state top-up ratio is highest for a married couple with two children, while a childless couple comes off worst at 26 per cent. This shows that for a given gross income, both childless singles and childless couples fare better with a tax allowance, while couples with two (or more) children benefit more from the state allowance model.

The forecast for 2002 that an additional €25 billion would flow into insurance and fund products⁴⁴² was far too optimistic. Inflows of €30 billion⁴⁴³ to €64

⁴³⁶ For 2002–2004, the core amount was €45 for people without children, €38 for one child allowance and €30 for several child allowances (section 86(1) EStG as amended by Art. 6 no. 15 AVmG). Starting in 2005, the core amount is a standard €60 (section 86(1) EStG as amended by Art. 1 no. 29 AltEinkG).

⁴³⁷ Section 82(1) EStG as amended by Art. 6 no. 15 AVmG.

⁴³⁸ Section 10a(1) sentence 1 EStG as amended by Art. 6 no. 8 AVmG.

⁴³⁹ €525/€1,050/€1,575/€2,100 correspond to just on 1 per cent/2 per cent/3 per cent/4 per cent of the income threshold for 2000 of €52,765 (DM103,200 in accordance with section 3(1) no. 1 *Sozialversicherungs-Rechengrößenverordnung 2000*).

⁴⁴⁰ Section 10a(2) EStG as amended by Art. 6 no. 8 AVmG.

⁴⁴¹ Section 22 no. 5 EStG as amended by Art. 6 no. 9 b AVmG.

⁴⁴² See Wirth (2001).

⁴⁴³ See Major (2002).

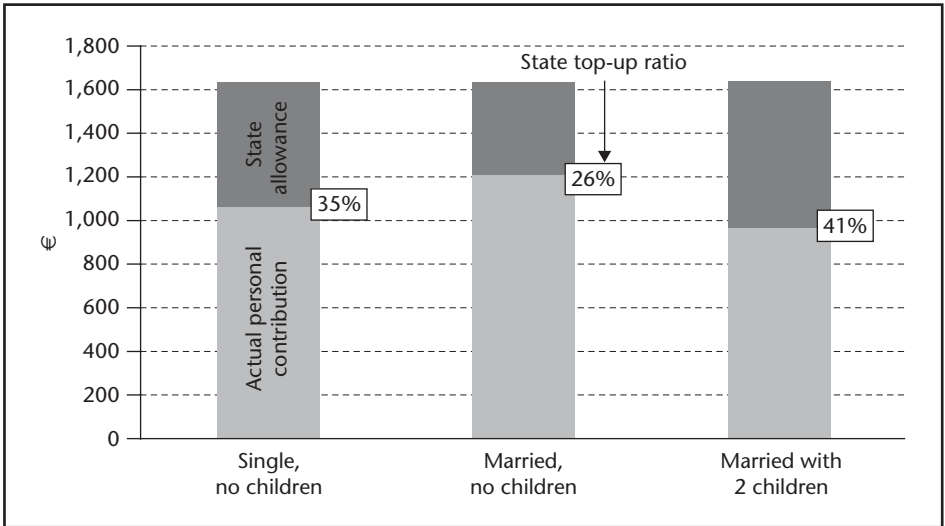


Figure 2.19 State pension subsidies based on allowances or tax savings in 2008 for an annual income subject to statutory pension insurance contributions of €40,900

Source: Allianz AG/Dresdner Bank AG (2001), p. 11

billion⁴⁴⁴ and state allowances of approximately €10 billion⁴⁴⁵ to €13 billion⁴⁴⁶ are now forecast for 2008.

Let us now look at the *structuring of investment products*: until 31 December 2004, the only products permitted were pension insurance policies,⁴⁴⁷ funds⁴⁴⁸ and bank savings schemes,⁴⁴⁹ as well as residential property.⁴⁵⁰ An amendment in 2004 eliminated the defined list of products,⁴⁵¹ and only the residential property alternative is now explicitly mentioned. This means that there has been a large degree of freedom in the product categories since 1 January 2005.⁴⁵² Eligible product providers are German and foreign life insurance companies and banks, and (subject to certain criteria) other EU investment services companies.⁴⁵³

⁴⁴⁴ See Wirth (2001).

⁴⁴⁵ See Federal Ministry of Labour and Social Policy, Berlin (2001).

⁴⁴⁶ See Federal Ministry of Health and Social Security (np, 2003), p. 1.

⁴⁴⁷ Section 1(1) no. 7 a AltZertG as amended by Art. 7 AVmG.

⁴⁴⁸ Both distributing and retaining domestic and foreign investment funds were permitted, although the latter were limited to UCITS. In the case of distributing funds, reinvestment of distributions free of charge must be possible (section 1(1) no. 7 c AltZertG as amended by Art. 7 AVmG).

⁴⁴⁹ Section 1(1) no. 7 b AltZertG as amended by Art. 7 AVmG.

⁴⁵⁰ Section 1(1) third sentence to last AltZertG.

⁴⁵¹ Art. 7 no. 1(a) ee AltEinkG.

⁴⁵² Art. 18(3) AltEinkG.

⁴⁵³ Section 1(2) AltZertG.

All products require certification by the Federal Financial Supervisory Authority⁴⁵⁴ (BaFin). This certification, for which a charge is levied,⁴⁵⁵ does not represent any government seal of quality for the return and security of the investment product concerned, but is merely a certificate that it satisfies mandatory legal minimum features.⁴⁵⁶ Existing contracts that satisfy these criteria are also eligible.⁴⁵⁷ These features are clearly driven by security aspects so as to exclude 'speculative investment forms'⁴⁵⁸ from state support, and do not include any requirement for risk/return optimization. Specifically, certification and thus eligibility for state support is linked to the following key points:⁴⁵⁹

- 1 The benefit is not paid out until the beneficiary reaches the statutory pensionable age, is entitled to an occupational disability pension, or reaches the age of 60.
- 2 Unisex tariffs have been obligatory since 1 January 2005 (i.e., women cannot be required to pay higher contributions than men for the same pension benefits despite their considerably higher average longevity, which is not offset by any higher retirement age). Women thus receive a higher present value than men without having to pay correspondingly higher contributions. Because the product providers are not offered any offsetting compensation payments by the government, the effective redistribution of contributions from male to female pension customers can be expected if internal product cross-subsidies at the vendor companies are ignored. This in turn runs counter to the principle of equal treatment.
- 3 The benefit must be paid either as a life annuity or as a payout plan with annuitization of the remaining capital. This requirement to annuitize the remaining capital must be satisfied by contributing a corresponding share of the capital accumulated at the beginning of the payout phase to a pension insurance that pays a life annuity starting from the age of 85. Up to 30 per cent of the capital saved at the start of the benefit phase can be paid out in a form of the pensioner's choice (i.e., including forms other than an annuity).⁴⁶⁰

⁴⁵⁴ Section 2(1) AltZertG as amended by Art. 17 no. 1 *Gesetz über die integrierte Finanzdienstleistungsaufsicht*. The certifying authority was originally the Federal Insurance Supervisory Office (BAV). On 1 May 2002, the BAV, BAKred (Federal Banking Supervisory Office) and BAWe (Federal Securities Trading Supervisory Office) were merged to form the single regulator BaFin (section 1(1) FinDAG).

⁴⁵⁵ An umbrella association of a product provider industry can have a specimen contract certified by BaFin for fee of €250. In other cases, the certification fees generally payable to BaFin are €5,000, but only €500 if certification is based on a specimen contract already certified by an umbrella association (section 12 AltZertG).

⁴⁵⁶ Section 1(3) AltZertG.

⁴⁵⁷ Section 1(1) last sentence AltZertG.

⁴⁵⁸ See Allianz AG/Dresdner Bank AG (2001), p. 10.

⁴⁵⁹ Section 1(1) AltZertG as amended by Art. 7 AltEinkG.

⁴⁶⁰ Section 1(1) no. 4 AltZertG as amended by Art. 7 no. 1(a) cc AltEinkG. This possibility of (partial) capitalization was not originally provided for.

- 4 Guaranteed life-long constant or increasing benefits.
- 5 Optional supplementary insurance to cover occupational disability and/or for survivors' benefits. In terms of biometric risks, this means that the risk of occupational disability and the survivor benefit risk are optionally covered, and the longevity risk is mandatorily covered.
- 6 Obligatory asset value guarantee: at the start of the payout phase, at least the contributions paid (nominal value maintenance) must be guaranteed.⁴⁶¹
- 7 Initial commission and selling costs must be spread evenly over five years.⁴⁶²
- 8 Requirement for the provision of minimum written information to the pension saver: the initial, selling, administrative and switching costs must be disclosed before the contract is signed.⁴⁶³ In the same way that US investment fund prospectuses are required to illustrate the long-term management costs, the following additional information must also be disclosed since 1 January 2005:
 - (a) model return calculations: based on a 10-year contract term (if the payout phase starts before the end of the 10-year period, the corresponding shorter term must be used) and constant contributions (if variable contributions have been agreed, these must be applied), the balance at the end of each year must be disclosed on the basis of (notional) returns of 2 per cent, 4 per cent and 6 per cent (if other guaranteed interest rates are specified, these must be used);⁴⁶⁴
 - (b) 'the investment opportunities, the structure of the investment portfolio and the risk potential':⁴⁶⁵ there is no more detailed information about the presentation of asset allocation or, in particular, about the presentation of risk information in a form appropriate to the reader (there is not even a stipulation whether quantitative risk indicators and/or qualitative risk descriptions are required).

Each year, the saver must be told in writing about the amount⁴⁶⁶ and utilization of the contributions paid,⁴⁶⁷ the capital accumulated⁴⁶⁸ and the returns

⁴⁶¹ In the case of the optional insurance against reduced capacity to work or total disability, the guaranteed amount can be reduced to 85 per cent of contributions (section 1(1) no. 3 AltZertG).

⁴⁶² The five-year period applies from 1 Jan. 2005 (section 1(1) no. 8 AltZertG as amended by Art. 7 no. 1(a) dd AltEinkG). Until 31 Dec. 2004, they had to be spread over at least 10 years (section 1(1) no. 8 AltZertG as amended by Art. 7 AVmG).

⁴⁶³ Section 7(1) AltZertG.

⁴⁶⁴ Section 7(1) no. 4 AltZertG as amended by Art. 7 no. 3(a) bb AltEinkG.

⁴⁶⁵ Section 7(1) no. 5 AltZertG as amended by Art. 7 no. 3(a) bb AltEinkG.

⁴⁶⁶ Section 92 EStG as amended by Art. 6 no. 15 AVmG.

⁴⁶⁷ Section 7(4) AltZertG as amended by Art. 7 no. 3(c) AltEinkG (until 31 Dec. 2004: section 1(1) no. 9 AltZertG as amended by Art. 7 AVmG).

⁴⁶⁸ Section 92 EStG as amended by Art. 6 no. 15 AVmG; Section 7(4) AltZertG as amended by Art. 7 no. 3(c) AltEinkG (until 31 Dec. 2004: Section 1(1) no. 9 AltZertG as amended by Art. 7 AVmG).

generated to date,⁴⁶⁹ the total amount of existing allowances,⁴⁷⁰ the initial, selling and administrative costs deducted so far⁴⁷¹ and whether any ethical, social and environmental aspects are considered in the investment policy.⁴⁷²

- 9 State support for residential property is possible, first, by means of a certified retirement provision contract⁴⁷³ and, second, in the form of the ‘interim withdrawal model’: to acquire owner-occupied residential property, a ‘retirement provision amount for owner-occupied property’ of between €10,000 and €50,000 may be withdrawn temporarily from the accumulated retirement provision capital.⁴⁷⁴ The repayment, to be made in instalments, must start in the second year following the withdrawal and must be completed by the time the saver reaches the age of 65.⁴⁷⁵ If the saver is permanently in arrears with the repayments⁴⁷⁶ or if the residential property is never used by the owner,⁴⁷⁷ the state subsidies must be repaid.⁴⁷⁸

Second pillar: supplementary occupational pensions

The German Improvement of Occupational Pension Schemes Act passed in 1974 was the first legal basis for tax-privileged occupational pension provision in Germany.⁴⁷⁹ The 2001 pension reform (Riester reform) extended the existing four occupational pension vehicles in Germany with a fifth, the pension fund. Three of the pension vehicles, namely the newly introduced pension fund, the *Pensionskasse* (staff pension scheme) and direct insurance are legally separate from the sponsor (external to the company), while the two others – direct commitments (pension provisions) and the *Unterstützungskasse* (benefit fund) – are internal to the company.

Not only the two internal pension vehicles,⁴⁸⁰ but also pension funds⁴⁸¹ and, in certain circumstances, direct insurance⁴⁸² offer obligatory protection in the

⁴⁶⁹ See n. 467.

⁴⁷⁰ See n. 466.

⁴⁷¹ See n. 467.

⁴⁷² See n. 467.

⁴⁷³ See n. 450.

⁴⁷⁴ Section 92a(1) EStG as amended by Art. 6 no. 15 AVmG.

⁴⁷⁵ Section 92a(2) EStG as amended by Art. 6 no. 15 AVmG.

⁴⁷⁶ Section 92a(3) EStG as amended by Art. 6 no. 15 AVmG.

⁴⁷⁷ Section 92a(4) EStG as amended by Art. 6 no. 15 AVmG.

⁴⁷⁸ US 401(k) pension plans offer a similar facility for early (interim) withdrawal (see section on Defined contribution occupational pensions: 401(k) plans, p. 160).

⁴⁷⁹ See Tepper (2003), p. 45.

⁴⁸⁰ The insurance protection for direct commitments results from section 7(1) sentence 1 BetrAVG, that for benefit funds from section 7(1) sentence 2 no. 2 BetrAVG as amended by Art. 9 no. 12(a) AVmG.

⁴⁸¹ Section 7(1) sentence 2 no. 2 BetrAVG as amended by Art. 9 no. 12(a) AVmG.

⁴⁸² If the employer has transferred the insurance claims or assigned them as collateral (section 1b(2) sentence 3 BetrAVG as amended by Art. 9 no. 5 AVmG), it must also pay insolvency protection premiums for a direct insurance policy (section 10(1) BetrAVG), providing insolvency protection (section 7(1) sentence 2 no. 1 BetrAVG as amended by Art. 9 no. 12(a) AVmG).

event of sponsor insolvency. Only the *Pensionskasse* is generally excluded from insolvency protection and therefore offers a corresponding cost advantage to the employer, who is responsible⁴⁸³ for paying the contributions to the insolvency insurance provider, the pension insurance association.⁴⁸⁴

At 54 per cent of all occupational pension commitments, direct commitments, which are funded on a pay-as-you-go (not a funded) basis, are by far the most important of the traditional four pension vehicles. The *Pensionskasse* trails well behind in second place at 19 per cent, followed by direct insurance at 14 per cent and the *Unterstützungskasse* at 13 per cent.⁴⁸⁵

The content of the legal framework for pillar two corresponds in part to that of the third pillar, although there are significant differences: for instance, there are three different ways that occupational pensions can be funded.

- 1 Pure employer financing, either as a (defined benefit) pension commitment⁴⁸⁶ or as a defined contribution with a minimum benefit.⁴⁸⁷ In the latter case, the three external pension vehicles are available. The minimum benefit takes the form of an asset value guarantee by the employer.⁴⁸⁸
- 2 Deferred compensation: employees in Germany now have a statutory right to deferred compensation, under which the employer is obliged, on application by the employee, to pay part of the compensation up to 4 per cent of the pension insurance income threshold for contribution assessment into one of the three external pension vehicles.⁴⁸⁹
- 3 Personal contributions by the employee: employees can pay amounts from their net income into one of the three external pension vehicles if the employer extends its pension guarantee to such personal contributions (comprehensive pension guarantee).⁴⁹⁰ Instead of tax-deductibility, there is a right to the state 'Riester' allowances that also apply to pillar 3 pensions.⁴⁹¹ Contrary to the wording of the law,⁴⁹² there is no right to Riester support for the three

⁴⁸³ Section 10(1) BetrAVG.

⁴⁸⁴ Section 14(1) BetrAVG defines the 'Pensions-Sicherungs-Verein Versicherungsverein auf Gegenseitigkeit' as the pension insurance association.

⁴⁸⁵ See Tepper (2003), pp. 46f.

⁴⁸⁶ Section 1(2) no. 1 BetrAVG as amended by Art. 9 no. 3 AVmG.

⁴⁸⁷ Section 1(2) no. 2 BetrAVG as amended by Art. 9 no. 3 AVmG.

⁴⁸⁸ The guarantee covers the contributions paid less any insurance expense to cover biometric risks (section 2(5)b BetrAVG as amended by Art. 3 no. 3(b) HZvNG).

⁴⁸⁹ Section 1(3) no. 2 BetrAVG as amended by Art. 9 no. 3 AVmG in conjunction with section 1a BetrAVG as amended by Art. 9 no. 4 AVmG.

⁴⁹⁰ This type of occupational pension was not a component of the original Riester reform on the basis of the AVmG, but was only introduced a year later by the HZvNG, which introduced funded occupational pensions for steelworkers and amended the BetrAVG and the VAG, which can in turn be interpreted as a reform of the AVmG (see DBV-Winterthur Versicherungen (2002), p. 2).

⁴⁹¹ Section 1(2) no. 4 BetrAVG as amended by Art. 3 no. 1 HZvNG in conjunction with section 1a(3) BetrAVG as amended by Art. 9 no. 4 AVmG.

⁴⁹² Section 1a(3) BetrAVG.

pension vehicles of direct insurance, *Pensionskasse* and pension funds if they are financed by deferred compensation, but only in the case of personal contributions.⁴⁹³ In contrast to pillar 3, the pillar 2 arrangements are more favourable in this respect because there is a higher and more dynamic upper contribution threshold: starting in 2002, up to 4 per cent of the *applicable* pension insurance income threshold for contribution assessment is tax-exempt.⁴⁹⁴

There is no certification requirement except for personal contributions qualifying for state support (see point 3 above).

When it comes to state support, depending on the pension vehicle and the type of financing, there are different tax and social security contribution arrangements, although only the major arrangements for the three external pension vehicles will be discussed here because the Riester reform relates primarily to these vehicles.

- 1 Personal contributions qualifying for state support (see point 3 above) are not generally tax- or social security contribution-exempt because the payments are made from net income. The pension payments are subject to personal income tax.⁴⁹⁵ The incentive to pay personal contributions lies in their eligibility for Riester support (i.e., they qualify for allowances in the same way as the rules for pillar three pensions).
- 2 Employer-financed contributions to pension funds, *Pensionskassen* and direct insurance policies of up to 4 per cent of the pension insurance income threshold for contribution assessment are recognized as operating expenses for tax purposes⁴⁹⁶ and are therefore always tax- and social security contribution-exempt for employers.⁴⁹⁷ The pension payments are subject to personal income tax.⁴⁹⁸
- 3 Deferred compensation: The same rules as for employer-financed retirement provision contributions apply except for the social security contribution exemption, which expires from 1 January 2009.⁴⁹⁹

Pension funds as a new type of pillar 2 pension

The structure of pension funds and their regulation is governed by the *Versicherungsaufsichtsgesetz* (German Insurance Supervision Act, or VAG) and a range of derivative legislation⁵⁰⁰ enacted on the basis of this law, which is why the term

⁴⁹³ See DBV-Winterthur Versicherungen (2002), p. 2.

⁴⁹⁴ Section 3 no. 63 EStG as amended by Art. 1 no. 2 AltEinkG.

⁴⁹⁵ Other income as defined by section 22 no. 5 EStG as amended by Art. 6 no. 9 b AVmG.

⁴⁹⁶ See n. 494.

⁴⁹⁷ Section 2(1) no. 3 ArEV.

⁴⁹⁸ See n. 495.

⁴⁹⁹ See n. 497.

⁵⁰⁰ Orders governing solvency (PFKAustV on the basis of section 114(2) VAG as amended by Art. 10 no. 4 AVmG), technical provisions (PFDeckRV on the basis of section 116 VAG as amended by Art. 10 no. 4 AVmG) and investment rules (*Pensionsfonds-Kapitalanlagenverordnung*, or PFKapAV, on the basis of section 115(2) VAG as amended by Art. 10 no. 4 AVmG).

'VAG pension funds' has now become common. As a result, the authorization⁵⁰¹ and supervision of pension funds is the responsibility of the BaFin.⁵⁰² One of the (at least formally) most significant legal differences between insurance companies and pension funds is to be found in the more liberal investment rules. The pension fund board, which must consist of at least two persons,⁵⁰³ must satisfy⁵⁰⁴ the fit and proper criteria that are standard for insurance companies.⁵⁰⁵ In addition, a VAG pension fund is permitted to transfer functions to third parties under certain conditions. Delegation may not be extended to the point where the pension fund loses its ability for 'adequate oversight' because 'final responsibility' always remains with the fund. Although the investment function may be outsourced, other 'core business functions, such as the establishment of the monitoring system or the definition of the investment principles' must at all events be exercised by the pension fund itself.⁵⁰⁶

The German government explicitly emphasizes the advantages of pension funds:⁵⁰⁷

- (a) employees have a legal claim on the pension fund as the *external* sponsor of the pension scheme;⁵⁰⁸
- (b) if employees switch jobs, their entitlements continue and are portable, encouraging workforce mobility;
- (c) they strengthen Germany as a financial centre, because the long-term nature of retirement planning plans is expected to increase investment in equities;
- (d) in addition to defined benefits, defined contributions with a minimum benefit⁵⁰⁹ (i.e., hybrid forms) are now also possible.

⁵⁰¹ Section 5(1) VAG in conjunction with section 113(1) VAG as amended by Art. 10 no. 4 AVmG.

⁵⁰² The original regulator was the Federal Insurance Supervisory Office (BAV); see n. 454. Under section 113(1) VAG as amended by Art. 10 no. 4 AVmG, the provisions applicable to insurance companies apply in general to pension funds. The duty to supervise insurance companies (section 81(1) VAG) thus results in the BaFin's responsibility for pension funds.

⁵⁰³ Section 34(1) VAG in conjunction with section 156(1) VAG.

⁵⁰⁴ BaFin can refuse authorization if the board members do not have appropriate professional qualifications, if they or persons or the representatives of companies invested in the pension fund do not appear to be reliable, or if the business plan (section 5 VAG in conjunction with section 113(2) VAG as amended by Art. 10 no. 4 AVmG) indicates that the interests of the insured persons will not be adequately protected (section 8(1) VAG in conjunction with section 113(1) VAG as amended by Art. 10 no. 4 AVmG).

⁵⁰⁵ The necessary professional qualifications of the board members 'will normally be assumed if a three-year managerial activity at an insurance company of comparable size and nature of business can be demonstrated' (section 7a(1) VAG).

⁵⁰⁶ BaFin (2002), pp. 5f.; we present the rules for the investment principles of VAG pension funds on p. 293.

⁵⁰⁷ See Federal Ministry of Labour and Social Policy, Berlin (2001).

⁵⁰⁸ Section 112(1) no. 3 VAG as amended by Art. 10 no. 4 AVmG.

⁵⁰⁹ Section 112(2) no. 1 VAG as amended by Art. 10 no. 4 AVmG in conjunction with section 1(2) no. 2 BetrAVG as amended by Art. 9 no. 2 AVmG.

One advantage of VAG pension funds that was not envisaged in the original Riester reform is that a life annuity or a payout plan with annuitization of the remaining capital can be arranged for the benefit phase in the same way as for Riester products (pillar 3).⁵¹⁰

On closer inspection, not all of these advantages can effectively be realized in practice because the legal situation is actually more complex: the scenario of a flourishing German equity culture due to the launch of VAG pension funds as a new form of institutional investor appears only superficially to be a strong possibility. The German government has issued encouraging declarations of intent about the investment rules for VAG pension funds, because this will give pension funds 'greater investment discretion'⁵¹¹ or allow them to invest 'relatively freely on the capital markets',⁵¹² which is why the establishment of 'risk management complying with international standards',⁵¹³ will be mandatory with the goal of 'matching the investment strategy to the profile of the obligations to the members of pension schemes and pensioners'.⁵¹⁴

In formal terms, VAG pension funds really do have far-reaching investment discretion. There are the following quantitative investment limits, although they do not apply to specific asset classes:⁵¹⁵

- limit on individual issuers to 5 per cent of the premium reserve fund⁵¹⁶
- limit on investments in the sponsor to 5 per cent of the premium reserve fund⁵¹⁷
- limit on shares in an individual corporation that can be acquired to 10 per cent of its share capital⁵¹⁸

⁵¹⁰ Section 112(1) no. 4 VAG as amended by Art. 4 no. 1(a) HZvNG in conjunction with section 1(1) no. 5 AltZertG. The payout plan option was not contained in the original Riester reform (AVmG), but only added a year later by the HZvNG; section 112(1) no. 4 VAG as amended by Art. 10 no. 4 AVmG still prescribed an obligatory life annuity as the sole option.

⁵¹¹ Federal Ministry of Labour and Social Policy (no date/b).

⁵¹² Ibid.

⁵¹³ Ibid.

⁵¹⁴ Ibid.; a corresponding wording was included in section 115(1) VAG as amended by Art. 10 no. 4 AVmG.

⁵¹⁵ The supervisory authority can allow quantitative limits to be exceeded 'if this does not impair the interests of the beneficiaries' (section 2(3) PFKapAV).

⁵¹⁶ 'All investments in one and the same issuer (debtor) must be limited to an aggregate of 5 per cent of the premium reserve fund' (section 4(1) PFKapAV). A different upper limit of 30 per cent of the premium reserve fund applies to EEA government bonds and bonds issued by certain international organizations, to certain debt issues of EEA credit institutions with a certain level of cover funds, and to bank balances at certain suitable credit institutions (section 4(2) PFKapAV). A limit of 10 per cent of the premium reserve fund applies to individual properties or to real estate funds invested in only a small number of properties (section 4(4) PFKapAV).

⁵¹⁷ 'Investments in a sponsor of the pension funds and its group companies are limited to 5 per cent of the premium reserve fund. If a pension fund is sponsored by more than two companies, investments in these companies are limited to an aggregate of 15 of the premium reserve fund' (section 4(1) PFKapAV).

⁵¹⁸ Subordinated assets, profit participation rights, shares and other equity instruments 'may not exceed a total of 10 per cent of the share capital of a single company' (section 4(4) PFKapAV).

- prohibition on investment ‘in group companies of the pension fund’⁵¹⁹
- at least 70 per cent of the premium reserve fund must be invested in matching currencies⁵²⁰

There are basically no other limits, and the ability to invest in the following asset classes should be highlighted as a particularly liberal regime:⁵²¹

- bonds traded on official markets outside the European Economic Area (EEA)
- other restricted assets may also be invested in equities admitted to official trading outside the (EEA)⁵²²
- German and foreign investment funds⁵²³

However, despite these liberal investment rules, pension funds will invest primarily in lower-risk asset classes for the following reasons.

- 1 The fact that defined contribution plans with minimum benefits are now also allowed in addition to defined benefit plans does not change the position that pure-play defined contribution plans are still prohibited. The minimum benefit in the form of the obligatory asset value guarantee (nominal value maintenance) represents an effective investment limit, and inefficient investment portfolios can be expected as a result.
- 2 Investment in higher-risk asset classes may result in higher policy reserves and thus in higher capital requirements for the pension fund: if the pension fund assumes an ‘insurance-type guarantee’,⁵²⁴ it is required to establish policy reserves.⁵²⁵ Because ‘the basis for measuring the policy reserves must be

⁵¹⁹ Section 2(4) PFKapAV.

⁵²⁰ Section 5 PFKapAV.

⁵²¹ The *Pensionsfonds-Kapitalanlagenverordnung* issued by the federal government on the basis of section 115(2) VAG as amended by Art. 10 no. 4 AVmG includes in section 2(1) an exhaustive list of permitted asset classes, and section 2(2) also contains an opening clause that allows up to 10 per cent (section 3(1) PFKapAV) of the premium fund reserve to be invested in asset classes not included in this list.

⁵²² In exactly the same way as for securities loans, subordinated assets and profit participation rights, the supervisory authority can also limit the permitted proportion of shares and other equity instruments ‘if this is necessary to safeguard the interests of the beneficiaries’ (section 3(2) PFKapAV).

⁵²³ Investment funds that use derivatives for speculative purposes are excluded. Foreign investment funds must be UCITS or ‘publicly distributed funds under the *Auslandinvestment-Gesetz* [(*AusInvestmentG*)]’ (section 1(1) no. 15 PFKapAV). Because the *AusInvestmentG* was replaced by the *Investmentgesetz* (InvG) on 1 Jan. 2004 (see n. 560, p. 100), only investment funds publicly distributed under the InvG are now permitted.

⁵²⁴ An insurance-type guarantee exists if the pension fund ‘guarantees a benefit whose amount is funded from contributions already made to the exclusion of any contractual top-up obligation’, or it ‘assumes a minimum benefit guarantee for defined contribution plans’ (section 1(2) PFDeckRV).

⁵²⁵ Section 1(1) PFDeckRV.

defined with sufficient caution,⁵²⁶ higher-risk assets must be discounted more heavily than lower-risk assets.⁵²⁷ The lower the discount rate that must be applied, the higher the policy reserves that have to be recognized on that basis. Because the necessary solvency range is measured as a percentage of the policy reserves,⁵²⁸ higher policy reserves result in higher capital requirements for a pension fund.

Main weak points of the new arrangements for second and third pillar schemes

The obligatory asset value guarantee for both second and third pillar pensions promotes inefficient asset allocation because of the excessively low risk, and thus an excessively low return. For example, although Riester products can also generally be structured using investment funds, the providers of such products would have to demonstrate *every month*⁵²⁹ that the market value of the investment portfolio discounted by a risk factor contingent on volatility exceeds the present value of the pension obligations (see equation 2.3).⁵³⁰ Under the standard assumption of normally distributed returns, a risk factor of 2.33σ means that a maximum shortfall risk of 1 per cent is tolerated (i.e., that there is a 99 per cent (model) probability that the guaranteed asset value will be available if the investment portfolio is immediately reallocated to zero bonds with a coupon of r at maturity):⁵³¹

$$\frac{M}{e^{2,33\sigma}} \leq \frac{B}{(1+r)^{RLZ-1}} \quad (2.3)$$

where M = Market value of pension portfolio
 e = Euler's number
 σ = 1-month standard deviation for the investment product based on a time-series of its value changes from min. 2 and max. 5 years
 B = Aggregate contributions subject to guarantee
 r = Interest rate corresponding to the residual maturity of the yield curve for government bonds
 RLZ = Residual maturity

If this cannot be demonstrated (i.e., if equation 2.3 is satisfied), a credit risk that has to be backed by equity in accordance with the principles of banking law

⁵²⁶ Section 2(1) PFDeckRV.

⁵²⁷ See Heinen (2001), p. 16 and p. 19.

⁵²⁸ The solvency range is generally 4 per cent of the policy reserves (section 1(1) no. 1 PFKAustV) if the pension funds also guarantees the level of contributions and benefits without transferring this risk by buying insurance cover (section 1(3) PFKAustV). If a pension fund that guarantees a minimum benefit for a defined contribution plan is overfunded, it can count 75 per cent of the overfunding to the policy reserves (section 1(1) no. 1 PFKAustV).

⁵²⁹ The monthly cycle is stipulated in: BaKred (2001), p. 4 in conjunction with section 1(1) Deutsche Bundesbank (2001) and section 10(1) sentence 5 KWG.

⁵³⁰ BaKred (2001), p. 3.

⁵³¹ See Maurer and Schlag (2003), p. 9 and p. 20.

is assumed.⁵³² This represents an incentive for the product providers to minimize the investment risk and avoid these capital requirements materializing.

Quite apart from the lack of efficiency, there are also considerable doubts about the effectiveness of this regulatory rule for assuring the asset value guarantee.⁵³³ The fear 'that the existing regulatory regime is unable to assure compliance with the asset value guarantee in the case of investment fund-based Riester products'⁵³⁴ is based on the belief that the nominal value maintenance guarantee represents a value that must be paid directly or indirectly (in the form of opportunity costs) by one of the contracting parties.⁵³⁵ But because 'the related funding costs are neither envisaged in the product concept nor calculated into the products',⁵³⁶ it is unclear where the investment company offering the product will take this capital from if the contingent capital requirement materializes. If the structure of the offering of the investment company in question is also poorly diversified (i.e., the Riester contracts sold have roughly the same maturity and their returns are highly correlated), it will be even more difficult to produce the capital.⁵³⁷ The only way to circumvent the capital requirement is then to reallocate into the risk-free investment, with 'the customer bearing the funding costs through reduced product performance'.⁵³⁸ In the same way as portfolio insurance, however, the ability to implement such a reallocation (at prices that exclude the need for capital backing) is most likely to be impossible, especially in the event of 'very rapidly emerging crash scenarios'.⁵³⁹

A more simple and more effective alternative for assuring the guarantee would be to structure investment fund-based Riester products in such a way that the paid-in contributions are split as follows: one part flows into a fixed-income investment for nominal value maintenance, while the other part could be used for higher-risk, and thus higher-return investments. Even if the risk part were to be totally lost, the part of the savings invested in fixed-income products would safeguard the nominal value.⁵⁴⁰

⁵³² See BaKred (2001).

⁵³³ Gründl, Nietert and Schmeiser (2003), p. 25 therefore term this rule a 'paper tiger'.

⁵³⁴ *Ibid.*, p. 2.

⁵³⁵ The value of the guarantee may be quantified, for example, using option pricing theory. All else being equal, the hedging costs per year rise as the contract term diminishes or the volatility of the underlying investment fund increases. Even for a 25 year term and investment in a bond-dominated German hybrid fund (39 per cent DAX, 61 per cent REXP), the hedging costs of 0.11 per cent of the monthly contributions are not negligible (see *ibid.*, pp. 13f).

⁵³⁶ *Ibid.*, pp. 17f; Gründl *et al.* draw attention here to the fact that 'only other cost types are listed' in section 1 AltZertG. However, the question arises of the extent to which it would be permissible to include hedging costs under the 'costs for administering the accumulated capital' permitted under section 7(4) AltZertG as amended by Art. 7 no. 3 (c) AltEinkG (corresponding to section 1 no. 9 AltZertG as amended by Art. 7 AVmG).

⁵³⁷ See Gründl *et al.* (2003), p. 16.

⁵³⁸ *Ibid.*, p. 18.

⁵³⁹ *Ibid.*, p. 19.

⁵⁴⁰ See *ibid.*, p. 23.

In 2001, Dresdner Bank's estimate of the annual cash flow into state-subsidized retirement products was upbeat: it forecast an inflow of funds of €6 billion as early as 2002, and an increase in this amount through €28 billion in 2010 to as much as €38 billion in 2020. Assuming a nominal return of 6 per cent per annum, the bank's prediction saw a rise in pension assets to €265 billion by 2010 and subsequently to approximately €650 billion by 2020. It expected occupational pensions to be the clear leader, exceeding private pensions by a ratio of 3:1.⁵⁴¹

In fact, growth in demand for Riester products has been disappointing: approximately 3,500 Riester products had been certified as at February 2002.⁵⁴² In the first quarter of 2002, around 1.9 million⁵⁴³ Riester contracts had been signed, and approximately 3.5 million⁵⁴⁴ by the end of 2002.

The second pillar has shown much more encouraging growth: according to an employer survey commissioned by the Federal Ministry of Health and Social Security, the share of private-sector employers with an occupational supplementary pension scheme rose from 38 per cent at 31 December 2001 to 42 per cent at 31 December 2002 and then to 43 per cent at 31 March 2003.⁵⁴⁵

The modest market penetration by the Riester products is certainly also due to the fact that the self-employed have been excluded from the related subsidies, despite political promises to the contrary (i.e., to extend the group of those eligible for support to all taxpayers).⁵⁴⁶

Index-linking of the subsidized maximum contributions would also be appropriate for securing the level of support for the long term. An alternative that would largely avoid additional complexity but still comply with the system would be to lift the maximum subsidized contributions to 4 per cent of the income threshold for contribution assessment, as in the case of deferred compensation.

Ultimately, however, a number of experts have awarded low marks to the 2001 pension reform because the assumptions underlying the pension reform were too optimistic or not free from contradictions.

- 1 The assumptions for life expectancy, immigration (190,000 immigrants per year), unemployment (3 per cent) and the retirement age result in the provision shortfall being seriously underestimated at a mere 2 per cent, instead of the expected 20 per cent. This means that the maximum statutory pension insurance contribution rate in 2030 will not be 22 per cent (see above), but rather 25 per cent to 27 per cent.⁵⁴⁷
- 2 The forecast that the proportion of working women will be the same as for men in a few years would imply a significantly unrealistic change in the present

⁵⁴¹ See Bulhaupt *et al.* (2001), p. 36.

⁵⁴² See Müller (2002).

⁵⁴³ See Harnischfeger (2002).

⁵⁴⁴ See Federal Ministry of Health and Social Security, Berlin (2003), p. 129.

⁵⁴⁵ See Infratest Sozialforschung (2003), p. 18.

⁵⁴⁶ See Federal Ministry of Health and Social Security, Berlin (2003), p. 11.

⁵⁴⁷ See Hahne (2001).

- situation, where 90 per cent of men aged between 30 and 60 are working, compared with only 70 per cent of women in the same age group. In addition, there is no reason to expect that the number of contribution payers in East Germany (the former GDR) will remain constant as assumed, as it is likely to fall by 25 per cent by 2030 and perhaps by even half by 2050.
- 3 In view of the by now very commonplace gaps in working life, the assumption of 'standard pensioners' with 45 contribution years is also unrealistic.
 - 4 With the number of pensioners set to rise by 10 million by 2050, but the number of contribution payers projected to fall by 16 million (even if immigration hits 170,000 per year), either the contribution rate would have to be hiked to 46 per cent by that year or the pension level slashed to 30 per cent. The maximum 4 per cent top-up pension contribution (2008 onwards) now adopted in the new law appears woefully inadequate to make good this shortfall.⁵⁴⁸
 - 5 Economics Nobel Prize winner Franco Modigliani has criticized the savings rate of initially 1 per cent (2002) rising to a maximum of 4 per cent of gross income from 2008; this is so low, he thinks, that it is practically 'nothing'.⁵⁴⁹
 - 6 The planned reduction in pensions to a minimum of 67 per cent by 2030 (see above) is too low from today's perspective to assure the sustainable affordability of the system.⁵⁵⁰

Other types of funded retirement provision in Germany

The 'Rürup pension', a new tax-advantaged annuity product

The *Alterseinkünftegesetz* (Retirement Income Act) came into force on 1 January 2005 to implement the uniform taxation of civil service pensions and employee state pensions demanded by the Federal Constitutional Court. This new law introduces an EET system for all forms of retirement provision, albeit with long transitional periods, and introduces a new private pension vehicle subsidized through the tax-deductibility of contributions, known as the 'Rürup pension'. A Rürup pension is a form of private pension provision that emulates many of the features of the state pension scheme. The main difference is that it is funded. The features in common are that the benefit may be paid out solely as a life annuity and that the entitlements are neither inheritable nor otherwise transferable, and may not be used as collateral or capitalized. Biometric risks may optionally be covered.⁵⁵¹ Only insurance companies are authorized as private-sector product providers.⁵⁵² There are no more far-reaching rules governing the permitted product structuring or associated information obligations.

⁵⁴⁸ See FAZ.NET (2001b).

⁵⁴⁹ See Hahne (2001).

⁵⁵⁰ See Allianz AG/Dresdner Bank AG (2001), p. 9.

⁵⁵¹ Section 10(1) no. 2(b) EStG as amended by Art. 1 no. 7(a) bb AltEinkG.

⁵⁵² Section 10(2) no. 2(a) EStG as amended by Art. 1 no. 7(b) AltEinkG.

The long-term transition to the EET system also applies to Rürup pensions. The contributions are tax-deductible up to an annual maximum limit; this is €12,000 in 2005 and will rise in stages to €20,000 in 2025 (equation 2.4⁵⁵³ gives a more detailed presentation of how the deduction is calculated).

$$\begin{array}{r}
 \text{Employee contribution to state pension scheme}^{554} \\
 + \text{Tax-free employer contribution to state pension scheme} \\
 \text{under EStG s. 3 no. 62}^{555} \\
 + \text{Contributions to Rürup pension}^{556} \\
 \hline
 = \text{Retirement provision expenses (max. €20,000 per annum)} \\
 \times \text{Percentage}^{557} \\
 - \text{Tax-free employer contribution to state pension scheme} \\
 \hline
 = \text{Deductible amount} \qquad (2.4)
 \end{array}$$

As with all other retirement benefits, benefits from Rürup pensions will be taxed as other income. In the same way that the contributions will only be fully deductible after the 20-year transitional period, the benefits will only be taxed gradually. The reference date is the year in which the beneficiary retires: if the beneficiary retires in 2005, 50 per cent of the pension is taxable. This percentage rises by two percentage points for each year of any subsequent retirement until it reaches 80 per cent in 2020. The annual increase thereafter is one percentage point until the benefits are taxed in full in 2040.⁵⁵⁸

AS-Fonds (*German retirement pension investment funds*)

The *Drittes Finanzmarktförderungsgesetz* (German Third Financial Markets Promotion Act) established *AS-Fonds* (German special retirement pension investment funds) in 1998.⁵⁵⁹ The *Investmentgesetz* (German Investment Act, or InvG) passed in 2003 as part of the *Investmentmodernisierungsgesetz* (German Investment Modernisation Act) took over to a large extent the corresponding provisions previously contained in the *Gesetz über Kapitalanlagegesellschaften* (German Investment Companies Act, or KAGG).⁵⁶⁰ In contrast to the KAGG, however, the InvG no longer

⁵⁵³ Section 10(3) EStG as amended by Art. 1 no. 2(c) AltEinkG.

⁵⁵⁴ Section 10(1) no. 2(a) EStG as amended by Art. 1 no. 7(a) bb AltEinkG.

⁵⁵⁵ Section 10(1) last sentence EStG as amended by Art. 1 no. 7(a) bb AltEinkG.

⁵⁵⁶ See n. 551.

⁵⁵⁷ In 2005, the percentage is 60 per cent and increases by 2 percentage points per annum until it reaches 100 per cent in 2025 (section 10(3) EStG as amended by Art. 1 no. 2(c) AltEinkG).

⁵⁵⁸ Section 22 no. 1(a) aa EStG as amended by Art. 1 no. 13(a) AltEinkG.

⁵⁵⁹ Art. 4 FinMFöG 3.

⁵⁶⁰ The new *Investmentmodernisierungsgesetz* that came into force on 1 Jan. 2004 combines the KAGG and the *AuslInvestmentG* into the new InvG. The KAGG and the *AuslInvestmentG* were rescinded on 1 Jan. 2004 (Art. 17(1) *Investmentmodernisierungsgesetz*). The major content innovations in the *Investmentmodernisierungsgesetz* are the implementation of UCITS III (see p. 12), the authorization of hedge funds (of funds) ('investment funds with additional risks'; sections 112–120 InvG) and the InvStG as the combination of the tax rules previously spread across the KAGG and the Foreign Investment Act (see Deutscher Bundestag, 2003).

has any provision for the direct acquisition of real estate by *AS-Fonds*. However, they may invest in real estate funds.⁵⁶¹ Silent partnerships are another category that may no longer be acquired by *AS-Fonds*.⁵⁶²

AS-Fonds must be structured as growth funds⁵⁶³ for private retirement provision.⁵⁶⁴ The first of these funds were launched in October 1998.⁵⁶⁵ The general provisions of the German Investment Act relating to UCITS funds apply to *AS-Fonds*, with the necessary modifications,⁵⁶⁶ and *AS-Fonds* are also subject to special quantitative investment restrictions that ensure that real assets are overweighted. *AS-Fonds* may invest in:

- EU and non-EU securities traded on an official or regulated market⁵⁶⁷
- real estate funds⁵⁶⁸
- bank accounts, certificates of deposit issued by banks, treasury notes and bills issued by public-sector bodies in EU and OECD member states⁵⁶⁹
- German or foreign investment funds subject to effective public supervision⁵⁷⁰
- derivatives, but only for hedging purposes⁵⁷¹

The following quantitative limits apply:

- real estate funds may not exceed 30 per cent of fund assets⁵⁷²
- equities may not exceed 75 per cent of fund assets⁵⁷³
- the combined share of equities and real estate funds must amount to at least 51 per cent of fund assets⁵⁷⁴
- unhedged foreign currency risks may not exceed 30 per cent of fund assets⁵⁷⁵

⁵⁶¹ Section 88(1) no. 1 InvG.

⁵⁶² Section 37i(1) no. 3 KAGG allowed silent partnerships as permitted investments for *AS-Fonds*. These could account for a maximum of 10 per cent of fund assets (section 37i(5) KAGG).

⁵⁶³ Section 87(2) InvG (replacing section 37h(2) KAGG).

⁵⁶⁴ The objective of long-term retirement provision is defined in section 87(1) InvG (replacing section 37h(1) KAGG).

⁵⁶⁵ See BVI (2000b), p. 24.

⁵⁶⁶ Section 87(1) InvG (replacing section 37h(1) KAGG, which postulated the applicability of the general provisions of the Investment Company Act (KAGG)).

⁵⁶⁷ Section 88(1) no. 1 in conjunction with section 47(1) InvG (replacing section 37i(1) KAGG).

⁵⁶⁸ Section 88(1) no. 2 InvG.

⁵⁶⁹ Section 88(5) sentence 1 InvG.

⁵⁷⁰ Section 88(5) sentence 2 InvG.

⁵⁷¹ Section 88(6) InvG (replacing section 37i(9) KAGG).

⁵⁷² Section 88(2) InvG (section 37i(4) sentence 2 KAGG stipulated this limit for the total of shares in real estate companies, real estate and silent partnerships).

⁵⁷³ Section 88(3) InvG (section 37i(6) KAGG stipulated a combined maximum volume of 75 per cent for equities and silent partnerships).

⁵⁷⁴ Section 88(4) InvG (section 37i(7) KAGG stipulated this combined maximum volume for equities and (in)directly held real estate).

⁵⁷⁵ Section 88(7) InvG (replacing section 37i(1)0 KAGG).

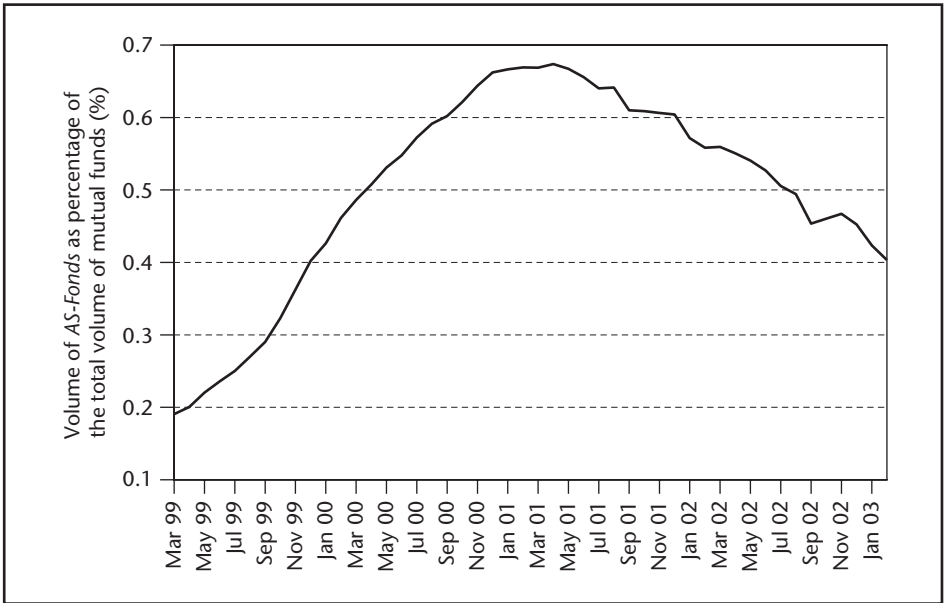


Figure 2.20 Volume of *AS-Fonds* relative to the total volume of mutual funds

Source: BVI (2002/2003)

The consequence of the first and third points is that equities must account for at least 21 per cent of fund assets. A pension savings plan that must be offered by the management company to investors must satisfy the following criteria.⁵⁷⁶

- 1 Regular payments for at least 18 years or until the investor reaches the age of 60.
- 2 No later than three-quarters of the way through the agreed term of the savings plan, the investor must be entitled to switch to any other *AS-Fonds* offered by the management company at no cost.
- 3 The investor must be offered an opportunity to annuitize the plan assets instead of a lump-sum payout when the plan matures. Because of this option, *AS-Fonds* are clearly superior to Riester products, which require annuitization (of most of the fund assets).

By early 2003, however, *AS-Fonds* had been unable to achieve any widespread success: the share of the total volume of German mutual funds attributable to *AS-Fonds* never exceeded 0.7 per cent and declined to 0.4 per cent in early 2003, the same level as at the end of 1999 (see Figure 2.20). Measured by fund volumes,

⁵⁷⁶ Section 90 InvG (replacing section 37m KAGG).

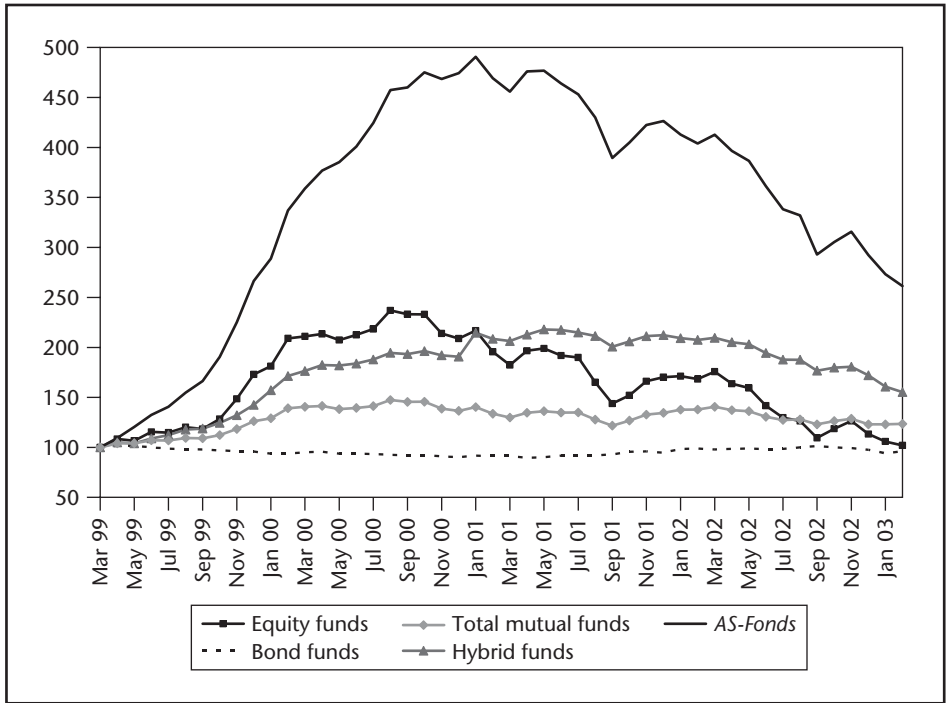


Figure 2.21 *AS-Fonds* assets, March 1999 to February 2003
(March 1999 = 100)

Source: BVI (2002/2003)

AS-Fonds recorded above-average performance until early 2001 compared with other mutual fund categories (see Figure 2.21), but when fund volumes started to decline, they were only exceeded (in the negative sense) by equity funds (see Figure 2.22). This poor performance was only due in part to capital market developments, as investor behaviour was procyclical in both the bear market and the preceding bull market, with a net withdrawal of capital from *AS-Fonds* that was above average compared with the net inflow for all mutual funds (see Figure 2.23). The *AS-Fonds* providers behaved in a similar way to the investors, and the steady rise in their number until mid-2001 was followed by an equally steady reduction (see Figure 2.24).

The poor acceptance of *AS-Fonds* is surely due to the lack of state subsidies, as the contributions are not tax-deductible, and the gains are not tax-privileged. Conventional *AS-Fonds* are not eligible for Riester support because they do not have the asset value and longevity guarantee demanded by the German Old-Age Provision Act.⁵⁷⁷

⁵⁷⁷ See Allianz AG/Dresdner Bank AG (2001), p. 15.

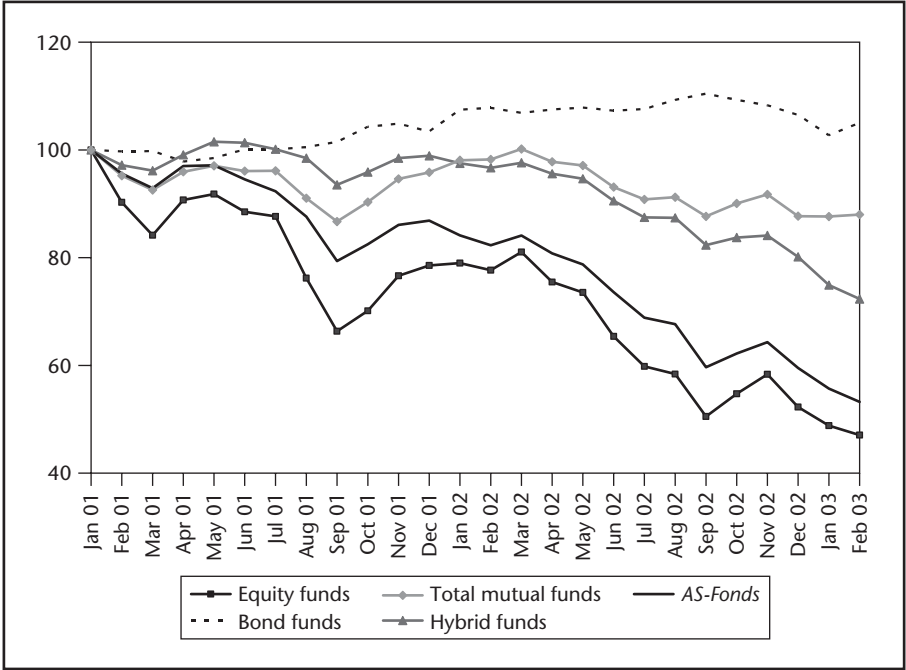


Figure 2.22 AS-Fonds assets, January 2001 to February 2003 (January 2001 = 100)

Source: BVI (2002/2003)

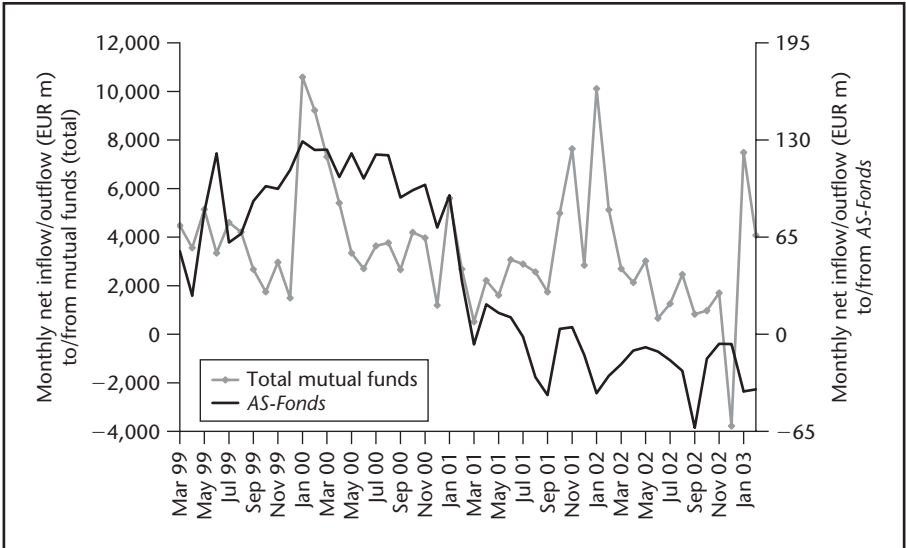


Figure 2.23 Monthly net inflow/outflow to/from AS-Fonds as against mutual funds (total)

Source: BVI (2002/2003)

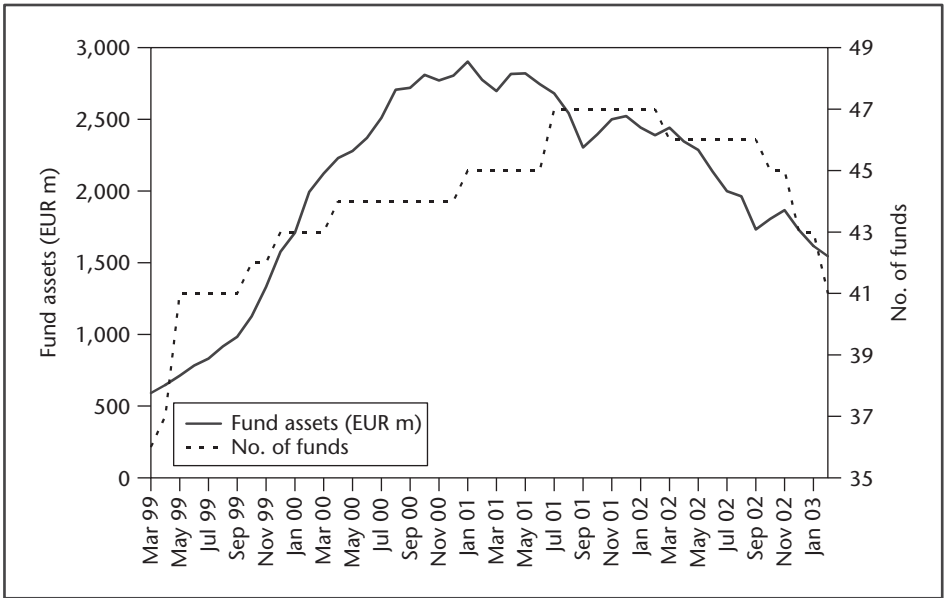


Figure 2.24 Assets and number of *AS-Fonds*, March 1999 to February 2003

Source: BVI (2002/2003)

The German Investment Companies Association BVI has not been successful in its efforts to lobby for equal tax treatment for *AS-Fonds* compared with conventional retirement provision instruments or private life insurance policies,⁵⁷⁸ despite the irrefutable argument that it is common practice in many other countries in and outside the EU to grant tax-deductibility to similar forms of retirement provision.⁵⁷⁹ It can therefore be expected that the private Riester products available since early 2002 will gradually displace *AS-Fonds* entirely due to their tax breaks.

Institutional funds as a key occupational pension instrument

Institutional funds (*Spezialfonds*) are available only to legal entities and can have a maximum of 30 shareholders.⁵⁸⁰ The expected risk and return can be tailored to the preference of the investor(s), usually by defining the investment strategy in the management agreement between the investment company and the investor(s). In contrast to mutual funds, there is normally continuous close

⁵⁷⁸ See BVI (2000d), p. 51.

⁵⁷⁹ See *ibid.*, p. 49.

⁵⁸⁰ Section 2(3) InvG; section 1(2) KAGG, which stipulated a limit of 10 shareholders, applied until the end of 2003.

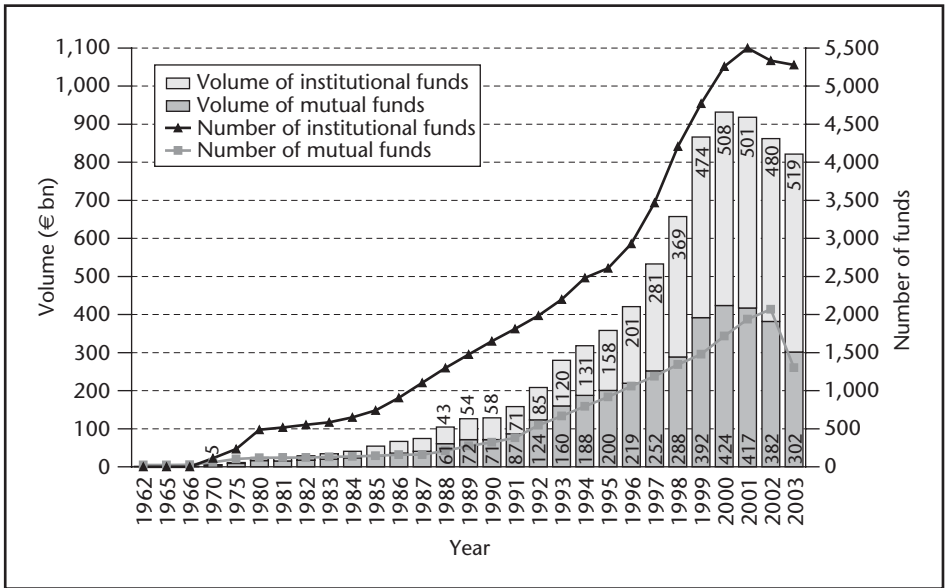


Figure 2.25 Volume and number of German mutual funds^a and institutional funds^b between 1962 and the end of September 2003

^aIncluding foreign mutual funds of German origin; from 1999 excluding funds of funds.

^bInstitutional funds in 2003 (2002) included 67 (50) open-end real estate funds with a total volume of almost €13 (11) billion.

Sources: Data for years up to and incl. 2002 see BVI (2003a), p. 80; for 2003 (at end-Sept. 2003) see Deutsche Bundesbank (2003a)

contact between the investor(s) and the investment company.⁵⁸¹ These advantages, available in Germany so far only to institutional funds, explain why they 'have been able to establish themselves as practically the only legal structure as an investment vehicle for institutional investors'.⁵⁸² Only a handful of legal systems outside Germany make provision for institutional funds⁵⁸³ and, in international terms, institutional investment in mutual and pension funds and individual management mandates are the dominant form.⁵⁸⁴

Figure 2.25 shows that institutional funds exceed mutual funds both in terms of numbers and volumes. At the end of September 2003, 5,280 institutional funds managed a total volume of nearly €520 billion, while at the same time 1,300 mutual funds held total assets of approximately €300 billion. However, this ranking has only been the case since 1997, as institutional funds only accounted for

⁵⁸¹ See Gerke and Bank (2000), pp. 218f.

⁵⁸² Hockmann (2003), p. 12.

⁵⁸³ In Austria, for example, institutional funds (*Spezialfonds*) have also been permitted since 1 March 1998 (section 1(2) InvFG as amended by BGBl. (*Federal Gazette*) I no. 41/1998).

⁵⁸⁴ See Hockmann (2003), pp. 12–14.

around half of the volume of mutual funds in the early 1980s. But within the space of a mere five years, institutional funds narrowed the gap to 85 per cent of the volume of mutual fund assets, although they had fallen back to 70 per cent by the mid-1990s. Between 1994 and 1998, however, institutional funds significantly gained ground over mutual funds, which also recorded a sharp increase during this period, and institutional funds inched ahead at the end of 1997 with a ratio of 1:1.12. Between 1998 and 2002, the ratio of mutual funds to institutional funds stabilized in the range of 1:1.2 to almost 1:1.3, before changing again dramatically in favour of institutional funds at the end of the third quarter of 2003 to 1:1.7. On the one hand, institutional investors were hit less hard than private investors by the fall in the value of the capital invested and, on the other, they did not switch to other investment forms to a comparable extent (building society deposits or life insurance policies, for example, are not investment alternatives for institutional investors); in addition, they are not normally confronted with the alternative of investing rather than saving, while private investors can opt for consumer spending.

In terms of the four traditional occupational retirement provision vehicles in Germany – direct commitments, *Unterstützungskassen* (benefit funds), direct insurance and *Pensionskassen* (staff pension schemes) – institutional funds already play a major role today and can be regarded as a type of dedicated pension fund in Germany: in September 2003, some 5,280 institutional funds held assets of €519 billion (see Figure 2.25), around 35 per cent of which served retirement provision purposes.⁵⁸⁵ At the end of 1998, around 40 per cent of the then total assets of institutional funds amounting to €369 billion (see Figure 2.25) were attributable to retirement provision.⁵⁸⁶

For example, the division of functions between a *Pensionskasse* and the institutional fund it has engaged is roughly as follows: the *Pensionskasse* is responsible for strategic asset allocation, selecting the fund managers, monitoring, performance measurement and reporting. Once strategic asset allocation has been fixed, individual institutional funds are then engaged (there may be different institutional funds for different asset classes), their managers are selected and the relevant performance benchmarks are defined. The institutional fund and its managers are in turn responsible for tactical asset allocation and for managing the investment process.⁵⁸⁷

Apart from the traditional four occupational pension vehicles mentioned above, it is also conceivable that, as a new type of pillar 2 retirement provision, pension funds will be able to invest the available funds (i.e., the contributions by employees and possibly employers as well) on the capital markets via institutional funds.⁵⁸⁸

⁵⁸⁵ This estimate by *Spezialfonds* expert Hans Karl Kandlbinder dates back to 2002 (see Bawden 2002).

⁵⁸⁶ See Gerke and Bank (2000), pp. 214f.

⁵⁸⁷ See Hilka and Schnabel (2000), p. 904.

⁵⁸⁸ See Gerke and Bank (2000), p. 223.

Current reform of funded supplementary retirement provision in Austria

Pillar 2: the new severance pay scheme

The Austrian Occupational Employee Pension Act (BMVG) that came into force on 1 July 2002 converted the traditional system of severance pay into an instrument of funded occupational⁵⁸⁹ retirement provision. Instead of a defined benefit amount (severance pay⁵⁹⁰) dependent on the length of service, employees⁵⁹¹ are now⁵⁹² paid a defined contribution supplementary pension with a minimum benefit (new severance pay scheme). Previously the benefit claim was against the employer; now, employee welfare and pension funds (staff provision funds)⁵⁹³ that are independent of the sponsor are responsible for investing the employer contributions⁵⁹⁴ and paying out the entitlements to the employees.

As part of the new severance pay scheme, a staff provision fund⁵⁹⁵ invests the capital fed from the monthly contributions by the employer, amounting to 1.53 per cent of the compensation⁵⁹⁶ and the investment income from these sums.

In addition to reinforcing pillar 2 pension provision, the new severance pay scheme also aims to promote worker mobility,⁵⁹⁷ to expand the number of

⁵⁸⁹ Limited to private-sector employees (section 1(1) BMVG).

⁵⁹⁰ From an uninterrupted period of employment of at least three years, termination of employment conveys the right to a severance payment of at least 2 months' salary, up to a maximum of 12 months' salary (section 23(1) AngG and section 22(1) *Gutsangestelltengesetz*), provided the employee does not give notice, termination is not due to the fault of the employee or the employee does not leave without justification (section 23(7) AngG and section 22(7) *Gutsangestelltengesetz*). Severance payments are also due on retirement if the employment has lasted at least 10 years (section 23a(1) AngG and section 22a(1) *Gutsangestelltengesetz*). Section 2(1) *Arbeiter-Abfertigungsgesetz* stipulates the application of sections 23, 23a AngG to hourly workers.

⁵⁹¹ In the event of the death of the beneficiary, the severance payment accrues to the statutory heirs (section 14(5) BMVG).

⁵⁹² New employment contracts commencing after 31 Dec. 2002 are in all cases subject to the new severance rules (section 46(1) BMVG). There are two options for older employment contracts: first, the existing severance arrangements can continue to be applied. Second, a switch can be made to the new system on the basis of a written agreement between the employee and the employer (section 47(1) BMVG), with the benefits from the former severance arrangements (section 3 no. 1 BMVG) either being transferred to the relevant staff provision fund (section 47(3) BMVG) or essentially being frozen (section 47(3) BMVG).

⁵⁹³ Under Art. 1(1) no. 21 BWG, a staff provision fund is classed as a credit institute.

⁵⁹⁴ Contributions are paid exclusively by the employer (section 6(1) BMVG).

⁵⁹⁵ For companies with a works council, the staff provision fund is selected by an (enforceable) employer/employee agreement (section 9(1) BMVG). If there is no works council, it is selected by the employer (section 10(1) BMVG), although the employees and their representatives, and ultimately the arbitration panel, may influence this decision in certain situations (section 10(2) BMVG).

⁵⁹⁶ Special payments must be added (section 6(1) BMVG); under section 49 ASVG, the compensation does not take account of the immateriality limit and the maximum contribution basis (section 6(5) BMVG).

⁵⁹⁷ In certain situations, employees now receive a benefit for employment contracts lasting less than three years, if employment is terminated due to the fault of the employee, if the employee leaves the company without justification or gives notice (section 14(3) and 4 BMVG), or they may require a payment if the employment is terminated for other reasons (section 17(1) BMVG), leave their existing entitlements in the staff provision fund of the previous employer (section 17(2) BMVG) or transfer them to the staff provision fund of the new employer (section 17(3) BMVG).

employees who actually receive severance pay or (now) optionally a supplementary pension,⁵⁹⁸ as well as reducing the severance expenses for employers⁵⁹⁹ and moving from a stochastic to a deterministic measure.

State support consists of the following tax breaks:

- (a) the employer's contributions are deductible as operating expenses;
- (b) the employer's contributions of up to 1.53 per cent of the compensation are not taxable income for the employee;⁶⁰⁰
- (c) staff provision funds are tax-exempt;⁶⁰¹
- (d) one-time cash payments by the staff provision fund to the employee are taxed at only 6 per cent;⁶⁰²
- (e) there is an option for a tax-free transfer of the capital invested by the staff provision fund to a pension insurance policy;⁶⁰³
- (f) investment income and capital gains during the investment and annuitization phase are tax-exempt;⁶⁰⁴
- (g) pension payments are tax-exempt.⁶⁰⁵

Some aspects of the structure of the staff provision funds are based on those of Anglo-American style pension funds. For example, sponsors and the staff provision fund are independent of each other, with the result that the insolvency of the employer does not impose any restrictions on the BMVG occupational pension. In addition, the benefit assets (investment community) are held by the staff provision fund in trust for the beneficiaries⁶⁰⁶ and are legally separate from it, ensuring that they are protected from claims against the staff provision fund that are not attributable to the investment community.⁶⁰⁷ In the event of the insolvency of the staff provision fund, the benefit assets are treated as special funds.⁶⁰⁸

⁵⁹⁸ Up to now, between 50 per cent and 60 per cent of employees did not earn severance entitlements during their entire working life (see Pro Consult (2002), p. 4), due in particular to (sequences of) short employment contracts (less than three years) or because the employees themselves were responsible for termination of their employment contracts.

⁵⁹⁹ In 1999, total wages of €63.23 billion produced total severance payments of €1.53 billion (see Pro Consult (2002), p. 4). Based on the new severance rules, only €967 million (1.53 per cent of €63.23 billion) would have arisen.

⁶⁰⁰ Section 26 no. 7 d EStG 1988.

⁶⁰¹ Section 5 no. 7 KStG 1988, section 6(1) no. 9 c UStG, section 4(1) no. 11 VStG.

⁶⁰² Section 67(3) EStG 1988.

⁶⁰³ Ibid.

⁶⁰⁴ Section 94 no. 6 c EStG 1988.

⁶⁰⁵ See n. 602.

⁶⁰⁶ Section 18(2) BMVG.

⁶⁰⁷ Sections 34(2), 35(1) and 3 BMVG.

⁶⁰⁸ Section 36(1) BMVG.

Three of the major differences between staff provision funds and pension funds are, first, there is a mandatory asset value guarantee,⁶⁰⁹ second, at present, a staff provision fund can offer only one investment alternative;⁶¹⁰ and third, the permitted asset allocation is subject to greater restrictions.

The mandatory asset value guarantee, and any further optional interest guarantee,⁶¹¹ conflict with optimum portfolio composition for the very long investment horizons that are typical for retirement provision plans. Low returns resulting from suboptimal portfolio mixes – the nominal returns must be at least 0 per cent (or, if an optional interest guarantee is offered, at least the – normally rather low – guaranteed interest) – are exclusively borne by the employees. Apart from these shortfalls, which can only be quantified as a probability measure, statutory capital requirements for the staff provision fund mean that employees also incur costs from the mandatory guarantee that can be calculated with comparative accuracy. The staff provision fund must transfer at least 5 per cent of the management fees to a special guarantee reserve until this reaches 1 per cent of the total severance pay entitlements.⁶¹²

The costs of the additional own funds of 0.25 per cent of the severance pay entitlements to be evidenced by the staff provision fund⁶¹³ must ultimately also be borne by the employees. Even though the law stipulates that if a corresponding bank guarantee (whose costs may not be charged to the investment community) is issued the guarantee reserve need not be established,⁶¹⁴ it can be assumed that the employees must implicitly also bear the costs resulting from a bank guarantee.

In addition to the asset value guarantee, which represents an incentive for as risk-free investment as possible by the staff provision fund, and the costs of the direct and indirect minimum own funds to be held due to the asset value guarantee, the following management costs reduce the return of the new severance pay scheme.

- 1 Between 1 per cent and 3.5 per cent of the contributions paid can be defined as management cost compensation in the membership agreement⁶¹⁵ to be entered into with the employer.⁶¹⁶

⁶⁰⁹ Section 24(1) BMVG.

⁶¹⁰ Section 28(1) BMVG limits a staff provision fund to one investment community (section 28(1) BMVG). The financial markets supervisory authority *may* issue an order no earlier than mid-2005 to increase this to two to four investment communities per staff provision fund (section 28(2) BMVG).

⁶¹¹ Section 24(2) BMVG.

⁶¹² Section 20(2) BMVG; if there is an interest guarantee, correspondingly higher provisions must be established (section 20(3) BMVG).

⁶¹³ Section 20(1) BMVG.

⁶¹⁴ Section 20(4) BMVG.

⁶¹⁵ Section 11(1) no. 4 BMVG.

⁶¹⁶ Section 26(1) BMVG.

- 2 If provided for in the membership agreement, 'cash outlays, such as custody account fees, bank charges, etc.' can also be deducted.⁶¹⁷
- 3 In addition, the staff provision fund is entitled to 1 per cent (from 2005: 0.8 per cent) per annum of the invested severance pay assets as a management fee.⁶¹⁸
- 4 The statutory health insurance funds, which are responsible for collecting and remitting the contributions, are entitled to 0.3 per cent of the contributions.⁶¹⁹

In terms of costs and fees, investment via a staff provision fund thus corresponds to an investment in an investment fund that charges a front-end load of 1 per cent to 3.8 per cent and an annual management fee that cannot be quantified exactly as a proportion of the assets under management because of the deductibility of cash outlays, but which amounts to at least 1 per cent per annum. That cash outlays are not covered by the management fee is unusual (at least from a US perspective, where this is standard). Ultimately, this aligns the interests of the asset manager and the investors: both are interested in keeping cash outlays as low as possible.

The second feature of the staff provision fund that represents a significant difference to pension funds is the restriction to a single investment community. This entails the drawback that the staff provision fund cannot offer the employees any investment alternatives that meet their individual risk preferences; rather, it is a 'one-size-fits-all' model. It is conceivable, for example, that older employees in particular would prefer an interest guarantee to an asset value guarantee, while younger employers might tend towards preferring a guaranteed minimum benefit so as to minimize the lower returns resulting from the inefficient portfolio composition. Because only one staff provision fund may be selected per employer,⁶²⁰ employees also do not have the option of choosing between several staff provision funds that offer investment or guarantee alternatives.

The third aspect that clearly distinguishes staff provision funds from pension funds are the relatively restrictive investment rules. The fundamental requirement to operate 'in the interests of the beneficiaries and in particular to consider the security, profitability and the adequate mix and diversification of the assets'⁶²¹ recalls the sort of wording found in prudent man/investor rules.⁶²² However, this qualitative formulation is significantly constrained by numerous quantitative

⁶¹⁷ Section 26(3) no. 1 BMVG.

⁶¹⁸ This fee is paid from the investment income of the financial year in question. If the income generated is less than the fee demanded, it must be carried forward to new account, i.e., the assets themselves may not be used for the payment (section 26(3) no. 2 BMVG).

⁶¹⁹ The staff provision fund can on-charge these amounts as cash expenses (section 26(3) no. 5 BMVG).

⁶²⁰ Sections 9 and 10 each(1) BMVG.

⁶²¹ Section 30(1) BMVG.

⁶²² See section on US standards of prudence: the prudent man/expert/investor rule, pp. 154ff.

rules. The following examples of the large number of quantitative restrictions deserve particular mention:

- maximum permitted equity proportion⁶²³ of 40 per cent⁶²⁴
- maximum of 50 per cent of the total investment in non-matching currencies⁶²⁵
- a maximum of 25 per cent of equity investments in non-matching currencies⁶²⁶

In view of the defensive 40 per cent limit for investments in equities, the limiting of single issuers to 10 per cent is unusually high. Parliament evidently thinks that diversified equity investments represent a higher risk than investments concentrated in individual equities. A lower single issuer limit and a higher equity limit would surely be more compatible with the sort of prudent person rule required for cross-border pension funds in the Pension Funds Directive. However, because it currently appears unlikely that staff provision funds will be active on a cross-border basis, the relevant investment rules can be classified as EU-compliant. This applies in particular to the (high) limit on individual issuers, as the Pension Funds Directive only stipulates qualitative limits in this respect.⁶²⁷

One positive aspect is certainly the pronounced quantitative limit on investments in the securities of the sponsor. This is possible only indirectly via investment funds.⁶²⁸ In particular, in the case of employer stock corporations with substantial market capitalizations, a general investment ban on such investments that also extended to investment funds would be difficult to enforce in practice, unless investments in investment funds were prohibited overall. In view of the lack of rules governing the problem area of the fees relating to such a fund of funds-type structure, such a prohibition would certainly be worth considering.

An overview of the structure of the staff provision funds' supervisory board rounds off this comparison of staff provision funds and Anglo-American style pension funds. Compared with the rights and obligations of the members of a US board of directors, the responsibilities of the members of the supervisory board are heavily restricted.

Similar to the non-executive directors on a US board, the employee members of the supervisory board are not associated with the company in the case of a staff provision fund. The supervisory board must comprise four shareholders and

⁶²³ These must be equities traded on an exchange in an OECD member state (section 30(3) no. 2 BMVG). Under certain circumstances, unlisted shares of companies domiciled in an OECD member state may be held up to a maximum of 10 per cent of the investment community assets (section 30(3) no. 3 BMVG).

⁶²⁴ Section 30(3) no. 5 BMVG.

⁶²⁵ Section 30(3) no. 6 BMVG.

⁶²⁶ *Ibid.*

⁶²⁷ Article 18(1)(f) Directive 2003/41/EC.

⁶²⁸ Section 30(4) BMVG.

two to three employee representatives.⁶²⁹ Whilst the method of compensation of US independent directors and the amount of the compensation itself are regular topics of debate, the employee representatives on the supervisory board of a staff provision fund are obliged to conduct their activity on an honorary basis.⁶³⁰ However, because their duties and the professional requirements they have to meet are low compared with US board directors, there is no need to provide any financial incentive for their commitment and specialist knowledge. Given the high level of professional knowledge that is required and the substantial (legal) responsibilities, it would be very difficult indeed to recruit qualified candidates for professionally demanding and (legally) responsible directorships (or similar) on an honorary basis (and not just in the USA). The areas of similarity, compared to the USA, are shown below:

- (a) certain transactions require the approval of the supervisory board;⁶³¹
- (b) the members of the supervisory board are obliged to inform themselves regularly of the transactions relating to the investment community;⁶³²
- (c) they must consult with the executive board on matters of investment policy;⁶³³
- (d) there are bans on transactions between the investment community and the managing directors or supervisory board members (termed 'affiliated transactions' or 'self-dealing' in the USA).⁶³⁴

This relatively brief list of duties for supervisory board members does not contain any general obligation to act primarily in the interests of the investors; on the other hand, many obligations that are fundamental to US boards are omitted in their entirety, such as involvement in:

- (a) fixing fees and cost reimbursements;
- (b) proxy voting for equities held in the portfolio;
- (c) the selection of brokers;
- (d) monitoring compliance with the best execution requirement;
- (e) elaborating and monitoring a code of ethics for persons involved in the investment process.

⁶²⁹ Section 21(1) and 2 BMVG.

⁶³⁰ Section 21(4) BMVG.

⁶³¹ Section 21(3) BMVG extends the approval requirement through section 95(5) AktG to investment rules, the granting of an optional interest guarantee and the conclusion of contracts for services with life insurance companies or pension fund providers.

⁶³² Section 21(5) BMVG.

⁶³³ Ibid.

⁶³⁴ Section 23 BMVG.

To sum up, the supervisory board is mostly harmless and certainly does not exercise the investor protection function of a US board. However, the cost of supervisory board members is also likely to be low, as the employees receive no compensation and the maximum four shareholder representatives received only 'appropriate compensation'.⁶³⁵

The new severance pay scheme was certainly a step in the right direction towards expanding funded occupational pension provision in response to the further deterioration in the funding problem for pillar 1 over the next quarter of a century. In addition to the asset value guarantee and the 40 per cent limit on equities, however, the low state-subsidized contribution rate of 1.53 per cent of compensation casts doubts on the suitability of the new severance pay scheme as a suitable supplementary pension. The average compulsory contribution rate was 22.2 per cent⁶³⁶ in 2002, after all, and the implied contribution rate was actually 31.3 per cent.⁶³⁷ It is therefore open to discussion whether what essentially amounts to an increase in pension contributions by around 5–7 per cent⁶³⁸ will be sufficient to close the expected significant pensions shortfall.

The low level of retirement provision efficiency is all the more serious because it is accompanied by generous tax privileges. Instead of adopting an EET system, a frequent recommendation, Parliament opted for the more expensive variant of full tax-exemption (EEE system). A more liberal investment regime, especially one following the prudent man/investor rule, in combination with EET, would surely be the preferred solution – and not merely from an economic perspective – rather than the current arrangements with these expensive tax breaks.

Pillar 3: premium-subsidized future provision

Since early 2003, all persons with unlimited tax liability in Austria have been able to take advantage of the 'premium-subsidized future provision', a state-subsidized pillar 3 pension vehicle.⁶³⁹ The permitted allowed investment options are Pension Investment Funds (PIFs), staff provision funds and EU insurance companies.⁶⁴⁰ Pension Investment Funds must be structured as accumulating

⁶³⁵ See n. 630.

⁶³⁶ In 2000, the weighted contribution rate for the three largest statutory pension insurance funds for salaried employees and hourly workers, the self-employed and farmers was 22.2 per cent (see Federal Ministry of Social Security, Inter-Generational Affairs and Consumer Protection (2002a), p. 35).

⁶³⁷ For an average contribution rate of 22.2 per cent (see no. 636), the statutory pension insurance funds received €15.35 billion from compulsory contributions in 2000 (see Federal Ministry of Social Security, Inter-Generational Affairs and Consumer Protection (2002a), p. 33). A top-up to the federal contribution of €4.16 billion (see *ibid.*, p. 34) and other income of €2.09 billion thus produce an implied contribution rate of 31.3 per cent (see Federal Ministry of Social Security, Inter-Generational Affairs and Consumer Protection (2002b), Table 5).

⁶³⁸ 1.53 per cent divided by 31.3 per cent = 4.89 per cent; 1.53 per cent divided by 22.2 per cent = 6.89 per cent.

⁶³⁹ Section 108g(1) EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 71/2003.

⁶⁴⁰ Section 108h(1) no. 1 EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 10/2003.

funds⁶⁴¹ and their income is tax-exempt.⁶⁴² The investment must be at least 30 per cent in equities and at least 30 per cent in bonds, with a maximum permitted 50 per cent in non-EU securities.⁶⁴³ Derivatives may only be used for hedging purposes.⁶⁴⁴ A compulsory feature of the benefit phase is an irrevocable payout plan⁶⁴⁵ resulting from the contribution of the fund's shares to a supplementary pension insurance that then provides a life annuity.⁶⁴⁶

The complexity of the investment rules to be followed by the product providers is low, but they are still able to significantly handicap any efficient pension provision investment: at least 40 per cent of the contributions paid must be invested in equities

that are initially admitted to a stock exchange domiciled in a member state of the European Economic Area. Over a multi-year period, the share of the gross domestic product of this member state attributable to the market capitalization of the equities initially listed in this member state may not exceed 30 per cent.⁶⁴⁷

An asset value guarantee must also be provided.⁶⁴⁸

In order to support the asset value guarantee there is an obligation to back the equity share of the portfolio with additional own funds under certain conditions. If the equities are neither hedged nor have their value guaranteed by an external financial service provider (e.g., in the form of a bank guarantee), the management company of the PIF, the staff provision fund or the insurance company providing the premium-subsidized future provision product has to fund an auxiliary provision if the equity value falls below a certain threshold.⁶⁴⁹

The calculation of this threshold and of the contingent capital requirement for investment fund-based Riester products have a great deal in common. The market value of the investment portfolio is adjusted by a risk premium based on the volatility and the value of the equity part of the portfolio. If the adjusted portfolio value falls below the present value of the contributions paid subject to the asset value guarantee, this shortfall has to be backed with own funds. As with Riester products, normally distributed returns are assumed. While providers

⁶⁴¹ Section 23c InvFG.

⁶⁴² Section 41(1) no. 1 InvFG.

⁶⁴³ Section 23d InvFG.

⁶⁴⁴ Section 23e InvFG.

⁶⁴⁵ Section 23g(1) 1st indent InvFG.

⁶⁴⁶ Section 23g(2) no. 2 InvFG.

⁶⁴⁷ See n. 640. This 'equity proportion may be calculated on the basis of an annual average. In the event of a shortfall at the end of the financial year, it may be topped up within a 2-month transitional period' (InvFR 2003, marginal note 27). Market capitalization is calculated as the average of the second, third and fourth preceding years. If the 30 per cent threshold of market capitalization to GDP is exceeded, there is no obligation to sell the shares concerned. If they are sold, only shares that meet the market cap-to-GDP rule may be purchased as substitutes (see InvFR 2003, margin note 28).

⁶⁴⁸ Section 108h(1) no. 3 EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 10/2003.

⁶⁴⁹ See Regulation on auxiliary provisions (2003).

of Riester products have to use a risk factor allowing for a maximum shortfall probability of 1 per cent (2.33 standard deviations below expected value, i.e., 99 per cent confidence level), the premium-subsidized future provision stipulates a 0.53 per cent shortfall probability (3 standard deviations below expected value, i.e., 99.47 per cent confidence level).

Similar to the German regulation this contingent capital requirement is an incentive for the product provider to opt for a risk-minimal asset allocation in order to prevent the breach of the threshold, which would trigger the obligation to allocate additional own funds.

The state support consists, first, of tax-exemption in the investment and benefit phase in the event of annuitization,⁶⁵⁰ and, second, of a percentage subsidy of the contributions of the investors up to a certain ceiling. Both the percentage subsidy and the ceiling are redefined every year on the basis of specific rules: the subsidy is oriented on the coupon of Austrian government bonds⁶⁵¹ and the ceiling on the maximum income threshold for contribution assessment for the statutory social security system.⁶⁵² For 2003, the subsidy was 9.5 per cent up to a maximum contribution amount of €1,851, producing a maximum absolute premium of €176.

The subsidy must be repaid by the investors if they exit the savings plan within 10 years.⁶⁵³ After at least 10 years, they have a choice between a payout (although this entails tax disadvantages), transfer to another provider of premium-subsidized future provisions or a variety of annuitization models.⁶⁵⁴ One of the positive aspects of the premium-subsidized future provision is that it is non-discriminatory, as it is open to all persons with unlimited tax liability and is not, for example, closed to civil servants or the self-employed.

The tax advantages of the premium-subsidized future provision, which have been pushed as a particularly attractive feature in campaigns by the government,⁶⁵⁵ the media and product providers, need to be qualified. The subsidized retirement provision amount was much higher than that for Riester pensions in 2003. Each beneficiary can invest up to 4.59 per cent of the maximum income threshold for contribution assessment, while the maximum under the Riester pension in 2003 is only 1 per cent of the maximum income threshold for contribution assessment for 2000.⁶⁵⁶ This means that the maximum amount that can be deducted for the private Riester pensions was €525⁶⁵⁷ in 2003, while up to €1,851 is subsidized for the premium-subsidized future provision. However,

⁶⁵⁰ See Federal Ministry of Finance (2003a).

⁶⁵¹ See n. 639.

⁶⁵² Section 108g(2) EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 71/2003.

⁶⁵³ Section 108g(5) EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 71/2003.

⁶⁵⁴ Section 108i(1) EStG 1988 as amended by BGBl. (*Federal Gazette*) I no. 10/2003.

⁶⁵⁵ See, for example, Schenz (2003), p. 19; or Federal Ministry of Finance (2003b).

⁶⁵⁶ The German income threshold is far higher than its Austrian equivalent; for example, the difference was around 40 per cent in 2003. The income threshold for 2000 was €52,765 (DM103,200 under section 3(1) no. 1 *SozialversicherungsRechengrößenverordnung* 2000).

⁶⁵⁷ Section 10a(1) EStG as amended by Art. 6 no. 8 AVmG.

the subsidized Riester pension contribution will rise successively to €2,100 by 2008,⁶⁵⁸ corresponding to around 4 per cent of the maximum income threshold for contribution assessment for 2000.

Although the absolute investment amount currently subsidized under the future provision system is thus considerably higher than under the Riester pension, the relative amount of the subsidy is comparatively low and the absolute investment amount subsidized under the Riester pension is set to be higher in 2008 than that for the premium-subsidized future provision.

Significant weaknesses of the premium-subsidized future provision are the 40 per cent quota for equities from EU countries with underdeveloped equity markets and the compulsory asset value guarantee. This inefficient design for adequate retirement provision is due to the conflict between supporting the Austrian capital markets and the establishment of an appreciable third pension pillar. In addition to this design, the notion that the premium-subsidized future provision owes its existence primarily to efforts to support companies listed on the underdeveloped Vienna Stock Exchange is encouraged by the fact that the Austrian Government Commissioner for the Capital Markets, who was significantly involved in drafting the legislation, talks of a retirement provision product 'anchored in Austria'⁶⁵⁹ that will 'have a sustained invigorating effect on the Austrian capital markets'.⁶⁶⁰ The body representing the interests of Austrian equity issuers and investors, the Equity Forum, which acts as a partner to the Federation of Austrian Industry, believes that the future provision product meets a 'longstanding demand' and draws attention in particular to the expected revival of the domestic capital markets, only mentioning its function as a supplementary pension in an aside.⁶⁶¹

Since an express formulation directed solely at Austrian equities would quite properly be seen as a breach of EU Single Market rules,⁶⁶² the vaguer wording tailored to the Austrian equity market at the time then found its way into the Income Tax Act. The fact that the first version of the law stipulated a corresponding equity ratio of 60 per cent⁶⁶³ supports this hypothesis. As the law is thus effectively forcing strategic asset allocation to concentrate on Austrian equities, this prompted corresponding criticism from the Austrian National Bank, which in turn led to a sometimes fierce backlash.⁶⁶⁴ But all the National Bank did was to point out that the rule in question made 'international diversification' of the

⁶⁵⁸ Ibid.

⁶⁵⁹ Schenz (2003), p. 5, p. 13 and p. 19.

⁶⁶⁰ Ibid., p. 5.

⁶⁶¹ See Longin (2003).

⁶⁶² See Schenz (2003), p. 13, p. 19.

⁶⁶³ Section 108h(1) no. 1 EStG 1988 as amended by BGBl. (Federal Gazette) I no. 155/2002.

⁶⁶⁴ The government commissioner for the capital markets commented that the Oesterreichische Nationalbank's criticism was 'not very helpful' (Federal Ministry of Finance (2003d)). The equity forum called the Nationalbank's criticism 'difficult to understand' and based on 'entirely unfounded arguments' (Fichtinger, 2003).

equity component of future provision products difficult and thus hampered 'efficient risk diversification'. It continued by saying that it is questionable 'whether this instrumentalization of institutionalized personal retirement provision can offset the associate risks and efficiency losses for capital market development'. Moreover, the effectiveness of using this for a capital market revival is doubtful because of the low equity investment volume expected from it in the medium term.⁶⁶⁵

The counterarguments, that the asset value guarantee means that there is no risk to the investor and that the product providers can deploy hedging strategies,⁶⁶⁶ miss the Austrian National Bank's point in criticizing the inefficiencies and unhedgeable risks. Of course it must be assumed that the product providers will deploy risk management methods such as derivatives-based portfolio insurance or portfolio insurance based on the dynamic adjustment of the proportion of equities and risk-free asset classes (CPPI) to master the asset value guarantee. Experts believe that there is an incentive to product providers to minimize the risk of their investments, and that a return 'close to a risk-free return'⁶⁶⁷ can be expected. Volksbanken KAG (Volksbanken Investment Company), for example, announced that for its own future provision product it would invest in Austrian equities for which derivatives are available.⁶⁶⁸ The implication that derivatives will actually be used results in hedging costs that will reduce the return, because the 'issuers will of course not grant the asset value guarantee at no cost'.⁶⁶⁹ And it is just this point that the Austrian National Bank is criticizing: that hedging strategies, which in any case are not appropriate to the long investment horizons typical for retirement provision investments, represent an unnecessary cost factor and are thus inefficient.

To further counter the Austrian National Bank by claiming that most of the stock exchanges in the new EU Member States following the eastward expansion in 2004 will also be candidates because of their low ratio of market capitalization to GDP, and that 'even greater diversification of the 40 per cent equity ratio will thus be possible',⁶⁷⁰ can only gradually rebut the claim of inefficiency, but not its substance, and this argument also clearly runs counter to the primary objective repeatedly presented by the same source of reviving the *domestic* capital markets by means of the premium-subsidized future provision. Moreover, the (by international standards) exceptionally good performance of the Austrian stock market in 2003, 2004 and 2005 casts doubt on the goal of *sustainable* encouragement for the Austrian equities market by the premium-subsidized future provision. At the end of the third quarter of 2005, the 30 per cent limit for the ratio of market

⁶⁶⁵ Oesterreichische Nationalbank (2003), p. 60.

⁶⁶⁶ See Federal Ministry of Finance (2003d).

⁶⁶⁷ Edwin O. Fischer (2003), p. 21.

⁶⁶⁸ See No author given (2003).

⁶⁶⁹ See n. 667.

⁶⁷⁰ Federal Ministry of Finance (2003d).

capitalization to GDP was clearly surpassed in Austria.⁶⁷¹ However, the effect on this positive performance by the Vienna Stock Exchange, which can be attributed to the future provision product, is comparatively negligible.⁶⁷² If there is neither a change in the law nor a sustained adjustment on the Vienna equity market, the private retirement provision capital of Austrian future provision investors will be largely invested in eastern European equities in the medium term.⁶⁷³

The claim that the 'Austrian connection for the investment should be seen as a particular opportunity for investors'⁶⁷⁴ is difficult to understand in that potential alternative legal formulations without any Austrian privilege would not necessarily hinder investments in Austrian equities. If Austrian shares really do offer the superior risk/return profile that is claimed for them, it can be assumed that they will be selected by competent asset managers. The alternative is most certainly not to support 'exclusively the developed capital markets in London, Paris and New York with Austrian taxpayers' money'.⁶⁷⁵

To sum up, we can say that the statements by the initiators of the premium-subsidized future provision that it is an 'attractive subsidized retirement provision product' which offers 'appealing return prospects', and that the 'asset value guarantee and the state subsidy represent an attractive combination'⁶⁷⁶ are mutually incompatible. Thomas Url, a pension provision expert at the Institute of Economic Research in Vienna, believes that the premium-subsidized future provision is 'basically worthless' because he is 'convinced that the return offered by this product is relatively low because of the costs of the asset value guarantee'.⁶⁷⁷ In turn, a finance ministry publication assumes an expected nominal return of 5 per cent per annum,⁶⁷⁸ because it holds out the prospect of a final total capital of €140,000 for a monthly investment of €154 per month over 30 years,

⁶⁷¹ Austrian GDP was €235.1 billion in 2004 (see Statistik Austria, 2005a), while the market capitalization of the Vienna Stock Exchange in Sept. 2005 was €102.67 billion (see Vienna Stock Exchange, 2005), i.e., just short of 44 per cent of GDP. When the product was launched in early 2003, the Vienna Stock Exchange's market capitalization was only €32.2 billion (see Vienna Stock Exchange, 2005), or 14.6 per cent of the then GDP of €221 billion (see Statistik Austria, 2005a).

⁶⁷² At the end of 2004, assets invested in future provision products amounted to around €530 million (see FMA – Finanzmarktaufsicht, 2005, p. 8). Assuming a hypothetical asset allocation with a 40 per cent share of Austrian equities, future provision assets would have accounted for around 0.3 per cent of the Vienna Stock Exchange's market capitalization of €64.6 billion at the end of 2004 (see Vienna Stock Exchange, 2005).

⁶⁷³ If the (South-)East European capital markets in the EEA experience a corresponding sustained upturn, the universe of eligible investment markets will, all else being equal, narrow further (Estonia, Malta and Cyprus have already exceeded the multi-year average limit of 30 per cent; see FMA – Finanzmarktaufsicht (2005), p. 13).

⁶⁷⁴ See n. 670.

⁶⁷⁵ See n. 670.

⁶⁷⁶ Federal Ministry of Finance (2003c).

⁶⁷⁷ Tabernik and Wolschlager (2003), p. 90.

⁶⁷⁸ Elsewhere, government representatives assume a long-term return of 4.5 per cent p.a. (see No author given, 2002b).

sufficient for a monthly supplementary pension of €870.⁶⁷⁹ What is misleading in these figures is that the expected loss in purchasing power due to inflation, the effects of which will be considerable over a 30-year investment horizon, is completely ignored. Assuming modest inflation of 2 per cent per annum, €140,000 corresponds to €77,290 in 30 years at today's purchasing power, and the €870 pension is equivalent to a pension today of only €480.⁶⁸⁰ Neither can it be simply assumed that low or average earners are actually in a position to afford monthly contributions of the amount stated in the future: after allowing for a state subsidy of 11 per cent,⁶⁸¹ €139 per month still has to be paid from the investor's *net* income. With the median net annual income in Austria at €15,470 in 2003,⁶⁸² this €139 per month (€1,668 per year) amounts to 10.8 per cent of average net income.

The fact that demand so far for premium-subsidized future provision products has been in the upper range of expectations⁶⁸³ is not necessarily an indication of the suitability of this product as an instrument for building up an *adequate* supplementary pension. Although the number of contracts for premium-subsidized future provision products stood at 272,000 (457,000) in 2003 (2004), the volume of premiums was only €154 (367) million.⁶⁸⁴ Thus the average investment amount was only €566,18 (€803,06) per year and thus considerably below the level of the model calculation presented above.

There are hopes that the Austrian Parliament will continue to stick to its essentially welcome initiative to expand state-subsidized private pensions and that it will change the design to enhance efficiency. If the eastward expansion of the EU does indeed result in appreciable investment of future provision capital in the Eastern European stock exchanges, the goal of supporting the domestic capital markets by means of private retirement provision will no longer be tenable. Such a development should be used to abolish the obligation to invest 40 per cent in equities of EU Member States with underdeveloped market capitalizations, to eliminate the asset value guarantee and to introduce more flexible investment rules (ideally freedom of investment in combination with the prudent man principle).

⁶⁷⁹ See Federal Ministry of Finance (2003c).

⁶⁸⁰ Alternative scenarios (i.e., 1.5 per cent and 2.5 per cent inflation) have the following effect: the total capital at maturity is equivalent to €89,567 or €66,744 in today's terms, while the pension would be €557 or €415.

⁶⁸¹ Depending on the capital market rate, the state premium is between 8.5 per cent (minimum) and 13.5 per cent (maximum) (section 108g(1) EStG 1988 as amended by BGBl (*Federal Gazette*) I no. 71/2003 in conjunction with section 108(1) no. 2 EStG 1988 as amended by BGBl (*Federal Gazette*) I no. 71/2003). The worked example presented by the finance ministry evidently assumes a constant 9.5 per cent premium over 30 years, which would produce an even more unfavourable picture for the own contributions.

⁶⁸² €12,000 for women and €18,320 for men (see Statistik Austria, 2004).

⁶⁸³ See Federal Ministry of Finance (2003e); and Wolschlagler (2003), p. 72.

⁶⁸⁴ See FMA – Finanzmarktaufsicht (2005), p. 4f.

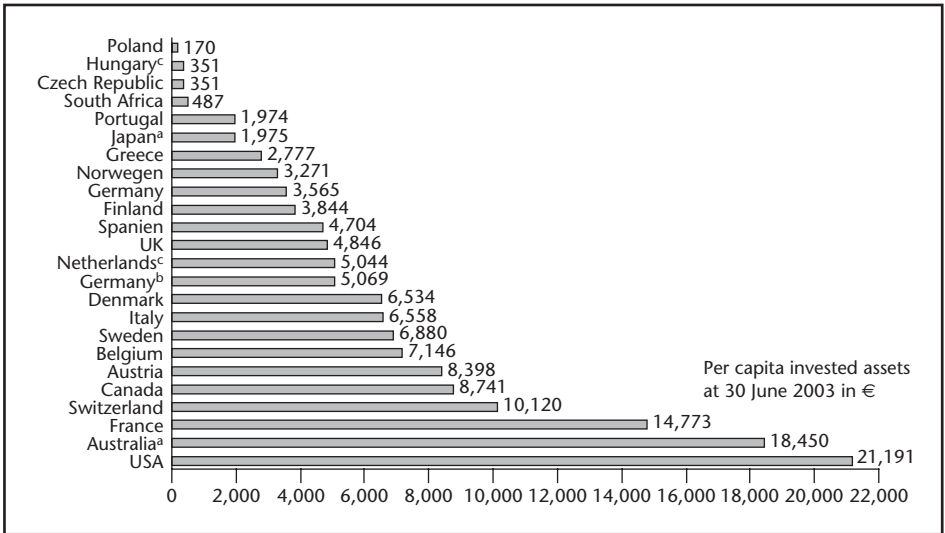


Figure 2.26 Per capita invested assets in mid-2003 in €

^a As at 31 March 2003

^b Including foreign funds of German origin

^c As at 31 December 2002

Sources: BVI (2003b) and BVI (no date/c)

Investment patterns in Germany compared with the USA

Although the volume of German mutual funds⁶⁸⁵ as good as doubled between 1994 and 2002 despite the equity market slump in 2001 and 2002 (see Figure 2.31 below), Germany's per capita fund assets are still lagging well behind comparable countries. The per capita invested assets in some other EU countries, such as France, Italy and Spain, are only slightly lower or even higher, although these countries have a lower per capita GDP than Germany⁶⁸⁶ (see Figure 2.26). The USA leads the world with €21,191 per capita, and the average German – with per capita invested assets of €5,069⁶⁸⁷ in mid-2003 – owns only around one-third of the asset volume of his or her average French neighbour. Austria and Switzerland, the two other German-speaking countries, are also well ahead of Germany with per capita invested assets of €8,398 and €10,120 respectively. Figure 2.27 shows that both this order and the clear US lead are no coincidence.

However, the significant role of institutional funds in Germany distorts the ranking to Germany's disadvantage. While US retirement provision assets are invested to a considerable extent in mutual funds, institutional funds are almost

⁶⁸⁵ Including foreign mutual funds of German origin.

⁶⁸⁶ Per capita GDP in US\$ in 2001: Germany 22,500, France 21,700, Italy 18,800, Spain 14,500 (see OECD, 2003).

⁶⁸⁷ This figure includes foreign funds of German origin; excluding them, the per capita invested assets amounted to €3,565 at the end of June 2003.

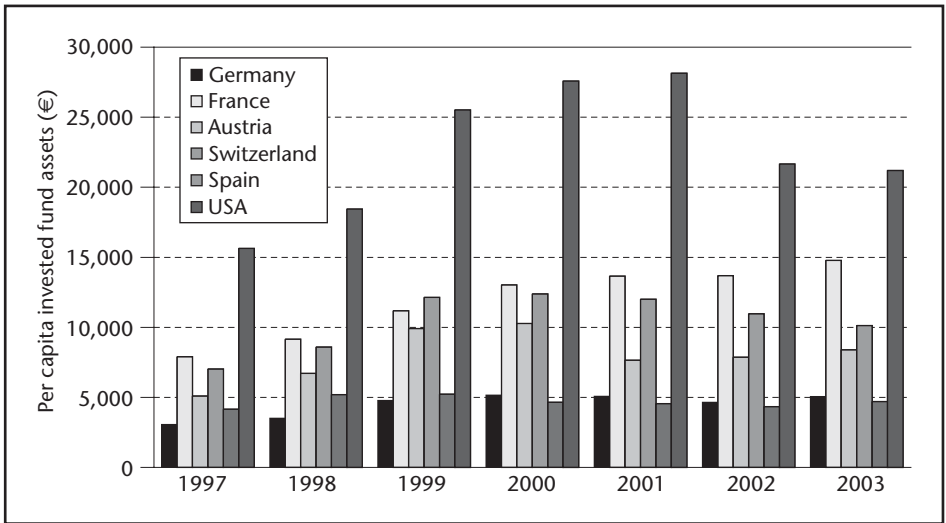


Figure 2.27 Per capita invested fund assets of selected European countries and the USA for 1997 to 2003 in €

Sources: BVI (2003b) and BVI (no date/c)

the only vehicle used for this purpose in Germany. Nonetheless, it can be assumed that the institutional funds used for retirement provision correspond largely to US pension funds, and only to a minor extent to US mutual funds. However, significant differences in the design of funded (especially occupational) pension systems prevent any more specific differentiation. For example, the essentially DC-based 401(k) plans, almost 45 per cent of which were invested in mutual funds in 2002, and which at US\$1.54 trillion accounted for 15 per cent of the total US\$10.2 trillion in US retirement provision assets,⁶⁸⁸ have no German equivalent.

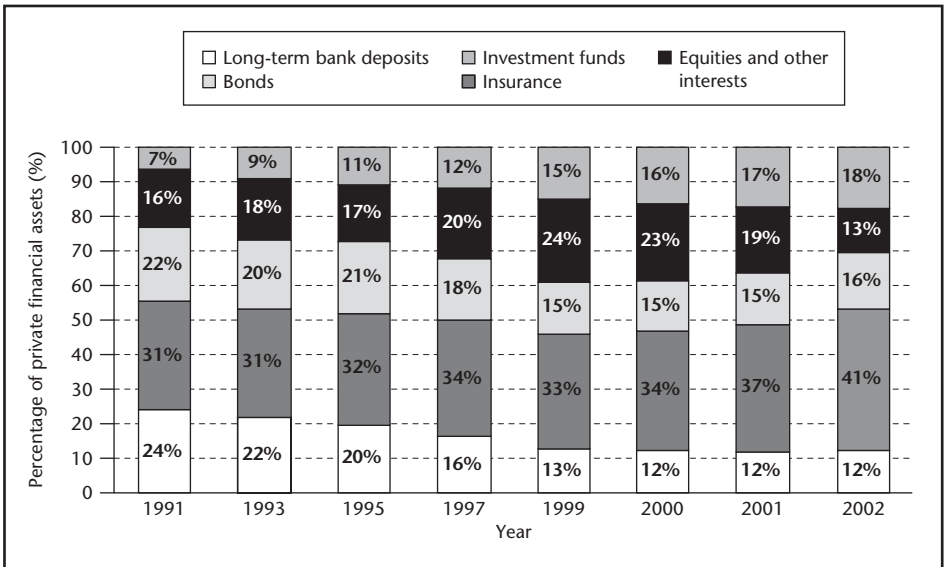
However, the growth in the assets of private households invested in investment funds was also impressive in Germany in recent years. As shown by the development in private financial assets between 1991 and 2002 (see Table 2.18 and Figure 2.28), the growth in investment fund assets exceeds the increases in alternative savings vehicles over this period by a multiple. Long-term savings deposits were still in second place in 1991 in terms of volume after investment in insurance products, and accounted for one-quarter of total private financial assets. However, 11 years and a nominal shrinkage of 3 per cent later, they had slid to last place in the savings vehicles shown and only accounted for just one-eighth of financial assets; over the same period investment funds, starting from last place, recorded an impressive 406 per cent growth to come second in 2002. This means that within the space of just over a decade, investment funds were able to increase their share of private financial assets by a factor of more than two-and-a-half, from 7 per cent in 1991 to 18 per cent in 2002.

⁶⁸⁸ See Investment Company Institute (2003a), pp. 53 and 56.

Table 2.18 Private financial assets in € billions in Germany 1991–2002 (year-end figures)

Asset type	1991	1993	1995	1997	1999	2000	2001	2002	Change 1991–	
									1999(%)	2002(%)
Long-term bank deposits	309	329	346	333	303	314	305	300	–2	–3
Insurances	401	479	573	684	808	866	929	994	101	148
Fixed-income instruments	276	307	364	358	363	368	381	394	32	43
Equities	131	172	191	296	473	439	347	166	261	27
Other equity instruments	80	99	102	119	113	130	137	145	41	81
Investment funds	84	136	190	244	362	408	435	425	331	406
Total	3,272	3,515	3,761	4,031	4,421	4,525	4,535	4,426	35	35

Source: Deutsche Bundesbank (2003c), p. 42

**Figure 2.28** Relative composition of private financial assets in Germany 1991–2002 (year-end figures) as a percentage of total financial assets

Source: Deutsche Bundesbank (2003c), p. 42

A comparison of the shares of 'safe' (bond, money market and real estate funds,⁶⁸⁹ bank deposits, insurances, bonds) versus 'risky' forms of investment (equity funds,⁶⁹⁰ shares and other equity instruments) in 1991 and 2002 shows that the split remained almost unchanged: the ratio of 'safe' to 'risky' was 83 per cent to 17 per cent in 1991, and this had only shifted marginally towards risky investments in 2002 at 82 per cent to 18 per cent.⁶⁹¹ The clear growth in the volume of investment funds over the same period changed the composition of private financial assets only slightly towards more risky investment forms that therefore offer a greater return in the long term. This is because, in contrast to the situation in the USA, equity funds did not account for the bulk, but (in 2002) only slightly less than one-third of mutual fund assets. The equity boom in the late 1990s saw equity-based mutual funds swelling briefly to half of total mutual fund assets, but the subsequent slide in prices prevented this position from being maintained (see Figure 2.32, p. 132).

Table 2.18 and Figure 2.28 also show clearly the effect of both the bull market up to the end of the 1990s and the following bear market on equities held (directly) by individuals in Germany. While the 261 per cent growth rate for equities between 1991 and 1999 was beaten only by that for investment fund assets (331 per cent), this growth was only 27 per cent between 1991 and 2002, coming second to last in the growth stakes. The data for end-1999, when shares and other equity instruments accounted for almost one-quarter of financial assets, mark the climax of the equity market exuberance; this then lost 65 per cent by the end of 2002, with shares and other equity instruments falling to only 13 per cent of financial assets.

In terms of inflows into German mutual funds,⁶⁹² there was a gradual trend in the early to mid-1990s away from bond funds and into equity funds (see Figure 2.29 on the absolute and Figure 2.30 on the relative inflows per fund type): up to 1992, the vast majority of annual net new cash flows went to bond funds, at times almost the entire volume. With high net new cash flows of almost €38 billion, the newly launched money market funds suddenly dominated the scene in 1994,⁶⁹³ accounting for almost two-thirds of total inflows, with equity funds trailing a distant second at just on 20 per cent of net new cash flows. One year later, total net new cash flows slumped to only €2.16 billion, most of which went into money market funds, while bond funds recorded net cash outflows of €6.46 billion, almost three times the cumulative net new cash flows across all fund types. In the period of sustained significant share price increases between 1997 and 2000, equity funds led net new cash flows by a wide margin, while bond

⁶⁸⁹ This item also includes half the volume of hybrid, AS and other funds (see Figure 2.32).

⁶⁹⁰ See n. 689.

⁶⁹¹ Figure 2.32 shows that the aggregate share of equity funds, plus half of the hybrid, AS and other funds accounted for 11 per cent (1991) and 33 per cent (2002) of the total volume of mutual funds, while bond funds plus the other half of the hybrid, AS and other funds, plus money market and open-end real estate funds accounted for 89 per cent (1991) and 67 per cent (2002). The 'investment funds' item in Table 2.18 must be broken down accordingly.

⁶⁹² See n. 685.

⁶⁹³ Section 1(1) KAGG as amended by FinMFöG 2.

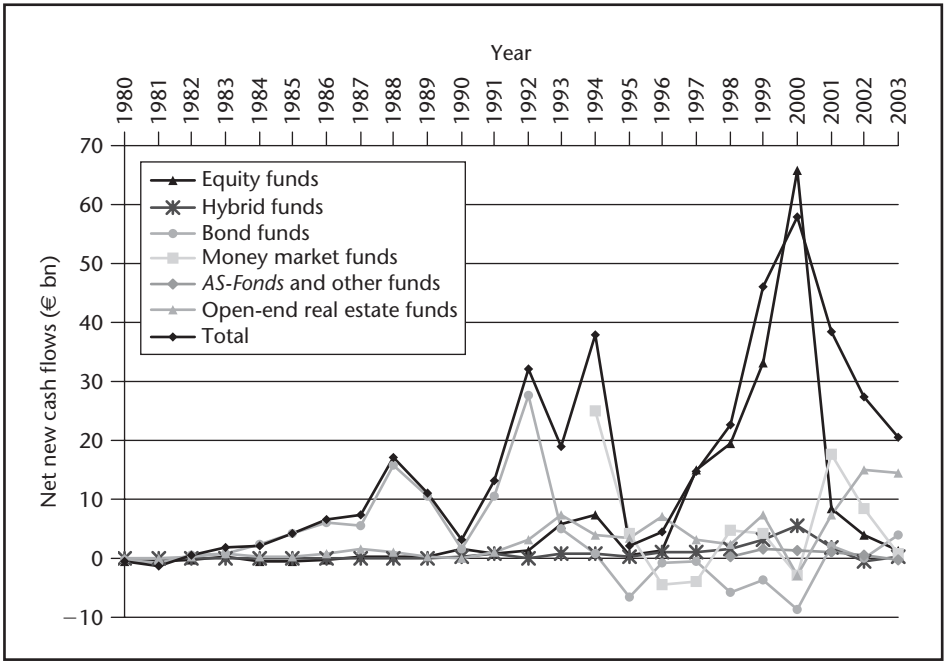


Figure 2.29 Net new cash flows to German mutual funds by fund type, 1980 to the end of September 2003 (in € billions)

Sources: Data for years up to and including 2002, see BVI (2003a), p. 86; data for 2003 (end-Sept. 2003), see Deutsche Bundesbank (2003a), p. 54f (the data include foreign mutual funds of German origin)

funds suffered net outflows in each year. In 2000, at the height of the stock market boom, equity funds accounted for 113.6 per cent of aggregate net new cash flows over all mutual funds together, at a record €66 billion. Demand for equity funds plummeted in 2001, and the prevailing climate of uncertainty now favoured money market funds, followed by open-end real estate funds. The latter recorded 54 per cent of total net new cash flows in 2002 and an impressive 71 per cent in the first three quarters of 2003. As a result, these fund types came to dominate the scene. The fact that equity funds were still able to record positive net new cash flows in 2001 to 2003 is remarkable in view of the dramatic stock price losses in these years, and was probably motivated by the belief that this was (supposedly) a good time to move into equities. During this period of sustained share price losses, however, bond funds were hardly able to make up any ground at all and still trailed well behind equity funds in 2001 and 2002 (2001: €2.13 billion compared with €8.29 billion; 2002: €−0.08 billion compared with €3.98 billion), and were only able to move ahead of equity funds again in 2003 (€3.9 billion compared with €1.4 billion).

A volume analysis of German mutual funds⁶⁹⁴ by fund type (see Figures 2.31 and 2.32) shows that bond funds, which had recorded annual growth rates in

⁶⁹⁴ See n. 685.

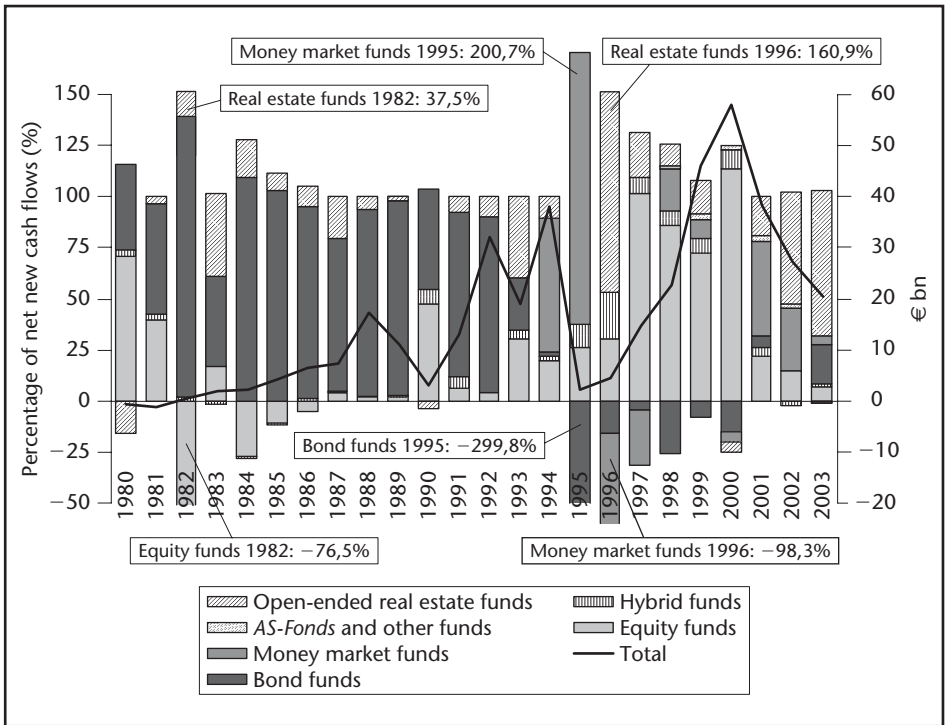


Figure 2.30 Net new cash flows to German mutual funds by fund type, 1980 to the end of September 2003 as a percentage of total new cash flows

Sources: Data for years up to and including 2002, see BVI (2003a), p. 86; data for 2003 (end-Sept. 2003), see Deutsche Bundesbank (2003a), p. 54f (the data include foreign mutual funds of German origin)

the high double digits more or less constantly since the mid-1960s, stagnated at around €115 from 1993 on. By contrast, the volume of equity funds rose successively and significantly from the early 1990s. Equity fund assets amounted to €9.7 billion in 1992, accounting for one-tenth of bond fund assets (€99 billion) but, with a total volume of €176 billion, they recorded a higher (1.5 times) volume than bond funds for the first time in 1999. Because almost half of this €166.3 billion growth was due to new cash flows,⁶⁹⁵ it is easy to draw the conclusion that the group of investors investing in equity funds has become much more broad-based, and that it was not merely former equity fund investors who were profiting from price growth. Because of the sustained net new cash flows to equity funds, they were only just ahead of bond funds at the end of 2002 following two years of dramatic price losses (€115.3 billion as against €114.4 billion). However, in the wake

⁶⁹⁵ Cumulative net new cash flows to equity funds were €82.9 billion for 1993 to 1999 (see BVI, (2003a), p. 86).

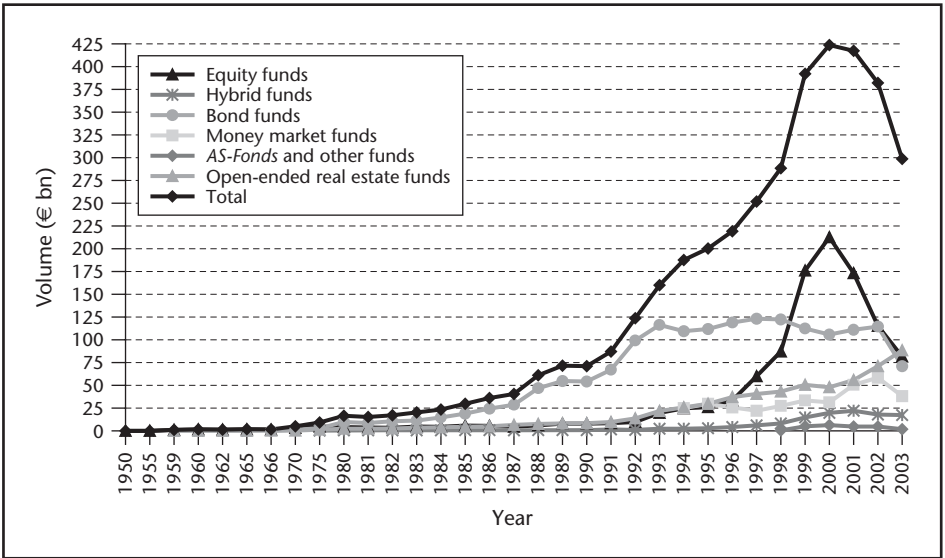


Figure 2.31 Volume of German mutual funds by fund type, 1950 to the end of September 2003

Sources: Data for years up to and including 2002, see BVI (2003a), p. 84; data for 2003 (end-Sept. 2003), see Deutsche Bundesbank (2003a), pp. 52f (the data include foreign mutual funds of German origin)

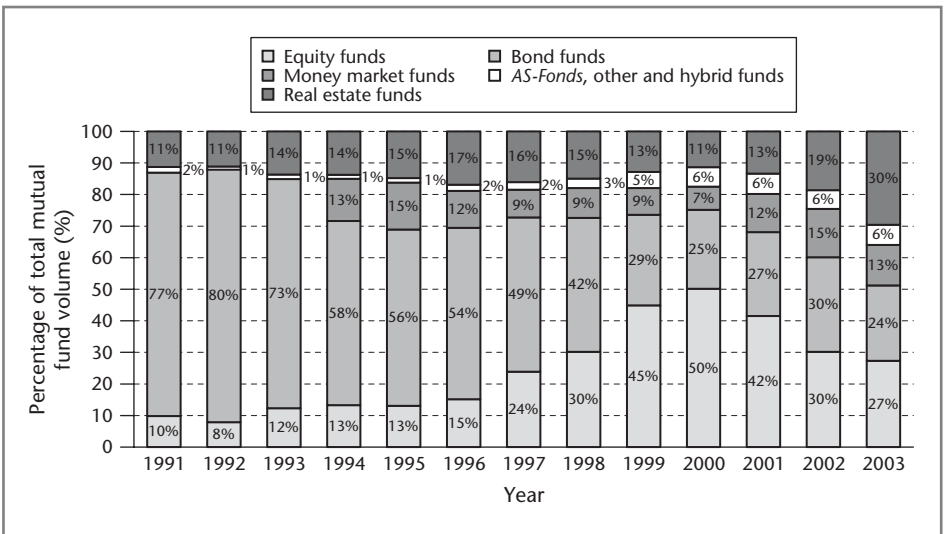


Figure 2.32 Breakdown of German mutual fund assets by fund type, 1991 to the end of September 2003

Sources: Data for years up to and including 2002, see BVI (2003a), p. 84; data for 2003 (end-Sept. 2003), see Deutsche Bundesbank (2003a), pp. 52f (the data include foreign mutual funds of German origin)

of the upturn on the equity markets in the second half of 2003, they were able to increase their lead again to a certain extent, albeit at a much lower absolute level.

Despite this significant growth in equity (fund) assets in Germany, they are certainly far from reaching the investment patterns in the US. The number of individuals and the number of households in the USA holding investment fund shares have increased appreciably and multiplied respectively in the past 20 years or so (see Figure 2.33). Not only the absolute figures, but also the figures relative to the population as a whole, have reached a level far above that in Germany. More than half of US households owned shares in investment funds in 2002, for example, although the figure was only 9 per cent (26 per cent) 20 (10) years previously. The number of individuals holding investment fund certificates (95 million) accounted for just on one-third of the US population in 2002.

The composition of private financial assets in the USA also differs substantially from that in Germany. People in the USA have a considerably larger risk appetite than people in Germany. A comparison of Figure 2.34, which presents the composition of financial assets in the USA, and its German counterpart, shown in Figure 2.28, p. 123, shows the following.

- 1 It was only at the height of the speculative bubble⁶⁹⁶ at the end of 1999 that the proportion of German private financial assets attributable to equities briefly matched the level of around one-quarter that has prevailed in the USA since the mid-1980s. A direct comparison at end-1999 shows the USA well ahead because of the doubling since the 1980s of US household financial assets held in equities: equities account for half of the financial assets in the USA, but only for one-quarter in Germany.
- 2 The proportion of 'safe' investments (bank deposits, money market certificates and money market funds, as well as government bonds) has fallen continuously in the USA since the early 1980s, when it was still around 70 per cent, to a level of 30 per cent in 1999. The start of the capital market crisis in 2000 then marked an abrupt trend reversal. Running counter to the more or less contrary development of the proportion of equities, the proportion of 'safe' investments rose by approximately 50 per cent in the final two years of the observation period.

⁶⁹⁶ A bubble is defined as a market price that contradicts reasonable economic explanation. Because the 'New Economy' phenomenon was frequently accompanied by the claim that it represented a new economic paradigm, the nature of the bubble could be questioned. For example, Garber (1990), p. 35, holds the view that the impression that there can be an increased expectation of high profits because of a *compelling* new economic theory can be seen as a sensible fundamental reason. But if the market development only appears to be absurd with hindsight, it cannot be a bubble (see *ibid.*, p. 41). In fact, however, both before the bubble started growing and during its growth, there were many critical voices warning against letting stock prices becoming too decoupled from fundamentally appropriate prices. Bubbles contradict the Efficient Market Hypothesis and can be explained, for example, by the phenomenon that an appreciable number of market participants do not act entirely rationally on the basis of fundamentals, and rational market participants are unable to counteract them entirely, because risk-free arbitrage is not possible in reality (see Shleifer and Summers (1990), pp. 19f).

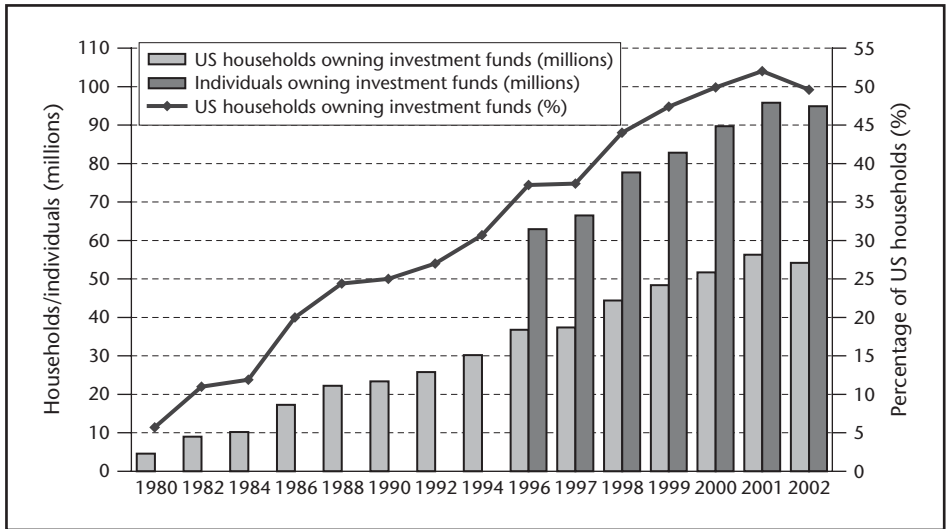


Figure 2.33 Individuals and households owning investment funds in the USA between 1980 and 2002

Sources: Data for households for 1980–96 and 1998–2002: see Investment Company Institute (2002b), p. 1; 1997: see Investment Company Institute (1998c), p. 1; data for individual fund ownership: for 1996, see Investment Company Institute (1997), S. 21; 1997: see Investment Company Institute (1998a), p. 36; 1998–2002: see Investment Company Institute (2002b), p. 2.

In terms of investing in funds, German and US investors are quite similar at first sight because a proportion of around 20 per cent of private financial assets was reached in both countries at the turn of the millennium. However, a detailed analysis of the asset classes dominating investments in funds for the period 1991 to 2002 (Figure 2.32 shows the development in Germany, while Figure 2.35, shows the development in the USA) shows that people in the USA had the same sort of higher risk tolerance that was already evident for direct investment.

1 In the USA, the share of equity funds in total fund assets grew to around half in the early twenty-first century, starting from around one-third in the early 1990s. In Germany, the initial basis of one-tenth was considerably lower; although the relative growth to around one-third by the end of the observation period was significantly higher, it was still not enough to catch up with the USA. This catching-up process was particularly evident between 1995 and 1999: in the USA, the proportion of equity funds grew from 44 per cent to 59 per cent over these four years, while Germany recorded an increase from 13 per cent to 45 per cent. The ratio between the proportion of equity funds in Germany and the proportion of equity funds in the USA has shifted appreciably in favour of Germany: it was still in the range of 1:3 to 1:4 in the early 1990s, but had almost reached parity by 2000 (Germany: 50 per cent; USA: 57 per cent). Thereafter, however, it widened again, initially to 1:1.5 at the end of 2002 and then to 1:1.8 at the end of the third quarter of 2003.

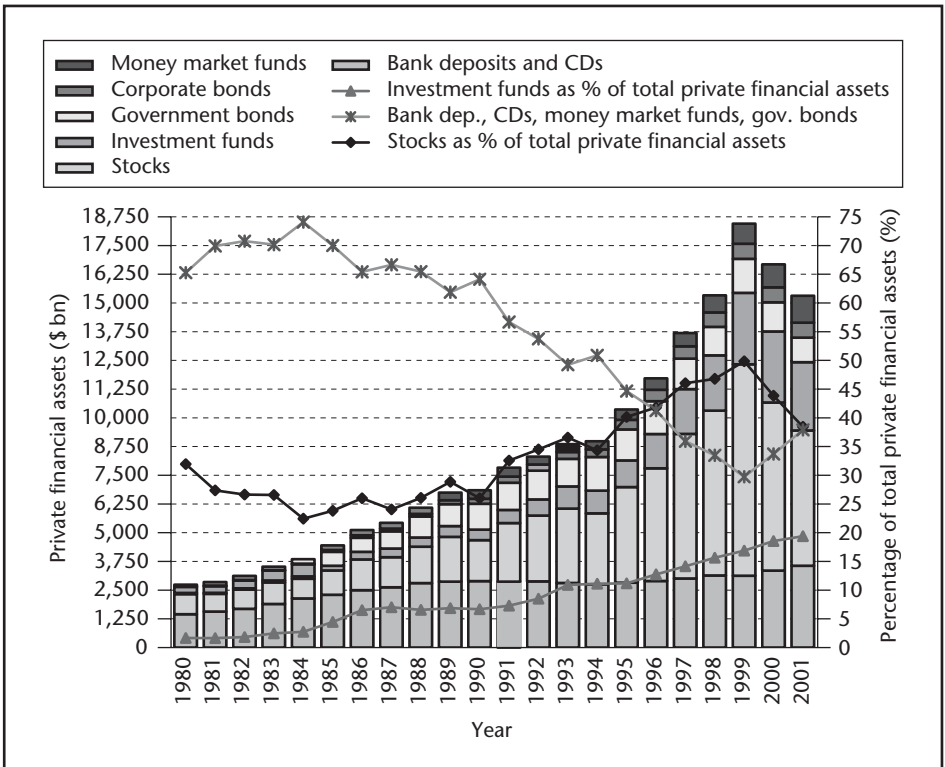


Figure 2.34 Private financial assets in the USA 1980–2001 (year-end figures) in billions of US\$

Source: Securities Industry Association (2002), p. 68

- 2 Reflecting the lower proportion of equity funds, bond funds are disproportionately more important in Germany than in the USA: in the early 1990s, bond funds accounted for more than three-quarters of mutual fund assets in Germany, but only a good quarter in the USA. This ratio of approximately 3:1 between German and US bond fund assets narrowed to around 2:1 at the turn of the millennium and then to only 1.5:1 by 2003, while at the same time the proportion of bond funds in total investment fund assets in each country fell to an even greater extent.
- 3 Real estate funds, which in Germany accounted for nearly one-fifth of mutual fund assets at the end of 2002 and almost as much as one-third by the end of the third quarter of 2003 (see Figure 2.32), hardly play any role at all in the USA. In the USA, real estate funds are organized as closed-end funds⁶⁹⁷ in the form of REITs (Real Estate Investment Trusts) and are normally listed although, at

⁶⁹⁷ Open-end real estate funds are implemented through investment funds investing in REITs.

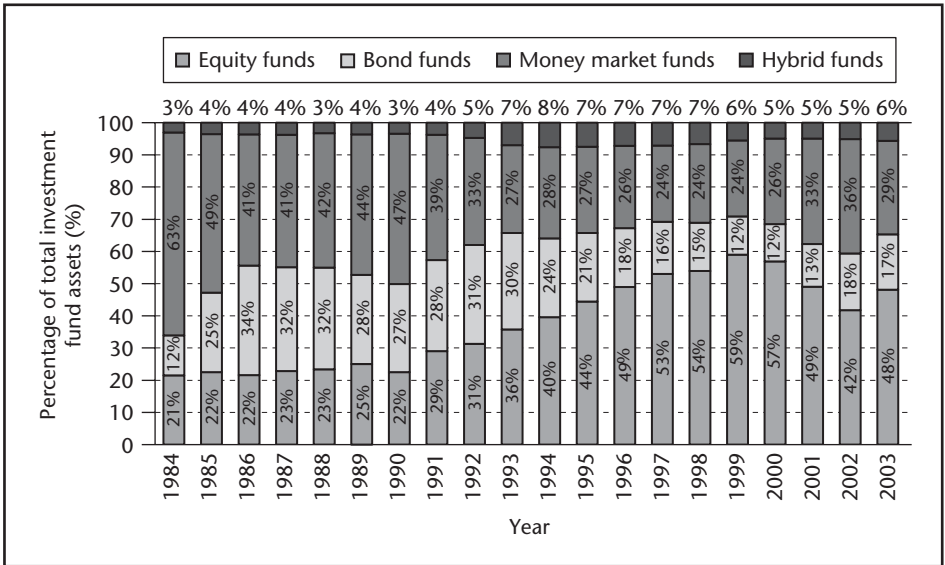


Figure 2.35 Breakdown of US investment fund assets by fund type, 1984 to the end of October 2003

Sources: Data up to and including 2001, see Investment Company Institute (2003a), p. 64; data for 2002 and 2003, see Investment Company Institute (2003b)

US\$162 billion,⁶⁹⁸ their share of total US stock market capitalization or of total US investment fund assets at the end of 2002 was only around 1.5 per cent and 2.5 per cent respectively.

The fact that money market funds, as the fund investment with the lowest risk, take a much higher share of total investment fund assets in the USA than in Germany, contrary to the picture of risk preference in the USA previously presented, may well be because they substitute current or savings accounts to quite a large extent (because of the very low marketing and management fees). In addition, the record outflow from money market funds of almost US\$230 billion in the first 10 months of 2003, which saw the proportion of money market funds in US total investment fund assets fall from 36 per cent at the end of 2002 to 29 per cent at the end of October 2003, accompanied by an inflow to equity funds of US\$123 billion, indicates that they are used to 'park' potential securities investments in times of volatile capital markets. Moreover, money market funds have been established far longer in the USA⁶⁹⁹ than in Germany, where they were only authorized for the first time⁷⁰⁰ in 1994. In the past ten years, the share

⁶⁹⁸ See NAREIT (no date).

⁶⁹⁹ The first US money market fund was launched in 1971 (see Investment Company Institute, (2003a), inside front cover).

⁷⁰⁰ See n. 693.

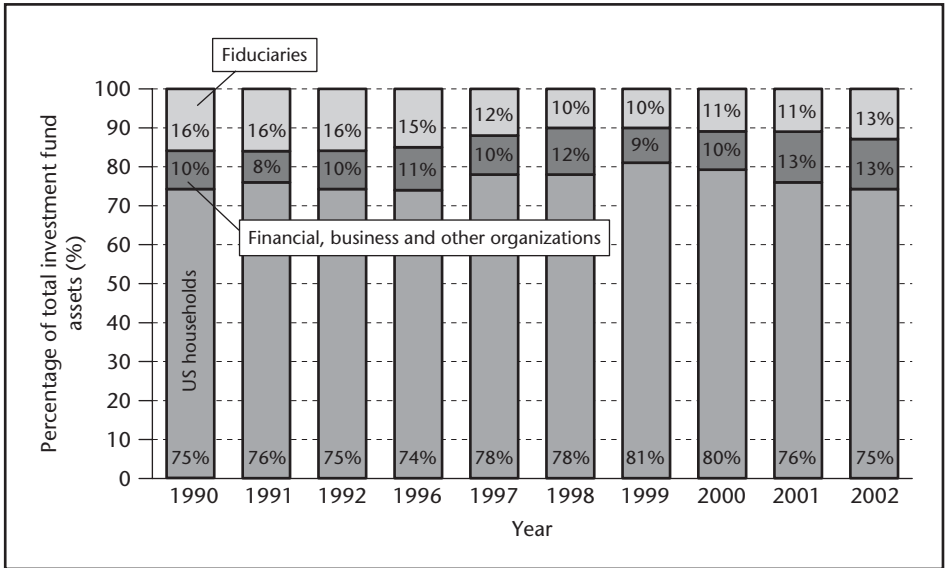


Figure 2.36 Breakdown of US investment fund assets across households, financial institutions/business/other organizations and fiduciaries between 1990 and 2002

Sources: Data for 1990, 1992 and 2002: see Investment Company Institute (2003a), p. 41; 1991 and 2001: see Investment Company Institute (2002a), p. 37; 1996: see Investment Company Institute (1997), p. 35; 1997: see Investment Company Institute (1998a), p. 36; 1998: see Investment Company Institute (1999b), p. 41; 1999: see Investment Company Institute (2000a), p. 41; 2000: see Investment Company Institute (2001), p. 43 (totals do not equal 100 per cent due to rounding)

of money market funds in the USA ranged between one-quarter and one-third, while in Germany it was only 9 per cent to 15 per cent.

The share of the total US fund volume held by US households has fluctuated only slightly between 75 per cent and 81 per cent since 1990 and, at 75 per cent, was at exactly the same level in 2002 as it had been in 1990 (see Figure 2.36).⁷⁰¹ The booming stock markets at the end of the 1990s pushed up this share to a peak of 81 per cent at the end of 1999.

Most US fund investors have substantial experience in equity instruments: 46 per cent of them first bought equities (in)directly prior to 1990, 27 per cent of them between 1990 and 1995, and only 17 per cent of them after 1995.⁷⁰² Investment saving therefore has a tradition in the USA, and is not a fad triggered by the booming equity markets in the 1990s.

Investment fund saving is practised across all income levels in the USA to a differing extent, and a good one-third of households owning funds have a low to medium income, just on half have a good income and 20 per cent have a very

⁷⁰¹ Fund shares held directly by mutual funds and employee-financed or held in personal retirement savings plans are attributed to households.

⁷⁰² See Investment Company Institute (2003a), p. 43.

good income.⁷⁰³ The typical American fund investor is middle-aged,⁷⁰⁴ has an annual income of at least US\$62,000 and has invested 40 per cent of his or her financial assets in investment funds, around half of which were bought as part of defined contribution pension plans. At 88 per cent, equity funds are the most common, followed by money market funds at 48 per cent.⁷⁰⁵

There appears to be a trend in the USA away from holding individual stocks directly and towards investment funds, because every year since 1994, US households have sold more directly held individual stocks than they have bought investment funds. The fund industry is clearly profiting from this trend, which has been driven above all by the tax breaks for certain fund-based retirement plans.⁷⁰⁶ As a result of this, only 11 per cent of US equity investors held only individual stocks directly in January 2002, while the remaining 89 per cent were split 1:0.73 across investors exclusively holding equity fund investments and investors combining funds and individual stocks.⁷⁰⁷

Until the early 1990s, the annual net new cash flows to bond funds exceeded those to equity funds almost every year. In the wake of the subsequent equity boom, however, equity funds recorded substantially higher net inflows than bond funds every year between 1992 and 2000, a trend that peaked in 2000 when there was an inflow to equity funds of US\$309.4 billion, but an *outflow* from bond funds of US\$49.8 billion (see Figure 2.37).

In this bull market, equity funds, together with money market funds in second place, thus clearly dominated net cash flows in the fund industry. The year 2001 then saw a trend reversal in both the USA and Germany: net new cash flows to equity funds in the USA fell back to only US\$31.9 billion, from almost ten times that figure the year before. The percentage decline in Germany was similar, with only €8.3 billion flowing to equity funds in 2001 following €65.8 billion the previous year. While German equity funds still recorded net inflows in the crisis year for the capital markets of 2002, albeit at a very low level of €3.98 billion, US equity fund investors withdrew US\$26.2 billion net. In this crisis phase, US equity fund investors thus behaved much more procyclically than their German counterparts, who had shown themselves to be trend followers to a greater extent in the boom phase. Reflecting the sustained substantial price rises on international stock markets since around the middle of 2003, US investors are again displaying highly procyclical investment behaviour, first by withdrawing the record sum of almost US\$230 billion from money market funds between January and

⁷⁰³ 34 per cent of US households owning funds have annual incomes of up to US\$50,000, 46 per cent of between US\$50,000 and US\$100,000, and 20 per cent of more than US\$100,000 (see Investment Company Institute (2002b), p. 2).

⁷⁰⁴ 49 per cent of the heads of US households owning funds are aged between 35 and 54 (see Investment Company Institute (2002b), p. 3), and the median age is 46 (see Investment Company Institute (2003a), p. 45).

⁷⁰⁵ See Investment Company Institute (2003a), p. 45.

⁷⁰⁶ See Investment Company Institute (np, 2000), p. 40.

⁷⁰⁷ See Investment Company Institute (2003a), p. 43.

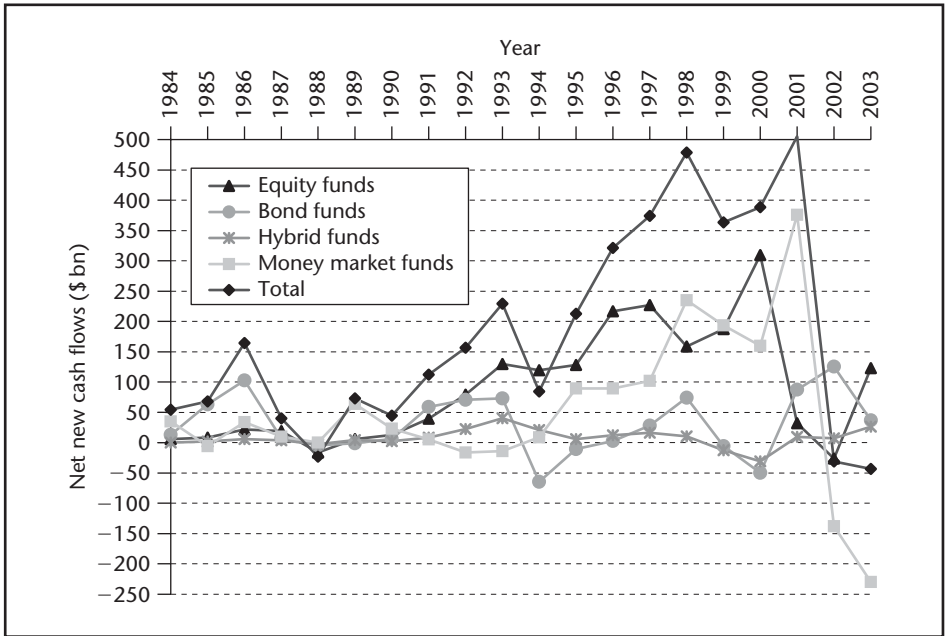


Figure 2.37 Net new cash flows to US investment funds from 1984 to the end of October 2003

Sources: Investment Company Institute (1999a), pp. 2, 5; (2000a), p. 2; (2003a), p. 35

October 2003, and second by investing US\$123 billion in equity funds (see Figure 2.37). By contrast, German fund investors in the first three-quarters of 2003 were more cautious, diverting 90 per cent of their net new cash flows totalling €39.2 billion to open-end real estate and bond funds, with equity funds only garnering 7 per cent of net cash flows, or €1.4 billion (see Figure 2.29, p. 125 and Figure 2.30, p. 126).

A comparison of net cash inflows to US and German mutual funds during the overheated equity boom between 1997 and 2000 shows that German fund investors almost exclusively invested in equity funds during this bull market, while in the USA funds also flowed to a considerable extent into money market funds as well as equity funds: 94.5 per cent of the cumulative net new cash flows of €141.42 billion between 1997 and 2000 went to German equity funds,⁷⁰⁸ while of the cumulative US net new cash flows of US\$1,604.9 billion over the same period, 55 per cent went to equity funds and 43 per cent to money market funds.⁷⁰⁹ This concentration of German net cash flows leads to the conclusion that the clearly

⁷⁰⁸ See BVI (2003a), p. 86.

⁷⁰⁹ See Investment Company Institute (1999a), p. 2 and p.5; for figures from 1999, see Investment Company Institute (2000a), p. 2; for figures from 2000 to 2002, see Investment Company Institute (2003a), p. 35.

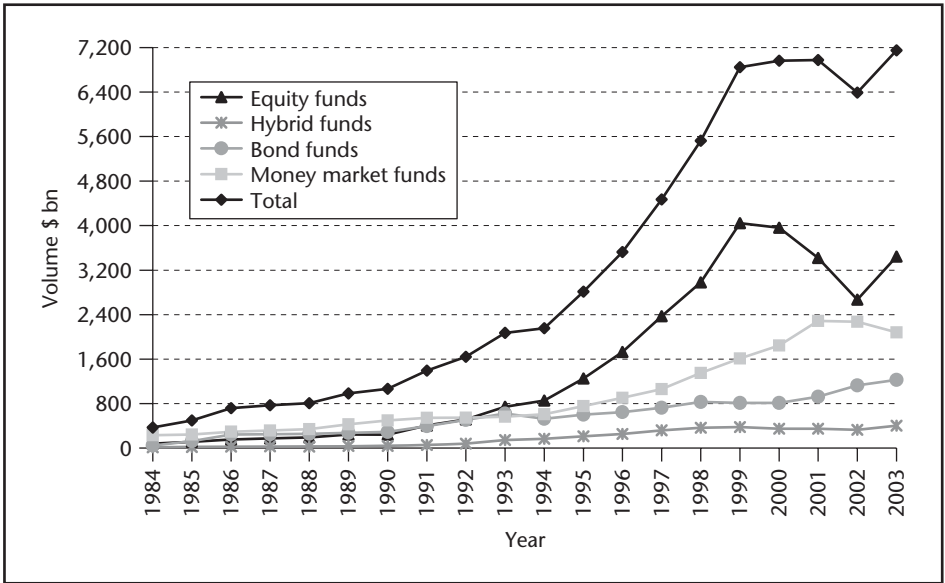


Figure 2.38 Volume of US investment funds by fund type, 1984 to October 2003

Sources: Data up to and including 2001, see Investment Company Institute (2003a), p. 64; data for 2002 and 2003, see Investment Company Institute (2003b)

underdeveloped equity (investment) culture compared with the USA stood in the way of sensible diversification. On the other hand, the (low) net new cash flows to German equity funds in 2002 and 2003 (January to September) can be seen as an indication of a learning curve in this respect: whereas sharp rises in stock prices led almost automatically to disproportionate growth in inflows to equity funds, a dramatic slide in stock prices did not result in net outflows.

The asset class ranking of US investment fund assets reflects that of net new cash flows, and at the end of 2002, equity funds accounted for 42 per cent of total mutual fund assets with a volume of US\$2,667 billion, followed by money market funds with 36 per cent, or US\$2,272 billion. At US\$1,125 billion, bond funds accounted for only 42 per cent of the volume of equity funds (see Figure 2.35, p. 131, on the relative development and Figure 2.38 on the absolute development).

At US\$4,042 billion or 59 per cent of total mutual fund assets, equity funds recorded their all-time high measured by year-end volume in 1999. Based on this high, and despite net new cash flows of US\$313.6 billion (for the period 2000 to 2002), they slipped by 34 per cent or US\$1,375 billion to US\$2,667 billion by the end of 2002. The recovery in the global equity markets that set in from mid-2003 ensured that, by the end of October 2003, they had risen again to slightly above the 2001 year-end level to US\$3,441 billion.

Although equities represent the dominant asset class in mutual funds, the vast majority of US equity instruments are held outside investment funds. Nevertheless, the significance of mutual funds as equity investors has risen almost

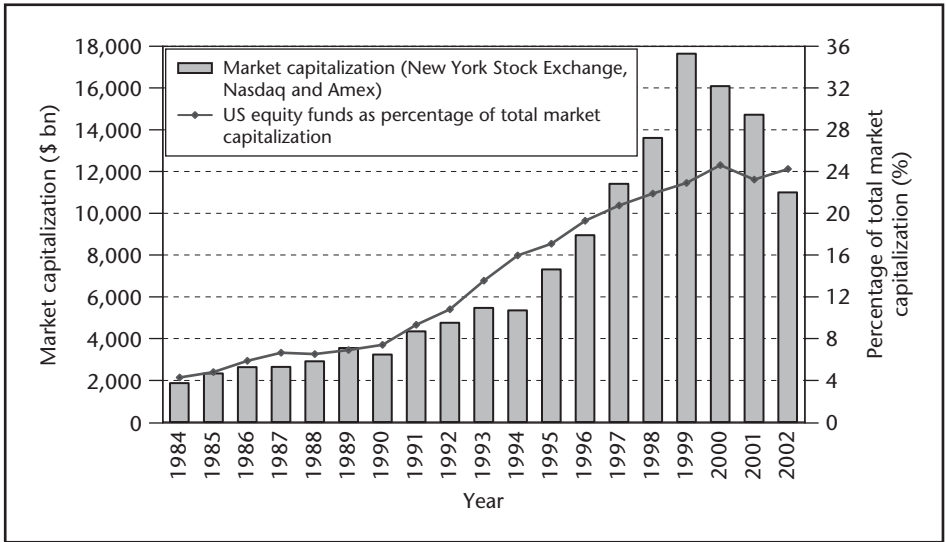


Figure 2.39 Share of equity funds in US stock market capitalization between 1984 and 2002

Note: Aggregated stock market capitalization of NYSE, Nasdaq and Amex (for 1994–2002, see Securities Industry Association (2002), p. 48; for 2002, see NYSE, New York, 2003).

Sources: Data up to and including 2001, see Investment Company Institute (2003a), p. 64; data for 2002, see Investment Company Institute (2003b)

continuously over the past two decades. Only a good 4 per cent of US equities were held by investment funds in 1984, but this figure had certainly more than doubled by the early 1990s, and had risen by a factor of four by the mid-1990s. At the height of the equity bubble in 2000, equity funds had lifted their share to almost one-quarter of all US equity instruments, but this level has since declined (see Figure 2.39).

The pervasive nature of investment funds in the USA is also driven by their significance as a retirement investment instrument. Investment funds for retirement provision have a different status in Germany: for occupational pension provision, funds are used – if at all – almost exclusively in the form of institutional funds rather than mutual funds. The extent to which mutual funds will be able to gain ground as part of the subsidized private Riestert pension is still unclear.

In the USA, on the other hand, a good 20 per cent (US\$2.1 trillion) of the total retirement assets of US\$10.2 trillion was invested in investment funds in 2002, a share that has risen slightly over the past ten years (see Figures 2.40 and 2.41). The remaining 80 per cent of US retirement assets is held by pension funds, insurance companies, banks and brokerage firms. Given that retirement assets of US\$2.1 trillion were invested in investment funds and the total assets held by US investment funds amounted to US\$6.4 trillion in 2002, this means that one-third of investment funds are used explicitly for retirement provision. This share was around one-quarter 10 years previously (see Figure 2.41).

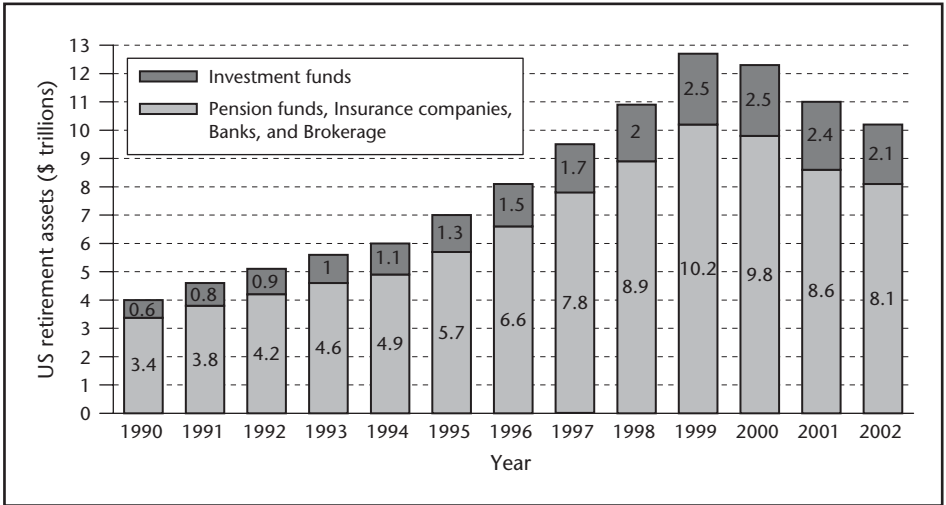


Figure 2.40 Composition of US retirement assets by investment vehicle

Sources: For the data on the composition of US retirement assets for 1990 to 1998, see Investment Company Institute (2000b), p. 2; 1999: see Investment Company Institute (2000a), p. 49; 2000: see Investment Company Institute (2001), p. 51; 2001: see Investment Company Institute (2002a), p. 45; 2002: see Investment Company Institute (2003a), p. 47

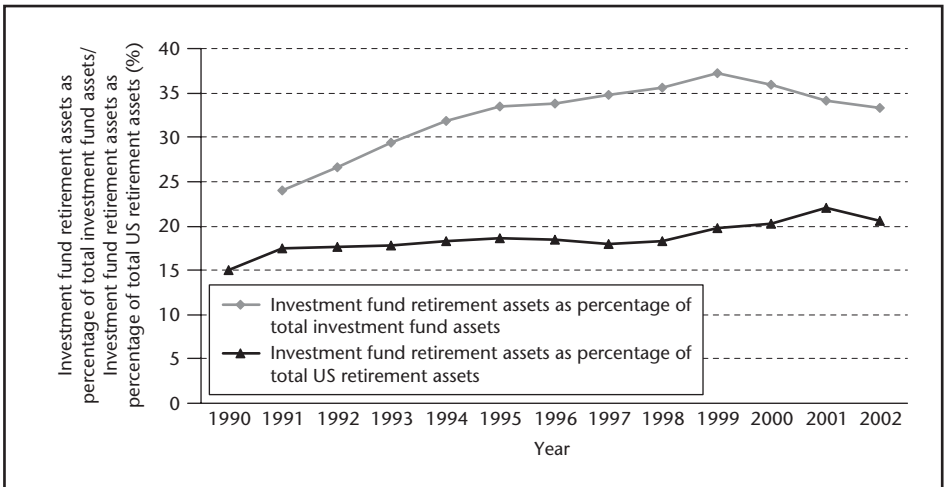


Figure 2.41 Investment fund retirement assets in the USA between 1990 and 2002

Sources: For the data on the composition of US retirement assets for 1990 to 1998, see Investment Company Institute (2000b), p. 2; 1999: see Investment Company Institute (2000a), p. 49; 2000: see Investment Company Institute (2001), p. 51; 2001: see Investment Company Institute (2002a), p. 45; 2002: see Investment Company Institute (2003a), p. 47. Data up to and including 2001, see Investment Company Institute (2003a), p. 64; data for 2002, see Investment Company Institute (2003b)

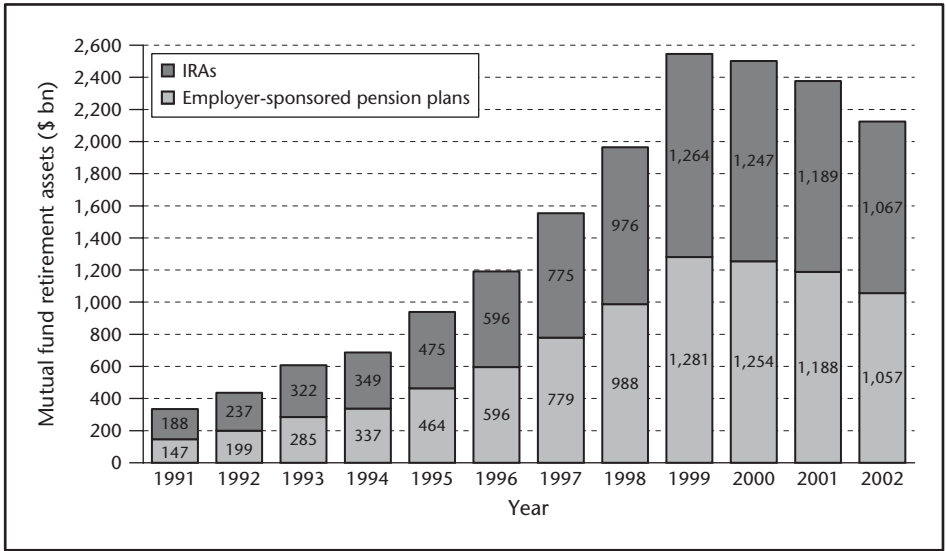


Figure 2.42 Distribution of investment fund retirement assets across pillar 2 and 3 pensions in billions of US\$

Source: Investment Company Institute (2003a), p. 48

In the mid-1990s, US retirement assets invested in investment funds were split almost evenly between pillar 2 and 3 funded pensions (Figure 2.42). The investment funds used for retirement provision in 2002 had assets of US\$2.1 trillion and 63 per cent of them were equity funds (56 per cent US equities, 7 per cent foreign; see Figure 2.43), although the share of equity funds in the total assets of all investment funds (i.e., including those that are not expressly used for pensions) was only 42 per cent in 2002 (see Figure 2.35, p. 131). At up to 76 per cent, the share of equities in retirement investment funds in recent years (1999 and 2000) was considerably higher, while the share of equities in all investment funds peaked at 'only' 59 per cent (1999).

THE NEED FOR ASSET MANAGEMENT STANDARDS IN THE EURO ZONE

Avoiding capital misallocations

The European Commission also emphasizes that efficient and transparent financial markets help optimize the allocation of capital, and that the EU's financial services sector at the end of the 1990s was lagging behind its counterparts in other industrialized countries.⁷¹⁰ The Commission's Financial Services Action Plan aims to remedy this situation.

⁷¹⁰ See European Commission, Com (1998) 625 (1998), p. 1.

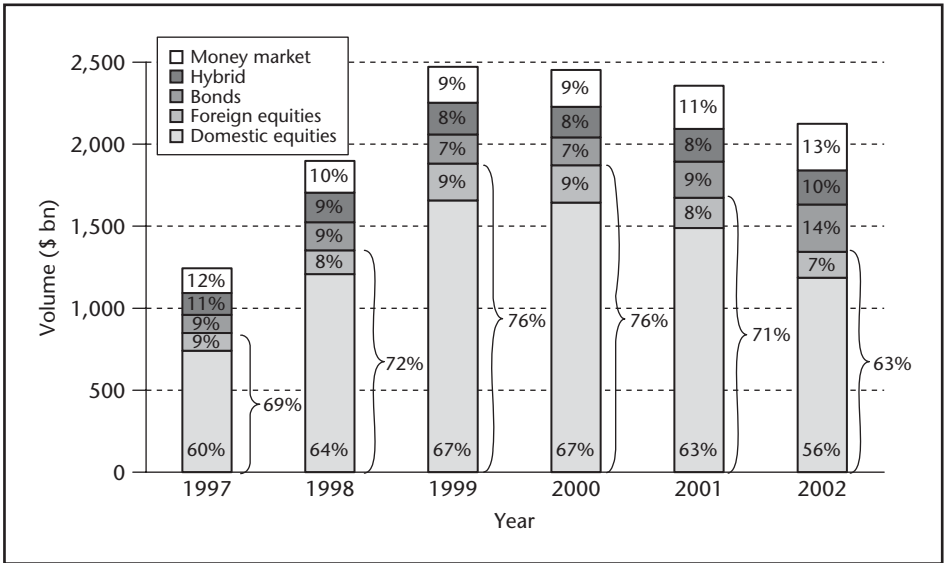


Figure 2.43 Distribution of investment fund retirement assets across the various asset classes in billions of US\$ and as a percentage

Sources: Investment Company Institute (1998a), p. 48; Investment Company Institute (1999b), p. 52; Investment Company Institute (2000a), p. 54; Investment Company Institute (2001), p. 58; Investment Company Institute (2002a), p. 54; Investment Company Institute (2003a), p. 56

As part of the preparatory work for the Pension Funds Directive that came into force in mid-2003, the European Commission was urged to consider whether quantitative investment restrictions discourage the efficient allocation of capital and thus not only jeopardize pension provision, but also adversely affect growth and employment⁷¹¹ because pension contributions have to be kept unnecessarily high. This increases non-wage labour costs, which in turn encourages the exodus of labour-intensive industries and the substitution of labour by capital.

The US asset management industry as the prime competitor

Europe faces a major challenge because of the huge volume of assets managed by the US investment funds and the well-established tradition of regulating these funds to protect investors. The first mutual fund was offered in the USA in 1924.⁷¹²

⁷¹¹ See Pragma Consulting (1999), p. 20.

⁷¹² See Investment Company Institute (np, 1997), p. 3. This was the 'Massachusetts Investment Trust', the first *open-end* investment fund. Closed-end funds had been launched prior to this: what was probably the first-ever (closed-end) investment fund, the 'Eendragt Maakt Magt', was launched in Holland in 1774 (see Rouwenhorst, n.d.). The Swiss then had their first open-end funds in 1849, the British in 1868, the Americans in 1894 and the Germans in 1923 (see Matthias (2002), p. 3).

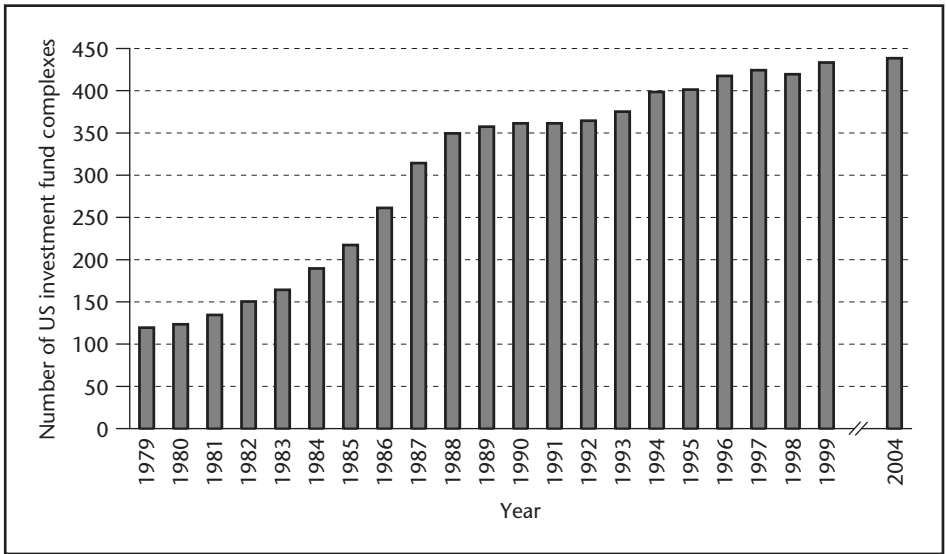


Figure 2.44 Growth fund company membership of the Investment Company Institute between 1979 and 2004

Note: A fund company manages a funds complex. A fund complex is a group of funds that are essentially jointly managed or marketed and that consist of one or more fund families.

Sources: Data up to and including 1999, see Investment Company Institute (2000a), p. 38; for 2004, see Investment Company Institute (np, 2004)

Since that date, the number of fund companies has risen sharply. A review of the period 1979 to 1999 produces the following picture for all fund companies that are members of the Investment Company Institute, accounting for 95 per cent of US mutual fund assets⁷¹³ (see Figure 2.44).

The Securities and Exchange Commission (SEC) attributes this success of the investment management industry, among other things, to the existence of a regulatory framework that helped ensure the integrity of the industry. In the 1920s and 1930s, the early days of the US investment industry, there was widespread abuse before the Investment Company Act of 1940 came into force. In particular, there were no comprehensive disclosure rules, so investors were kept in the dark about how their money was actually being invested, or about self-dealing. The Investment Company Act of 1940 is credited with establishing the ground rules that allowed investor confidence to be regained. This increased confidence was illustrated by the tripling of US mutual fund assets between 1941 and 1945 despite the Second World War.⁷¹⁴

Figure 2.45 shows the volume lead that the US fund industry has over the rest of the world. US mutual funds had assets of nearly US\$6.4 trillion in 2002,

⁷¹³ For list of ICI members as at 31 Dec. 1999, see Investment Company Institute (np, 2000), pp. 49ff.

⁷¹⁴ See Roye (1999e).

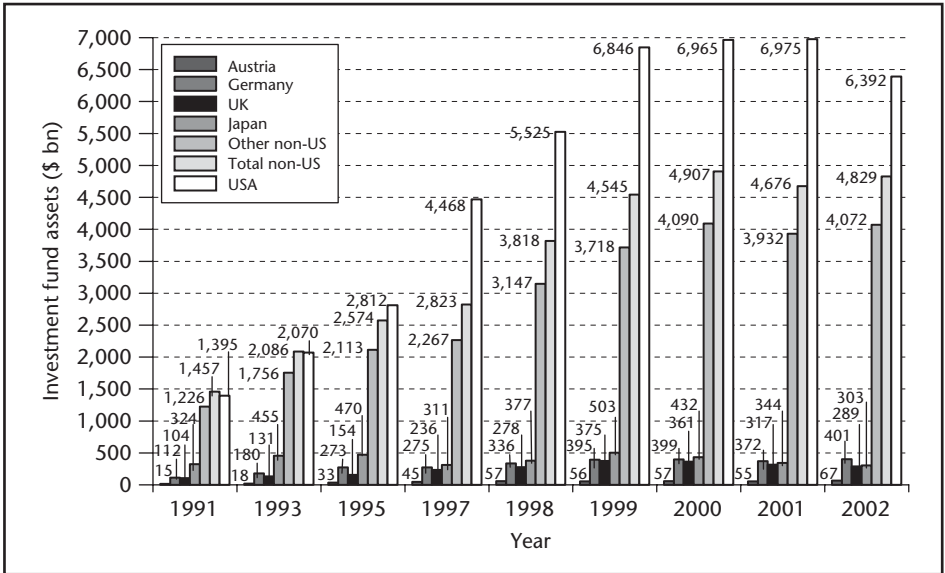


Figure 2.45 Assets of open-end mutual funds worldwide and in selected countries in US\$ billions between 1991 and 2002

Note: The data for Austria exclude real estate funds; for Germany they exclude institutional funds, and for the UK they exclude funds of funds.

Sources: Data for Germany, see BVI (2003a), p. 80; currency translation of the basis of US\$/DM and US\$/€ exchange rates from www.oanda.com. For the data (excl. Germany) for 1994 to 1996, see Investment Company Institute (2000a), p. 105; for 1997 to 2002, see Investment Company Institute (2003a), p. 100

but all non-US mutual funds together had only US\$4.83 trillion, of which the EU accounted for US\$3.45 trillion. Table 2.19 illustrates that US funds had 56 per cent of the total volume of open-end funds worldwide at the end of 2002, and thus almost double that of the share of all EU funds together. In the wake of the longest bull market in the twentieth century, the USA was able to further extend its already substantial lead in the early 1990s. The USA accounted for around 50 per cent of global investment fund assets in 1991, with the EU taking exactly a third. Japan still held nearly 12 per cent at that time, but then suffered clear relative losses over the course of the 1990s, accounting (together with Hong Kong) for only 4.1 per cent at the end of 2002. Whereas the EU and Japan lost a few percentage points in the 1990s, the USA was able to grow to over 60 per cent by 1997. The share attributable to the EU fell from 33 per cent in 1991 to around 28 per cent at the end of the 1990s, although it then recovered to a good 30 per cent by the end of 2002. This gain corresponded to an equivalent percentage point loss by the USA, which fell by a good 3 percentage points from 2001 to 2002. Taken together, the USA and the EU accounted for 82 per cent to 88 per cent of global fund assets between 1991 and 2002, so an analysis of these two markets measured by volume is representative.

Table 2.19 Percentage distribution of global assets of open-end mutual funds by region and continent between 1991 and 2002 (%)

	1991	1995	1997	1999	2000	2001	2002
South Africa	0.0	0.2	0.2	0.2	0.1	0.1	0.2
Latin America	0.0	1.4	1.6	1.3	1.5	1.6	1.2
Australia + New Zealand	1.2	0.8	0.7	1.7	2.9	2.9	3.2
Asia	13.2	11.5	6.0	7.6	6.5	5.8	6.0
Japan + Hong Kong	11.6	9.5	5.0	5.8	5.2	4.4	4.1
Asia excl. Japan + HK	1.6	2.0	1.0	1.8	1.3	1.4	1.9
Europe	34.2	31.1	28.7	28.6	28.7	28.2	31.2
EU	33.4	30.2	27.7	27.8	27.9	27.4	30.3
Non-EU	0.8	1.0	0.9	0.9	0.9	0.8	1.0
USA + Canada	51.4	55.0	62.9	60.6	60.2	61.4	58.2
Canada	1.5	2.0	2.7	2.3	2.3	2.3	2.2
USA	49.9	52.9	60.2	58.3	57.9	59.1	56.0
USA + EU	83.2	83.1	88.0	86.1	85.7	86.5	86.3
Total (in billions of US\$)	2,798	5,312	7,419	11,742	12,032	11,795	11,411

Sources: Data for Germany, see BVI (2003a), p. 80; currency translation of the basis of US\$/DM and US\$/€ exchange rates from www.oanda.com. For the data (excl. Germany) for 1994 to 1996, see Investment Company Institute (2000a), p. 105; for 1997 to 2002, see Investment Company Institute (2003a), p. 100

On top of this, the US fund industry is now showing signs of wanting to expand outside the USA. This could threaten the European fund industry if it does not respond quickly and build on its existing strengths by establishing competitive standards so as not to leave the entire field open to the Americans. For example, the Investment Company Institute (ICI) is actively lobbying both inside and outside the USA for the removal of barriers to market entry for US funds in Europe (and Asia). At the same time, the ICI is trying to eliminate legal (fiscal) barriers to investments in US funds by foreigners.⁷¹⁵ The comment by the ICI that only 1 per cent of all US fund assets were held by non-US citizens in 1999⁷¹⁶ does not, however, stand up to closer inspection: on the one hand, just over 1 per cent of total US fund assets were held by Europeans in early 2000 and, on the other, US fund companies had gained a market share in the EU of 6.5 per cent by 2002 through Irish and Luxembourg subsidiaries.⁷¹⁷

On the other side of the Atlantic, the European fund industry is in turn calling for equality with US funds on the US market: the law generally prohibits the marketing of foreign investment funds in the USA, and authorization can only be

⁷¹⁵ The aim is to ensure that investments in US funds are treated in the same way for withholding and capital gains taxes as direct investments in US equities or investments via non-US funds.

⁷¹⁶ See Investment Company Institute (np, 2000), p. 24.

⁷¹⁷ See Heinemann, Schröder, Schüler, Stürböck and Westerheide (2003), pp. 37f.

issued in exceptional cases by the SEC.⁷¹⁸ Such exemptions have occurred only a very few times in the past. In addition, complex US tax arrangements prevent European funds from reaching any appreciable market share in the USA.⁷¹⁹ The European Commission, too, criticizes the unequal environment for the mutual marketing of US and EU investment funds and comes to the conclusion that ‘even though US investment funds can be freely marketed in the EU, EU funds are required to establish “mirror funds” in the US before they can market their products with US investors, despite the fact that EU and US regulations are broadly equivalent’.⁷²⁰ The BVI and now EFAMA, the European Fund and Asset Management Association (former FEFSI), are consequently calling on the European Commission (and the German Finance Ministry) to put the issue of US market access on the World Trade Organization agenda.⁷²¹ The implementation of strong European standards would make it extremely difficult for the USA to continue ring-fencing its fund industry against the European competition.

The risk of impracticable legislation and opaque case law

Transferring the opaque legal situation in the USA, based as it is on case law, to the EU without substantial modification would be neither possible nor desirable. The litigious nature of the US legal system, a feature regarded by many Europeans as excessive, is a further significant weakness of the US regulatory framework for the investment fund industry, and should be avoided at all costs when developing European standards. A common practice at US funds, for example, is for independent directors to seek legal advice about whether they are exposed to any personal liability hazard before implementing many of their decisions.⁷²² Lawyers frequently attend board meetings and are asked for legal opinions on the spot. This involves (substantial) costs, and can delay or even prevent decisions being taken if the consequences are regarded as legally too risky, even if they would be in the best interests of the investors.

Another US practice is the SEC’s habit of burdening fund boards with ‘overwhelming stacks of paper’, often leaving little time for important strategic decisions. Even the SEC is examining the issue of whether fund boards are being troubled with too many trivial matters.⁷²³ The SEC itself⁷²⁴ thinks that financial industry associations and self-regulation⁷²⁵ are more appropriate means than

⁷¹⁸ Section 7(d) Investment Company Act of 1940.

⁷¹⁹ See Heinemann *et al.* (2003), p. 37.

⁷²⁰ European Commission, Com (2000) 692/2 final (2000), p. 12.

⁷²¹ See BVI (2000b), p. 29.

⁷²² See US Securities and Exchange Commission (1999b).

⁷²³ *Ibid.*

⁷²⁴ In the person of Barry Barbash, Director of the Division of Investment Management at the SEC (see US Securities and Exchange Commission (1999b), p. 152).

⁷²⁵ Arthur Levitt, former SEC Chairman, favoured the voluntary initiative by the Investment Company Institute (ICI) to achieve better practice (see Levitt (np, 1999a)).

legislators for regulating asset managers in the wider sense. Legislators should do no more than stipulate a fiduciary relationship between the client and the adviser, with the industry taking charge of defining concrete codes of conduct and fundamental qualification requirements. The industry itself is increasingly voicing its frustration about overlapping, inconsistent, overly burdensome and outdated regulations under the Employee Retirement Income Security Act (ERISA) and other federal securities laws.⁷²⁶

There were also warnings against overregulating investment options for pension funds during the course of the legislative process leading to the EU Pension Funds Directive and, in line with the EU principle of subsidiarity, there was a recommendation for a prudential regime that does not mete out draconian punishments, but rather provides an enabling infrastructure.⁷²⁷ The European Commission takes the compatible view that a light, state-of-the-art prudential framework would be the best solution for the rapidly changing and increasingly complex financial services market. To achieve the objective of ensuring state-of-the-art prudential rules, rapid response times in the lawmaking process are at least as important as capping the number of regulations – to reduce complexity – and ensuring that they are of high quality.

To do this will mean overcoming the inertia of the normal legislative process, because 'by the time directives are proposed, debated and adopted, they can amount merely to detailed solutions to yesterday's problems'.⁷²⁸ Delays in modernizing the EU's prudential framework for financial services to bring it in line with international developments have 'already proved costly in terms of competitiveness',⁷²⁹ as well as handicapping efforts by regulators and supervisors to maintain the stability of the financial system. The introduction of the 'Four-Level Approach' recommended in the Lamfalussy Report is thus a major step towards reforming the EU's legislative process.

Establishing voluntary standards would go a long way to meeting these calls for a regime incorporating the greatest possible degree of flexibility, and would certainly make a significant contribution to enhancing the status of self-regulation, as opposed to government supervision. Two good arguments in favour of self-regulation that the fund industry can voice to the European Commission are, first, that it itself has the greatest expertise in the day-to-day business of funds, and second, that it has a great interest in assuring consumer confidence.⁷³⁰ In other words, it is the industry itself that is very well suited to being its own regulator in terms of both instruments and motivation. Legally binding consequences for infringements could be stipulated for black sheep in a self-regulatory mechanism.⁷³¹ Fund companies that commit voluntarily to such a code of conduct

⁷²⁶ See Investment Company Institute (np, 1997), pp. 3f.

⁷²⁷ See Pragma Consulting (1999), p. 8.

⁷²⁸ European Commission, Com (1998) 625 (1998), p. 6.

⁷²⁹ *Ibid.*

⁷³⁰ See Heinemann *et al.* (2003), p. 71.

⁷³¹ *Ibid.*

benefit because they can advertise a seal of quality, but at the same time they subject themselves to the threat of enforceable penalties in the event of infringement. Any inherent ambivalence in this is only superficial, because the notion of equipping self-regulation with state sanctions in the event of infringements significantly increases credibility, and thus the advertising effect (or possibly even allows it to reach a necessary level in the first place). In addition, this would compellingly eliminate the European Commission's misgivings about self-regulation⁷³² affecting consumer protection on the grounds of a lack of enforceability.

THE BASIS FOR ASSET MANAGEMENT STANDARDS IN THE EURO ZONE

Legislation in the European Union, Germany and Austria

Prompted on the one hand by the implementation of monetary union, and on the other by the primarily demographic funding problems for traditional pay-as-you-go compulsory pension insurance systems, the past few years have seen far-reaching legislative initiatives in the EU in the area of financial services at both national and supranational level. Particular progress was made in the fields of fund-based savings vehicles and funded pensions using occupational and private retirement provision institutions and products. At EU level, for instance, the Pension Funds Directive adopted in 2003 and the amended UCITS Directive (UCITS III) can serve as significant sources of efficient pan-European asset management standards. The EU's harmonization efforts are also aimed at establishing greater coherence in the regulation of pension funds, UCITS and life insurance policies, which the European Commission believes are 'largely substitutable products'.

Based on this cross-product approach, a number of chapters refer to the Pension Fund and UCITS Directives. Instead of a monolithic approach with individual chapters dedicated solely to pension funds and UCITS, we have opted for a primarily functional presentation. For example, the section above on The EU UCITS Directive (see p. 10), contains an overview of UCITS III as well as a summary of the objectives of the Directive, while the detailed rules governing UCITS are covered as set out below:

- Chapter 4, Prohibition on transactions involving conflicts of interest in the EU (p. 187)
- Chapter 4, The situation in the EU (p. 191)
- Chapter 4, Proxy voting (p. 212)

⁷³² See European Commission, Com (2001) 531 final (2001), p. 6.

- Chapter 4, Valuation of fund assets (p. 220)
- Chapter 5, Investment Rules for UCITS and IORPs in the EU (p. 228)
- Chapter 5, Legal basis for the use of financial derivatives by UCITS (p. 265)
- Chapter 5, Fixed maximum percentage of fund assets in securities of a single issuer (p. 267)
- Chapter 5, Diversification for investment funds and pension plans in the EU (p. 270)
- Chapter 5, Prospectuses in the EU (p. 315)
- Chapter 5, Annual and semi-annual reports to UCITS shareholders (p. 328)
- Chapter 6, Authorization/registration and continuing oversight in the EU (p. 372)
- Chapter 6, Enforcement (p. 376)
- Chapter 6, Legal basis for compliance (p. 381)
- Chapter 6, Reporting perceived irregularities to the supervisory authority in the case of UCITS and IORPs (p. 384)
- Chapter 6, The duties of the custodian in the EU (p. 390)

At national level, the present study examines in particular the rules governing supplementary funded pensions adopted in Germany and Austria since the turn of the millennium, as well as codes of conduct applying primarily to fund-based products although, as a rule, these are (currently still) recommendations without any binding legal force.

Existing United States standards

Investment Company Act and Investment Adviser Act

The Investment Company Act is based on collective efforts by the SEC and the fund industry between 1935 and 1940.⁷³³ The remarkably good spirit of cooperation on the part of the fund industry has been repeatedly praised by government leaders.⁷³⁴ In 1935, the United States Congress directed the SEC to undertake a study of the fund industry. Lasting six years, it culminated in the Investment Company Act of 1940. This legislation is the fundamental nationwide law that regulates mutual funds and their directors. It lays down the structure and activities of funds, including in particular rules for protecting investors. It also

⁷³³ See US Securities and Exchange Commission (1999b) and Investment Company Institute (np, 1997), p. 13.

⁷³⁴ See Investment Company Institute (2000a), p. 33.

imposes certain duties on fund directors that have been extended by the numerous rules and regulations⁷³⁵ promulgated by the SEC over time.⁷³⁶ Together with the Securities Act of 1933 and the Securities Exchange Act of 1934, the Investment Company Act of 1940 is one of the core sources of law regulating the supervision of the securities market by the SEC.⁷³⁷ It contains the following four core pillars of protection for mutual fund investors.⁷³⁸

- 1 Investors' funds are managed in accordance with the fund's investment objectives.⁷³⁹
- 2 Fund assets are kept safe.⁷⁴⁰
- 3 When investors redeem, they receive a pro rata share of the fund's assets.⁷⁴¹
- 4 The fund is managed for the benefit of its shareholders, and not the fund's adviser or its affiliates. This principle results first, from a general clause,⁷⁴² and second, from a variety of individual provisions.⁷⁴³

Figure 2.46 shows the structure of a US mutual fund: because mutual funds normally do not have any employees of their own, all the operations are conducted by companies hired by the fund⁷⁴⁴ (which can also terminate these contracts). These companies include the investment adviser (management company), the distributor, the transfer agent, the custodian and the accountants. The rights and obligations of the *investment adviser*, the *custodian* and the *accountants* are dealt with at a later point in this study, so only the functions of the *transfer agent* and the *distributor* are outlined below.

⁷³⁵ 17 CFR 270.

⁷³⁶ See Investment Company Institute (np, 1999).

⁷³⁷ See US Securities and Exchange Commission (2000i).

⁷³⁸ See Roye (1999c).

⁷³⁹ Written documentation of the fundamental investment policy to the SEC on registration in accordance with section 8(b) Investment Company Act of 1940 and changes in the fundamental investment policy in accordance with section 13(a) Investment Company Act of 1940.

⁷⁴⁰ Safekeeping of fund assets in accordance with section 17(f) Investment Company Act of 1940 and the right of the SEC in accordance with section 17(g) Investment Company Act of 1940 to force employees of the management company to access fund assets have led to the provision of insurance cover for theft or embezzlement.

⁷⁴¹ Redeemable securities in accordance with sections 22(c) and (d) Investment Company Act of 1940, right of redemption in accordance with section 22(e) Investment Company Act of 1940 and definition of redeemable securities in accordance with section 2(a)(32) Investment Company Act of 1940.

⁷⁴² Section 1(b)(2) Investment Company Act of 1940.

⁷⁴³ Transactions by certain affiliated persons and fund issuers in accordance with section 17 Investment Company Act of 1940, fund involvement in issues by affiliates in accordance with section 10(f) Investment Company Act of 1940, investment advisory contract in accordance with section 15 Investment Company Act of 1940, election rules for the Board of Directors in accordance with section 16 Investment Company Act of 1940 and the ability of the SEC or individual shareholders to take legal action in the event of suspected breach of fiduciary duty (see section below on Fiduciary duty, p. 152) by the investment adviser or the fund directors in accordance with section 35 Investment Company Act of 1940.

⁷⁴⁴ See Investment Company Institute (np, 1999), p. 4.

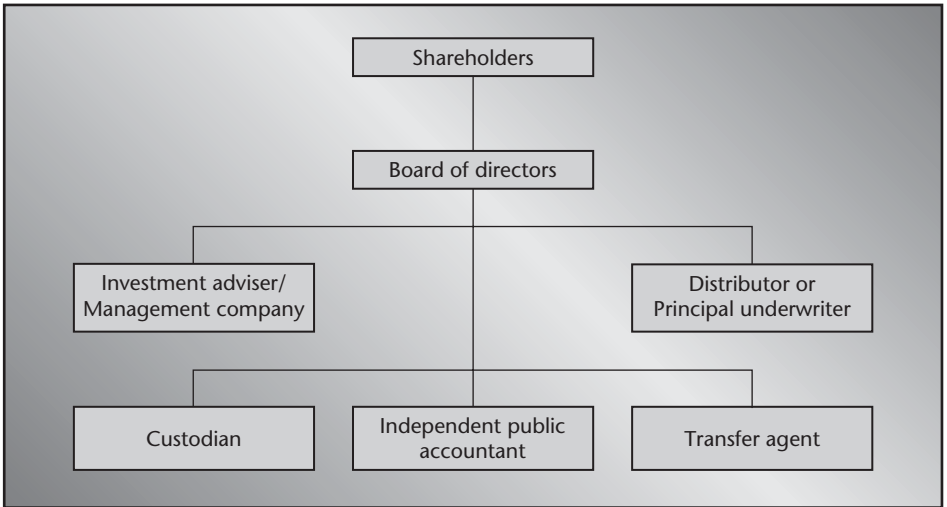


Figure 2.46 Structure of a mutual fund under US law

Source: Investment Company Institute (2000a), p. 34

Distribution (i.e., the direct or indirect sale of mutual funds to investors) is normally handled by a separate company, the *distributor*, because Rule 12b-1 under the Investment Company Act generally prohibits investment advisers from selling the funds they have issued.⁷⁴⁵ The *transfer agent* maintains records of shareholder accounts, calculates and pays dividends, and prepares income tax information and other notices to shareholders.⁷⁴⁶

Figure 2.47 illustrates the function of the distributor and the transfer agent in the case of cash flows between the shareholders and the fund company: if a potential or existing shareholder buys fund shares, redeems them, or receives dividends on them, that shareholder's transaction partner is the distributor, either directly or via the shareholder's bank. The distributor in turn does not interact directly with the fund manager, but via the intermediate transfer agent. The shares on which these cash flows are ultimately based are not held by the fund manager, but by the custodian.

Among other things, the Investment Adviser Act of 1940 regulates the following three core areas:⁷⁴⁷

- full and fair disclosure to clients, especially as regards conflicts of interest
- fiduciary duty of the investment advisers to their clients⁷⁴⁸
- anti-fraud regulations giving the SEC far-reaching powers

⁷⁴⁵ See the explanation of 12b-1 distribution fees in the section on Fees and expenses expense ratio, on p. 303.

⁷⁴⁶ See Investment Company Institute (2000a), pp. 35ff.

⁷⁴⁷ See US Securities and Exchange Commission (2000c).

⁷⁴⁸ See section 36(b) Investment Company Act of 1940.

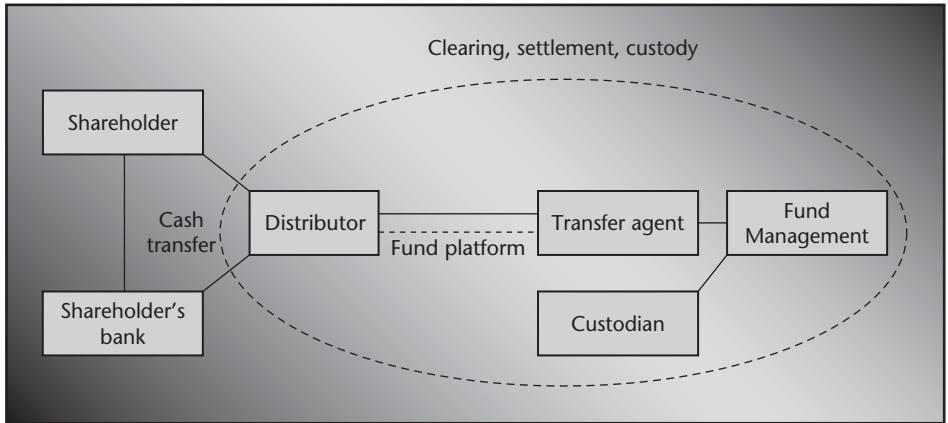


Figure 2.47 Intermediation chain of transactions from/to shareholders

Source: Adapted from Heinemann *et al.* (2003), p. 59

Concrete rules resulting from these principles cover such issues as advertising rules, custody requirements and the imposition of disclosure of financial and disciplinary information on the advisers.

ERISA

The objective of ERISA, which came into force in 1974, is to protect US occupational pensions against (negligent or deliberate) mismanagement and misinvestment.⁷⁴⁹ It imposes stringent fiduciary duties and disclosure standards on the managers of the occupational pension plans⁷⁵⁰ and ensures that plan assets are clearly segregated from corporate assets.⁷⁵¹ As a federal law, ERISA takes precedence over state law and thus represents uniform nationwide rules throughout the USA.⁷⁵² Through ERISA, the USA realized a goal many years ago that the EU is still trying to achieve with its constant efforts at harmonization.

In contrast to Germany or Austria, occupational pension provision in the USA is significant not only in the private, but also in the public sector. As Figure 2.48 shows, the total volume of private-sector employer-funded pension plans was US\$3,800 billion in 2002, with defined benefit plans accounting for well under half of this total at US\$1,600 billion, while equivalent public-sector pension plans had assets of approximately US\$2,800 billion.

ERISA was enacted at a time when DB pension plans predominated, rather than today's more common DC plans, which had reached around \$2.2 trillion by

⁷⁴⁹ The scope of ERISA extends to the private sector; it does not include the public sector and religious communities (see section 4 ERISA).

⁷⁵⁰ Recitals in section 2 ERISA.

⁷⁵¹ See Investment Company Institute (np, 2000), pp. 28f.

⁷⁵² See ERIC (1996), p. 1.

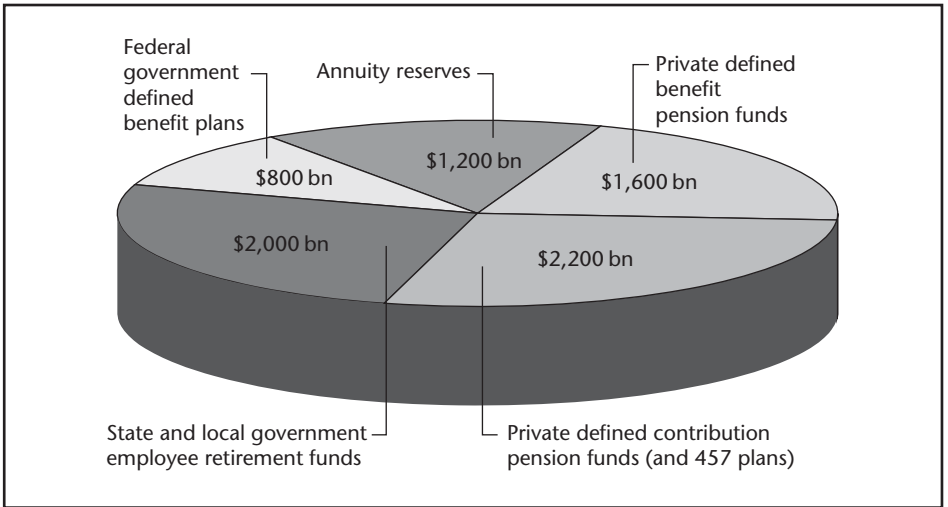


Figure 2.48 Breakdown of US occupational plan assets across various private- and public-sector plan types (year-end 2002)

Source: Investment Company Institute (2003a), p. 54

2002. The number of DB pension plans fell from 170,000 to 56,000 between 1985 and 1998, while the number of DC pension plans rose over the same period by almost 50 per cent from 462,000 to 674,000; the proportion of DB plans over this 13 year period thus fell from 27 per cent to only 8 per cent (see Figure 2.49).

The trend away from DB and towards DC plans is illustrated even more clearly by an analysis of pension plan holders (i.e., the number of employees and pensioners with an occupational pension plan). Whereas defined benefit plans accounted for almost three-quarters of the 45 million employees with an occupational pension plan in 1975, the figure for 1998 was only 42 per cent of the number of occupational pension plan holders, which had grown to 99 million (see Figure 2.50). The shift in investment risk from the sponsor to the employee that accompanied this structural change is sometimes seen as a step backwards in terms of social policy because the risk-bearing capacity of employees is relatively lower, and a loss of individual prosperity is ultimately more probable.⁷⁵³ In addition, the rapid growth of new patterns of employment, where employees often switch employer or frequently move between conventional employment relationships and self-employment (genuine or bogus), is a significant social development that has not yet been reflected in ERISA.⁷⁵⁴

⁷⁵³ Bodie (2003), p. 26.

⁷⁵⁴ For considerations on how such new forms of employment can be better integrated in ERISA, see Gordon (1998).

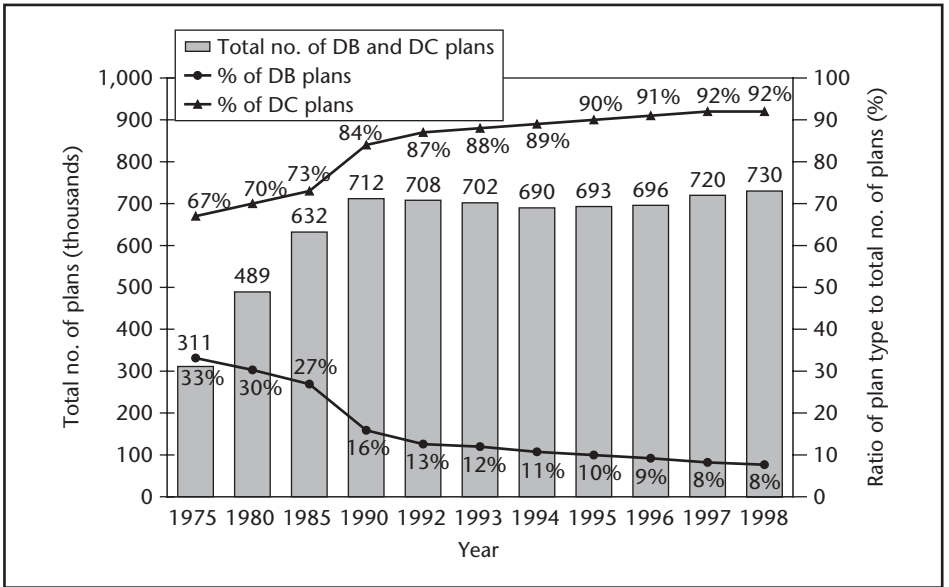


Figure 2.49 Number of defined contribution and defined benefit US occupational pension plans

Source: Rajnes (2002), p. 6

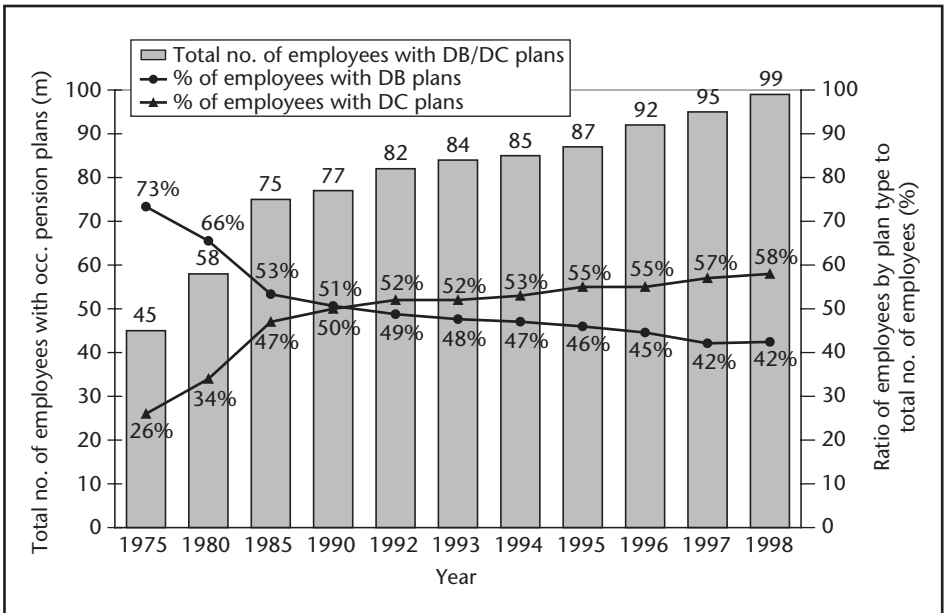


Figure 2.50 Breakdown of US occupational pension plans by defined contribution and defined benefit plans

Source: Rajnes (2002), p. 6

Fiduciary duty

The concept of fiduciary duty is a core principle of US law that is not just restricted to mutual funds or pension plans. However, it is not conclusively and clearly defined. The principle is applied to asset management in the wider sense (i.e., including portfolio and fund management), and to the management of personal matters (for example, by lawyers) for third parties. Fiduciaries – for instance, investment advisers, fund managers (or other bodies exercising influence on the fund) as well as lawyers – are expected to exercise a greater degree of loyalty, prudence and professional knowledge than normal individuals. In general terms, a fiduciary is a person or institution that has a relationship of trust with one or more persons or institutions. Priority is given to the best interests of the client, which thus take precedence over the interests of the fiduciary and its affiliates. The need for this construct arises from the asymmetry of expertise and information between the client and its fiduciary, and the particularly sensitive nature of investment and legal matters. This directly impacts the well-being of the client, who is placed in a dependent position, based on trust, that requires particularly stringent prudential criteria to protect the client as far as possible against abuse, incompetence, or even merely negligent misconduct. ERISA defines the fiduciary of a pension plan as a person or group with the following functions:⁷⁵⁵

- (a) exercise of discretionary authority and control relating to the management or disposition of pension plan assets;
- (b) remunerated investment advice relating to money, investments, or other assets of the pension plan;
- (c) vested discretionary authority or responsibility relating to the management of the pension plan.

All fiduciaries must discharge their duties in accordance with the principle of prudence, which represents a set of rules for a specific decision-making behaviour to define asset allocation, while the converse concept of quantitative restrictions defines asset allocation itself.⁷⁵⁶

For occupational funded retirement provision, the prudent expert rule anchors in law a list of requirements applicable to pension fund fiduciaries. These fiduciary duties are set out below.

*Fiduciaries must act exclusively in the interests of the fund members (i.e., participants and beneficiaries: duty of loyalty).*⁷⁵⁷ In case of any conflict of interest between the fiduciary and the pension plan, the resulting decision may not adversely

⁷⁵⁵ See Rodrick and Rosen (1999), p. 80.

⁷⁵⁶ See Galer (2002), p. 55.

⁷⁵⁷ See section 404 (a) (1) ERISA.

affect the plan or the beneficiaries. In addition, due to the 'exclusive benefit rule', the only objectives permitted in the management of the pension plan are the provision of benefits to beneficiaries and the minimization of management costs (cost-consciousness).⁷⁵⁸ Employee stock ownership plans (ESOPs) illustrate that the exclusive benefit rule does not always work in the employees' favour, but may well reduce their active income because retirement provision is the sole governing criterion. In the case of an ESOP, the exclusive benefit rule also means that the fiduciary may not accede to employee demands to preserve jobs, to pay out above-average additional wage components, to preserve unprofitable plants or retail outlets or to take other steps that could impair maximization of the value of the pension plan portfolio, for example.⁷⁵⁹

While ERISA is devoted in great detail to preventing or solving conflicts of interest between fiduciaries and pension plan members, it does not seek to govern conflicts between the beneficiaries, in particular between plan participants and pensioners.⁷⁶⁰

*Avoidance of prohibited transactions*⁷⁶¹ that may involve a conflict of interests. There are general rules,⁷⁶² as well as detailed regulations concerning self-dealing⁷⁶³ or kickback transactions. For example, accepting any pecuniary advantage to the fiduciary's own benefit during the course of pension fund transactions is a breach of fiduciary duty.⁷⁶⁴

The duty of diversification:⁷⁶⁵ ESOPs, stock bonus plans⁷⁶⁶ and sometimes also 401(k) plans often only meet this requirement inadequately if they invest large parts of the portfolio in securities issued by the plan sponsor.⁷⁶⁷ What is important here is that the securities risk is analysed in conjunction with the portfolio and not in isolation. This latter is required by numerous US state laws which lay down that each individual investment must itself be prudent; in practice, this leads to low diversification and, all else being equal, to unnecessarily high risk or unnecessarily low returns.⁷⁶⁸

Compliance with the 'governing documents' of the pension fund, as long as these do not conflict with other fiduciary duties: this is known as the 'document rule'.⁷⁶⁹ In practice, this refers in particular to the investment policies. An implied consequence

⁷⁵⁸ See section 404 (a) (1) (A) ERISA.

⁷⁵⁹ See Rodrick and Rosen (1999), p. 81.

⁷⁶⁰ See Louge and Rader (1998), p. 57.

⁷⁶¹ See section 406 to 408 ERISA.

⁷⁶² See section on Prohibition on transactions in the USA involving conflicts of interest, p. 175.

⁷⁶³ See section on Affiliated transactions and self-dealing, p. 176.

⁷⁶⁴ Section 406(b)(3) ERISA.

⁷⁶⁵ See section 404 (a) (1) (C) ERISA.

⁷⁶⁶ A stock bonus plan is a defined contribution plan.

⁷⁶⁷ ESOPs and stock bonus plans are explicitly excluded from the requirement to diversify (see section 404 (a) (2) in conjunction with section 407 (d) (3) ERISA).

⁷⁶⁸ See Louge and Rader (1998), p. 42.

⁷⁶⁹ See section 404 (a) (1) (D) ERISA.

of this requirement is that a plan sponsor must always have written investment policies.⁷⁷⁰

Restriction on delegation of functions: fiduciaries may be able to reduce their responsibility or liability under certain conditions by delegating fiduciary duties. The delegation to qualified third parties of the asset management function in particular is explicitly permitted. The basic principle is that fiduciaries may only delegate functions in a manner that exempts them from their liability in the event of misconduct by the engaged party if they act with sufficient prudence both in outsourcing and in the required continuous supervision of the delegated functions.⁷⁷¹

A breach of fiduciary duty entails personal liability to compensate the plan for any losses to the plan resulting from the breach, and to restore to the plan any profits unlawfully made by the fiduciary. The court may resolve further sanctions, such as removal of the fiduciary.⁷⁷²

US standards of prudence: the prudent man/expert/investor rule

US legislation and court rulings have fleshed out the principle of prudence over the years through various rules. The historical starting point is the 'prudent man rule', which was subsequently developed into the 'prudent investor rule' for the field of asset management. Funded occupational retirement provision in turn follows the 'prudent expert rule' that has been in place since the 1970s.

The *prudent man rule* goes back to a Supreme Court ruling in the case of *Harvard v. Amory* in the year 1830, which laid down the following principle:

All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.⁷⁷³

This ruling saw the Supreme Court departing from the highly restrictive rule that had been applied prior to that date, which stated that fiduciaries/trustees were only allowed to invest in government securities because their own obligation was that of nominal value maintenance. The ruling is based on a qualitative concept of investment behaviour, and also expressly recognizes that return is a factor to be considered when investing, as well as security. In addition, the ruling expressly admitted shares as an admissible asset class and removed the previously exclusive

⁷⁷⁰ See Louge and Rader (1998), p. 43.

⁷⁷¹ More detailed explanations of the three cases in which functions can be delegated and liability discharged under ERISA are contained in the section on Delegation of functions in the case of pillar 2 pension plans in the USA, p. 206.

⁷⁷² Section 409 ERISA.

⁷⁷³ Louge and Rader (1998), p. 41.

status of bonds as an admissible investment by establishing that bonds, too, are not always a secure investment.⁷⁷⁴ However, this original intention of the ruling did not become established in practice because subsequent court rulings focused solely on the instructions also contained in the original ruling to avoid speculation and consider the safety of the capital invested.⁷⁷⁵

This produced the 'prudent man rule', which clashes with modern insights into capital market theory, but is still applied by many US courts. In particular, the prudent man rule prohibits risk/return optimization of the portfolio because it places an obligation on the asset manager to *preserve the principal of the individual securities* and not of the overall portfolio. This rule has therefore been interpreted as requiring the elimination of risk, and has led to highly restrictive investment rules that normally allowed only investments in time deposits and government bonds. In the mid-1990s, however, the American Law Institute came up with a new draft 'prudent investor law' that was enacted at the end of 1995, including in the two states with the largest public pension plans, California and New York. US courts are now being asked to apply the following (considerably more flexible) criteria in their rules that reflect the insights of modern financial theory:⁷⁷⁶

- 1 All investments must be assessed at a portfolio level, not on the basis of individual securities.
- 2 No investment is itself inherently prudent or imprudent.
- 3 The portfolio should normally be diversified.
- 4 The effects of inflation must be included in investment decisions (i.e., the real, and not the nominal, return is what matters). Nominal value maintenance alone ignores the loss of purchasing power due to inflation.
- 5 If the fiduciary has insufficient investment expertise, asset management must be delegated to a qualified 'prudent expert'.

The *prudent investor rule*. The restrictive nature of the prudent man rule, which was shown to be excessive by Modern Portfolio Theory,⁷⁷⁷ led to a new understanding by US courts, which now apply the following standards:⁷⁷⁸

- 1 *Overall portfolio risk* must be appropriate. One of the fiduciary's core duties is to master the conflicting goals of risk and reward.

⁷⁷⁴ See Galer (2002), p. 70 footnote 15.

⁷⁷⁵ See *ibid.*, pp. 49f.

⁷⁷⁶ See Louge and Rader (1998), pp. 43f.

⁷⁷⁷ The significant aspect here is the core concept that aggregate risk must be considered, not that of the individual investment (see the sections on Diversification, p. 268, Foreign currency assets, p. 275 and Special criteria for defined benefit plans, p. 281).

⁷⁷⁸ Whereas the prudent man rule was the standard for almost the whole of the twentieth century, the prudent investor rule is now well on the way to displacing it from this position of pre-eminence and to being applied by almost all US courts.

- 2 Appropriate diversification must be ensured. There are no longer any quantitative investment restrictions, and essentially any investment is possible as long as it contributes to portfolio risk/return optimization (and satisfies other prudence rules).
- 3 Application of the prudence principle allows fiduciaries to delegate responsibilities (something that was generally prohibited by the prudent man rule).
- 4 Investment decisions taken must be cost-conscious; in particular, the return of a certain investment strategy must be weighed against the resulting transaction costs.

The *prudent expert rule*. This rule, which is found in ERISA and thus applicable to pension funds in particular, requires fiduciaries to exercise the same level of prudence and professional knowledge as a prudent man familiar with such matters (i.e., actual experts, and not merely average prudent persons).⁷⁷⁹

Operationalization of this abstract principle takes the form of a list of requirements for fiduciaries. This includes in particular the fiduciary duty to the pension plan members, the prohibition of certain transactions involving a potential conflict of interests, the duty to diversify, the governing documents rule and the prohibition on delegation.

The interpretation of what is 'prudent' has undergone considerable change in the past. One hundred years after the *Harvard v. Amory* ruling, investing in equities was still regarded as imprudent because of the high risk associated with these instruments. Nowadays, exactly the opposite holds true (i.e., most investors would regard turning a blind eye to equity investments as imprudent, partly because of the insights provided by Modern Portfolio Theory).⁷⁸⁰ This also means that, in certain circumstances, even not using derivatives may amount to a breach of the prudent man/investor rule, and especially the prudent expert rule, and thus ultimately lead to claims for damages. The use of derivatives may be necessary if they are designed not for speculation but to reduce risk, or as a cost-effective instrument of diversification. The consequences of this for fiduciaries are that they must keep themselves well informed about the latest developments in the field of capital market theory,⁷⁸¹ for example, so that they have sufficient skills

⁷⁷⁹ The 'prudent man standard of care' requires ERISA fiduciaries to act in accordance with the following criteria: 'with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims' (section 404(a)(1)(B) ERISA).

⁷⁸⁰ The corresponding arguments can be found in the section on Qualitative investment rules versus quantitative restrictions, pp. 223ff.

⁷⁸¹ The time-consuming duty to keep abreast of the latest developments in mainstream capital market theory and the related empirical studies certainly does not mean that the fiduciary has to believe in and apply all new findings, but rather that the fiduciary must examine them so as to be in a position to substantiate their rejection or application in respect of the portfolio under the fiduciary's charge (see Louge and Rader (1998), p. 46).

nowadays to decide when derivatives can be used and when they should be avoided.⁷⁸²

This changing interpretation of what is deemed admissible under the prudent man/investor rule also illustrates that increased requirements in terms of expertise and responsibility are placed on asset managers and their supervisory bodies compared with a regime of purely quantitative investment rules. In the event of conflicts, asset managers cannot rely on a list of admissible/required percentages that will indemnify them and hold them free and safe from litigation if complied with. For example, if there is a bear market for bonds of the sort that has occurred frequently in industrialized countries in the past because of a succession of cumulatively substantial interest rate hikes, an asset manager who is forced by a quantitative approach to hold substantial quantities of bonds need hardly fear lasting criticism or even claims for damages. But an asset manager subject to the prudent man/investor rule who is confronted with the same scenario and who also has a large number of bonds in the portfolio will probably have to invest a considerable amount of time and money to enable his investment behaviour in such a tricky situation to be deemed to be prudent; with hindsight, all market participants will claim to have predicted the fall in prices. In brief: the flexible nature of the prudent man/investor rule is at the same time its greatest strength and its greatest weakness.⁷⁸³

The prudent person rule in the EU

The prudent person rule in the Pension Funds Directive

The Pension Funds Directive requires institutions to 'act prudently'⁷⁸⁴ – also known as the 'prudent person rule'⁷⁸⁵ – and thus establishes a concept in Europe that is similar to the prudent investor/expert rule. However, the interpretation of the prudent person rule referred to in this Directive⁷⁸⁶ is nowhere near as restrictive as the prudent man rule in the USA. Rather, the EU prudent person rule is in the same spirit as the original US prudent man rule as formulated by the Supreme Court in its *Harvard v. Amory* ruling in 1830. Table 2.20 presents a comparison of the key differences in the interpretation of the concepts under US and EU law.

The Pension Funds Directive aims to overcome the restrictive quantitative investment rules that are currently still widespread in Europe so that, in future, retirement assets are managed primarily on the basis of qualitative criteria. Pension funds should be able to opt for asset allocation that suits the 'precise nature

⁷⁸² See Louge and Rader (1998), pp. 44f.

⁷⁸³ See Galer (2002), p. 55.

⁷⁸⁴ Recital 31 Directive 2003/41/EC.

⁷⁸⁵ Art. 18 Directive 2003/41/EC.

⁷⁸⁶ Recitals 6 and 31, and Art. 18 Directive 2003/41/EC.

Table 2.20 Differing terms for quantitative and qualitative investment rules in the EU and the USA

EU concept	Corresponding US concept	Features
Restrictive quantitative investment rules	Prudent man rule	<ul style="list-style-type: none"> ■ No portfolio-based analysis; the principal of individual securities must be preserved ■ In practice, investment restricted to CDs and government bonds
Prudent person rule	Prudent investor/expert rule	<ul style="list-style-type: none"> ■ Portfolio-based analysis: appropriate overall risk ■ Duty to diversify ■ Governing documents of the pension plan are the reference point

and duration of their liabilities', and their investment policy must be 'geared to [their] membership structure'.⁷⁸⁷

The EU prudent person rule stipulates the following general obligations.⁷⁸⁸

- 1 Similar to the ERISA exclusive benefit rule and the duty of loyalty in the USA, EU pension funds are required 'in the case of a potential conflict of interest ... [to] ensure that the investment is made in the sole interest of members and beneficiaries'.
- 2 Risk/return/liquidity optimization must be ensured at portfolio level, and assets held to fund defined benefits must be invested 'in a manner appropriate to the nature and duration of the expected future retirement benefits'.
- 3 Securities not admitted to trading on regulated markets must be kept to 'prudent levels'.
- 4 Derivatives are permitted for hedging and to 'facilitate efficient portfolio management'.
- 5 Duty of diversification: in addition to a general requirement for diversification and a prohibition on concentration, there is a general 5 per cent limit on investment in securities of the sponsor.⁷⁸⁹
- 6 Prohibition on borrowing and acting as guarantor on behalf of third parties.
- 7 There may be no obligatory minimum levels of investment in particular asset classes.

⁷⁸⁷ Recital 31 Directive 2003/41/EC.

⁷⁸⁸ Art. 18 (1)–(4) Directive 2003/41/EC.

⁷⁸⁹ See n. 151, p. 268.

In combination with a number of other provisions of the Pension Funds Directive, the EU prudent person rule results in a requirements profile that is similar to the US prudent expert rule. Both rules dispense largely with quantitative investment rules and instead require the qualitative orientation of the investment on the defined benefit, stipulate a fiduciary duty to the pension plan members, a duty of diversification and the obligation to prepare and comply with written investment principles. However, when dealing with transactions entailing a potential conflict of interests and the regulation of the delegation of functions, the Pension Funds Directive still lags behind the prudent expert rule because it does not contain any explicit detailed provisions in this respect. At present, an examination of these problem areas is evidently possible only on the basis of fiduciary duty.

The Directive also offers several opportunities for exemptions from the prudent person rule, which therefore does not have to be applied in its pure form.

- 1 Regarding IORPs domiciled in their territories, the Member States have the option to impose more detailed quantitative rules, in particular corresponding to those for life insurance companies,⁷⁹⁰ provided that these are 'prudentially justified' and that they tally with the general obligations under the prudent person rule described above. The scope of such limits is restrained by the following minimum freedoms.⁷⁹¹ IORPs may not be prevented from investing:
 - (a) at least 70 per cent of the fund assets (in case of a DC scheme) or of the assets covering the technical provisions (in case of a DB scheme) in listed shares or corporate bonds (a lower limit is only possible if the pension fund grants and itself provides for direct interest or asset value guarantees);
 - (b) at least 30 per cent of the assets covering the technical provisions (in the case of a DB scheme) in non-matching currencies;
 - (c) in risk capital markets.
- 2 Regarding guest IORPs (i.e., IORPs authorized in another Member State), the host Member State may impose the following quantitative restrictions if they apply equally (or more strictly) to domestic IORPs:⁷⁹²
 - (a) at least 70 per cent of the assets have to be invested in listed shares or bonds;
 - (b) a single issuer limit of 5 per cent or of 10 per cent for individual companies or groups;
 - (c) no more than 30 per cent of assets may be invested in assets denominated in non-matching currencies.

⁷⁹⁰ Investment rules under the (new) Life Assurance Directive 2002/83/EC.

⁷⁹¹ Art. 18 (5) Directive 2003/41/EC.

⁷⁹² Art. 18 (7) Directive 2003/41/EC. Only the guest IORP's part of the assets corresponding to the host country may be subjected to such limits.

Qualitative investment rules for UCITS

Investment funds in the EU are also subject to some qualitative criteria, albeit to a lesser extent than pension funds. For example, UCITS are also subject to a fiduciary duty similar to the exclusive benefit rule or the duty of loyalty.⁷⁹³ In addition, they are obliged to comply with rules of conduct that must meet a certain minimum standard.⁷⁹⁴

Defined contribution occupational pensions: 401(k) plans

In addition to ERISA, funded pension plans have been encouraged by the US Internal Revenue Code (IRC) since the 1920s.⁷⁹⁵ Introduced in 1978,⁷⁹⁶ section 401(k) of this Code is the legal framework that allows US employees to participate in the most popular DC pension plans. 401(k) plans are defined contribution plans for employees in the private sector while 403(b) plans are the equivalent for charitable/religious/scientific or sporting organisations⁷⁹⁷ and for public-sector training and educational establishments. In turn, 457 plans offer public-service employees a retirement provision opportunity similar to 401(k) plans.

Payments to these 401(k) plans can be made either by the employer only, the employee only, or both employer and employee together, and are tax-deductible up to a certain limit per year (see Table 2.21). The employer may also allow the employee to pay contributions from *taxed* income over and above the annual Internal Revenue Service (IRS) limits.⁷⁹⁸ Investment income and capital gains from a 401(k) plan are also tax-free, and only the pensions paid in the benefit phase are taxed.⁷⁹⁹ The terms and conditions of the 401(k) plan define the percentage of gross salary, possibly capped by an absolute maximum amount below the ceiling stipulated by the IRC, that may be paid in each year to the 401(k) plan.⁸⁰⁰

The employer's 'matching contributions'⁸⁰¹ do not count towards the employee limits, and there is a separate limit of US\$40,000 per year⁸⁰² for the total of employer and employee contributions to all defined contribution plans (including those that are not 401(k) plans). The rule is that employee contributions vest immediately, while the vesting of employer contributions depends on the length

⁷⁹³ 'The management company and depositary must act ... solely in the interest of the unit-holders' (Art. 10 (2) Directive 85/611/EEC).

⁷⁹⁴ Art. 19 Directive 2004/39/EC, corresponding to Art. 11 Directive 93/22/EEC.

⁷⁹⁵ See ERIC (1996), p. 1.

⁷⁹⁶ See Gebhardtshauer (2002), p. 2.

⁷⁹⁷ See section 501(c)(3) IRC.

⁷⁹⁸ Strictly speaking, this is then a 401(a) plan whose income is taxed, but whose payouts are tax-free (see Nieters *et al.*, 2002).

⁷⁹⁹ See FMR Corp (Fidelity Investments) (no date/b).

⁸⁰⁰ See FMR Corp (Fidelity Investments) (no date/a).

⁸⁰¹ See section 401(m)(4)(A) IRC.

⁸⁰² Section 411(a)(2) IRC.

Table 2.21 Maximum annual amount that can be contributed tax-free to occupational plans under the US Internal Revenue Code

Year	Limit (US\$)
2002	11,000
2003	12,000
2004	13,000
2005	14,000
2006	15,000
From 2007	Inflation adjustment in US\$500 steps

Note: For the limits applicable to 2002 to 2006, see section 402(g)(1)(B), and for the inflation adjustment, see section 402(g)(4) IRC as amended by Economic Growth and Tax Relief Reconciliation Act of 2001.

of the employee's service. The options are either 100 per cent vesting after three years, or a proportion rising in equal stages from 20 per cent to 100 per cent during the second to sixth year of service.⁸⁰³

In the event of early withdrawals – before reaching the minimum age of 59.5 – a tax penalty ('early withdrawal penalty') of 10 per cent of the amount withdrawn is levied.⁸⁰⁴ In addition, a loan can be taken out from the 401(k) plan in the same way as the Riestter pension. If the loan does not exceed the minimum of US\$50,000 and half the present value of the vested benefits, and is repaid within five years (the repayment period can be extended considerably if the loan is used to buy a house), no tax penalty is incurred.⁸⁰⁵ But even if a loan meets these criteria, the advantages of taking out such a loan are limited to emergency situations, because in addition to the opportunity costs, there is the drawback that the loan will be called in if the employee loses his or her job, plus double taxation of the loan interest because the interest – which flows back into the 401(k) plan – must be paid from taxed income, as opposed to normal contributions to the 401(k) plan, and will be taxed again when it is ultimately paid out in the form of a pension.⁸⁰⁶

Employees can choose from certain alternative investment opportunities offered by the employer under the terms of the 401(k) plan (in particular investment funds and shares of the employer). The 401(k) plan assets must be managed

⁸⁰³ See section 415(c)(1)(A) IRC as amended by Economic Growth and Tax Relief Reconciliation Act of 2001. Until 31 Dec. 2001, there were less favourable limits for the employees: either 5 years for 100 per cent, or an annual increase from 20 per cent to 100 per cent from the third to the seventh year.

⁸⁰⁴ Section 72(t) IRC.

⁸⁰⁵ Section 72(p) IRC.

⁸⁰⁶ Early withdrawals from 401(a) plans are subject to less severe restrictions than in the case of 401(k) plans (see Nieters *et al.*, 2002).

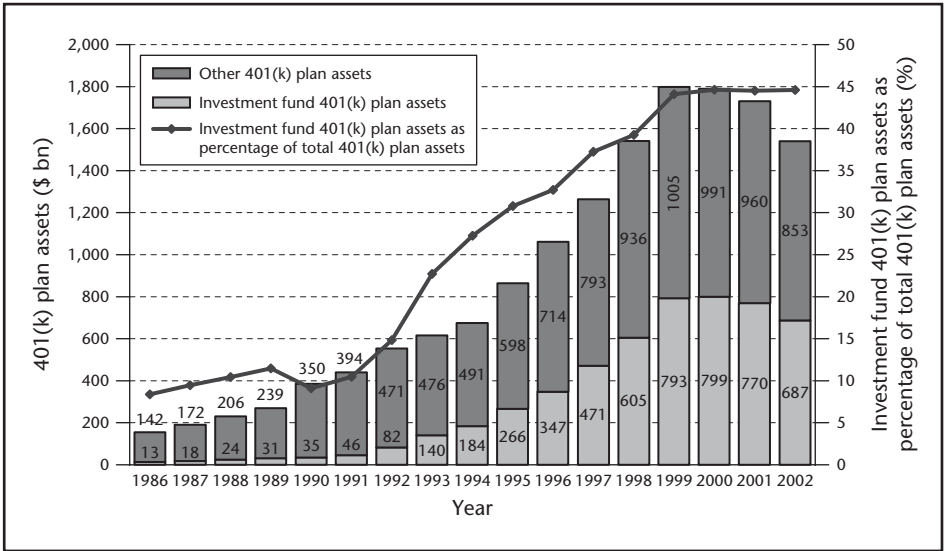


Figure 2.51 Investment funds and other assets of 401(k) plans between 1986 and 2002 (US\$ billions)

Sources: Data for 1986 to 1989 inclusive, see Investment Company Institute (1997), p. 54; data for 1990 and thereafter, see Investment Company Institute (2003a), p. 53

separately from the assets of the plan sponsor in accordance with the ERISA principles.⁸⁰⁷ 401(k) plans are also portable across employers and are thus not tied to a particular employer.⁸⁰⁸

Figure 2.51 shows the development of assets held in 401(k) plans between 1986 and 2002. The nominal growth during these 17 years was just on 1,000 per cent; the existing record was posted in 1999 with US\$ 1,798 billion. At the end of 2001, the average volume of the then around 45 million⁸⁰⁹ 401(k) plans was US\$ 43,215, although increasing age and length of service are normally accompanied by higher 401(k) plan assets. For example, the average 401(k) plan assets of employees aged 60 and older with at least 30 years of service were a good US\$162,000.⁸¹⁰

Figure 2.51 also shows the rapid growth in the share of investment funds in the total assets invested under 401(k) between 1986 and 2002. In the mid-1980s, investment funds accounted for less than 10 per cent of total 401(k) plan assets, but this had grown to around 45 per cent by the end of the 1990s, and has since remained around this high level. The importance of asset management standards for pension provision using investment funds is evident from the fact that a good two-thirds of all fund investments under defined contribution pension plans are

⁸⁰⁷ See FMR Corp (Fidelity Investments) (no date/b).

⁸⁰⁸ See BVI (2000d), pp. 45f.

⁸⁰⁹ See Harnischfeger (2002).

⁸¹⁰ See Investment Company Institute (2003a), pp. 55f.

attributable to 401(k) plans, and that investment funds also account for 13 per cent of the capital invested under employer-financed pension plans.⁸¹¹

Defined contribution private pension plans: IRAs

ERISA in combination with the IRC⁸¹² allows each working American to establish personal retirement provision in the form of an Individual Retirement Account, into which they can pay untaxed income up to a certain annual limit (see Table 2.22).⁸¹³

Table 2.22 Maximum annual amount that can be contributed tax-free to private pension plans (IRAs) under the US Internal Revenue Code

Year	Limit (US\$)
before 2001 ^a	2,000
2002–2004	3,000
2005–2007	4,000
from 2008	5,000

^aThe tax-free amount of US\$ 2,000 was not adjusted for 20 years (see Patterson (2002), p. 17).

Source: See section 219(b) IRC as amended by Economic Growth and Tax Relief Reconciliation Act of 2001

Since 1998, Roth IRAs (named after Senator William Roth, who led the corresponding legislative initiative) have enabled the development of a supplementary private pension from taxed income, which offers tax-exemption during the pay-out phase in contrast to traditional IRAs.⁸¹⁴ IRAs invest in individual securities, investment funds (approximately 50 per cent), or insurance policies.⁸¹⁵ and enjoy extensive freedom of investment, apart from restrictions on options and a prohibition on real estate purchases.⁸¹⁶

The SEC's role

One consequence of the great stock market crash of 1929, which occurred in an ineffectively regulated capital market because of the lack of any uniform federal

⁸¹¹ See Investment Company Institute (2003a), p. 54.

⁸¹² Section 408(a) IRC provides the legal definition of the IRA.

⁸¹³ An EET regime applies, i.e., not the contributions, but the pension payouts, which can either be in the form of a one-time payment or be annuitized, are taxed (see sections 219(b), 408(d) IRC).

⁸¹⁴ Provided that a higher tax rate is expected during retirement than during active life, a Roth IRA is thus the most efficient vehicle (see Lott *et al.*, 2001). For the majority of employees, the opposite situation will normally be expected, and there is also a political risk that tax-exemption during retirement may be (partially) abolished.

⁸¹⁵ See BVI (2000d), p. 45.

⁸¹⁶ See Lott *et al.* (2002).

law, was the Securities Act of 1933 and the Securities Exchange Act of 1934,⁸¹⁷ which were enacted to restore investor confidence in the capital markets. One of the core outcomes of these two laws was government supervision of the capital markets, and the SEC was established in 1934.⁸¹⁸

The SEC works together with a range of different institutions, such as Congress, various federal departments and agencies, self-regulatory organizations,⁸¹⁹ state securities regulators and various private sector organizations. The SEC oversees almost all the key participants in the capital markets, including public companies, stock exchanges, broker-dealers, investment advisers (including investment fund management companies), investment funds and public utilities.

Investor protection lies at the heart of the SEC's activities, in particular overseeing compliance with corporate disclosure regulations. The SEC has overall responsibility for enforcing capital market laws, and not just those affecting disclosure. The powers vested in the SEC to launch its own administrative (penal) proceedings and file cases in federal courts are crucial to its effectiveness. Each year, the SEC brings 400 to 500 administrative actions for breaches of securities laws, focusing in particular on insider trading, accounting fraud and breaches of disclosure requirements. The SEC's powers are restricted to civil enforcement actions, but it works together with other government agencies where there is a need for criminal prosecution.

In its preliminary investigations away from the public eye, the SEC gathers evidence by a variety of means, including informal inquiries and interviews with witnesses, examining brokerage records and reviewing trading data. If a formal investigation is then launched, witnesses can be subpoenaed and the SEC can require all relevant documents to be produced. Following the investigation, the SEC can decide to file a case in federal court or to bring a civil or administrative action.⁸²⁰

The SEC emphasizes that it regards itself as part of a team. It believes that educated and careful investors are the best protection against irregularities on the capital markets and therefore offers a wealth of information to the public. All public documents are available for inspection at the SEC's Public Reference Room in Washington, DC, where copies can be obtained free of charge. All documents filed since May 1996 are available on the Internet.⁸²¹

However, the SEC does more than merely enforce and interpret existing regulations. It can also issue its own rules, although major rules are subject to congressional review and veto. The Division of Investment Management oversees

⁸¹⁷ US Securities and Exchange Commission (1999e), provides a brief overview of these and other US capital market laws that are only of peripheral importance for investment funds.

⁸¹⁸ See US Securities and Exchange Commission (1999e).

⁸¹⁹ For a list of the most important self-regulatory organizations, see US Securities and Exchange Commission (1999e).

⁸²⁰ For a description of the differences between court and administrative actions, see US Securities and Exchange Commission (1999e).

⁸²¹ The SEC's homepage is at <http://www.sec.gov>.

investment companies and funds and their advisers, and has the following responsibilities.

- 1 Interpretation of laws and regulations to support investors and to assist the SEC's own inspection and enforcement staff.
- 2 Handling no-action requests. These are an application to the SEC for a preliminary decision that a particular activity complies with the law and will not result in action by the SEC. Applications for exemptive relief (i.e., a request to be exempted from certain rules or regulations) have a similar function.
- 3 Review of documents filed with the SEC by investment companies and advisers.
- 4 Review of enforcement matters.
- 5 Development of new rules.

APPENDIX: REPLACEMENT MIGRATION

Table A1 Annual net new migration between 1990 and 1998 by country or region

Country or region	1990	1991	1992	1993	1994	1995	1996	1997	1998
France	80,000	90,000	90,000	70,000	50,000	40,000	35,000	40,000	40,000
Germany	656,166	602,563	776,397	462,284	315,568	398,263	281,493	93,433	50,821
Italy	24,212	4,163	181,913	181,070	153,364	95,499	149,745	126,554	113,804
Japan	2,000	38,000	34,000	-10,000	-82,000	-50,000	-13,000	14,000	38,000
South Korea	-	-	-10,000	-	-	-	-	-	-20,000
Russian Federation	164,000	51,600	176,100	430,100	810,000	502,200	343,600	352,600	285,200
UK	68,384	76,416	44,887	90,141	84,242	116,869	104,075	88,476	-12,406
USA	1,536,483	1,827,167	973,977	904,292	804,416	720,461	915,900	798,378	660,477
Europe	-	-	1,047,000	-	-	-	-	950,000	-
EU	1,008,251	1,078,441	1,350,132	1,062,116	782,855	805,363	734,596	512,208	378,687

Source: United Nations Population Division (2000), p. 26

Table A2 Total net new migration from 1995 to 2050 by country or region

Country or region	Scenario A Constant total population	Scenario B Constant working population	Scenario C Constant old-age dependency ratio
France	1,473,000	5,459,000	93,794,000
Germany	17,838,000	25,209,000	188,497,000
Italy	12,944,000	19,610,000	119,684,000
Japan	17,141,000	33,487,000	553,495,000
South Korea	1,509,000	6,426,000	5,148,928,000
Russian Federation	27,952,000	35,756,000	257,110,000
UK	2,634,000	6,247,000	59,775,000
USA	6,384,000	17,967,000	592,757,000
Europe	100,137,000	161,346,000	1,386,151,000
EU	47,456,000	79,605,000	700,506,000

Source: United Nations Population Division (2000), p. 24

Table A3 Average net new migration per year from 1995 to 2050 by country or region

Country or region	Scenario A Constant total population	Scenario B Constant working population	Scenario C Constant old-age dependency ratio
France	27,000	99,000	1,705,000
Germany	324,000	458,000	3,427,000
Italy	235,000	357,000	2,176,000
Japan	312,000	609,000	10,064,000
South Korea	27,000	117,000	93,617,000
Russian Federation	508,000	650,000	4,675,000
UK	48,000	114,000	1,087,000
USA	116,000	327,000	10,777,000
Europe	1,821,000	2,934,000	25,203,000
EU	863,000	1,447,000	12,736,000

Source: United Nations Population Division (2000), p. 24

Table A4 Number/percentage of immigrants in 1990 by country or region

Country or region	Number of immigrants	Percentage of immigrants to total population
France	5,897,000	10.4
Germany ^a	5,037,000	6.4
Italy	1,549,000	2.7
Japan	868,000	0.7
UK	3,718,000	6.5
USA	19,603,000	7.9
Europe ^b	11,152,000	4.3
EU	21,378,000	5.8

^aThe data also cover foreign residents in Germany.

^bData for the following countries: Bulgaria, Hungary, Poland, Romania, Denmark, Finland, Iceland, Ireland, Norway, Sweden, UK, Albania, Andorra, Greece, Italy, Malta, Liechtenstein, Luxembourg, Monaco, Netherlands, Switzerland.

Source: United Nations Population Division (2000), p. 26

Table A5 Percentage of immigrants to total population between 1995 and 2050 by country or region

Country or region	Scenario A Constant total population	Scenario B Constant working population	Scenario C Constant old-age dependency ratio
France	2.9	11.6	68.3
Germany	28.0	36.1	80.3
Italy	29.0	38.7	79.0
Japan	17.7	30.4	87.2
UK	5.5	13.6	59.2
USA	2.5	7.9	72.7
Europe	17.5	25.8	74.4
EU	16.5	25.7	74.7

Source: United Nations Population Division (2000), p. 25

The Structural Components of the Synopsis

INVESTOR RISK

Management risk: confidence risk

In addition to operational risk, management risk extends to the risk of loss due to the inadequate implementation of the investment strategy, perhaps because of an excessively risky or recklessly defensive investment strategy. Operational risk is the risk of 'potential losses resulting from inadequate systems, management failure, faulty controls, fraud, or human error'.¹ That is why the risk of fraud, of defective or inefficient processes, or of the loss of key employees, for example, also falls under management risk.²

An investment fund/company (supervisory) board structured along the lines of a US fund board can be deployed as a highly effective instrument for reducing management risk. In the USA, the board of directors' fiduciary duties, which demand a high level of prudence and professional knowledge and which entail (a high level of) personal liability for losses due to any infringements, mean that its prime obligation is to safeguard the interests of the shareholders. To discharge these obligations, the fund board enjoys far-reaching powers, in particular in respect of the management company. This is of particular importance for avoiding or solving conflicts of interest between the shareholders and other (legal) entities involved in the fund.³

¹ Jorion (1997), p. 16.

² See Pragma Consulting (1999), p. 26.

³ See Pragma Consulting (1999), p. 27.

Prudence – in the shape of the prudent man rule – is one of the primary obligations under these fiduciary duties. The EU's interpretation of the prudent person rule is to include in this category law-abiding asset managers who take into account any existing liabilities and all other necessary information in their investment (strategy) decisions, and who are independent, forward-looking, willing to learn from their mistakes and cost-conscious. They must comply with the underlying principles of security, profitability, diversification, quality and liquidity to be regarded as prudent.⁴ Quality of asset management and of assets means sustaining security, and is thus the opposite, for example, of sloppiness, complacency and inappropriate risk policies. The quality of the assets should not be viewed in isolation, but rather taken together with the principles of diversification and profitability. Otherwise, it could be thought to mean that investments should only be made in government bonds or possibly overvalued large caps.

The view in the USA is somewhat more sophisticated, due no doubt to the longer tradition of fiduciary duties and prudence. In the USA, the prudent man rule means restrictions on investment, the antithesis of the interpretation in the EU. ERISA and the updating of legal interpretation through court rulings have led to the establishment of more modern standards: the prudent expert rule and the prudent investor rule. In addition to the organizational instrument of the board of directors, the procedural instrument of the code of ethics, disclosure rules for ensuring appropriate transparency and, finally, public, market-based and internal supervision and control are the keys to effectively mastering management risk.

Investment risk: the risk inherent in the investment

Investment risk is the uncertainty resulting from investment decisions and market changes. It is multi-faceted by nature and thus consists of a variety of subrisks, including the risk of poor asset allocation or securities selection, interest rate risk, bankruptcy risk and reinvestment risk.⁵

RULES FOR REDUCING THE INVESTOR'S RISK

Investment rules

Quantitative investment rules aim to control the investment risk and limit asset allocation by either completely prohibiting investments in certain asset classes or restricting them to a certain maximum percentage of the funds under management. Conversely, they may require the asset manager to invest certain minimum percentages of the fund assets in certain asset classes. In practice, rules governing

⁴ See Pragma Consulting (1999), p. 28.

⁵ For a more detailed, albeit not conclusive list, see Pragma Consulting (1999), p. 25.

pension funds generally appear to involve restrictions or prohibitions on 'risky' asset classes such as equities, and above all derivatives, while at the same time privileging debt instruments, and especially government debt instruments.

However, such investment rules seem to be losing their importance, especially as a consequence of both Modern Portfolio Theory, which has demonstrated that the risk of fluctuation can be better controlled by diversification, and of active portfolio management, which permits risk/return management going beyond Modern Portfolio Theory, with the result that diversification and prudence are now the most important principles for reducing investment risk. Fund managers are also increasingly relying on qualitative investment rules that place as few quantitative barriers as possible in the way of portfolio optimization, and emphasize the management of the overall risk of the fund instead of the risks of its individual securities.

The investment rules that control management risk relate in particular to transactions involving (potential) conflicts of interest between the fund shareholders and the individuals and entities involved in fund management. They are elaborated in great detail, especially in the USA, where such investment rules are used to spell out what is actually involved in implementing the principle of fiduciary duty.

Separation of functions

In contrast to a normal company, a fund normally does not have its own employees. Those persons working for it are generally employees of the investment adviser – the management company – of the fund which is a separate corporate entity from the fund and which also remunerates these persons. However, the management company is not the only service provider, albeit the most important one: the services it is required to provide and the payment to which it is entitled (generally a certain percentage of the fund assets) are defined in the USA in the investment advisory contract. Its most typical service is that of portfolio management, with the resulting securities orders being passed to broker-dealers.

This special organizational structure (see Figure 2.46, p. 148) of a fund may lead to conflicts of interest between the fund (and its shareholders) and the investment adviser who manages it: on the one hand, both of these parties have common interests, such as seeking outstanding investment performance,⁶ but there are also various areas of conflict resulting from the fact that the fund manager's aim is to maximize profits, which may conflict with its paramount duty of acting solely in the interests of the fund and its shareholders.⁷

The separation of functions aims to minimize the potential for abuses resulting from conflicts of interests by preventing any single institution from exercising sole

⁶ See US Securities and Exchange Commission (1999a).

⁷ See US Securities and Exchange Commission (1999c).

overall control of the funds (comparable with the 'dual control' principle). Curbs are imposed on management by ensuring that safekeeping of the fund's assets is normally entrusted to another institution (custodian), that broker-dealers are required to execute securities transactions and that day-to-day responsibility for supervision lies with a partly independent board of directors.

In the EU, the separation of custody from the sponsoring undertaking (sponsor) at pension funds is regarded as the most important precaution,⁸ while the separation of custody from investment management is not viewed as an 'absolute condition',⁹ although it is desirable. Such separation is not being proposed vigorously for cost reasons, because smaller pension funds in particular would become less competitive. The separation of asset management and the controlling fund board, as the body safeguarding the interests of the shareholders, is also regarded as paramount.

Disclosure

The aim of disclosure requirements – i.e., the mandatory publication of material facts and circumstances – is primarily to allow (prospective) investors to make rational investment decisions by informing them about the risks and rewards of the investment. They arise from the need to resolve conflicts of interest between the fund manager aiming to maximize profits for its owners, and the investors aiming to maximize their own personal investment performance, through the instrument of transparency. However, they are also a control instrument for regulators. Control is thus not devolved solely to the market or to investors, as it can be assumed that the average non-institutional investor has only a limited capacity to interpret qualitative and quantitative information, and because investors who 'vote with their feet' by fleeing from dubious investments may put themselves at a tax disadvantage since they may face capital gains taxes. To avoid over regulation resulting from an accumulation of disclosure requirements, this instrument of protection and control should only be used with restraint, as it would otherwise become less effective, and its inherent costs and expertise requirements could see it slipping into a barrier to market entry.

Disclosure is one of the guiding principles for best practice and should be an element of EU-wide harmonization that is as comprehensive as possible, certainly in terms of minimum requirements. Extremely comprehensive disclosure requirements apply to pension plans and investment funds in the USA. The SEC is certainly not alone in thinking that the success of the US investment fund industry in the second half of the twentieth century was due in large part to the fact that investors knew what they were buying. This is why most of the regulatory efforts in recent history in the USA have concerned disclosure.¹⁰

⁸ See Pragma Consulting (1999), p. 27.

⁹ Pragma Consulting (1999), p. 27.

¹⁰ See Roye (1999e).

Control and enforcement of rules

In the US regime, the most important institution for the continuous control of the fund's activities is the fund board, which has two types of members, 'interested' and 'disinterested/independent' directors. The first type are normally employees of the fund's management company or investment adviser. By contrast, the independent directors are prohibited from having any significant business or professional relationship with the management company or the underwriter, or with their related parties,¹¹ so that they can ideally provide a controlling counterbalance to the fund's management.¹² This supervisory body aims in particular to resolve conflicts of interest between the fund (and its shareholders) and the management company, as illustrated by the following two examples:¹³

- 1 Is it realistic to assume that a management company will decide to close a fund (temporarily) to new investors and thereby waive additional profit if it has grown so quickly in the past that it will find it extremely difficult to invest the new money sensibly?
- 2 Are the interests of the shareholders safeguarded if the management company transfers the management of additional funds to one of its portfolio managers, possibly resulting in this manager being overloaded?

The control of these and many other conflicts of interests to safeguard the fund's shareholders is the responsibility of the independent directors, and the SEC terms this supervisory role 'critical'.¹⁴

Neither the UCITS Directive amended in early 2002 (UCITS III) nor the Pension Funds Directive adopted in mid-2003 provide for a board similar to a US fund board. The concept of a regulator as a supervisory body, on the other hand, has been established for a long time. The notion of delegating responsibility from the often overworked regulatory authority to a board composed (at least in part) of independent members has not yet found its way into the relevant Directives, although such a proposal was made to the European Commission when the Pension Funds Directive was being drafted. This sort of tiered supervisory concept is comparable with the principle of subsidiarity, the model that underlies the division of responsibilities between the EU and its Member States.

Considerable progress was made in 2002 and 2003 in the harmonization of cross-border regulatory supervision: two initiatives were the key to establishing and improving the framework for the emergence and deepening of a single

¹¹ See section 10(a) in conjunction with section (2)(a)(19)(vii) Investment Company Act of 1940.

¹² See Investment Company Institute (np, 1999), p. 5.

¹³ See US Securities and Exchange Commission (1999b).

¹⁴ See US Securities and Exchange Commission (1999a) and (1999c).

market for investment and pension funds. The first was the 'single European passport' that came out of UCITS III and enabled EU-wide authorization and the home country regulation of investment funds, and the second was the introduction of regulatory arrangements for the cross-border activities of institutions for funded occupational retirement provision under the Pension Funds Directive.

The Regulation of Management Risk

INVESTMENT RULES

Prohibition on transactions in the USA involving conflicts of interest

Definition

The conflicts of interest to be regulated involve situations in which legal entities or natural persons directly or indirectly involved in the management or custody of the fund (assets) have a vested interest that might influence the objective exercise of their professional duties that are subject to certain (fiduciary) duties towards clients (or the employer). This interest does not necessarily have to be of a directly financial nature; it may also involve pecuniary advantage or patronage.¹

In the USA, this general definition is fleshed out in numerous regulations under US capital market laws. For example, the Investment Company Act prohibits any person who is able to control or influence a fund from exploiting this power to their financial advantage.² Alongside such broadly worded rules, there are many concrete and detailed provisions, particularly in the form of SEC regulations, and even experts find it difficult to navigate their way through this dense regulatory jungle.

Personal investing by affiliated persons

Investments by portfolio managers or other employees or directors affiliated with the fund who invest on their own account are not rejected out of hand,

¹ See McDonald (1995).

² Section 17 Investment Company Act of 1940.

but they may easily lead to conflicts of interest with their 'own' fund.³ An SEC rule governing personal investing by affiliated persons and persons in a control relationship with the fund has been repeatedly tightened in recent years.⁴ The designated persons must undertake in writing to abide by a code of ethics governing such investments and are then subject to stronger supervision by the fund board. Personal securities portfolios of such persons are also subject to certain reporting obligations and any investment in Initial Public Offerings (IPOs) or limited offerings is subject to pre-approval requirements.

However, an excessively restrictive code of conduct could deter talented portfolio managers from taking a job at the management company in question.⁵ It should be sufficient for personal investing by fiduciaries to satisfy the following criteria to be classified as ethically acceptable:

- the client is not disadvantaged
- the fiduciary does not gain any personal benefit from transactions conducted for the client
- no applicable laws or other rules are violated

These requirements should be seen as the absolute minimum because the elaboration of such a code of conduct is ultimately very company-specific and is very difficult to define in more generic terms. However, a code of conduct is only half of the solution, because without any accompanying compliance procedures, it could easily become just another paper tiger.

Affiliated transactions and self-dealing

Presentation of the problem and definition

The Investment Company Act and its derivative legislation codify restrictions for business relationships and transactions between the funds and persons or companies who are affiliated with (or in a control relationship with) the fund and would thus be in a position to defraud the fund in its transactions. The restrictions apply, as a rule, not only to such affiliated persons or those in a control relationship with the fund, but also to persons affiliated with them. The SEC itself sees these provisions governing affiliate transactions as lying at the heart of the Investment Company Act,⁶ because such malpractice was common before it came into force.⁷

³ See Investment Company Institute (2000), p. 22.

⁴ Rule 17j-1, 17 CFR 270.

⁵ See US Securities and Exchange Commission (2000d).

⁶ 'The Investment Company Act restricts a wide range of transactions and arrangements involving investment companies ("funds") ... and their affiliated persons. These restrictions lie at the heart of the Act, and are designed to prevent affiliated persons from managing the fund's assets for their own benefit, rather than for the benefit of the fund's shareholders' (US Securities and Exchange Commission, (2002b)).

⁷ See US Securities and Exchange Commission, (1992), pp. 473f.

A person or a company is defined in particular as affiliated if it directly or indirectly controls the person or company in question (i.e., the fund or its affiliates, such as the management company)⁸ or is controlled by it or them. This is defined first, as owning, controlling or holding the power to vote at least 5 per cent of the ordinary shares, and second, as the status of an officer, director or employee. If the company in question is an investment company, any affiliates of its investment advisers are also deemed to be direct affiliates of the fund.⁹ The management company is explicitly defined as an affiliate.¹⁰ Transactions with persons or companies defined as affiliates are termed 'affiliated transactions'.

Figure 4.1 presents a selection of potential affiliates, with the majority of the affiliate relationships branching out from the fund itself; that is to say, from the fund's perspective, these are controlling, not controlled, persons or companies. An exception to this is the company shown at the bottom of the tree which is defined as a company where at least 5 per cent of the share capital is held in the fund portfolio. This is known as a 'portfolio affiliate'.¹¹ The affiliation of this type of affiliated company is defined in such a way that the affiliation to the fund is solely due to the fact that the fund (or one of its affiliated persons or companies) holds at least 5 per cent of voting securities.¹²

Figure 4.1 also shows that both the management company and the principal underwriter are affiliates. The subadviser, as shown in the tree, is a management company that undertakes asset management functions for the fund on the basis of a contractual relationship with the fund's (principal) management company.¹³ In contrast, the (principal) management company/investment adviser has a contractual relationship with the fund (investment advisory contract).

Affiliated transactions commonly relate to the purchase or sale of securities for the fund involving the management company or other affiliates as counterparties dealing for their own account. Potential conflicts of interest that may arise are illustrated by the following practices.¹⁴

- 1 Dumping poor quality securities.
- 2 Incorrect selling/buying price. This is often assumed to be the case if the corresponding market price is used, because the effects of market impact are ignored (i.e., the impact of the trade in question on the price of the trade caused by the law of supply and demand).

⁸ 'Control' is defined in section 2(a)(9) Investment Company Act of 1940. In particular, control is always assumed if at least 25 per cent of the voting equity securities are held directly or indirectly (by the controlling person or company).

⁹ See section 2(a)(2) and 2(a)(3) Investment Company Act of 1940.

¹⁰ See section 2(a)(3)(E) Investment Company Act of 1940.

¹¹ Rules 17a-6 and 17d-1(d)(5), 17 CFR 270, define general conditions under which transactions with portfolio affiliates are exceptionally permitted.

¹² See Rule 17a-6(b)(3), 17 CFR 270.

¹³ Rules 10f-3, 12d3-1, 17a-10 and 17e-1, 17 CFR 270, define general conditions under which transactions with subadvisers are exceptionally permitted.

¹⁴ See US Securities and Exchange Commission (2000e).

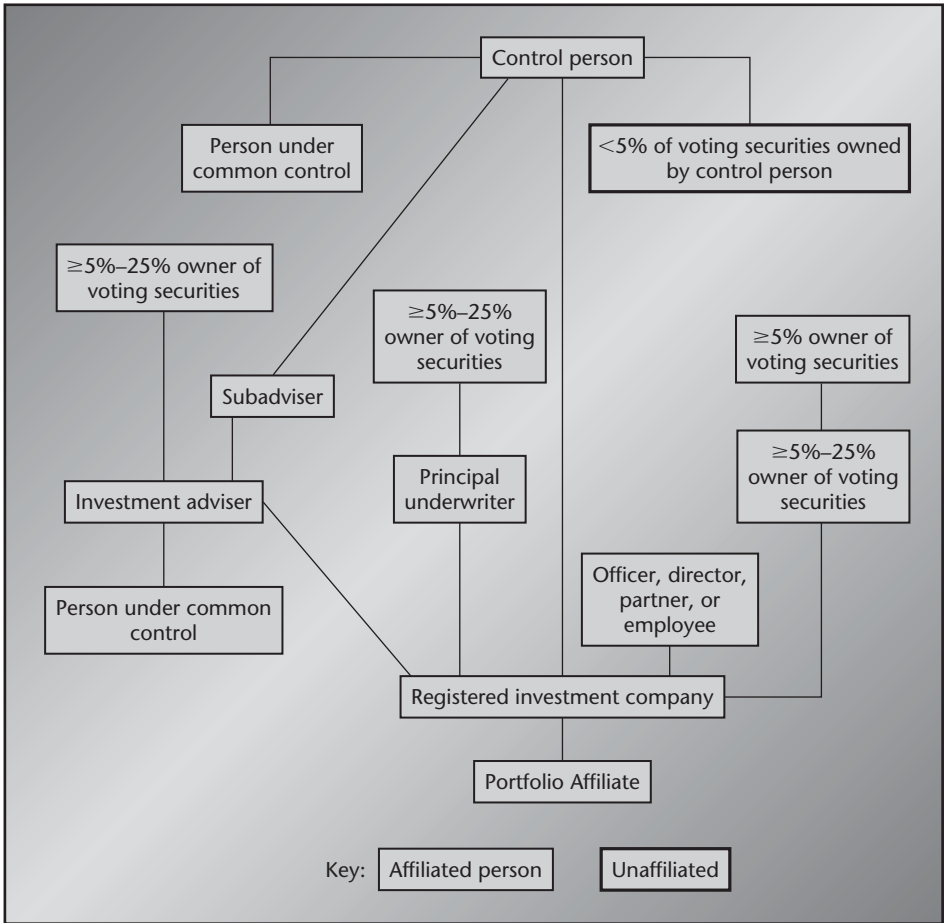


Figure 4.1 Affiliated persons of a US investment fund

Source: Adapted from US Securities and Exchange Commission (1992), p. 476

There are proposals to counter such abuses through volume restrictions, permitting only orders with a negligible market impact to be traded. However, such a rule would itself run into problems because it is impossible (according to current research) to devise a generic formula for calculating market impact, a factor that is contingent upon numerous parameters – some of which simply cannot be captured – that are mostly also specific to the individual security.

Another example of bad practice is pushing certain securities in the manager's own portfolio, which may be questionable even in the case of high-quality securities and a correct price, simply because potentially better alternatives are ignored, and the management company and/or its affiliates are primarily pursuing their own interest in selling these securities, rather than the interest of the fund, which in turn runs counter to their fiduciary duties.

The SEC relies in particular on oversight by the fund board and above all its independent directors.

The regulation of affiliated transactions

The Investment Company Act generally prohibits affiliated transactions, although certain exceptions are possible by means of individual exemption orders (on application),¹⁵ and in particular by means of generally applicable SEC rules and regulations under the Investment Company Act.¹⁶ The SEC uses these two options to grant numerous exemptions that allow transactions that would normally be largely prohibited because of conflicts of interest.¹⁷ The following applies to direct and indirect fund affiliates.

- 1 They may not sell or buy securities and other assets for themselves to or from the fund or a company controlled by it or borrow or lend money or other assets from or to the fund or a company controlled by it.¹⁸
- 2 They may not enter into transactions in which the fund or a company controlled by it participates jointly or jointly and severally.¹⁹ The SEC may issue rules and regulations that enable it to grant individual exemption orders and that lay down conditions for the utilization of certain general exemptions.²⁰
- 3 They are generally prohibited from accepting commissions from third parties for the sale or purchase for third party account of assets of the fund or a company controlled by it, unless they are acting as a broker or a member of an underwriting syndicate.²¹ If they act as a broker, the commission or any other consideration is subject to certain restrictions.²²

¹⁵ Section 17(b) Investment Company Act of 1940.

¹⁶ Section 6(c) Investment Company Act of 1940 gives the SEC the authority to issue such rules and regulations.

¹⁷ These rules and regulations are the following General Rules and Regulations promulgated under the Investment Company Act of 1940: Exemption of Certain Underwriting Transactions Exempted by Rule 10f-1 in accordance with Rule 17a-1; Exemption of Certain Purchase, Sale or Borrowing Transactions in accordance with Rule 17a-2; Exemption of Transactions with Fully Owned Subsidiaries in accordance with Rule 17a-3; Exemption of Transactions Pursuant to Certain Contracts in accordance with Rule 17a-4; Pro Rata Distribution Neither 'Sale' nor 'Purchase' in accordance with Rule 17a-5; Exemption of Transactions with Certain Affiliated Persons in accordance with Rule 17a-6; Exemption of Certain Purchase or Sale Transactions Between an Investment Company and Certain Affiliated Persons Thereof in accordance with Rule 17a-7; Mergers of Certain Affiliated Investment Companies in accordance with Rule 17a-8; and Purchase of Certain Securities From a Money Market Fund by an Affiliate, or an Affiliate of an Affiliate in accordance with Rule 17a-9.

¹⁸ 'Principal transactions'; see section 17(a) Investment Company Act of 1940. Section 17(c) Investment Company Act of 1940 exempts certain goods and leasing transactions from the scope of section 17(a).

¹⁹ 'Joint transactions' and 'joint and several transactions'; see section 17(d) Investment Company Act of 1940.

²⁰ See Rules 17d-1 to 17d-3, 17 CFR 270.

²¹ 'Agency transactions'; see section 17(e) Investment Company Act of 1940.

²² See section 17(e)(2) Investment Company Act of 1940 and Rule 17e-1, 17 CFR 270.

The following restrictions apply to *certain* types of direct and indirect affiliates of the fund.

- 1 If these affiliates are directors, officers, or employees of the fund or persons affiliated with them, they may not act as regular brokers,²³ principal underwriters, or investment bankers for the fund.²⁴
- 2 If these affiliated persons are persons as defined in the preceding paragraph or the management company or an advisory board of the fund or persons affiliated with them, they may not be members of any underwriting or selling syndicate that sells securities to the fund as part of new issues.²⁵

Utilization of exemptions governed by rules and regulations is linked either to the existence of certain objective criteria or to involvement of the fund board. The latter case normally requires, first, a review by and subsequent consent of the board, and, second, compliance with the fund governance standards adopted by the SEC in 2004 (see p. 196), giving the independent directors a key role in this area. Most²⁶ of these exemptions linked to the fund board originate from the pool of 'exemptive rules'.²⁷ Such transactions requiring approval include, for example, the purchase or sale of securities by funds in the same fund complex, or the purchase of securities from an underwriting syndicate that includes the fund management company.

The fund board review required under these exemptive rules must satisfy the following requirements: the fund board – with the approval of a majority of independent directors – must have defined and approved certain procedures for such transactions which ensure that the standards and conditions required for such transactions by the Investment Company Act are actually observed. In addition, the fund board must determine each quarter that all such transactions during the preceding quarter were effected in compliance with the defined procedures.²⁸ Instead of such a rule-based review, exemptive rules governing the merger of certain affiliated funds require a specific decision in each case that meets certain criteria, under which the required approval of the directors – which in turn requires a majority of independent directors – must safeguard the interests of the shareholders.²⁹

²³ For a definition of the 'regular broker', see Rule 10b-1, 17 CFR 270.

²⁴ See section 10(b) Investment Company Act of 1940.

²⁵ See section 10(f) Investment Company Act of 1940; Rules 10f-1 to 10f-3, 17 CFR 270, permit certain conditional exemptions. For Rule 10f-3, see the explanations on the 'exemptive rules' (p. 195) in the section on Initiatives to improve mutual fund governance, p. 194.

²⁶ An exception to this is Rule 10f-1, 17 CFR 270, which makes the exceptional permission of certain issuing transactions dependent on the written approval of a majority of fund board members, without imposing more far-reaching requirements on the resolution procedure or the composition of the fund board.

²⁷ These are the following 'exemptive rules' (see p. 195): Rules 17a-7, 17a-8, 17d-1(d)(7), 17e-1 and 10f-3, 17 CFR 270.

²⁸ See Rules 10f-3 (10), 17a-7 (e), 17e-1 (b), 17 CFR 270.

²⁹ See Rule 17a-8 (a)(2), 17 CFR 270.

Regulation of self-dealing transactions/code of ethics

Self-dealing is a special class of affiliated transaction. Reflecting the special characteristics of such conflicts of interest, the SEC regulates self-dealing, over and above the general statutory prohibition, by requiring the adoption of a code of ethics³⁰ and the subsequent internal control of its application governing those persons who, because of their affiliation with the fund, have particular opportunities to engage in self-dealing with the fund.

Specifically, both the fund (investment company) and its management company³¹ and primary underwriter(s) must adopt a written code of ethics for their directors, officers and advisers ('access persons'). It governs direct and indirect securities sales and purchases by these persons to and from the fund. The objective of the provisions of the code must be to prevent the fund from being defrauded or taken advantage of by self-dealing affiliates involved in the transaction.

Figure 4.2 provides an illustrative overview of the allocation of responsibilities and obligations applying to the adoption, amendment, enforcement and control of the code of ethics. For reasons of simplicity, Figure 4.2 is limited to the code of ethics of the investment company. The responsibilities and obligations relating to the corresponding codes of the management company and principal underwriter are similar. Logically, the fund board has a key role in the code of ethics because it is essentially the front-line body safeguarding the interests of the shareholders. On the one hand, the fund board must approve the codes of both the fund and the investment adviser(s) and principal underwriter(s) by a majority vote of the independent directors (as well as all subsequent amendments to these codes: see steps 1 and 7 in Figure 4.2), and on the other, it must be provided at least once a year with special written reports by these companies for review (see step 6 in Figure 4.2). These reports must describe all unusual events that have occurred since the last report and that affect the scope of application of the code, in particular infringements of the code and subsequent action taken and any sanctions imposed (see step 5 in Figure 4.2).

To enable the fund, the investment adviser(s) and the principal underwriter(s) to supervise self-dealing by these persons, they (the persons) are obliged to provide regular reports on their securities holdings and related transactions (see step 3 in Figure 4.2);³² these reports must be reviewed by suitable managers or compliance staff at the company concerned (see step 4 in Figure 4.2). The company is obliged first to disclose the names of its access persons, and second to inform

³⁰ See Rule 17j-1 (c), 17 CFR 270.

³¹ 'Investment advisers' generally assume the function of the management company. Since 31 Aug. 2004, they have been obliged to adopt and monitor compliance with a code of ethics, even if they do not work for an investment fund (see US Securities and Exchange Commission, (2004c): Introduction of a new Rule 204A-1, 17 CFR 275).

³² For all securities for which direct or indirect beneficial ownership exists, and for all broker/dealers and banks at which custody accounts bringing these persons direct or indirect financial benefits are held, holdings reports must be furnished when the person becomes an access person as well as once a year, plus quarterly transaction reports; see Rule 17j-1 (d)(1) and (5), 17 CFR 270.

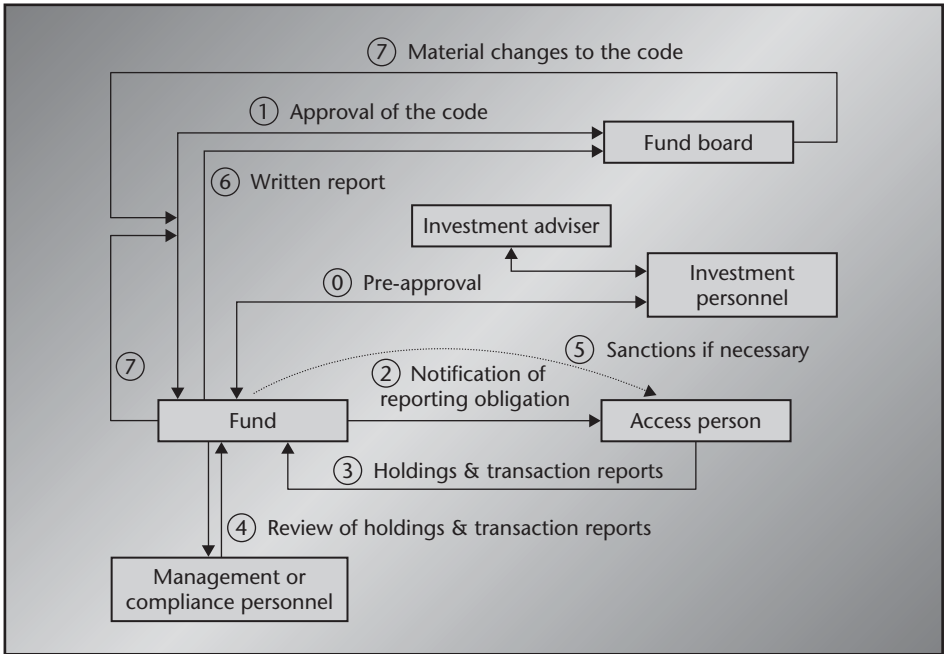


Figure 4.2 Code of ethics for self-dealing: allocation of responsibilities and review obligations according to Rule 17j-1, 17 CFR 270

them about their reporting obligations (see step 2 in Figure 4.2). Those employees of the fund or the investment adviser whose standard functions include (involvement in) investment recommendations for the fund and all (natural) persons who control the fund or the investment adviser and receive information on such investment recommendations ('investment personnel') are specifically required to obtain pre-approval for personal investments in new issues (see step 0 in Figure 4.2). Before such persons can acquire securities under IPOs or limited offerings (meaning direct or indirect beneficial ownership), they must obtain the prior consent of the fund or its investment adviser.

Overview of prohibited and restricted transactions for pension funds in the USA

ERISA provides a number of specific rules for US pension funds in this problem area.

- 1 ERISA fiduciaries may not deal for their own interest or account with the fund's assets (prohibition on self-dealing³³).³⁴

³³ Not to be confused with the equally critical practice of self-investment (see the section on Fixed maximum percentage of fund assets in securities of a single issuer, p. 267), which involves investing the fund's money in the fiduciary's own or third party securities.

³⁴ Section 406(b)(1) ERISA.

- 2 As a rule,³⁵ transactions by the fund in favour of (legal) entities whose interests run counter to the interests of the fund³⁶ or who can exercise an influence on the fund (a party in interest) represent a breach of fiduciary duties. This general rule is put into more concrete form by a list of prohibited direct or indirect transactions between the fund and parties in interest:³⁷
- (a) the sale, exchange, or lease of any assets;
 - (b) loan transactions;
 - (c) the manufacture of goods or provision of services;
 - (d) the transfer of fund assets or their use to benefit a party in interest;
 - (e) the acquisition of securities or real property of the fiduciary's employer unless certain rules are complied with.

Allocation of securities

Where demand for certain securities exceeds supply, which is often the case especially with IPOs, the question arises of how securities received by the management company or by the individual portfolio managers managing several funds should be allocated fairly to the individual funds. The desirable solution – albeit one which is not (yet) obligatory – would be a written, published allocation policy. However, the fiduciary duties imposed by the Investment Adviser Act can be interpreted in such a way that the management company is obliged to prepare such a policy statement, at least in the long term.

If there is general acceptance of the need for such guidelines, the question then arises of how these will be formulated, because the fiduciary duties do not allow any scope for arbitrary or inequitable mechanisms. The least disputed solution is pro rata allocation, but rotating random allocation also appears to be suitable. This latter method illustrates clearly that allocation procedures do not necessarily have to satisfy the aforementioned requirements in terms of each individual allocation, although they certainly have to over a longer period. There are also controversial suggestions that smaller (or more poorly performing) funds should be preferred,³⁸ as mini-allocations do not hold out any significant improvement in the performance of very large funds in any case. An

³⁵ Such transactions may be permitted under exceptional circumstances (section 408 ERISA), but the conditions include a requirement that a detailed list of each of this type of transaction during the reporting period must be provided to the supervisory authority as a part of the annual report (section 103 ERISA).

³⁶ Section 406(b)(2) ERISA.

³⁷ Section 406(a)(1) ERISA.

³⁸ Equal treatment as opposed to preferencing does not mean here that all funds must receive the same allocation, but that at least all funds of the same investment strategy should receive the same allocation.

exaggerated instance of the preferential treatment of certain funds, which has already been prohibited by the SEC as fraudulent, is the preferential treatment of an extremely popular fund; this is a clear breach of the primacy of investors' interests over those of the management company under the terms of its fiduciary duties.

If a code of ethics has been adopted, the oversight problem then arises. This can be solved, for example, by the establishment of a committee ('Equity Steering Committee' or 'Brokerage Control Committee'), although paramount responsibility still rests, of course, with the fund board. As an illustration, an analysis of the comparative performance of funds employing the same investment strategy may identify (unlawful) differences in the allocation of outperforming securities as the underlying cause.³⁹

Soft dollars/soft commissions

'Soft dollars' is the term used to denote a practice by which asset managers or fund management companies use the brokerage commissions generated by their clients' transactions to obtain research on securities, issuers, markets and related topics from the broker-dealers without having to pay for it in 'hard' dollars.⁴⁰ In Europe, this practice is termed 'soft commissions'.⁴¹ This practice traces its origins back to the unreasonably high minimum broker-dealer fees commonly charged until 1975,⁴² which exceeded the actual cost of executing the orders. At the time, this meant that competition between broker-dealers was not price-driven, resulting in compensatory soft-dollar arrangements.

However, this practice may represent a breach of the asset manager's fiduciary duty, because a fiduciary may not use the assets entrusted to it for its own advantage or for the benefit of clients other than the principal, even if this does not cause additional costs for or otherwise disadvantage the client, unless the client concerned has given its consent on the base of complete and fair disclosure.⁴³ The possibly unlawful advantage to the asset manager is that it does not have to prepare or pay for the research (and so on) itself. A common exacerbation of this conflict of interest – the asset manager wants (cheap) research and its clients want low fees and optimum order execution – is where orders are no longer executed at best, counter to the duty to ensure best execution.⁴⁴ Neither is the scale

³⁹ See US Securities and Exchange Commission (2000d).

⁴⁰ See Investment Company Institute (np, 1999), p. 16.

⁴¹ The European Commission terms soft commissions 'economic benefits' (European Commission (2004a), p. 8).

⁴² Effective 1 May 1975, the SEC abolished the existing system of fixed fees and introduced a system of negotiable fees (still in place today) so as to strengthen competition.

⁴³ Customer consent is deemed given if disclosure requirements are complied with.

⁴⁴ For the roles of the investment adviser, broker/dealers and the fund board in connection with the requirement for best execution, see the section on Oversight of internal fund procedures in the USA, p. 353.

of this problem negligible, as estimates put the volume of soft dollars at over US\$ 1 billion in 1998, and an SEC study⁴⁵ reckons that almost all asset managers make use of this practice.

Subject to certain conditions (defined in greater detail in the 'safe harbor' contained in Section 28(e) of the Securities Exchange Act of 1934) asset managers may pay more than the lowest possible order execution fee if internally generated or otherwise not generally available⁴⁶ research and other services⁴⁷ are received as an additional consideration. This regulation defines in particular the nature and scope of the services covered and permitted by it. Below is a list of the permitted activities:

- 1 Advice – including in the form of periodicals or similar – concerning the valuation of securities or their current supply/demand situation, as well as buy/sell recommendations.
- 2 The preparation of research and reports on issuers, industries, securities, the macro-economic environment, portfolio strategies and portfolio performance.
- 3 The execution of securities transactions and ancillary services, such as clearing, settlement and safekeeping.
- 4 Products and services with mixed applications (i.e., where research is only part of the business). The rest of the business must be paid in 'hard' dollars, unless the customer's consent has been obtained in advance following disclosure of the transaction. Appropriate documentation and storage of this documentation must also be ensured.

The most important condition for admissibility is disclosure of the details of the soft dollar arrangements to the clients. A general note that various services and products were 'paid' in soft dollars is not sufficient because of a lack of specification. On the other hand, there is no need to list each individual service/product, but a classification of these must be presented.

The primary instrument for complying with these disclosure requirements is the registration form to be filed with the SEC (and updated annually) by the investment adviser ('Form ADV'). Fund managers are also investment advisers. The Statement of Additional Information⁴⁸ and the semi-annual reports to shareholders⁴⁹ are secondary disclosure instruments in that they are required to discuss

⁴⁵ See US Securities and Exchange Commission (1998c).

⁴⁶ As a rule (exceptions are possible), a broker/dealer cannot therefore sell third party research that is generally obtainable (for a consideration) without any significant delay against soft dollars.

⁴⁷ Subject to certain limits, services other than research are permitted, but there is increasing abuse and inadequate or no disclosure in this area. For example, office rent or office equipment leases, mobile phones, personal expenses, salaries, advertising expenses, legal expenses, hotels and hire cars, and travel, including entertainment programmes, etc., are being illegally paid for with soft dollars.

⁴⁸ See the section on Statement of Additional Information, pp. 331ff.

⁴⁹ See the section on Annual and semi-annual reports to investment fund shareholders and supervisory authorities in the USA, pp. 319ff.

the case-specific 'material facts' and the resulting conclusions that result in signature or renewal of the current advisory contract.⁵⁰ Any soft dollars from which the fund manager may have benefited must also be explained. The SAI must also explain the criteria by which the fund selects the brokers that act for it ('brokerage selection') and how the appropriateness of brokerage fees is assessed. If appropriate, it must also disclose whether soft dollars flow into the decision-making and assessment process. If this is the case, the goods and services acquired through soft dollars must be described.⁵¹

Soft dollars can also be covered by a 'safe harbor' if more than the lowest possible order execution fee is paid. This is not a breach of fiduciary duty if the fiduciary believes in good faith that the amount of commission is reasonable in relation to the value of the brokerage service, including research (and so on). The reasoning behind this is that issuing an order solely on the basis of the (lowest achievable) commission does not necessarily have to be in the best interests of the investors, because they certainly stand to gain from the broker-dealer's analysis activities, and because selection of the broker-dealer is a matter for the fiduciary's reasonable business judgement.

In practice, breaches relating to soft dollars⁵² fall into two categories, namely research and other services:

- (a) that are essentially permitted under the terms of the 'safe harbor', but for which compliance with the disclosure requirements is either inadequate or non-existent;
- (b) that are most certainly unlawful and that cannot be remedied by disclosure. Asset managers frequently claim 'safe harbor' protection without meeting the safe harbor requirements.

The fact that both of these types of infringement of the relevant rules occur frequently in practice is largely because only very few broker-dealers and asset managers have adequate internal controls and documentation relating to soft dollars. This is thus a compliance issue.

The SEC recommends the establishment of internal central administration and control systems for soft dollar arrangements so as to counteract the widespread shortcoming of uncoordinated soft dollar decisions at various management and function levels resulting in inadequate documentation.⁵³ For example, if an asset manager cannot provide a complete list of soft dollar services received during the

⁵⁰ For the SAI, this disclosure requirement results from Item 12(b)(10), Form N-1A, 17 CFR 274, and for the semi-annual and annual report, from Item 21(d)(6), Form N-1A, 17 CFR 274.

⁵¹ See Item 15(c) and (d), Form N-1A, 17 CFR 274.

⁵² For case studies on SEC sanctions relating to soft dollars, see footnote 33 in US Securities and Exchange Commission (1998c).

⁵³ For a summary of recommended internal control procedures as regards soft dollars, see US Securities and Exchange Commission (1998c).

course of an SEC inspection, it can be assumed that any established compliance system is not effective. However, the fund board, whose duties also include control of soft dollar arrangements, sits between the regulator and the compliance department.⁵⁴

The complexity of the soft dollar issue can be countered by an unambiguous code of ethics, although this can never represent a complete list of procedures, which is why the principles of the primacy of client interest and fair disclosure must always be applied in situations not explicitly covered by such a code.

Prohibition on transactions involving conflicts of interest in the European Union

Conflicts of interest also affect EU funds, of course, but there are no comparable extensive rules and regulations there. In contrast to the USA, the EU in its supranational regulatory regime relies almost exclusively on abstract basic rules to manage conflicts of interest. National legislation in Germany and Austria also follows this principle and contains very few detailed rules and regulations. In particular, the recent laws on the Riester pension (Germany) and the new severance pay scheme and the premium-subsidized future provision (Austria) primarily govern the pension products and ignore prohibitions and requirements for the management of conflicts of interest specific to funded pensions.

Although the inclusion of provisions restricting personal investing was recommended for the Pension Funds Directive,⁵⁵ the recommendation was ultimately not implemented. The amendment to the UCITS Directive (UCITS III) that came into force in February 2002 obliged the Member States to enforce rules of conduct for management companies by 13 February 2004⁵⁶ to ensure that conflicts of interest are minimized or, if they cannot be avoided, that the UCITS they manage are 'fairly treated'.⁵⁷ The 'European passport' is qualified in this respect in that the organizational arrangements for a branch established outside the home country may not conflict with the rules of conduct laid down by the host Member State to cover conflicts of interest.⁵⁸ If a management company also offers discretionary portfolio management, all or part of such discretionary portfolios may only be invested in UCITS managed by the management company with the client's prior approval.⁵⁹

In Germany, for example, there are rules of conduct governing conflicts of interest in the form of the DVFA's Standards of Professional Conduct that apply

⁵⁴ See the section on Oversight of internal fund procedures in the USA, p. 353.

⁵⁵ See Pragma Consulting, (1999), p. III.

⁵⁶ Art. 3 Directive 2001/107/EC.

⁵⁷ Art. 5h (d) Directive 85/611/EEC.

⁵⁸ Art. 5f (1)(b) Directive 85/611/EEC.

⁵⁹ Art. 5f (2) Directive 85/611/EEC.

to all professionals in investment services enterprises within the meaning of the German Securities Trading Act (i.e., financial analysts, portfolio managers and investment advisers).⁶⁰

- 1 Compliance with the provisions of the German Securities Trading Act to avoid conflicts of interest is a professional obligation.⁶¹
- 2 Own account dealing is generally permitted, but using inside information is prohibited to professionals in investment services organizations (and not only for own account dealing) and their families.
- 3 Front-running is prohibited.
- 4 The publication of investment recommendations serving the professional's own interests is also prohibited.

The BVI code of ethics for investment companies that came into force in Germany on 1 January 2003 requires funds to be managed 'solely in the interests of the shareholders' and obliges investment companies to establish 'rules of conduct and responsibility governing conflicts of interest with significant consequences whose management represents a particular challenge'.⁶²

The essence of future standard-setting

When devising investment rules to control management risks, a distinction can be made between two fundamental approaches, although in practice a middle way between these 'pure' forms appears to be desirable: they can either be highly restrictive and based on specific cases, or they can be extremely liberal in terms of legislation if reliance is placed instead on a written commitment (code of conduct, code of ethics), including its effective supervision by the largely independent fund or pension plan board, although it must then be possible to place reasonable trust in the independence of this body.

⁶⁰ See DVFA (nd).

⁶¹ Section 31 (1) No. 2 WpHG: 'An investment services enterprise is required to make efforts to avoid conflicts of interest and to ensure that if conflicts of interest are unavoidable, the customer order is executed such that the customer's interests are safeguarded.'

Section 32 (1) No. 1 and No. 2 WpHG: 'An investment services enterprise or an enterprise affiliated with it is prohibited:

- 1 from recommending to customers of the investment services enterprise the purchase or sale of securities, money market instruments or derivatives if and to the extent that the recommendation does not coincide with the customers' interests;
- 2 from recommending to customers of the investment services enterprise the purchase or sale of securities, money market instruments or derivatives for the purpose of manipulating prices in a particular direction for the proprietary transactions of the investment services enterprise or its affiliated enterprise;

⁶² BVI (2004a); Principle I, p. 4.

In the USA, there is no harmonious synthesis of these two approaches under the auspices of the SEC, but rather a situation of co-existence, a solution that appears less than optimal especially in terms of cost. If the EU wants to move over to boards similar to the US fund board in future, they will have to be designed such that there can be no doubts about their structural integrity and effectiveness. Under such conditions, the liberal approach would be more beneficial because it would offer flexibility and cost advantages to cope with changes in market structure and non-EU competitors.

As part of the standards relating to these issues, a code of ethics should cover the following potential conflicts of interest, with an overall principle that the board to be designed under the aspects outlined above and its independent members should have an arbitration role, and that there should be adequate documentation of the processes (and their safekeeping).

A blanket ban on personal investing would fail the test of legal and constructive barriers; it would not be necessary if there were clear rules of conduct combined with reporting obligations, supervised by an effective compliance department.

Guidelines that govern transactions between the funds on the one hand, and its management company or other service providers and their affiliates on the other, should at least enshrine the principle that such transactions must be avoided in cases of doubt; otherwise, there would certainly be a need for highly detailed rules and regulations, although experience shows that these too would never in themselves be enough to cover every conceivable situation. The highly comprehensive US rules were unable to prevent the market timing scandal, for example. On the other hand, the low density of (continental) European regulation on such transactions does not appear to be any more effective because it can be assumed that malpractice frequently goes undetected due to the far less comprehensive disclosure requirements there than in the USA. Based on the UCITS Directive and the Pension Funds Directive, and also on derivative legislation, it would thus be most desirable at least to address the most important of these problem transactions and to require the adoption of adequate relevant national legislation or the establishment and supervision of appropriate industry standards.

The problem of allocation of securities for which demand is heavy, but supply is tight, to individual funds or portfolio managers can be solved by defining a written, fair allocation policy, combined in turn with supervision by the compliance department, the fund board, or a special board committee.

The limits of efforts to tackle soft dollar abuses through detailed guidelines are shown by the unsatisfactory situation in the US, where the safe harbor rules are often insufficient to prevent breaches because of inadequate compliance. The nature of the disclosure obligations applying to soft dollars is also open to criticism: the registration form for the management company is hardly a source of information that is actually used by investors in practice. The same applies to the SAI and, to a lesser extent, to the semi-annual reports. Because soft dollars are an implicit cost component that can have a more than negligible effect on fund performance, prospectuses are a suitable instrument for disclosure.

There is certainly a need for more extensive research into the extent of soft commissions throughout the EU in order to establish whether there is in fact any need for action. However, there is a strong probability that the problem of soft commissions is considerably less acute in Europe because its history of capital market regulation differs from that in the USA.

SEPARATION OF FUNCTIONS

Institutional separation

The situation in the USA

Among other things, the US Glass–Steagall Act bans senior bank executives from serving as members of the board of a fund affiliated with the bank. Banks that issue funds do not have to be registered with the SEC as investment advisers, but this does not mean, of course, that they are not subject to legislation, and their fund activities are subject to stricter control by the banking regulator than would otherwise be the case for regulation by the SEC.⁶³

The supervisory perspectives of the two US regulators responsible for bank-related funds – the banking regulators and the SEC – are very different: the prime directive for banking regulators is to protect the bank as an institution and the depositors, and they have an ambivalent relationship towards disclosure, especially in the case of information that could unsettle depositors. The top priority for the securities regulator, on the other hand, is investor protection, and it pushes for the greatest possible disclosure.⁶⁴ The ICI, in its function as a lobbyist for the US fund industry, is pressing for the present practice to be replaced by an oversight regime in which each subsidiary of a holding company is subject to functional supervision (i.e., banks would be supervised by the banking regulator, and investment funds – including bank-related funds – by the SEC). It rejects the notion that certain funds should be regulated by the Federal Reserve Board.⁶⁵

In the case of bank-related funds, the question that arises most in practice is that of affiliated transactions: in some cases, banks may act as custodians, securities lenders or (money) lenders for ‘their’ funds. However, such services may also be regarded by the directors as restricted affiliated transactions that are then reviewed to establish whether they are really in the fund’s best interests, or are geared more to serving the bank’s interests.⁶⁶

The separation between the management company and the custodian is based on Section 17(f) of the Investment Company Act and the related rules and

⁶³ See US Securities and Exchange Commission (1999b).

⁶⁴ See US Securities and Exchange Commission (1999b).

⁶⁵ See Investment Company Institute (np, 1997), p. 14.

⁶⁶ See US Securities and Exchange Commission (1999b).

regulations issued by the SEC.⁶⁷ The fundamental principles here include the safekeeping of fund securities in a separate physical location from third-party securities (dematerialized safekeeping through record-keeping procedures is also possible); no authorization of the custodian to encumber, pledge, or claim a right of retention on the securities; frequent inspection of the securities holdings by independent public accountants and the right of the SEC to inspect at any time; the dual-control principle governing disposition of securities; and compulsory fidelity insurance for all persons enjoying access to the securities in an amount pegged to the fund volume.

Certain banks (including foreign banks), members of a national securities exchange, (foreign) securities depositories, or clearing houses are eligible to act as the custodian, and – under certain circumstances – even the investment company itself.

The situation in the EU

The separation of management and custody of the fund assets represents one of the most important investor protection measures. The effective separation of these two functions ensures degree with a very high degree of probability that neither the management company nor the custodian can embezzle fund assets. For investment funds, the European Commission regards the control function of the custodian as ‘crucial’ and emphasizes the resulting need for ‘an effective independence between the management company and the depository’.⁶⁸ Despite this programmatic stress on the importance of custodians/depositories, UCITS III hardly produced any concrete requirements and prohibitions for custodians, although one of the two draft Directive proposals underlying UCITS III still contained rules for the following situations to safeguard independence and avoid conflicts of interest:⁶⁹

- (a) the management company and the custodian belong to the same group;
- (b) the management company has a qualifying holding in the custodian or vice versa;
- (c) the management company otherwise exercises significant influence on the custodian or vice versa;

⁶⁷ These rules are the following General Rules and Regulations promulgated under the Investment Company Act of 1940: Rule 17f-1, 17 CFR 270: Custody of Securities with Members of National Securities Exchanges; Rule 17f-2, 17 CFR 270: Custody of Investments by Registered Management Investment Company; Rule 17f-4, 17 CFR 270: Deposits of Securities in Securities Depositories; Rule 17f-5, 17 CFR 270: Custody of Investment Company Assets Outside the U.S.; Rule 17f-6, 17 CFR 270: Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations.

⁶⁸ European Commission, Com (1998) 449 final (1998), Recital 15.

⁶⁹ See European Commission, Com (1998) 449 final (1998), Recital 15.

- (d) the management company is permitted to enter into transactions with the custodian.

The actual requirements in the UCITS Directive are limited to the explicit separation of the management company and the custodian,⁷⁰ and the requirement that these two institutions must act independently of one another and solely in the interests of the shareholders.⁷¹ Delegation of the asset management function to the custodian is also expressly prohibited.⁷²

The original UCITS Directive laid down that a management company could have no activity other than managing investment funds or companies.⁷³ Together with investor protection by avoiding conflicts of interest, the purpose of this exclusivity principle was to enable the greatest possible specialization. In particular, the ban on management companies conducting own name investment business aims to prevent both conflicts of interest and stability problems. The UCITS amendment that came into force in early 2002 (UCITS III) followed the corresponding proposed Directive⁷⁴ and abolished this exclusivity clause by allowing Member States to make provision in national laws for management companies to act as custodians for investment fund shares and/or to apply for authorization to conduct discretionary portfolio management, including the management of pension funds, and/or to provide specific additional services.⁷⁵

The separation of the management company and the custodian was also proposed for the Pension Funds Directive.⁷⁶ Ultimately, however, the Pension Funds Directive only provides for the explicit legal separation – as already announced during the preparatory work on the draft Directive⁷⁷ – between the *sponsor* and the IORP (in other words, the pension fund).⁷⁸

In addition, a recommendation was made to the Commission to include in the Pension Funds Directive a requirement for actuaries, who are necessary for defined benefit schemes,⁷⁹ to be independent of the sponsor. Moreover, the separation between asset management and the fund board or the supervisory board should be mandatory.⁸⁰ These proposals were not included in the proposal for the Directive published in October 2000⁸¹ and were consequently also not implemented in the Pension Funds Directive itself.

⁷⁰ Art. 10 (1) Directive 85/611/EEC.

⁷¹ Art. 10 (2) Directive 85/611/EEC.

⁷² Art. 5g (1) Directive 85/611/EEC.

⁷³ Art. 6 Directive 85/611/EEC.

⁷⁴ Art. 5 (3) European Commission, Com (1998) 451 final (1998).

⁷⁵ Art. 5 (3) Directive 85/611/EEC.

⁷⁶ See Pragma Consulting (1999), p. III.

⁷⁷ See European Commission, Com (1999) 134 final (1999), p. 20; and Pragma Consulting (1999), p. III.

⁷⁸ Art. 8 and Art. 6 (a) Directive 2003/41/EC.

⁷⁹ Art. 15 (4) Directive 2003/41/EC.

⁸⁰ See Pragma Consulting (1999), p. III.

⁸¹ European Commission, Com (2000) 507 final (2000).

Ensuring effective separation

Independence criteria

US investment companies/funds have boards of directors or fund boards with extensive powers and obligations. The Investment Company Act defines two different types of fund board members. The first of these are employees of the management company or persons with another business or family relationship with the management company or its affiliates (interested directors); the second are those who are independent of the management company (non-interested directors or independent directors).⁸²

A crucial question is whether formally independent directors can in fact ever be effectively independent, as they must necessarily collaborate with the management company in the best interests of the fund, while at the same time supervising the same management company. In turn, the primary source of information for conducting this oversight function is the management company. For the directors, this poses the question of how they should judge the reliability and adequacy of this information. How can the directors simultaneously maintain a good working relationship – experience shows that effective relations between the management company and the fund board do not necessarily have to be permanently confrontational – at the same time as they supervise it?⁸³

Independent directors with multiple appointments, (i.e., directors who are members of 30 or 40 fund boards) may also experience restrictions on their independence, normally because of inadequate knowledge about the circumstances of each individual fund and the limited time available to them. Membership of several boards in a family of funds also entails a risk that directors will weigh up – and possibly offset – the interests of one particular fund against the others: it may happen, for instance, that a handful of funds in a family of funds with otherwise excellent performance have performed very badly, and the fund board may decide to renew the investment advisory contract because the poor performance of individual funds is not viewed to be sufficient grounds for changing the investment adviser. Because renewal of the investment advisory contract is the sole responsibility of the fund board,⁸⁴ this decision can be interpreted as subordinating the interests of the shareholders of the ‘bad’ funds to those of the ‘good’ funds. However, this sort of compensatory arrangement by the fund board is prohibited in the USA.⁸⁵

The incompatibility of a particular person with the position of an independent director may arise first of all from non-compliance with the independence criteria set out in the Investment Company Act,⁸⁶ and, second, because of an SEC order.

⁸² For a definition of ‘interested person’, see section 2(a)(19) Investment Company Act of 1940.

⁸³ See US Securities and Exchange Commission (1999b).

⁸⁴ Section 15(c) Investment Company Act of 1940 requires the consent of the majority of independent directors to the investment advisory contract.

⁸⁵ See US Securities and Exchange Commission (1999b).

⁸⁶ See n. 82.

The SEC can issue an order finding that a person is an ‘interested person’ due to a material business or professional relationship with a fund or certain persons or entities. The period for such relationships starts at the beginning of the two preceding fiscal years of the fund (two-year period). The relationships that the SEC believes are material are of practical importance here.⁸⁷ Such a relationship is material if it might jeopardize the independence of the (potential) director, although this is not the case if the benefits from such a relationship flow from the (potential) director to the other party, rather than vice versa. In particular, the holding of certain positions or involvement in certain transactions with certain natural persons or legal entities is considered by the SEC to impair independence, and these are outlined below:

- 1 When evaluating professional positions at certain entities (this would normally be the investment adviser) during the two-year period, the level of responsibility and compensation linked to the position are the decisive factors. On this basis, for instance, the position of a fund’s portfolio manager is regarded as a material relationship. The same applies in most instances to directors or employees of the fund’s investment adviser (or of its holding company), although simultaneously holding an additional directorship of a fund managed by the same fund manager is not classed as grounds for exclusion.
- 2 When evaluating transactions (which could merely involve a single transaction) during the two-year period (and in the future for proposed transactions), the following examples of incompatible situations are cited:
 - (a) the investment adviser manages an advisory or brokerage account for the director and favours it (or creates the impression that it will favour it) over comparable accounts of other clients, perhaps in terms of fees or securities allocations;
 - (b) the director is the (CEO) of a company for which the CEO of the investment adviser is also a director, and since the investment adviser’s CEO has a say in the director CEO’s compensation, the latter’s independence as a fund director is impaired;
 - (c) the director has a controlling interest in a company that conducts material business with the investment adviser.

Initiatives to improve mutual fund governance

In 1999, the SEC launched an initiative to improve mutual fund governance together with the fund industry, and in particular with the ICI,⁸⁸ resulting in a

⁸⁷ See US Securities and Exchange Commission (1999c).

⁸⁸ For an overview of the proposals by the Advisory Group on Best Practices of the ICI on best practices for fund boards, see Investment Company Institute (np, 1999), pp. 23f.

change in the way that US investment funds are regulated.⁸⁹ The primary objectives were, first, to enhance the effectiveness and independence of fund boards, and, second, to improve the opportunities for shareholders to assess the effective independence of 'their' directors.⁹⁰

A 'troubling series of enforcement actions' by the SEC against fund management companies involving late trading of funds, inappropriate market timing activities and misuse of non-public information about fund portfolios led to a renewed mutual fund governance initiative in 2004. Despite the fact that the previous amendments were only three years old, the SEC was now of the opinion that they 'did not go far enough'. There had been a 'serious breakdown in [fund] management controls and in some cases, the fund was used for the benefit of fund insiders, often the management or its employees'.⁹¹

A feature common to both SEC initiatives is that they amend⁹² ten exemptive rules⁹³ frequently used by management companies that exempt funds and their affiliated companies or persons from certain prohibitions under the Investment Company Act in certain circumstances. These rules govern situations and transactions involving potential conflicts of interest and thus demanding particularly effective control by the (independent) directors so as to safeguard the interests of the shareholders in respect of the management company.⁹⁴ The amendments linked utilization of these exemptive rules to certain conditions whose objective is to strengthen the role of the independent directors.

⁸⁹ The reform included amendments on the following four sets of rules: 17 CFR 270, 17 CFR 274, 17 CFR 240 and 17 CFR 239.

⁹⁰ See Levitt (np, 1999a) and US Securities and Exchange Commission (2001).

⁹¹ US Securities and Exchange Commission (2004d), pp. 46,378f.

⁹² Section 6(c) Investment Company Act of 1940 gives the SEC the authority to approve exemptions for the authorization of a person or for a transaction, provided that this is dictated by the public interest or compatible with it, and is consistent with the investor protection and other provisions intended by the Investment Company Act.

⁹³ These are the following ten 'exemptive rules', contained in the Rules on the US Investment Company Act, 17 CFR 270:

Rule 10f-3: Exemption of acquisition of securities during the existence of underwriting or selling syndicate

Rule 12b-1: see 'Rule 12b-1' in the section on Fees and expenses expense ratio, p. 303

Rule 15a-4(b)(2): Approval of an interim (max. 150 day contract period) investment advisory contract by the fund board without the consent of the shareholders

Rule 17a-7: Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof

Rule 17a-8: Mergers of affiliated companies

Rule 17d-1(d)(7): Conclusion of a joint liability insurance policy for the fund and its affiliates

Rule 17e-1: Conditions for allowing commission payments to brokers affiliated with the fund in connection with brokerage transactions on a securities exchange

Rule 17g-1(j): Joint insured bonds

Rule 18f-3: Issue of several classes of common stock by the fund

Rule 23c-3: Authorization of 'interval funds'; these are closed-end funds that allow their shareholders to surrender their shares by repurchasing them during pre-determined intervals

⁹⁴ See US Securities and Exchange Commission (2004d), p. 46,378.

The 2001 amendment implemented the following amended or entirely new rules as at 1 July 2002.⁹⁵

- 1 Utilization of one or more exemptive rules must satisfy the following three criteria:⁹⁶
 - (a) the independent directors must represent a majority of fund board members;
 - (b) the independent directors must themselves select and nominate new independent directors;⁹⁷
 - (c) persons who act as legal counsel for the fund board's independent directors must be independent legal counsel.⁹⁸
- 2 Extended disclosure requirements about board members: the shareholders must be provided with comprehensive detailed information to enable them to assess the independence of 'their' directors.⁹⁹
- 3 Liability insurance for board members: joint liability insurance policies covering both the independent directors and other affiliated persons of the funds are permitted only if they do not exclude coverage for bona fide claims made against any insured independent director.¹⁰⁰

The second 2004 amendment implemented the following amended or entirely new rules as at 16 January 2006:¹⁰¹

- 1 The exemptive rules are contingent on compliance with the fund governance standards¹⁰² established in the amendment.¹⁰³ The fund governance standards are a catalogue of seven conditions that apply to the organization of the fund board. Two of the conditions were taken over unchanged from the three criteria introduced in the 2001 amendment, but the majority of them have been tightened:
 - (a) at least 75 per cent of the fund board members must be independent directors (the only exception applies to three-person boards, which must have at least two independent directors);

⁹⁵ See US Securities and Exchange Commission (2001).

⁹⁶ See 17 CFR 270, Rules: 10f-3(c)(11), 12b-1(c), 15a-4(b)(2)(vii), 17a-7(f), 17a-8(c), 17d-1(d)(7)(v), 17e-1(c), 17g-1(j)(3), 18f-3(e), 23c-3(b)(8) each as amended by US Securities and Exchange Commission (2001).

⁹⁷ See the section on The role of independent directors in nominating new independent directors and setting their own compensation, p. 198.

⁹⁸ See the section on Independent legal counsel, p. 200.

⁹⁹ See the section on Extended disclosure requirements, p. 201.

¹⁰⁰ Rule 17d-1(d)(7)(iii) 17 CFR 270.

¹⁰¹ See US Securities and Exchange Commission (2004d).

¹⁰² The fund governance standards are codified in the new (a)(7) in Rule 0-1, 17 CFR 270.

¹⁰³ See the following Rules on the US Investment Company Act (17 CFR 270): Rule 10f-3(c)(11), 12b-1(c), 15a-4(b)(2)(vii), 17a-7(f), 17a-8(a)(4), 17d-1(d)(7)(v), 17e-1(c), 17g-1(j)(3), 18f-3(e), 23c-3(b)(8), each as amended by US Securities and Exchange Commission (2004d).

- (b) the independent directors must themselves select and nominate new independent directors;
 - (c) persons who act as legal counsel for the fund board's independent directors must be independent legal counsel;
 - (d) the chairman of the fund board must be independent, and he has substantially the same responsibilities and duties as the chairman of a board of directors of a company;
 - (e) at least once annually, the fund board must evaluate its own performance (this must include a consideration of the effectiveness of the committee structure of the fund board and of the individual directors; in particular, the number of funds controlled by each director must be included);
 - (f) the independent directors must meet at least once quarterly in a session at which no directors who are not independent directors are present;
 - (g) the independent directors must be expressly authorized by the fund to hire their own employees and retain advisers necessary to carry out their duties.
- 2 The record retention duties of the investment company were extended as follows: all documents or other written information considered by the fund board directors when approving or renewing the investment advisory contract must be preserved for a period of not less than six years.¹⁰⁴ The SEC believes that this will bring improvements for its staff reviewing funds to establish whether the directors have observed their fiduciary duties in considering the contract. In addition, the SEC couples this measure with the expectation that in future, the directors will consider more information when approving or renewing the contract, and will thus be able to negotiate better terms for the shareholders.¹⁰⁵

Majority of independent directors

In principle, at least 40 per cent of the board members must be independent directors.¹⁰⁶ In practice, most US fund companies now have fund boards with a majority of independent directors,¹⁰⁷ because such a majority is a condition for the fund manager to be able to utilize various exemptions. What is of particular practical importance is the rule that the principal underwriter¹⁰⁸ and the

¹⁰⁴ Rule 31a-2(a)(6), 17 CFR 270.

¹⁰⁵ See US Securities and Exchange Commission (2004d), p. 46,385.

¹⁰⁶ Section 10(a) Investment Company Act of 1940 says that not more than 60 per cent of the directors may be interested persons.

¹⁰⁷ See US Securities and Exchange Commission (1999b); Levitt (np, 1999a) concurs.

¹⁰⁸ Principal underwriter under section 2(a)(29) Investment Company Act of 1940.

management company may only be affiliated with each other (commercially) if the fund board has such a majority.¹⁰⁹

The draft Investment Company Act of 1940 stipulated a majority of independent directors, but this was not implemented.¹¹⁰ The number of exemptive rules linked to a majority of independent directors was substantially expanded only as the outcome of the mutual fund governance improvement initiative accomplished by way of an SEC rule. The subsequent 2004 amendment on mutual fund governance then increased the qualified majority from 51 per cent to 75 per cent.

The purpose of such a qualified majority is to strengthen independent oversight of the management company, a factor of particular importance in the event of conflicts of interest between the fund and its investment adviser. A (simple) majority of independent directors without the involvement of the management company can have a far-reaching influence on the core organizational decisions of the fund.¹¹¹

The efforts that could be observed during the course of the EU's preparatory work on the Pension Funds Directive to stipulate at least one or two independent directors for EU pension funds¹¹² did not, unfortunately, bear fruit in the final Directive.

The role of independent directors in nominating new independent directors and setting their own compensation

The level of effective independence of directors depends principally on whether and to what extent their appointment and dismissal, and the stipulation of their compensation, are independent of the investment adviser. If this responsibility lies with the investment adviser, then they are unlikely to be independent.¹¹³ Until the arrival of the rules resulting from the mutual fund governance improvement initiative, nomination of new independent directors by the independent directors themselves was required only for those funds in the USA with a 12b-1 plan.¹¹⁴

A desirable move would be the election of independent directors by those persons whose interests they represent (i.e., the shareholders).¹¹⁵ In Germany and Austria, the members of the supervisory board, which has a similar function to that of a fund board, albeit (in practice) with fewer rights and obligations,

¹⁰⁹ Section 10(b)(2) Investment Company Act of 1940. For the considerable significance of this provision, see Investment Company Institute (1999), p. 5 and US Securities and Exchange Commission (1999d), footnote 39.

¹¹⁰ See Roye (1999a).

¹¹¹ In particular the selection of fund employees, the convening of meetings or solicitations of (proxy) votes (see US Securities and Exchange Commission (2001), II.A.1.(a)); see also Johnson (2000).

¹¹² See Pragma Consulting (1999), p. V.

¹¹³ See US Securities and Exchange Commission (1999a).

¹¹⁴ See the section on Fees and expenses expense ratio, p. 303; see also Rule 12b-1(c) 17 CFR 270 in the version valid until the effective date of US Securities and Exchange Commission (2001).

¹¹⁵ Under section 16(a) Investment Company Act of 1940, the common stockholders of the investment company, (i.e., the fund shareholders) elect the members of the board of directors at the general meeting.

are elected by the shareholders. However, this sort of 'shareholder democracy' is seriously hampered by the lack of organization on the part of individual investors that would be necessary to influence the process of appointment. Industry experts believe that the shareholders often do not even know who 'their' independent directors actually are,¹¹⁶ or are only contacted by them if there is a crisis, so the common situation in practice is that the independent directors are primarily independent of the shareholders, with whom they generally have no relations at all.¹¹⁷

As part of their initiative to improve mutual fund governance, the SEC and the ICI have been able to enforce the rule that since 1 July 2002, independent directors must be appointed by other independent directors if the fund utilizes at least one exemptive rule.¹¹⁸ The selection and appointment¹¹⁹ of new independent directors is the responsibility of the current independent directors. This does not affect the rights of shareholders under state law to appoint independent directors. Neither is the involvement of the investment adviser excluded, first, because it can be invited by the independent directors to propose candidates, and second, because it can provide administrative support. However, the involvement of shareholders and/or the investment adviser does not release the independent directors from their duty to acquire, recruit, interview and solicit candidates.¹²⁰

If the compensation of the independent directors is set by the management company, as is usually the case in the USA, this does, of course, restrict their independence: the SEC is increasingly investigating cases where the main issue centres around the high level of compensation paid to certain independent directors and the consequent question of the extent to which these highly paid directors avoid disputes with the management company that would serve investors' best interests, for fear of being dismissed or suffering a drop in income. On the other hand, in all five cases of excessive compensation adjudicated in the 1980s, the judge ruled that the independent directors concerned were indeed independent. Ultimately, the shareholders themselves can reach a judgement because the level of compensation must be published.¹²¹

¹¹⁶ See US Securities and Exchange Commission (1999a), comments by John Markese, President of the American Association of Individual Investors.

¹¹⁷ See US Securities and Exchange Commission (1999a), comments by Harold Evensky, Certified Financial Planner at Evensky, Brown & Katz, Florida.

¹¹⁸ The requirement that independent directors must be appointed by other independent directors was included in the Exemptive Rules in 2001 as one of the outcomes of the Fund Governance Initiative launched in 1999 (see 17 CFR 270, Rules: 10f-3(b)(11)(i), 12b-1(c)(1), 15a-4(b)(2)(vii)(A), 17a-7(f)(1), 17a-8(c)(1), 17d-1(d)(7)(v)(A), 17e-1(c)(1), 17g-1(j)(3)(i), 18f-3(e)(1), 23c-3(b)(8)(i), each as amended by US Securities and Exchange Commission, 2001). The next Fund Governance reform in 2004 made this requirement part of the 'Fund Governance Standards' that were then introduced (see Rule 0-1(a)(7)(ii), 17 CFR 270 as amended by US Securities and Exchange Commission (2004d)), although this represented merely a formal, not a material, amendment.

¹¹⁹ 'Selection and nomination refers to the process by which board candidates are researched, recruited, considered, and formally named' (US Securities and Exchange Commission (2001), footnote 30).

¹²⁰ See US Securities and Exchange Commission (2001), II.A.2.

¹²¹ See US Securities and Exchange Commission (1999b).

The SEC and industry experts are also aware of the problems surrounding the term of office of independent directors.¹²² The argument advanced in favour of limiting the term of office is that the investment adviser and the independent directors may become too close over time.¹²³

Independent legal counsel

The view that a legal adviser can simultaneously represent the management company and the fund or its independent directors is increasingly viewed as obsolete in the USA.¹²⁴ Until the adoption of the mutual fund governance improvement initiative in 2001, it was common practice either for counsel to the management company to also advise the fund board, or for the fund's counsel to also advise the management company. In the past, both the government and the fund industry were of the opinion that the need to disclose potential conflicts of interest and the requirement for client consent to such multiple advisers meant that the rules were sufficiently sound. Before this mutual fund governance amendment, however, it often happened that the fund board voluntarily engaged its own adviser in cases of very blatant conflicts of interest involving the common legal counsel.¹²⁵

Through its mutual fund governance improvement initiative in 2001, the SEC introduced conditionally mandatory independence for external legal counsel to the fund board, among other things. If one or more exemptive rules are being utilized, only independent legal counsel have been permitted since 1 July 2002.¹²⁶ The SEC's justification for this requirement of independence is that funds operate within a highly complex legal framework and are also exposed to conflicts of interest with their investment adviser.¹²⁷ The first of these factors makes the use of legal counsel necessary in the first place, while the second makes their independence from the management company advisable.

A legal counsel is independent if a majority of independent directors determine that any representation of the investment adviser or the principal underwriter or any of their control persons by the legal counsel in question in the past two fiscal years of the fund was sufficiently limited that it is unlikely to adversely affect the professional judgement of the legal counsel in question. The information on the basis of which the independent directors took their decision must be recorded in the minutes of the meeting and re-assessed at least once a year. To be able to make a reasonable decision in the first place, the legal counsel must both provide

¹²² The minimum term of office of directors is one year, with a maximum term of five years (see Section 16(a) Investment Company Act of 1940).

¹²³ See n. 121.

¹²⁴ See n. 121.

¹²⁵ See Roye (1999a).

¹²⁶ The Mutual Fund Governance reform in 2004 made the independence requirement for legal counsel to the independent directors on the fund board part of the 'Fund Governance Standards' (see Rule 0-1(a)(7), 17 CFR 270).

¹²⁷ See Roye (1999d).

the necessary information and also undertake to update this information if the counsel begins to represent, or materially increases his representation of, one of the named legal entities or natural persons. If the independent directors know or have reason to believe that the information provided by the legal counsel is false or incomplete, they may not still base their decision on this information.¹²⁸

The decision by the independent directors must be reasonable and justified and 'consider all relevant factors in evaluating whether the conflicting representations are sufficiently limited'. For example,¹²⁹ the independent directors must consider the following factors when faced with conflicting representations:¹³⁰

- (a) whether the representation is current and ongoing;
- (b) whether it involves a minor or substantial matter;
- (c) whether it involves the fund, the adviser, or an affiliate;¹³¹
- (d) the duration of the conflicting representation;
- (e) the importance of the representation to counsel and their firm (including the extent to which counsel relies on that representation economically);
- (f) whether it involves work related to investment funds;
- (g) whether the individual who will serve as legal counsel was or is involved in the representation.

At EU level, rules governing such legal advisers have not been incorporated into either the UCITS or the Pension Funds Directive. This is logical in that these Directives do not even envisage the appointment of independent directors. During the course of drafting the Pension Funds Directive, however, the consultants engaged by the Commission suggested that directors should be able to obtain support from both internal (management company) and external advisers. An illustrative list of eligible professionals in this context included actuaries, asset managers, custodians, auditors and investment consultants.¹³²

Extended disclosure requirements

One of the objectives of the SEC's mutual fund governance improvement initiative was to provide shareholders with a better basis for evaluating the independence of 'their' directors by extending the information obligations about the fund

¹²⁸ Rule 0-1(a)(6)(i) and (ii), 17 CFR 270.

¹²⁹ The following list contains examples only and is not exhaustive or mandatory (see US Securities and Exchange Commission (2001), footnote 52).

¹³⁰ See US Securities and Exchange Commission (2001).

¹³¹ If an affiliated natural person or legal entity is involved, the nature and extent of the relationship with the fund or the investment adviser must be included.

¹³² See Pragma Consulting (1999), p. V.

directors. The following facts¹³³ must now be disclosed as a component of the SAI¹³⁴ and/or the annual report¹³⁵ and/or the Proxy Statement.¹³⁶

- 1 Management information about the individual members of the fund board and the officers: the following data must be disclosed in tabular form for each of these persons:¹³⁷
 - (a) name, address and age;
 - (b) position(s) held with fund;
 - (c) term of office and length of time served;
 - (d) principal occupation(s) during the past 5 years;
 - (e) number of portfolios in fund complex overseen by director;
 - (f) other directorships held by director.

Except for independent directors, information on any positions as officer, employee, or partner held with affiliated persons or principal underwriters of the fund must also be disclosed.

- 2 The volume of securities held by the director personally or in trust, both in the fund in question, and in the fund complex.¹³⁸ To avoid disclosures that might reveal excessive private data, no precise monetary amounts are required to

¹³³ The following rules are attributable largely to considerations that emerged during the Round Table on Fund Governance Improvement (see Roye (1999a)).

¹³⁴ The SAI is a component ('Part B') of the fund registration statement, which is based on one of the following three registration forms, depending on the fund type involved: Form N-1A, Form N-2 or Form N-3; see the section on Statement of Additional Information, pp. 331ff. All three of these forms were amended as part of the initiative to improve mutual fund governance.

¹³⁵ Items 21(b) and 21(d) on Form N-1A, Item 23 on Form N-2 and Item 27 on Form N-3 (all from 17 CFR 274) stipulate the obligatory financial statement disclosures/items for the annual report.

¹³⁶ 'Solicitation of proxies' (see section 14(a) Securities Exchange Act of 1934) means an attempt to solicit participation at the general meeting or for votes or the appointment of a proxy. The soliciting parties are not exempt from rules, but must – among other things – issue a 'Proxy Statement' containing the most important information that will allow the adequate formation of opinion for a vote. The technical details are stipulated in Rules (Rules 14a-1 to 14b-2, 17 CFR 240), and Schedule 14A, 17 CFR 240, stipulates in great detail on (currently) 38 pages the specific information to be supplied. This schedule was amended as part of the initiative to improve mutual fund governance.

¹³⁷ See Item 12(a)(1) [SAI] and Item 21(b)(5) [Annual Report] on Form N-1A (the amendment actually referenced Item 13 instead of Item 12 and Item 22 instead of Item 21 (see US Securities and Exchange Commission, 2001)); however, another amendment shortly thereafter eliminated Item 5 from Form N-1A and renumbered the subsequent items to match (see VII(14), US Securities and Exchange Commission (2004a)), Item 18.1 and Instruction 4.e on Item 23 on Form N-2, Item 20(a) and Instruction 4(v) on Item 27 on Form N-3 (each from 17 CFR 274) and Item 22(b)(1) on Schedule 14A, 17 CFR 240.

¹³⁸ See Item 12(b)(4) on Form N-1A, Item 18.7 on Form N-2, Item 20(f) on Form N-3 (each from 17 CFR 274) and Item 22(b)(5) on Schedule 14A, 17 CFR 240.

be disclosed; rather, certain 'dollar ranges'¹³⁹ must be identified. Information should be provided as of 'the most recent practicable date' in the case of the Proxy Statement,¹⁴⁰ and as of the end of the most recently completed calendar year for the SAI.¹⁴¹

3 Disclosure of potential conflicts of interest: this hinges around relationships between the independent directors¹⁴² and/or their immediate family members,¹⁴³ on the one hand, and those natural persons or legal entities managing the fund, on the other. Specifically, the following three categories of such relationships must be disclosed as they may affect the fiduciary relationship between the directors and the shareholders:

(a) Professional relationship: all positions, including as an officer, employee, director, or partner held by the director or his immediate family in the two most recently completed calendar years (for the SAI) or in the past five years (for the Proxy Statement) with:

- the fund,
- another fund that has the same investment adviser or principal underwriter as the fund, or whose investment adviser or principal underwriter is controlled by those of the fund,
- the investment adviser, principal underwriter, or affiliated natural person or legal entity of the fund,
- any natural person or legal entity directly or indirectly controlling, or controlled by, or under common control with the investment adviser or principal underwriter

must be disclosed,¹⁴⁴

¹³⁹ See Instruction 4 on Item 12(b)(4) on Form N-1A; Instruction 3 on Item 18.7 on Form N-2; Instruction 4 on Item 20(f) on Form N-3 (each from 17 CFR 274) and Instruction 4 on Item 22(b)(5) on Schedule 14A, 17 CFR 240.

¹⁴⁰ See Instruction 1 on Item 22(b)(5) on Schedule 14A, 17 CFR 240.

¹⁴¹ See Instruction 1 on Item 12(b)(4) on Form N-1A, Instruction 1 on Item 18.7 on Form N-2, Instruction 1 on Item 20(f) on Form N-3 (each from 17 CFR 274).

¹⁴² In contrast to the SEC's original intention, the interested directors are not covered by the conflict of interests disclosure requirement, because the objective is to require the provision of an appropriate decision basis for assessing the degree of effective independence of *uninterested* directors (see E.3.a.1 US Securities and Exchange Commission 2001). Ultimately, the interested directors are by definition in a position that is subject to conflicts of interest.

¹⁴³ Immediate family members are spouses, children and dependents residing in the same household (dependents as defined in section 152 of the US IRC, which extend to all children, grandchildren, (step-)brothers and sisters, parents and grandparents, step-parents, nephews and nieces, uncles and aunts, children, sisters/brothers and parents in law, or other persons residing in the same household who received more than half of their means of subsistence from the supporting person in the last calendar year); see Instruction 1(c) on Item 12 on Form N-1A, Instruction 1(c) on Item 18 on Form N-2 and Instruction 1(c) on Item 20 on Form N-3 (each from 17 CFR 274) and Item 22(a)(1)(vii) on Schedule 14A, 17 CFR 240.

¹⁴⁴ See Item 12(b)(3) on Form N-1A, Item 18.6 on Form N-2, Item 20(e) on Form N-3 (each from 17 CFR 274) and Item 22(b)(4) on Schedule 14A, 17 CFR 240.

(b) equity investments: all direct and indirect investments whose value exceeds US\$ 60,000,¹⁴⁵ of the director or his immediate family members in the two most recently completed calendar years (for the SAI) or in the past five years (for the Proxy Statements) in:

- the investment adviser or principal underwriter,
- or in a natural person or legal entity directly or indirectly controlling, controlled by, or under common control with the investment adviser or principal underwriter

must be disclosed,¹⁴⁶

(c) transactions and relationships:

- all (and any series of similar) direct or indirect transactions during the two most recently completed *calendar* years (for the SAI) or *fiscal* years of the fund (for the Proxy Statement) whose amount exceeds US\$ 60,000 and in which a director or one of his immediate family members on the one hand, and one or more directly or indirectly affiliated natural persons or legal entities involved in the management of the fund¹⁴⁷ on the other, was or will be a party,¹⁴⁸
- in the same way as for transactions,¹⁴⁹ the following types of relationships that exceed routine retail relationships must be disclosed.¹⁵⁰
 - payments for property or services to or by the director by or to affiliated persons of the fund;
 - provision of legal or investment banking services by the director to affiliated persons of the fund;
 - any consulting or other relationships that are substantially similar in nature and scope to the two relationships described above;

¹⁴⁵ In its Rule, however, the SEC makes clear that anti-fraud provisions of federal securities laws may require the disclosure of smaller investments if these represent a material conflict of interests (see US Securities and Exchange Commission (2001), E.3.b.1).

¹⁴⁶ See Item 12(b)(6) on Form N-1A, Item 18.9 on Form N-2, Item 20(h) on Form N-3 (each from 17 CFR 274) and Item 22(b)(7) on Schedule 14A, 17 CFR 240.

¹⁴⁷ In the rule, the persons in question are divided into eight categories, including the fund and its officers, the investment adviser and the distributor or principal underwriter, and the officers of these companies, or natural persons or legal entities and their officers controlling these companies or controlled by them.

¹⁴⁸ See Item 12(b)(7) on Form N-1A, Item 18.10 on Form N-2, Item 20(i) on Form N-3 (each from 17 CFR 274) and Item 22(b)(8) on Schedule 14A, 17 CFR 240.

¹⁴⁹ Meaning that the period involved is also two full fiscal or calendar years, the value of the relationship must exceed US\$ 60,000 and the persons involved must be directors/family members and persons (in)directly involved in the management of the fund.

¹⁵⁰ See Item 12(b)(8) on Form N-1A, Item 18.11 on Form N-2, Item 20(j) on Form N-3 (each from 17 CFR 274) and Item 22(b)(9) on Schedule 14A, 17 CFR 240.

- if an officer of an affiliated natural person or legal entity of the investment adviser was or is a member of the board of directors of a company where the director or an immediate family member of the director was or is an officer during the two most recently completed calendar or fiscal years, this fact must be disclosed.¹⁵¹
- 4 Fund Board and fund governance: both the SAI and the Proxy Statement require the provision of information on the standing committees of the fund board,¹⁵² and the SAI and the (semi-)annual reports¹⁵³ require the disclosure of the case-specific ‘material factors’ and the conclusions drawn from them that formed the basis on which an investment advisory contract was approved or renewed. If applicable, any benefits derived by the investment adviser from the relationship with the fund, such as soft dollar arrangements, must be discussed.¹⁵⁴ Although it is not a component of the relevant rule, the SEC makes clear in its comments on it that, when discussing the reasons behind the decision to renew the contract, in particular the fee levels charged by the investment adviser must also be included.¹⁵⁵

The disclosure requirements outlined above are extremely detailed. Based on the documents and disclosure periods, which differ depending on what has to be disclosed, Table 4.1 illustrates that the underlying rule is so complex that it must surely be too much for the average educated investor without any specific financial and legal expertise. The SEC itself says that it is aware of this problem, because both the SAI and the (semi-)annual reports need only be provided on request, rather than mandatorily as with the prospectus. However, the information contained in the prospectus is not necessarily sufficient to make an informed fund investment decision. For example, there is no list of portfolio positions, but even the information on the effective independence of the board members contained only in the SAI and the Proxy Statement is surely of more than merely minor significance.

Chinese walls and firewalls at the management company

Chinese walls and firewalls denote the functional and organizational separation (especially by the physical separation of the staff concerned) of the

¹⁵¹ See Item 12(b)(9) on Form N-1A, Item 18.12 on Form N-2, Item 20(k) on Form N-3 (each from 17 CFR 274) and Item 22(b)(10) on Schedule 14A, 17 CFR 240.

¹⁵² For each standing committee, its functions and members, plus the number of meetings in the last fiscal year must be disclosed. In the case of a nomination committee, a statement about whether the shareholders may proposed as members and, if so, the procedure for doing so. See Item 12(b)(2) on Form N-1A, Item 18.5 on Form N-2, Item 20(d) on Form N-3 (each from 17 CFR 274) and Items 7(e) and 22(b)(14) on Schedule 14A, 17 CFR 240.

¹⁵³ See Item 21(d)(6) on Form N-1A, 17 CFR 274.

¹⁵⁴ See Item 12(b)(10) on Form N-1A, Item 18.13 on Form N-2, Item 20(l) on Form N-3 (each from 17 CFR 274).

¹⁵⁵ See US Securities and Exchange Commission (2001), E.4.

Table 4.1 Extended disclosure requirements relating to board members: documents and disclosure periods

Information to be disclosed	Document and disclosure period		
	SAI	Proxy Statement	Annual report
Management information	x	x	x
Securities holdings of directors	x	x	
Conflicts of interest:			
Professional relationships	2 calendar years	5 years	
Equity investments	2 calendar years	5 years	
Transactions and relationships	2 most recently completed calendar years	2 most recently completed fund fiscal years	
Committee information	x	x	
Investment advisory contract	x		x

independent departments of a securities firm, with the aim of restricting access to non-published, material information to individuals who necessarily need this information ('need-to-know' principle), thereby preventing the unlawful use of inside information. For example, data from the research or investment banking department of a securities firm should not be passed on to the dealing department because the latter's staff might draw inadmissible advantages from the use of inside information. The dealing room is the primary goal of this screening process, because it contains the people who could most easily misuse inside information.

For the regulation of EU pension funds, a range of internal controls, including structural measures and in particular a division between front office and back office functions as well as regular controls, had been planned,¹⁵⁶ but none of these made their way into the final Directive.

Delegation of functions

Delegation of functions in the case of pillar 2 pension plans in the USA

Occupational pension plans and ERISA-based pension funds can transfer certain functions involving fiduciary responsibility to third parties under certain conditions. As a rule, reasonable care must be exercised when delegating and

¹⁵⁶ See European Commission, Com (1999) 134 final (1999), p. 23.

supervising the function(s) transferred. In particular, ERISA allows fiduciary responsibilities to be delegated in three cases, as explained below.

- 1 Delegation of asset management: only an 'investment manager', defined as a registered investment adviser, a bank or an insurance company (and which must acknowledge in writing¹⁵⁷ its status as a fiduciary), may be the party appointed by a fiduciary to manage the assets of the pension plan.¹⁵⁸ The individual fiduciary is not liable for acts or omissions of the investment manager if he had no knowledge of a breach by another fiduciary or did not enable another fiduciary to commit a breach by failure to comply with his own responsibilities.¹⁵⁹
- 2 Delegation of functions with fiduciary duties not involving asset management: the conditions for delegating such functions are first, a corresponding provision in the bylaws of the pension plan and, second, the definition of a specific procedure for delegating functions in that provision. If the fiduciaries comply with this delegation procedure, they are not liable for acts or omissions of the designated party provided that, when delegating and supervising the exercise of the delegated functions, the fiduciary took reasonable care that there were no breaches of fiduciary duty, the duty of cost management, the document rule, or the prudent expert rule.¹⁶⁰
- 3 The possibility open to defined contribution plans to let the plan members themselves decide (in part or from a range of alternatives) on the asset allocation of their retirement accounts can also be seen as a form of delegation. Some plans, and 401(k) plans in particular, often offer the employees a range of investment alternatives from which they can make a choice. Such pension plans are also termed 'self-directed plans', or '404(c) plans', reflecting the ERISA paragraph that forms the legal basis.

If the pension plan members do indeed exercise this control over their asset allocation, the fiduciaries are generally not liable for any losses resulting from such investment decisions.¹⁶¹ However, if employees do not undertake the asset allocation themselves, the default option applies to their retirement account. Responsibility for the prudent selection and continuous performance monitoring of this default option is then the responsibility of the fiduciary. The fiduciary is thus liable for losses under the default option resulting from a lack of prudence.

The Employee Benefits Security Administration (EBSA)¹⁶² falls under the auspices of the US Department of Labor – which, together with the IRS, is responsible

¹⁵⁷ Section 3 (38) ERISA.

¹⁵⁸ Section 402 (c) (3) ERISA.

¹⁵⁹ Section 405 (d) (1) in conjunction with section 405 (a) (2) and (3) ERISA.

¹⁶⁰ Section 405 (c) ERISA.

¹⁶¹ Section 404 (c) ERISA.

¹⁶² Until February 2003, the EBSA was called the 'Pension Welfare Benefits Administration' (PWBA).

for the legal enforcement of ERISA – and it has issued regulations defining the conditions for effective release from liability as part of 404(c) plans. They start by referring to the features of 404(c) plans: these must provide an opportunity for the member to exercise control over the assets in his individual account and to choose from a broad range of investment alternatives.¹⁶³

- 1 The member can only exercise this control if he has a reasonable opportunity both to give investment instructions¹⁶⁴ and to obtain sufficient information to make informed investment decisions. To satisfy such requirements for information quality, the investment alternatives must be described with respect to their investment objectives and risk/return profiles, and information must be provided on the diversification of their assets and on the related transaction fees and expenses.¹⁶⁵ A description of the annual operating expenses and documents (such as prospectuses and financial statements) must be provided at least on request.¹⁶⁶ Charging reasonable expenses for carrying out investment instructions is explicitly permitted,¹⁶⁷ as are reasonable restrictions on the frequency of investment instructions.¹⁶⁸
- 2 A range of investment options is broad if it offers at least three investment possibilities. Each of these investment opportunities must be diversified and have a materially different risk and return profile.¹⁶⁹ The investment choices offered must enable the plan member to diversify that part of the retirement portfolio which he or she can control by issuing investment instructions to minimize the risk of large losses. Where the portion of the portfolio that the employee can control is so limited in size that such diversification can only be achieved by investment funds or other collective investment vehicles ('look-through investment vehicles'), the plan is permitted to offer investment options consisting only of such investment vehicles.¹⁷⁰

In addition, potential conflicts of interest in the exercise of control on the investment must be considered.

- 1 Exercise of control must be independent to the extent that neither the plan fiduciary nor the plan sponsor may exercise improper influence.¹⁷¹

¹⁶³ Section (b) (1) EBSA, 29 CFR 2550, 404c-1.

¹⁶⁴ Section (b) (2) (i) (A) EBSA, 29 CFR 2550, 404c-1.

¹⁶⁵ Section (b) (2) (i) (B) (1) EBSA, 29 CFR 2550, 404c-1.

¹⁶⁶ Section (b) (2) (i) (B) (2) EBSA, 29 CFR 2550, 404c-1.

¹⁶⁷ Section (b) (2) (ii) (A) EBSA, 29 CFR 2550, 404c-1.

¹⁶⁸ At least three options from the range of investment alternatives must offer an opportunity for issuing an investment instruction at least once every three months (section (b) (2) (ii) (C) (1) EBSA, 29 CFR 2550, 404c-1).

¹⁶⁹ Section (b) (3) (i) (B) EBSA, 29 CFR 2550, 404c-1.

¹⁷⁰ Section (b) (3) (i) (C) EBSA, 29 CFR 2550, 404c-1.

¹⁷¹ Section (c) (1) (i) in conjunction with (c) (2) (i) EBSA, 29 CFR 2550, 404c-1.

- 2 If a fiduciary or an affiliate is the counterparty in an investment transaction, the purchase or sale price may not exceed or fall below the (fair) market price.¹⁷²
- 3 Fiduciaries are under no obligation to provide investment advice.¹⁷³ If they do provide advice to plan members, they can generally be held liable for the advice provided.
- 4 The direct or indirect purchase of real property of the plan sponsor or loans to the sponsor are prohibited.¹⁷⁴ By contrast, the purchase or sale of securities of the plan sponsor – in particular, employer securities – is explicitly permitted subject to certain conditions,¹⁷⁵ and is widespread, especially for 401(k) plans.¹⁷⁶ In fact, the main feature of employee equity compensation programmes in the form of ESOPs is that they invest primarily in securities of the plan sponsor.

Certain investment instructions are always prohibited, especially those listed below.

- 1 Transactions involving the plan sponsor as described above.
- 2 Transactions that would not be in accordance with the governing documents of the plan.¹⁷⁷
- 3 Investments that could result in a loss in excess of the member's retirement account balance.¹⁷⁸

The employee-controlled asset management (of parts) of the retirement portfolio should be seen in an ambivalent light: on the one hand, the extensive freedom of investment that this gives the plan participants enables them to tailor the investment decisions to their personal risk/return preferences. On the other, it cannot simply be assumed that a reasonably large number of the investing employees are actually explicitly aware of their own preferences and also have the asset management expertise to make investment decisions that are compatible with these preferences. Many EU Member States, such as Germany and Austria, have tended to focus their funded pensions legislation on this information or expertise deficit of the average person and rely on what are generally 'nanny state' rules that – especially in the form of obligatory asset value guarantees – offer

¹⁷² Section (c) (3) EBSA, 29 CFR 2550, 404c-1 in conjunction with section 3 (18) ERISA.

¹⁷³ Section (c) (4) EBSA, 29 CFR 2550, 404c-1.

¹⁷⁴ Section (d) (2) (ii) (E) (2) and (3) EBSA, 29 CFR 2550, 404c-1.

¹⁷⁵ The conditions for permitted transactions in employer securities are listed: section (d) (2) (ii) (E) (4) (i) to (ix) EBSA, 29 CFR 2550, 404c-1.

¹⁷⁶ At the end of 2001, employer shares accounted for around 17 per cent of the assets of all 401(k) plans, and 45 per cent of all members of 401(k) plans had the option to invest in employer shares (see Holden and VanDerhei (2003), p. 6 and p. 1).

¹⁷⁷ Section (d) (2) (ii) (A) EBSA, 29 CFR 2550, 404c-1.

¹⁷⁸ Section (d) (2) (ii) (D) EBSA, 29 CFR 2550, 404c-1.

little effective investment flexibility and accept inefficiencies that are likely to jeopardize adequate retirement provision.

The logical solution would be to find a middle way between the US and the European models. This could contain the actual freedom of investment under the US model, but coupled with obligatory basic and continuing education courses on the fundamentals of prudent asset and retirement planning and management. This could limit the inflexible obligation to provide an asset value guarantee to those individuals who are either unwilling or unable to demonstrate their ability to take independent, reasonable investment decisions.

The Enron case has reinforced efforts in the USA to expect or even oblige the sponsors of defined contribution pension plans to educate or advise their employees in this area to a far greater extent in the future, because to date an estimated only 20 per cent of large US corporations offering such pension plans also offers corresponding education or advisory programmes.¹⁷⁹

Delegation of functions for UCITS and IORPs in the EU

UCITS III has extended the scope for investment fund management companies because, under certain conditions, they can now delegate all types of functions to third parties.¹⁸⁰ However, the delegation of functions never affects the management company's liability.¹⁸¹ The management company may only delegate functions if:¹⁸²

- (a) both the regulator and (potential) investors are informed about this (in the prospectus);
- (b) effective supervision of the management company is possible at all times;
- (c) management of the UCITS in the best interests of the investors is not prevented;
- (d) the management company is able at all times to issue instructions to the mandated party and it can 'withdraw the mandate with immediate effect when this is in the interest of investors';
- (e) the mandated party is qualified to exercise the functions delegated to it and is capable of undertaking those functions.

In addition to these conditions, which apply to all potential functions, specific rules apply to the delegation of asset management. For instance, asset management may only be delegated to licensed asset management companies if there are no conflicts of interest between them and the management company and/or the

¹⁷⁹ See Arnone (2002), p. 36.

¹⁸⁰ Directive 2001/107/EC added Article 5g on the delegation of functions to the UCITS.

¹⁸¹ Art. 5g (2) Directive 85/611/EEC.

¹⁸² Art. 5g (1) Directive 85/611/EEC.

shareholders¹⁸³ and they comply with the management company's investment policies.

The provisions of the Pension Funds Directive mean that the delegation of functions is subject only to very light regulation. For the delegation of functions 'of material importance',¹⁸⁴ the regulator must be able to control and impose sanctions on the party or parties to whom the function(s) have been delegated.¹⁸⁵ These include in particular functions such as 'investment management, information technology, or accounting'.¹⁸⁶ Another rule that applies to asset management is that its delegation to duly authorized asset managers 'established in another Member State' must be explicitly allowed.¹⁸⁷

Delegation of functions in the case of VAG pension funds in Germany

VAG pension funds may only delegate functions to third parties if 'the pension fund retains sufficient control of business activities', requiring in particular that 'ultimate control and responsibility' rests with the pension fund, that the mandated person or company 'complies with the pension fund's investment policies' if asset management is delegated, that business documents remain the property of the pension fund and the mandated party may not retain them or the pension fund's contribution income (if its collection is delegated), and finally that the pension fund's right of (extraordinary) termination of the 'function delegation contract' may not be 'unreasonably restricted'. 'Core business functions, such as the establishment of the monitoring system or the definition of the investment policies' may not be delegated.¹⁸⁸

Corporate governance

Asset managers' impact on corporate governance

Corporate governance became a very important issue for US investors in the 1990s. Unprecedented fraud and mismanagement scandals in recent capital market history in the USA, such as Enron, Tyco, Worldcom and others, have seen investors, issuers, analysts, regulators and politicians focusing on corporate governance in their search for ways to restore investor confidence.

¹⁸³ For this reason, the delegation of asset management to the custodian is never permitted (Art. 5g (1) (e) Directive 85/611/EEC).

¹⁸⁴ Recital 25 Directive 2003/41/EC.

¹⁸⁵ There must be an opportunity to supervise those delegated functions 'influencing the financial situation [of the pension fund] or being in a material way relevant for effective supervision' (Art. 13 (b) Directive 2003/41/EC).

¹⁸⁶ See n. 184.

¹⁸⁷ Permitted asset managers are UCITS management companies, licensed investment services firms, credit institutions and life insurance companies (Art. 19 (1) Directive 2003/41/EC).

¹⁸⁸ BaFin (2002), pp. 5f. See also the section in Chapter 5 which presents the rules for the investment principles of VAG pension funds on p. 293.

Institutional investors are extremely influential when it comes to enforcing effective corporate governance. Although Parliament can lay down a theoretical framework in its company, accounting and banking law, it will be ineffective, or at least inefficient, without the corresponding commitment of market participants and analysts. Institutional investors can influence corporate management through their market and securities selection decisions on the one hand, and by exercising the voting power vested in their shareholdings on the other. Poor corporate governance in certain markets or countries, or at individual companies, can be sanctioned by avoiding these markets or securities and communicating the reasons for this to the interested public. Because of their market power and expertise, institutional investors send signals to smaller market participants.

In the case of existing investments, however, influencing corporate management by exercising voting rights conveyed by shareholdings can prove to be the dominant strategy, in particular if it is inappropriate to sell securities because of high transaction costs. By contrast, because of their negligible market power as individuals, the only option open to retail investors is normally to vote with their feet, (i.e., to sell their shares in companies that are not satisfactorily managed).

In the USA, pension funds have a potentially outstanding position as champions of strong corporate governance standards because they hold around one-quarter of the entire US share capital.¹⁸⁹ Calpers, one of the largest US pension funds, is considered to be a pioneer in this field.¹⁹⁰

Proxy voting

The significance of proxy voting

In the past, US and European institutional investors exercised their voting rights only irregularly. Instead of strategic voting patterns, there was often interaction with management only in times of crisis. Such a strategy soon reaches its limits in thin markets, however, especially with small and mid-caps where large block trades can have a seriously negative market impact.¹⁹¹ One consequence of this is that the trade-off with such investments is low liquidity (or that suboptimal management must be accepted as the price for investing in certain markets or stocks), so the only feasible investment targets would then be blue chips. In turn, this would push up the price of blue chips disproportionately (with a risk of overpricing), and, above all, any opportunities to be gained away from large caps would disappear. Moreover, index funds are by definition generally¹⁹² unable to exclude (index) companies that they think are being badly managed from the fund portfolio. The corporate scandals in the USA and Europe in recent years

¹⁸⁹ See Word (2002).

¹⁹⁰ As early as 1984, Calpers committed itself to promoting corporate governance, and established its international corporate governance programme in 1996 (see Calpers (2004a), p. 4).

¹⁹¹ See Schneider and Wünsch (2003), p. 1.

¹⁹² Index tracking using sampling avoids including all index securities in the fund portfolio.

have also heightened awareness among professional asset managers of the need for more active access to corporate governance issues.

These problems highlight the importance of voting. If there is acceptance for this need, the next question to be faced centres around rule-based, transparent voting practice and the associated responsibility of the proxy. The reason for this is that in the USA, proxy voting is a fiduciary duty: because exercise of a voting right has an economic value, votes must be cast in the interests of the shareholders or pension plan members, which in turn means that the fiduciary must gather and analyse all the necessary information about the matters being voted on.

Proxy voting by investment funds in the USA

Since 1 July 2003, US investment funds have been required to adopt written voting policies, and since 31 August 2004 they have been required to disclose their proxy voting record.¹⁹³ The corresponding information must be made available to the shareholders without charge on request by the (investment adviser of the) fund and must be made accessible, again without charge, on the SEC's website.¹⁹⁴ The shareholders must be notified of their right to this information in the semi-annual reports.¹⁹⁵

In addition to improved management of the problem areas described in the previous section, the SEC expects that this amendment will provide greater encouragement for increased involvement in corporate governance issues because of the greater transparency of (the investment advisers of) investment funds due to the new disclosure requirements.¹⁹⁶ The standards for the content of voting policies are relatively succinct and primarily require rules for conflicts of interest. The SEC argues that its rules and regulations are not aimed at mandating the content, but merely at promoting transparency.¹⁹⁷

The procedure for preparing voting policies was not regulated. Based on the principles involved, the fund board would be the logical author. In turn, the general principle would have to be observed that a fiduciary cannot discharge its liability through delegation (to specialized persons or firms). If such advisers are engaged, their supervision must be ensured so that they do not breach fiduciary duties and suitability criteria.

¹⁹³ See US Securities and Exchange Commission (2003e).

¹⁹⁴ Internet-based access uses the SEC's EDGAR data management system (Electronic Data Gathering, Analysis and Retrieval System); <http://www.sec.gov/edgar.shtml>.

¹⁹⁵ For the notice on how to obtain the proxy voting policies, see Item 21(d)(4) on Form N-1A; Instruction 6c on Item 23 on Form N-2; Instruction 6(iii) on Item 27(a) on Form N-3; each 17 CFR 274. For the notice on how to obtain the proxy voting record, see Items 12(f) and 21(d)(5) on Form N-1A; Item 18.16 and Instruction 6d on Item 23 on Form N-2; Item 20(o) and Instruction 6(iv) on Item 27(a) on Form N-3; each 17 CFR 274.

¹⁹⁶ See US Securities and Exchange Commission (2003e), I.

¹⁹⁷ See n. 193.

Specifically, the voting policies must either be described in or attached to the SAI¹⁹⁸ or, in the case of closed-end funds, to the report to shareholders.¹⁹⁹ As a rule, the fund board delegates its voting powers to the investment adviser,²⁰⁰ which means that the voting policies of the investment adviser, if the exercise of voting rights has been delegated to it, or of any other persons or companies who may influence the voting procedure, must be described or attached. The rules explicitly govern voting procedures for votes that present a conflict of interest between the shareholders on the one hand and the investment adviser or principal underwriter, or of affiliated persons of the fund, investment adviser, or principal underwriter on the other. As a typical example of a conflict of interests, the SEC describes the case of an investment adviser that manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund, and the fund's adviser may have an incentive to support management recommendations when exercising its proxy votes, ignoring the interests of the fund's shareholders, to keep its investment advisory contract or enter into a new one.²⁰¹

Although the SEC does not prescribe more specific guidelines or requirements over and above the abstract description of conflict of interest situations, its comments accompanying the final rule under the Investment Company Act do give some examples of content that some funds have previously included in their proxy voting policies on a voluntary basis, and whose disclosure the SEC believes would be 'appropriate':²⁰²

- (a) the extent to which proxy voting decisions are delegated;
- (b) policies and procedures relating to matters that may substantially affect the rights of shareholders;
- (c) policies regarding the extent to which the fund will support or give weight to the views of management of the corporation concerned;
- (d) corporate governance matters, including changes in the state of incorporation, mergers, restructurings and anti-takeover provisions;
- (e) changes to capital structure;
- (f) management compensation, including stock option plans.

The proxy voting record for the most recent 12-month period ended 30 June must be filed with the SEC no later than 31 August²⁰³ and made available to shareholders (without charge) on request. Investors must be notified about this

¹⁹⁸ See Item 12(f) on Form N-1A; Item 18.16 on Form N-2; Item 20(o) on Form N-3; each 17 CFR 274.

¹⁹⁹ See Item 7 Form N-CSR; and the section on Annual and semi-annual reports to investment fund shareholders and supervisory authorities in the USA, p. 319, discusses this reporting form.

²⁰⁰ See n. 196.

²⁰¹ See n. 196.

²⁰² See US Securities and Exchange Commission (2003e), II.A.

²⁰³ The report must be filed with the SEC on 'Form N-PX, annual report of proxy voting record of registered management investment company' (section 274.129, 17 CFR 274). The legal basis is Rule 30b1-4, 17 CFR 270, introduced by the US Securities and Exchange Commission (2003e).

disclosure opportunity in the SAI, and should be told that the proxy voting record may be obtained without charge on request by calling a telephone number, in which case it must be sent within three working days, and/or on the fund's website (again free of charge), as well as through the EDGAR system on the SEC's website.²⁰⁴ In view of the volume of between several hundred and several thousand pages of such proxy voting records, it can be assumed that the funds and their advisers will rely on Internet-based communication. Steps should be taken in this connection to ensure that it is relatively easy to find the proxy voting record, because the wealth of information available on the websites (especially of the large US fund companies and their advisers, which may include other financial services as well as funds) means that trying to locate this information may well turn out to be a more than trivial research exercise. There were no such (SEC) requirements, at least by the end of 2004.

In addition to information that identifies the company concerned, the proxy voting record must include a brief description of the matter to be resolved and whether the resolution was proposed by the company or by a shareholder, whether a vote was cast and if so, how, and whether the vote was cast for or against management.

Instead of a full proxy voting record available on request, the SEC originally intended the obligatory inclusion of a list of votes that did not comply with the proxy voting policies, or cases when no votes were cast, in the semi-annual reports to shareholders.²⁰⁵ Each item would have had to be accompanied by an explanation of why the vote breached the policies or no vote was cast. However, based on feedback from the fund industry and investors, this project was dropped, and the SEC concurred with misgivings that such a rule could encourage the excessively vague wording of voting policies so as to raise the barrier for non-compliant voting, and also felt that the need to filter out non-compliant voting from the large number of decisions taken and the wording of each individual written justification that would be required would represent a very high cost that would be matched by only a relatively low benefit, as such a record would tell investors very little.²⁰⁶

The introduction of obligatory disclosure of proxy voting records – not specifically in the non-compliance form originally planned, but in general – met with strong opposition from parts of the fund industry. However, the SEC countered their arguments most vigorously as follows.²⁰⁷

- 1 The argument that investors are not generally interested in the disclosure of proxy voting records cannot be accepted because of the large number of favourable comments from investors on the proposal.
- 2 Fears that if funds cannot vote confidentially, they will face great pressure by the management of the public companies concerned, are outweighed both by

²⁰⁴ See n. 195.

²⁰⁵ See US Securities and Exchange Commission (2002c), II.B.

²⁰⁶ See US Securities and Exchange Commission (2003e), II.B.

²⁰⁷ *Ibid.*

shareholders' information interests and by the fact that voting is not disclosed *prior to* the vote being exercised in any case.

- 3 The SEC's counter to similar concern that funds' efforts to influence corporate governance matters 'behind the scenes' in confidential meetings with (the boards of) companies would be undermined is that such forms of influence will not be subject to disclosure in the future either, and that it can be expected that the transparency in proxy voting will actually encourage this sort of 'behind the scenes' engagement.
- 4 Concerns that political interest groups could try by means of media campaigns based on voting record disclosure to push through agendas that might run counter to shareholders' interests met with conditional acceptance by the SEC. The SEC will therefore monitor the effects of the new disclosure rules and any unintended consequences and report on this by no later than the end of 2005.
- 5 The SEC's response to the charge that the authority of fund boards would be undermined is that it does nothing to change the board's responsibility for proxy voting. In particular, when proxy voting is delegated to the fund adviser (which is generally the case), continuing oversight by the fund board remains obligatory.
- 6 Finally, the SEC does not concur with the objection that disclosure may impose excessive costs, noting that several funds which have already disclosed their proxy voting records on a voluntary basis commented that the related costs are minimal, and also that the records must only be provided to those shareholders requesting them and not (as originally planned) to all shareholders. The option to publish the records on the Internet also minimizes costs.

Proxy voting by pension funds in the USA

The rule for US pension funds regulated by ERISA is that either the investment adviser can have sole authority to decide voting policies and procedures, or the sponsor reserves the right to determine them and can issue instructions to the management company, which can only refuse to implement them if they would breach the prudence principles or other ERISA regulations. The voting policy statement must be reviewed regularly (which in turn requires precise rules of conduct for the preparation and storage of corresponding documentation); this may result in it being revised, which in practice is normally the consequence of votes on controversial issues.

The matter again at issue in this area of fiduciary duty is the avoidance of conflicts of interest by setting down requirements and prohibitions, as well as disclosure rules. Potential conflicts include, for example, situations where individuals who can influence voting behaviour:

- (a) also have (senior) positions at the companies on which the vote is being taken;
- (b) are shareholders of these companies;

- (c) are personally dependent on them (e.g., as a business partner or borrower);
- (d) have been pressured or even bribed by the management of these companies.

The proxy voting policies of two exceptionally large US pension funds provide good examples here: Calpers, the world's largest pension fund with a reputation for being a corporate governance activist in the USA, and TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund), one of the world's largest financial services companies, which specializes in retirement provision for US teaching and research establishments.²⁰⁸

- 1 The board of directors (meaning the board of the corporation concerned, not a fund board) should adhere to the principle that each share of common stock has one vote and that votes should be resolved by a simple majority of votes cast. Multiple classes of common stock with disparate voting rights as well as super-majority voting requirements should therefore be avoided, except if necessary to protect the interests of minority shareholders.
- 2 The board should adopt the principle of equal financial treatment for all shareholders to limit the corporation's ability to buy back shares from *particular* shareholders at higher-than-market prices.
- 3 Regarding defensive measures to prevent hostile takeovers, TIAA-CREF believes that the market provides appropriate mechanisms for disciplining management, and that takeover defences should not make a board impregnable. TIAA-CREF specifically opposes defensive measures containing provisions that seek to limit the discretion of a future board to modify such measures. Many states have adopted statutes that protect companies from unfriendly takeovers, in some cases through laws that dilute directors' fiduciary obligations to shareholders. Proposals to change the corporation's domicile to another state should therefore be opposed if their purpose is to take advantage of protective statutes. Where possible, the board should opt out of coverage under state laws mandating anti-takeover protection.
- 4 The board should not combine disparate issues and present them for a single vote. An entire proxy issue proposal should be rejected if *any* of the constituent parts are opposed.
- 5 A proposal to increase the authorized number of common shares should be accepted only if they are intended for a valid corporate purpose and are not to be used in a manner inconsistent with shareholder interests (for instance, an excessively generous stock option plan). An increase in the authorized number of preferred shares should be opposed if they can be used without further shareholder approval as part of an anti-takeover programme (for example, for a 'poison pill').

²⁰⁸ See TIAA-CREF (2000) and Calpers (2001).

Proxy voting by mutual funds in the EU

Awareness of the proxy voting issue is far less pronounced in the EU. For example, UCITS are generally prohibited from exercising 'significant influence over the management of an issuing body' through proxy voting.²⁰⁹ In Germany, too, the new BVI code of ethics merely contains the general wording that voting should be 'independent and exclusively in the interests of the shareholder', and normally exercised by the management company itself.²¹⁰

For institutional investors in the UK, on the other hand, influencing corporate policies by selective voting at annual general meetings to enhance shareholder value is an important issue.²¹¹

The essence of future standard-setting

The separation of the asset management and custody functions is essential for preventing abusive practices that damage investors' interests, up to and including embezzlement. Investment funds that are affiliated with banks or that form part of bancassurance groups are an especially fertile ground for such conflicts of interest because the asset management and custody functions in these arrangements are often (at least) closely related. Such (legally) entangled constructions are also particularly susceptible to the problem of affiliated transactions.

A board similar to the US fund board could make a major contribution to managing these conflicts of interest. However, the EU UCITS and IORP (pension funds) Directives do not provide for any such executive body to protect the interests of investors. The (legal) situation in the USA shows that institutionalizing an effective fund board is accompanied there by extremely comprehensive and detailed regulatory measures. This refers not only to the many rights and obligations of the board members, in particular their involvement in transactions exposed to conflicts of interests, but also extends to organizational aspects. These range from (varying) ratios for independent directors through appointment and dismissal arrangements down to the regulation of the board's legal counsel. Not all of these rules can be applied to the EU, but at least a majority of effectively independent board members would certainly be desirable, although a corresponding proposal was not, unfortunately, adopted in the final Pension Funds Directive. Examples of the relevant areas that need not necessarily be regulated in the EU are the board's legal counsel, whose independence in the USA is now becoming increasingly important. In (continental) EU countries, the importance of such legal advisers is certainly far lower because the legal system is an entirely different one which is much less driven by case law, making the need for legal advice superfluous in many cases.

²⁰⁹ Art. 25 (1) Directive 85/611/EEC.

²¹⁰ BVI (2004a), Principle I, p. 4.

²¹¹ See Schneider and Wünsch (2003), p. 1.

Neither would the extremely extensive disclosure requirements for (independent) directors meet across-the-board approval by EU financial service providers. Such far-reaching transparency governing the fund board conflicts especially with the current legal principles and the (communication) practice of the investment and pensions industries, as in Germany and Austria, which are dominated by (the subsidiaries of) the large national 'universal' banks. Of course this would in any case first require the executive or supervisory boards to be endowed with rights and obligations that were at least half-way similar to those of US fund boards.

The objective of transparency for directors in the USA is to ensure that fund boards really do comply with their investor protection function. Even if only a small minority of fund investors actually sifts through the information in practice, it does offer analysts, consumer protection agencies, the financial press and others opportunities for effective control and (indirect) discipline. Giving European fund investors and pension plan members similar information and protection facilities is ultimately in the long-term interests of the EU financial services industry, whose position versus the US competition will otherwise be weakened.

Another problem area that is subject to comprehensive specific regulation in the USA but has attracted very little attention in the EU is the exercise of the fund's proxy voting rights: here, too, the objective is to solve conflicts of interests and ensure the best possible safeguards for investors' interests. Standards in this area must ensure that proxy votes are exercised to reflect shareholder value considerations, and not to support personal or professional interests. Based on the US regulatory framework, the management of such conflicts of interest would entail both the preparation and disclosure of proxy voting policies, and also the publication, in full or in part (based on certain filtering criteria) of the fund's proxy voting record. However, neither lawmakers nor large parts of the financial services industry appear to be broadly aware of this problem, and pan-EU harmonization is likely to be a long way off. This regulatory gap offers yet further scope for profiling voluntary European asset management standards.

DISCLOSURE

Disclosure of all material facts by US fund investment advisers

US investment advisers have an obligation of 'full and fair disclosure of all material facts' as part of their primary duty to safeguard the interests of clients under their fiduciary duties.²¹² This disclosure is made above all by way of the prospectus,²¹³ the SAI,²¹⁴ the semi-annual reports to shareholders²¹⁵ and the

²¹² US Supreme Court (1963).

²¹³ See the section on Prospectuses in the USA pp. 301ff.

²¹⁴ See the section on Statement of Additional Information, pp. 331ff.

²¹⁵ See the section on Annual and semi-annual reports to investment fund shareholders and supervisory authorities in the USA, pp. 319ff.

standardized registration form for investment advisers, Form ADV.²¹⁶ This form must be filed with the SEC on registration²¹⁷ and updated at least annually;²¹⁸ it contains in particular key information about the investment adviser's financial position. It can normally be obtained by the general public from the nearest SEC office.

Valuation of fund assets

The rule for UCITS is that the custodian is obliged to ensure the proper valuation of the fund assets,²¹⁹ although there is no explicit obligation to use market prices. In addition, the issue and redemption price of the fund shares must be published at least twice a month (or even only once a month in approved exceptional cases).²²⁰

The recommendation to the Commission was to require pension fund assets to be marked to market²²¹ and to harmonize valuation rules across the EU.²²² The proposal for valuing derivatives made a distinction between futures, for which the underlying value should be used (for example, using the cost of carry model), and options and warrants, whose market value should be used. However, the significance of this valuation problem needs to be qualified because EU pension funds may only use derivatives for hedging and to 'facilitate efficient portfolio management'.²²³ The final version of the Pension Funds Directive did not feature any valuation rules for assets, but only for liabilities. For example, defined benefit pension plans are obliged to have their policy reserves calculated by 'an actuary or ... another specialist in this field ... on the basis of [recognized] actuarial methods'.²²⁴

In the USA, investment funds are required by law to determine the price (net asset value) of their shares at least once a day. This price is the value of the fund's assets less any liabilities, divided by the number of shares outstanding.²²⁵ US law requires listed securities to be valued at market prices,²²⁶ with a fair value determined for all others in good faith by the fund board (with the assistance of the independent and 'interested' directors).²²⁷ Even if market quotations are available, the fair value method can be used as long as the resulting

²¹⁶ Form ADV, for application for registration of investment adviser and for amendments to such registration statement; 17 CFR 290.

²¹⁷ See section 203 (c) Investment Advisers Act of 1940.

²¹⁸ See rule 203-1 (a) 17 CFR 275.

²¹⁹ See the section on The duties of the custodian in the EU, p. 390.

²²⁰ Art. 34 Directive 85/611/EEC.

²²¹ See Pragma Consulting (1999), p. IV.

²²² See Pragma Consulting (1999), p. 18.

²²³ Art. 18 (1) (d) Directive 2003/41/EC thus followed the corresponding expert recommendation (see Pragma Consulting (1999), p. 18).

²²⁴ Art. 15 (4) Directive 2003/41/EC.

²²⁵ See Investment Company Institute (np, 1999), p. 17.

²²⁶ For ERISA pension funds, there is a corresponding provision in section 103(b)(3)(A) ERISA.

²²⁷ Section 2(a)(41)(A) Investment Company Act of 1940.

value does not exceed the market value.²²⁸ The fair value method is of particular importance in the case of foreign or illiquid securities, or large positions in small caps. The following aspects of the fair value method deserve more detailed explanation.²²⁹

- 1 Good faith valuation: valuation does not necessarily have to be accurate to the *n*th degree, but the process used must be understood by the fund board and determined to be consistent (see below). The fund board cannot waive its duty of prudence by outsourcing (e.g., by engaging specialist pricing services).
- 2 Determination by the fund board: this does not mean that the directors have to discharge a management duty on a daily basis by determining the actual fair value of each security concerned: this would also run counter to their statutory independence because, if the directors essentially become part of management, they can no longer be independent of it. Rather, the responsibility of the directors is to ensure that prices are correct in that they have to understand the pricing process and the methodologies used, and to determine that these are consistent. They are ideally – but not necessarily – assisted here by external advisers or by the establishment of a board valuation committee, which may also consist solely of ‘interested’ directors. It would be impossible in reality to involve the entire board in each individual valuation because the board does not meet in continuous session. Not even any valuation committee is normally permanently available (unless it consists solely of ‘interested’ directors), which is why daily valuations are made by the investment adviser, and specifically by the portfolio managers, who use valuation methodologies that have been reviewed and approved by the fund board. However, because of their inherent bias, excessive reliance on portfolio managers is not desirable (they are, after all, responsible for the decision to buy), and may represent a breach of fiduciary duties by the fund board.

The valuation committee or the entire fund board is only convened when the established methodologies are insufficient in specific instances. If even then no satisfactory solution can be found, it is best not to include the security concerned in the fund portfolio in the first place.

The IRS defines fair value in the USA as the price at which an asset would be exchanged between a willing purchaser and a willing seller if the seller is under no pressure to sell and the buyer is under no pressure to buy, and both parties are reasonably informed about all relevant facts.²³⁰

²²⁸ Section 2(a)(41) Investment Company Act of 1940.

²²⁹ See US Securities and Exchange Commission (1999a).

²³⁰ See IRS Revenue Ruling 59–60, section 2.02.; cited in Rodrick and Rosen (1999), p. 57.

The essence of future standard-setting

In the USA (the EU has not adopted any EU-wide rules here), conflicts of interest between the management company (and its affiliates) and the fund are regulated in a number of ways:

- (a) by (generally case-by-case) prohibitions on certain transactions with an inherent potential for conflicts of interest;
- (b) by disclosure requirements covering (potential) conflicts of interest;
- (c) by the fund board's oversight obligations under its fiduciary duties.

Relying too heavily on disclosure could be risky because the ability of the average investor to process information is limited. Rather, reliance should be placed above all on the fund board and its independent directors, although here too, it is vital to structure the fund board such that there can be no doubt about its integrity and effectiveness. This would also have the advantage of eliminating strict prohibitions, which in turn would help increase the flexibility of the management company and, one would hope, thus enhance performance (and cut costs) for the investors.

The Regulation of Investment Risk

INVESTMENT RULES

Qualitative investment rules versus quantitative restrictions

Efficiency edge of prudential rules

Investment rules for investment and pension funds, regardless of whether they are quantitative, qualitative or a blend of the two, serve to optimize the following conflicting goals: on the one hand, they should make a substantial contribution to safeguarding the assets invested and, on the other, they should offer the fund managers a framework that will facilitate an investment strategy with an optimal risk/return profile. The outcome of managing these conflicting goals is strategic asset allocation. The security aspect tends to be restrictive, while the second objective tends to be associated with freedoms. The main focus of quantitative investment rules is on the security aspect, while qualitative investment rules – that is, being prudent (prudent man rule) – aim in principle to allow the fund managers an investment strategy that is more oriented towards returns.

The European Commission believes that as a rule, the regulatory regime for financial services should be pegged more to qualitative than to quantitative criteria.¹ However, the UCITS Directive does not (yet) reflect this approach. The UCITS III amendment adopted in 2002 authorized the use of derivatives funds and thus intensified criticism of the quantitative risk management approach of the UCITS Directive. 'There is no way in the modern world of trying to define and constrain risk by writing rules around investment powers and borrowing limits

¹ See European Commission, Com (1998) 625 (1998), p. 7.

as UCITS does'. Rather, it is important 'to define financial products ... in terms of the risk and reward outcome'.²

The Commission's intention of squeezing out the traditionally predominant quantitative investment rules in continental Europe and replacing them by qualitative rules is further evident from its belief that 'restrictions imposing arbitrary limits on asset holdings by type of asset, country, or currency distribution run contrary to the prudential principle because they severely limit risk diversification'. The belief stated during the process of drafting the Pension Funds Directive that 'investment rules should not unnecessarily restrict the investment strategy of pension funds'³ reflects the view that pension funds are otherwise forced 'to assume more risks, while sacrificing return, and to conduct investment policies that are detrimental to their members in the long run'.⁴ The Commission itself says that 'experience has shown that over-restrictive investment rules have considerably harmed the yields of pension funds without any gains in security'.⁵ It is even clearer when it notes that stringent limits on the proportion of equities that pension funds can have in their portfolio might not only reduce the rate of return, but could actually even represent 'a threat to security. Such restrictions might prevent investors from benefiting from the euro zone in order to diversify their risks'.⁶ A rigid regulatory system for pension funds would result in lower benefits and/or higher contributions; the latter would further increase the already high burden of non-wage costs and thus negatively impact employment. At the same time restrictions, especially those targeting equity investments, limit the private sector's financing opportunities.⁷

However, the European Commission is aware that pension funds 'make investments in order to meet future obligations'.⁸ The Commission understands that even very slight improvements in the risk/return equation can produce considerable gains for future pensioners,⁹ while at the same time reducing the ever-growing cost of pension provision.¹⁰ The Commission therefore wants to curb quantitative investment restrictions: 'It is the role of the fund managers to determine the best investment strategy for the ultimate benefit of pensioners, subject only to appropriate prudential supervision'.¹¹

² Skypala (2004).

³ European Commission, Com (1999) 134 final (1999), p. 3.

⁴ Solnik 'Fundamental considerations in cross-border investment: the European view', Research Foundation of the Institute of Chartered Financial Analysis, April 1994, cited in European Commission, Com (1997) 283 (1997), p. 11.

⁵ European Commission, Com (1999) 134 final (1999), p. 4.

⁶ European Commission, Com (1999) 134 final (1999), p. 17.

⁷ See European Commission, Com (1999) 134 final (1999), p. 4.

⁸ European Commission, Com (1997) 283 (1997), p. 8.

⁹ Assuming that a supplementary pension is supposed to cover 35 per cent of the previous salary level after 40 working years, a pension contribution of 19 per cent of the salary is necessary (at an assumed return of 2 per cent), but 10 per cent for a 4 per cent return and only 5 per cent for a 6 per cent return (see European Commission, IP/98/447 (1998), p. 2).

¹⁰ See European Commission, IP/98/447 (1998), p. 2.

¹¹ European Commission, Com (1997) 283 (1997), p. 10.

'Sensible'¹² prudential rules would allow pension funds to optimize their portfolio structures by diversifying risk.¹³ 'Pan-European equity, international equity, real estate and fixed income assets'¹⁴ are the investment vehicles explicitly mentioned. Pension funds should be able to select assets that better match the long-term nature of their liabilities and thus reduce risk.¹⁵

The 'Rebuilding Pensions' study also vigorously advocated the view that traditional investment rules should be rejected in favour of freedom of investment, because – together with the need to invest in equity instruments – this is a fundamental requirement for funding future retirement provision.¹⁶ A regulatory regime based solely or primarily on quantitative investment rules sacrifices greater returns and reduced risk because it hinders or even makes impossible the use of what are generally recognized to be efficient investment techniques: both passive portfolio management (implementing Modern Portfolio Theory) and active portfolio management, which casts doubt on this theory, regularly conflict with restrictive quantitative limits. The result is, first, a distortion of competition, because asset managers are largely robbed of the ability to deploy their specialist knowledge, and, second, an environment that favours inertia by preventing the emergence of a developed pension management industry.¹⁷ This thwarts (or at least significantly impairs) the efficient financing of reasonable supplementary pensions.

The outright rejection of quantitative investment rules cannot be the best solution, however. Even Anglo-American pension fund managers investing heavily in equities are not subject to a regulatory regime based exclusively on the prudent man rule. Rather, *supplementing* the prudent man rule by appropriate quantitative limits in certain areas makes sense if the additional security this brings outweighs the related efficiency loss. In addition to the risk management instrument of asset/liability management¹⁸ and a fund board endowed with additional powers and responsibilities,¹⁹ these restrictions aimed at optimizing conflicting goals are fundamental for ensuring the security of pension funds.

The European Commission's move towards the prudent man rule is helped by the fact that pension funds are mainly widespread in those countries in which they are not subject to significantly restrictive quantitative restrictions. Empirical studies confirm that substantial quantitative investment rules restrict asset allocation and that a pension fund governed by a prudent man/investor rule has

¹² European Commission, Com (1998) 625 (1998), p. 12.

¹³ Portfolio theory was developed by Harry Markowitz (see Markowitz, 1952): assuming a risk-averse investor, portfolios are only efficient if the risk cannot be reduced further for a given expected return, or if no higher return can be expected for a given risk.

¹⁴ European Commission, Com (1998) 625 (1998), p. 12.

¹⁵ See European Commission, Com (1999) 232 (1999).

¹⁶ See Pragma Consulting (1999), pp. 17ff.

¹⁷ See Pragma Consulting (1999), p. 20.

¹⁸ See Pragma Consulting (1999), p. 21.

¹⁹ See Pragma Consulting (1999), p. 23.

Table 5.1 Real average rates of return (in local currencies) of the pension fund portfolios of selected countries between 1984 and 1998

Country	Real average return 1984–98 (%)
Belgium ^a	10.33
Denmark	6.14
Germany	6.72
Ireland ^a	12.54
Netherlands ^a	9.64
Switzerland	4.90
UK ^a	10.35
USA ^a	10.49
Prudent man rule countries excl. USA	10.71
Prudent man rule countries incl. USA	10.67
Countries with substantial quantitative investment restrictions	5.92

^a One of the countries that applies the prudent man/person rule.

Source: Pragma Consulting (1999), p. 64

a better performance on average.²⁰ The 4.75 percentage point additional return generated by a pension fund portfolio subject to a prudent man/investor rule that was identified for the survey period 1984–98 (see Table 5.1) was attributable in particular to the high proportion of equities.

These results favouring the prudent man rule must, however, be qualified in that the prudent man rule is not applied in its 'pure' form in any of the countries surveyed, but is supplemented by quantitative restrictions to a varying extent,²¹ especially relating to investments in the securities of the sponsor or an investment concentrated in the securities of a *single* other company (single issuer restriction). Moreover, performance is affected not only by the design of the investment restrictions or freedoms, but especially by differences in valuation, reserve, accounting, tax and actuarial rules. The analysis of aggregated data may also lead to distorted outcomes because the average maturity of the pension funds (the ratio of active to retired fund members) may well differ across national borders, whereby it may be assumed that – all other things being equal – more mature pension funds tend to have a more conservative investment strategy.²²

²⁰ See Galer (2002), p. 64.

²¹ See Galer (2002), pp. 24f.

²² See Galer (2002), p. 26.

Importance of quantitative investment restrictions in the EU

Shortly before the single European currency was launched, the types of investment permitted by the individual Member States varied considerably:²³ the proportion of equities permitted in the UK – and to a lesser extent in Ireland – was high (80 per cent and 55 per cent respectively), but most other Member States required a greater weighting towards fixed-income securities, and in particular government bonds, because only these were available in the volumes sufficient to satisfy demand.²⁴ The European Commission casts doubt on the effectiveness of relaxing or abandoning the existing quantitative restrictions that favour bonds: product providers will not necessarily make use of greater investment freedom in practice because, in many cases, the ceilings of restrictive limits themselves were not fully utilized.²⁵

Efficiency can be ruled out as the cause of this defensive investment policy (meaning efficiency in the sense of the risk/return efficiency of the investor seeking to maximize his expected retirement provision, and not from the perspective of the product provider seeking to maximize its profits). In a market driven by asset value and interest guarantees and informational inefficiency, an investment strategy that minimizes risk may be the dominant one for retirement product providers. If risk/return efficiency does not offer any significant competitive advantage because of informational inefficiency, but at the same time the asset value/interest guarantee is tested once a year (or even more frequently) by the regulator, the loss resulting from the additional capital requirements following a negative test outcome may exceed any gain expected from expanding market share.

A growing awareness of the problem, especially among retirement savers, should see a shift in their demand for retirement provision towards more efficient products. All else being equal, substantial cuts in the level of pillar 1 benefits, coupled with continued inefficient investment in pillars 2 and 3, will give rise to a pensions shortfall in old age. If people draw the appropriate consequences from the perception that the share of pillar 2 and 3 pensions will have to be significant in future if they want to maintain their standard of living at a level similar to today, extremely inefficient retirement products will be far less significant than they are at present. The fact that the long equity market crisis that set in in the spring of 2000 has indeed led to strong demand for products offering capital guarantees does not conflict with this theory by any means, but is rather evidence of the continuing inadequate awareness of the problem.

Similar to restrictions on equity investments, there have also been substantial national differences in the EU regarding limits on foreign investments: British and Dutch pension funds were limited to 30 per cent and 25 per cent of investments in foreign securities respectively, and most other Member States imposed a

²³ This fact applies almost equally to providers of pillar 2 and pillar 3 products.

²⁴ See European Commission, Com (1997) 283 (1997), table IX.

²⁵ See European Commission, Com (1997) 283 (1997), p. 14.

10 per cent limit.²⁶ Following Economic and Monetary Union, the significance of these requirements for investments in matching currencies is no more than minor for euro zone countries. Because there is no longer any foreign currency risk in the euro zone, restrictions to domestic investments are now incompatible with the Single Market.

Investment rules for UCITS and IORPs in the EU

Following its reform by UCITS III, the UCITS Directive uses a purely quantitative approach to investment rules that restricts the flexibility of fund managers in terms of the nature and scope of permitted investment vehicles for considerations of security. Although UCITS III has extended the range of permitted investment vehicles and strategies, the following restrictions remain:

- general prohibition on borrowing with only a few exceptions²⁷
- prohibition on short selling²⁸
- general prohibition on lending²⁹

UCITS III extends the range of eligible investments by the following instruments.

- 1 Liquid money market instruments whose value is determined regularly³⁰ as well as such instruments that are not traded on a regulated market, so long as certain conditions are met.³¹
- 2 Shares of other UCITS,³² normally³³ up to a maximum of 10 per cent of the fund's assets in shares of a single UCITS.³⁴ The general prohibition on investing in funds of funds contained in the proposed Directive³⁵ was deleted in favour of a less restrictive rule that allows investments in funds that invest up to a maximum of 10 per cent in other funds.³⁶ Shares of the same or of an affiliated

²⁶ See European Commission, Com (1997) 283 (1997), pp. 8f.

²⁷ Art. 36 Directive 85/611/EEC.

²⁸ Art. 42 Directive 85/611/EEC.

²⁹ Art. 41 Directive 85/611/EEC.

³⁰ Art. 1 (9) Directive 85/611/EEC.

³¹ Art. 19 (1) (h) Directive 85/611/EEC.

³² Funds of funds have been possible in Germany since April 1998 on the basis of the Third Financial Markets Promotion Act, and by the end of 1999, German investors had already invested €5.83 bn (DM 11.4 bn) in this type of fund. The rule here is that a maximum of 20 per cent of fund assets may be invested in the shares of a single subfund. The share of the fund of funds in the total assets of one of these subfunds may not exceed 10 per cent. If the fund invests in subfunds of the same fund complex as the fund of funds, fees may not be charged twice (see BVI (2000c), pp. 33ff).

³³ The EU Member States may lift this ceiling to a maximum of 20 per cent (Art. 24 (1) Directive 85/611/EEC). The draft Directive still provided for a maximum increase of 35 per cent, but subject to the condition that the UCITS invested in at least five different UCITS (European Commission, Com (1998) 449 final (1998), Art. 24 (2)).

³⁴ Art. 24 (1) Directive 85/611/EEC.

³⁵ European Commission, Com (1998) 449 final, 1998, Art. 24 (3).

³⁶ Art. 19 (1) (e) 4th indent Directive 85/611/EEC.

fund complex may be acquired subject to certain conditions, in particular the waiver of fees and costs.³⁷

- 3 Bank deposits with a maximum term of 12 months,³⁸ with a limit of 20 per cent of the fund assets invested in any single bank, similar to the single issuer limit.³⁹ This enforced concentration on one (or just a few) banks represents a compromise from the corresponding rules in the draft Directive, under which a general limit of 10 per cent was proposed that Member States could lift to 35 per cent if they wanted, in which case the fund would have had to invest in at least five banks that were independent of each other.⁴⁰ The proposed ban on deposits with banks that were also acting as custodians⁴¹ was not adopted in the final Directive.
- 4 Derivatives traded on certain regulated markets and, under certain conditions, over the counter derivatives as well.⁴² The requirement to fully hedge the risks associated with investing in these derivatives by holding appropriate amounts of matching assets, as proposed in the draft Directive,⁴³ was not included in the final Directive.

The freedom of investment (under the prudent man/person rule) that is vital for the efficiency of pension funds was not fully implemented in the Pension Funds Directive to the extent originally envisaged. The proposed Directive still postulated 'a qualitative approach to investment rules':⁴⁴ investment portfolio management should be based on the principles of security, quality, liquidity, return and diversification, rather than on quantitative investment rules.

Although the Pension Funds Directive still follows this approach in principle, it is subject to certain reservations that give the Member States some latitude to dilute this fundamental principle. The efficiency of cross-border EU pension funds may be reduced because they can be subjected to certain specific quantitative limits in the individual countries in which they operate.⁴⁵

Quantitative restrictions for US investment and pension funds

In contrast to continental Europe, where quantitative investment rules predominate, countries with an Anglo-American type of legal system that employs the

³⁷ Art. 24 (3) Directive 85/611/EEC.

³⁸ Art. 19 (1) (f) Directive 85/611/EEC.

³⁹ Art. 22 (1) Directive 85/611/EEC.

⁴⁰ European Commission, Com (1998) 449 final (1998), Art. 24a (1) and (2).

⁴¹ European Commission, Com (1998) 449 final (1998), Art. 24a (4).

⁴² Art. 19 (1) (g) Directive 85/611/EEC. Art. 19 (1) (g) Directive 85/611/EEC imposes minimum conditions on counterparties and the liquidity of OTC derivatives.

⁴³ European Commission, Com (1998) 449 final (1998), Art. 24b (1).

⁴⁴ European Commission, Com (2000) 507 final (2000), p. 7.

⁴⁵ See the section on The prudent person rule in the Pension Funds Directive, p. 151, which describes the possible exemptions to the prudent person rule in detail.

prudent person rule rely primarily on a qualitative, behaviour-driven approach. Even if the prudent person rule is ring-fenced by quantitative investment rules in practice, it gives asset managers a large degree of flexibility in strategic asset allocation.⁴⁶ Quantitative investment rules are ultimately nothing more than legally required strategic asset allocation.

Such quantitative restrictions of the prudent person rule in the USA include, for example, prohibiting US investment funds buying securities on credit⁴⁷ as well as short selling,⁴⁸ or allowing ERISA pension plans to invest in securities or real estate of the sponsor (self-investment) only up to certain percentage limits.

At the end of 1999, almost 75 per cent of US 401(k) pension plan balances were invested in equity instruments. Sensibly, however, the proportion of fixed-income securities rises as the plan member grows older; only 20 per cent of the plan assets of members aged between 20 and 30 was invested in fixed-income securities, but this proportion grew to just over 40 per cent for plan members over the age of 60.⁴⁹

Stocks versus bonds

Historical performance

Investment principles following the prudent man/investor rule offer an opportunity for equity-dominated asset allocation. Compulsory effective risk management is an inherent component of the prudent man/investor rule, so the proportion of equities and their hedging in response to the prevailing equity market situation must be aligned. The advantages of investing in equities lie in the significantly higher expected returns on equities compared with bonds. Exploiting this return advantage is vital for building up an adequate capital stock whilst maintaining contributions at an affordable level. This in turn results in the need to ensure that quantitative rules governing equity investments for retirement investment plans do not go beyond restricting investments in one and the same issuer (especially the sponsor). In particular, this means avoiding restrictions on the aggregate equity component of the portfolio and on investing in foreign equities.

During the course of drafting and reviewing the Pension Funds Directive, the European Commission consequently came down in favour of an investment regime based on the prudent man/investor rule. In this context the European Commission explicitly noted the importance of diversification;⁵⁰ applied properly, it can both cut risk and increase return. In the case of a long-term investment horizon matching the duration of a defined pension benefit, both return and the risk expressed by volatility are more favourable for equity investments than for

⁴⁶ See Galer (2002), p. 44.

⁴⁷ Section 12(a) (1) Investment Company Act of 1940.

⁴⁸ Section 12(a) (3) Investment Company Act of 1940.

⁴⁹ See Investment Company Institute (np, 2000), p. 43.

⁵⁰ For the diversification of pension fund assets of the 11 EU Member States in 1994 plus Japan and the USA in 1994, see European Commission, Com (1997) 283 (1997), table IV.

Table 5.2 Excess returns over corresponding bond market returns in selected equity markets (in local currencies) (%)

	1970–98 (29 years)	1984–98 (15 years)
Netherlands	5.92	7.18
France	4.97	3.12
UK	3.95	3.67
Germany	1.48	4.36
USA	4.79	5.29
Japan	1.92	–3.32

Source: Pragma Consulting (1999), p. 17

investments in government bonds.⁵¹ The express reference by the Commission to the fact that government bonds do not offer security in every macro-economic or capital market situation, because their price falls in response to increases in interest rates and inflation,⁵² is further evidence for the inadequacy of purely quantitative investment rules favouring investments in bonds.

The return advantages offered by equities are further demonstrated by a historical analysis of the higher returns offered by equities compared with bonds (see Table 5.2): in the period 1970–98, return advantages of 1.48 (Germany) to 5.92 percentage points (Netherlands) were observed in the six equity markets. The return advantage is in some cases even more pronounced in the second half of the analysis period, reaching 7.18 percentage points for the Netherlands. In Japan, on the other hand, equities lost out to bonds in the same period as a result of the bear market there since the early 1990s. Note that the statistical significance of this study is limited because the analysis period is before the speculative equity market bubble in the 1990s burst.

The European Commission draws on a US study to support its view that, in a long-term analysis, equities are more secure than bonds: Figure 5.1 shows the risk/return characteristics of portfolios of US equities and bonds distinguished by investment horizon. It is based on performance data for 1802 to 2001. For each of the six different time horizons (1, 2, 5, 10, 20 and 30 years), a curve represents the return and volatility values of those portfolios that shift from a purely equity-based to a purely bond-based investment as a result of a successive change in investment weighting. What is very clear is the time horizon effect on performance (i.e., the risk, measured as the annualized volatility, reduces the longer the investment horizon). This chart shows that during the survey period, and starting with a time horizon of 10 years, US equities are 'just as secure' as US bonds, meaning that they have almost the same volatility, although they generate an annual return some four percentage points higher over the same period. The

⁵¹ See European Commission, Com (1999) 134 final (1999), p. 47.

⁵² See European Commission, Com (1997) 283 (1997), pp. 10f.

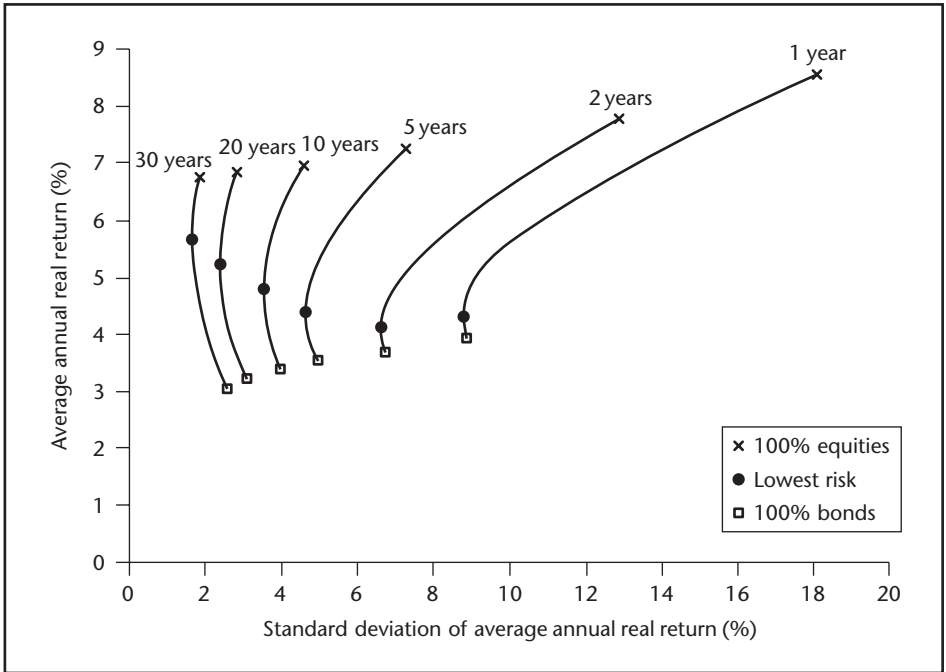


Figure 5.1 Risk/return of US equities and bonds for various investment horizons (1802–2001)

Source: Siegel (2002) p. 37

analysis of even longer periods shows the further superiority of the risk/return profile of US equities over bonds: the average annual return advantage for equities remains around the four percentage point level for 20 and 30 year investment horizons, but the average volatility falls even more conspicuously, so that starting with an investment horizon of 20 years, US equities have a lower average volatility than US bonds. Using volatility as a measure of risk, US equities are thus more secure than US bonds for the long investment horizon that is characteristic of saving for retirement. This study is thus a further argument against the frequently advanced claim that equity investment is too risky for retirement provision.

Although US data cannot simply be applied to Europe one-to-one, studies of European capital markets show a similar picture. The analysis of historical performance data of euro-denominated bonds and international equities over a period of 33 years (1970 to 2003) shown in Figure 5.2 demonstrates the long-term return advantage of equity portfolios. This study compares euro-denominated bonds, specifically German government bonds represented by the German government Bond index REX, and international equities, represented by the MSCI World Share Index. It depicts the average values for annual return and annual volatility for five different investment horizons, extracted from rolling 1, 3, 5, 10 and 20 year periods, for five different portfolio mixes in terms of their bond and equity components: the starting point in each case is a 100 per cent

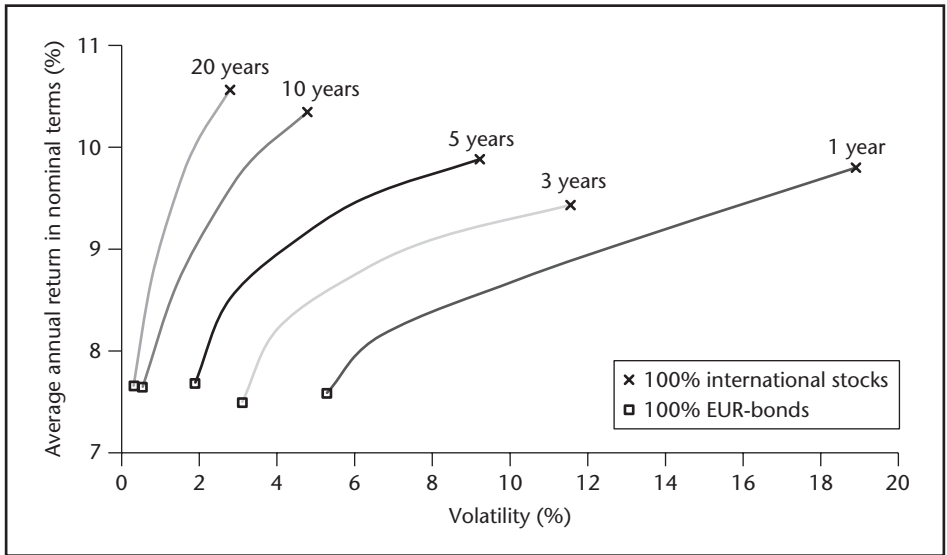


Figure 5.2 Risk/return of five differently structured portfolios for 1, 3, 5, 10 and 20 year holding periods

Note: The five portfolio models are: (1) 100% EUR bonds, (2) 75% EUR bonds plus 25% international equities, (3) 50% EUR bonds plus 50% international equities, (4) 30% EUR bonds plus 70% international equities and (5) 100% international equities.

Source: Kraus (2003), p. 18

euro-denominated bond portfolio, to which international equities are added successively, initially producing a portfolio of 75 per cent euro-denominated bonds and 25 per cent international equities, then a 50 per cent/50 per cent portfolio of euro-denominated bonds/international equities, followed by a 30 per cent/70 per cent portfolio and finally a portfolio with 100 per cent international equities.

The risk/return profile of rolling 10-year observation periods shows a return advantage of international equities over euro-denominated bonds of 2.69 percentage points (10.34 per cent versus 7.65 per cent) for a 4.23 percentage point higher volatility (4.77 per cent versus 0.54 per cent). For a 20-year horizon, the return from international equities was 2.90 percentage points higher than that of euro-denominated bonds (10.56 per cent versus 7.66 per cent), whereby the risk downside of equities shrank to 2.47 percentage points (annual volatility of 2.78 per cent versus 0.31 per cent). Compared with the US data cited above, this produces a picture that is less pronounced in favour of equities, both because the return advantage of equities is lower, and because at least in the 20-year observation period analysed, equities have a higher, not a lower volatility risk than bonds. In contrast to its US counterpart, however, this study also reflects the clearly negative returns following the speculative boom at the end of the 1990s.

As it may be assumed that the volatility downside of equities will reduce further over the sort of longer investment period that is typical for retirement planning, and the return advantage of around three percentage points per annum has a considerable impact on the final value of the capital stock because of the

Table 5.3 The effect of the equity bubble at the end of the 1990s on the long-term average returns on equities and bonds in Germany

Period	Investment period in years	Real return (%)		Return advantage for equities in percentage points (pp) and %	
		Equities	Bonds		
1967–94	28	6.41	3.49	2.92 pp;	83.67%
1967–95	29	6.41	3.86	2.55 pp;	66.06%
1967–96	30	7.04	3.93	3.11 pp;	79.13%
1967–97	31	8.10	3.96	4.14 pp;	104.55%
1967–98	32	8.39	4.16	4.23 pp;	101.68%
1967–99	33	9.20	3.97	5.23 pp;	131.74%
1967–2000	34	8.61	4.11	4.50 pp;	109.49%
1967–2001	35	7.65	4.16	3.49 pp;	83.89%
1967–2002	36	5.68	4.30	1.38 pp;	32.09%

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21; REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7. The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

compound interest effect, equities are an indispensable investment alternative for funded pension provision in Europe as well.

For the German capital market, various studies on the historical performance of German equities and bonds come to the conclusion that over a long-term investment horizon, equities generate significantly higher returns than bonds.⁵³ However, including 2000 to 2002, which were disastrous years (and not only for the German equity market), illustrates the significant effect of longer, unusually pronounced equity market slumps on the average return of even long-term observation periods. Between 1967 and 2002,⁵⁴ for example, an equity portfolio based on the German blue-chip stock index (DAX) generated an average geometric⁵⁵ real return of 5.68 per cent per annum,⁵⁶ while the REXP (performance index for German Government bonds) achieved a real return of 4.30 per cent⁵⁷ in the same period, giving a relatively low 1.38 percentage point lower return for bonds.

⁵³ For an overview of estimated returns on German equities in different periods between 1948 and 1997, see Stehle (1998), p. 826.

⁵⁴ The DAX and REXP values before 1988 are based on back-calculations (see Stehle (1999), p. 10).

⁵⁵ The geometric return (i.e., the n th root of the product of all annual n returns formulated as growth factors [i.e., return + 1]) is the suitable measure for calculating historical returns. By contrast, the arithmetic return, calculated as the mean value of n annual returns, should be used for forecasted returns (see Copeland *et al.* (2000), pp. 218ff.). Except in the case of a time series of constant (annual returns), the arithmetic return always provides a higher value than the geometric return.

⁵⁶ Calculated on the basis of data from Stehle *et al.* (2003).

⁵⁷ For 1967–98, calculated on the basis of data from Stehle (1999); for 1999–2002, taken from REXP, Deutsche Bundesbank (2003b), p. 7.

Successively reducing the time series starting in 2002 back to 1995 (see Table 5.3) illustrates the effect of both the growing bubble in the second half of the 1990s and its subsequent bursting. Although long-term DAX average returns were 6.41 per cent before the bubble, and thus a good 2.5 percentage points higher than the corresponding bond return, the return advantage for equities expanded to more than 5 percentage points for the period 1967–99, with the average equity return in this period rising to 9.20 per cent. Within the space of only five years, the long-term average equity return thus rose by almost 44 per cent, while the rise in bond returns over the same period was only 12 per cent. At the height of the bull market, this then resulted in a percentage long-term return advantage for equities versus bonds of over 130 per cent, almost doubling against the situation before the stock market boom. Once the bubble had burst, the long-term average return then fell more sharply than it had previously risen, finally settling at the 5.68 per cent mentioned above for the period 1967–2002 (i.e., 11 per cent below the pre-bubble average return of 6.41 per cent).

Such extreme changes on the equity market may demonstrate how vital it is to implement appropriate risk management techniques (for all asset classes deemed to be suitable for strategic asset allocation), but they certainly do not mean that equities are not suitable for use as one (of several) investment categories appropriate for retirement provision. A more detailed analysis of the entire period from 1967 to 2002 using Figure 5.4 (p. 237) shows that even an unhedged bond investment suffered negative one-year returns quite frequently. The unhedged equity investment had a negative real return a total of 14 times, while with ten real annual losses, the REXP also implies a significant risk.

For the sort of long-term investments corresponding to the nature of retirement planning, however, one-year observation periods are less useful when making decisions, than investment horizons of up to 50 years, depending on the expected remaining working life. Ultimately, what is of primary importance for retirement savers is the amount available for their retirement at the end of the investment phase, less the interim amounts generated during the investment phase.

However, return comparisons for such long periods that are suited to making forecasts contain two flaws whose optimization is subject to conflicting goals. On the one hand, 'more historical data and/or data from less representative periods'⁵⁸ flow too heavily into the outcome unless special (under-)weighting measures are applied and, on the other, the number of long periods that are independent of each other is usually too low.

Prolonging the time series may lead to a higher number of multi-year periods that are independent of each other, but it exacerbates the problem of a lack of representative periods (too many historical periods). The 36-year time series presented in this section, for example, includes only two independent 15-year periods and only one 20-year period, but it does have the advantage of, for instance, not containing unrepresentative data from the period immediately before, during,

⁵⁸ Stehle (1999), p. 10.

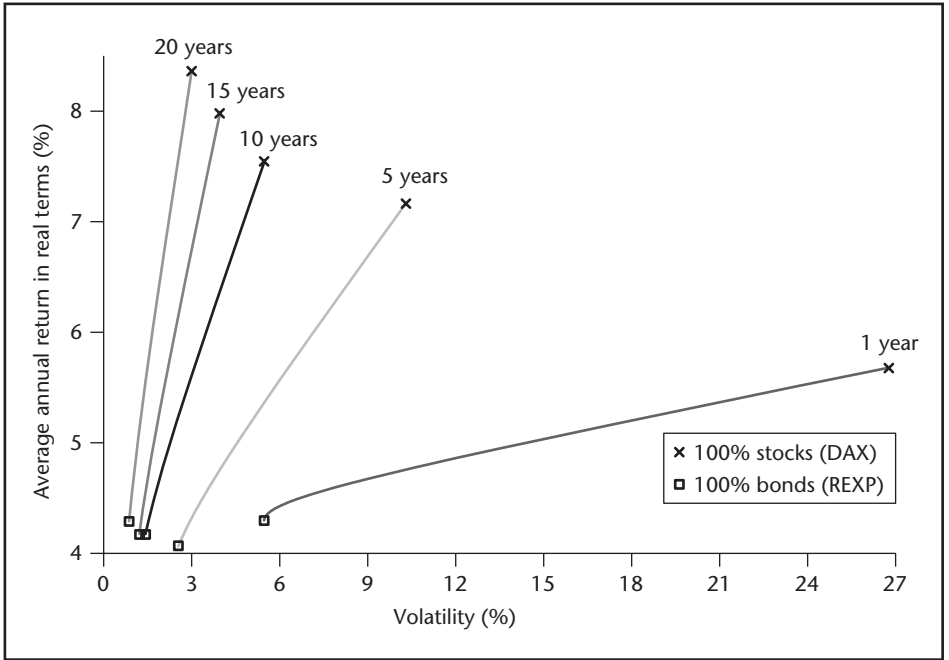


Figure 5.3 Risk/return of German equities and bonds for various investment horizons (1967–2002)

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21;

REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

and immediately after the Second World War. The brevity of the observed time series is countered at this point by the use of rolling multi-year periods. Although this results in the use of largely overlapping multi-year periods, their number is relatively large.

Similar to the chart describing the US capital market (Figure 5.1: see p. 232), Figure 5.3 shows that the risk, measured as volatility, diminishes as the investment horizon grows. At 26.8 per cent, the volatility of a 100 per cent DAX-based equity portfolio is very high for an average return of 5.7 per cent over a one-year horizon, while the REXP volatility is only 5.5 per cent, for a return of 4.3 per cent. Extending the investment horizon to five years changes the picture considerably in favour of equities: both a clear rise in the return 7.2 per cent and a dramatic reduction in volatility to 10.3 per cent are evident for a 100 per cent equity investment, while a purely bond investment not only offers a lower return of 4.1 per cent, but the reduction in volatility to 2.5 per cent is also relatively low. Finally, a look at the 20-year investment horizon shows a return for equities of 8.4 per cent that is almost double the return for bonds of only 4.3 per cent. The most conspicuous feature, however, is that for the 20-year horizon, equities have a very low volatility of 3 per cent (bonds: 0.9 per cent). This figure is only just short of half the volatility of bonds in the one-year horizon. Assuming normally distributed returns and a

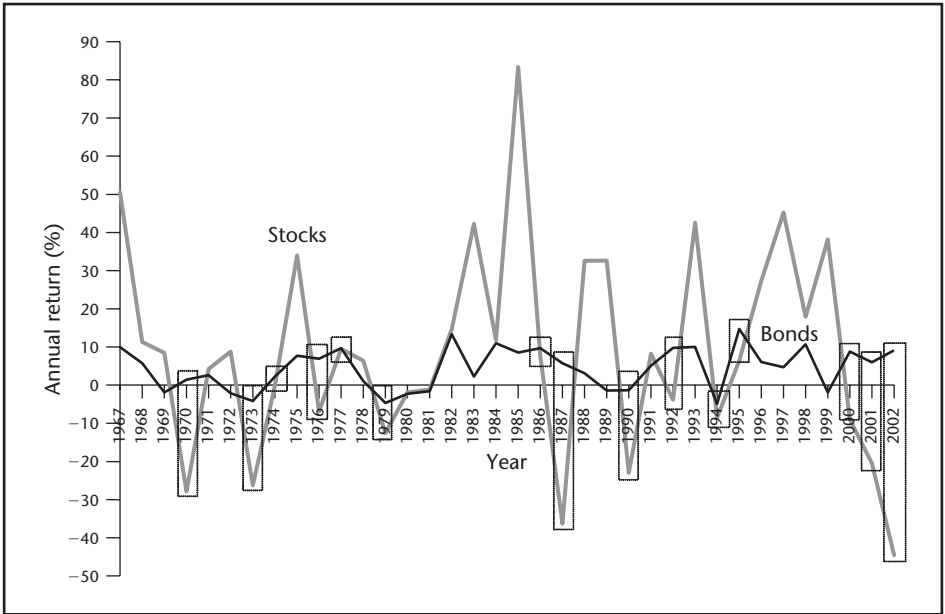


Figure 5.4 1 year return of the DAX and the REXP for the period 1967–2002

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21;

REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

standard deviation of 3 per cent, a mean of 8.4 per cent indicates that there is a good 68 per cent (good 95 per cent) probability that a return in the range of 5.4 per cent to 11.4 per cent (2.5 per cent to 14.4 per cent) can be achieved.

Figures 5.4–8 present an alternative view of the same multi-year periods as in Figure 5.3. Instead of reflecting the characteristics for the relevant investment horizon of the two moments, volatility and expected value, and a successively adjusted weighting of the equity and bond components, the following charts show the historical return characteristics themselves. This enables a direct comparison of the equity and bond returns for each of the 1, 5, 10, 15 and 20 year horizons between 1967 and 2002. By successively extending the investment horizon, the return characteristics increasingly converge on their 36 year mean (i.e., the curves get flatter and flatter). The risk of extreme return outcomes – for risk-averse investors, the downward outcomes are particularly interesting – declines as the time horizon grows. This effect is reflected in Figure 5.3 by the decline in annual volatility as the investment horizon extends.

The subsequent charts then show the number of periods with real value losses for equity and bond investments. Figure 5.4 shows that equities had a negative annual return in 14 of the 36 years, and this was still the case in ten years for bonds. Nine of the 32 five-year periods shown in Figure 5.5 had a negative real return for a 100 per cent equity investment, while this was only the case twice for bonds. When the investment horizon is doubled to ten years, the equity investment still

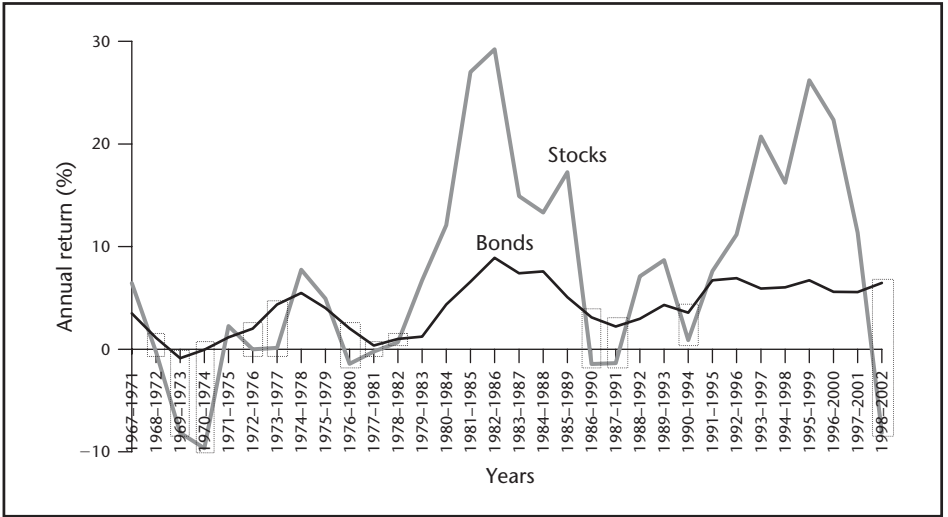


Figure 5.5 Annualized returns of the DAX and the REXP for rolling 5-year periods between 1967 and 2002

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21; REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

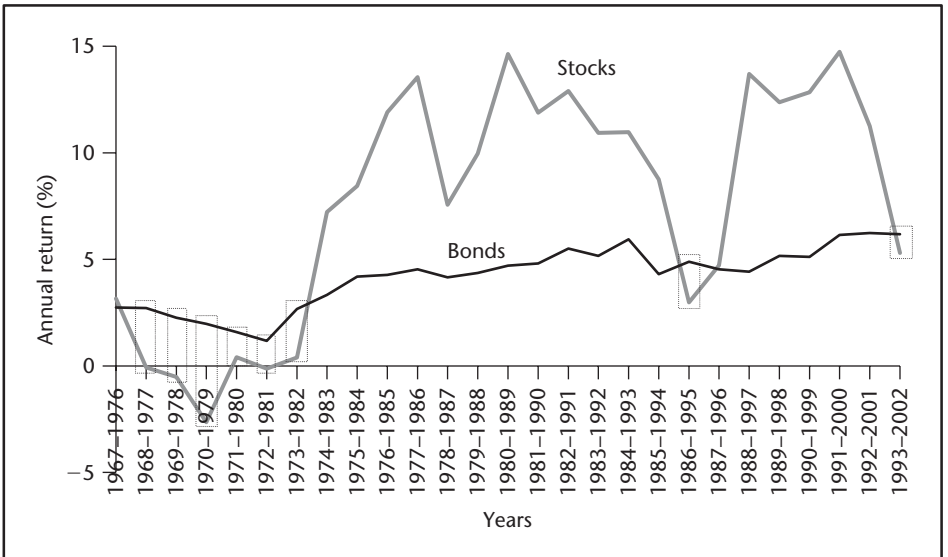


Figure 5.6 Annualized returns of the DAX and the REXP for rolling 10-year periods between 1967 and 2002

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21; REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

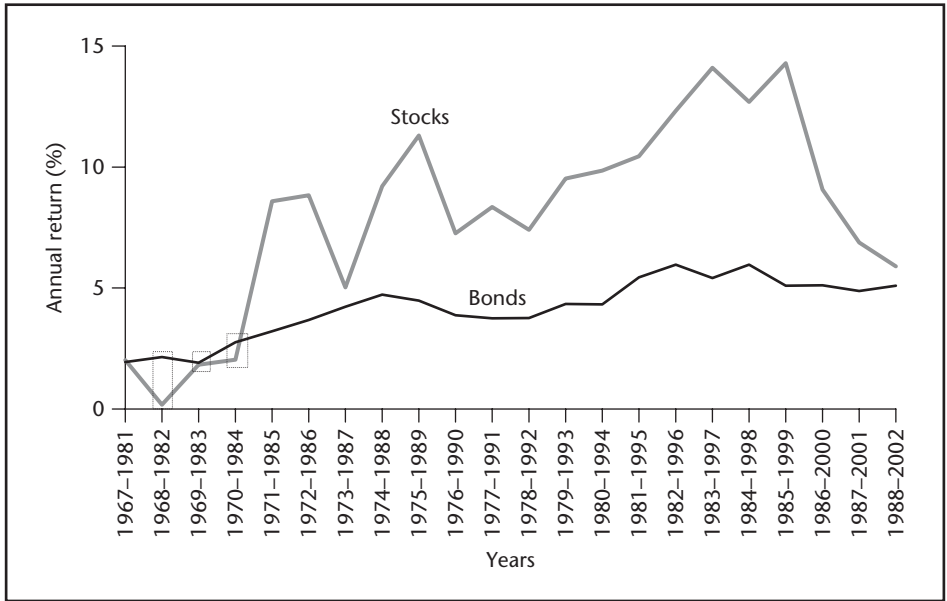


Figure 5.7 Annualized returns of the DAX and the REXP for rolling 15-year periods between 1967 and 2002

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21;

REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

produced a real return below 0 per cent four times, while the bond portfolio did not have a single 10-year loss period (see Figure 5.6). An investment horizon extended by a further five years to 15 years always produced a positive real return even for the 100 per cent equity investment (see Figure 5.7).

In addition to the frequency of the occurrence of negative returns, the frequency of negative return differences between equity and bond investments is also interesting. In Figures 5.4–8, those years or multi-year periods in which the REXP beat the DAX in the previous 36 years on the basis of real returns are therefore highlighted by rectangular markings, whose vertical size is proportional to the extent of the return advantage for the bond investment. For a one-year horizon, bonds generated a better return than equities in 15 of the 36 years (see Figure 5.4), and in 12 of the total of 32 periods for a five-year horizon (see Figure 5.5). The following investment horizons growing in intervals of five years show that those periods in which bonds beat equities based on real pre-tax returns fell from 8 (10 years; see Figure 5.6) through three (15 years; see Figure 5.7) to zero for a 20-year investment horizon (see Figure 5.8).

To sum up, we can say that from an investment horizon of around 20 years, German equities perform better than German government bonds. The return advantage for equities is 4.1 percentage points (8.4 per cent for equities versus 4.3 per cent for bonds) for a higher volatility of a mere 2.1 percentage points (3 per cent versus 0.9 per cent). An original investment amount of €1,000 grew

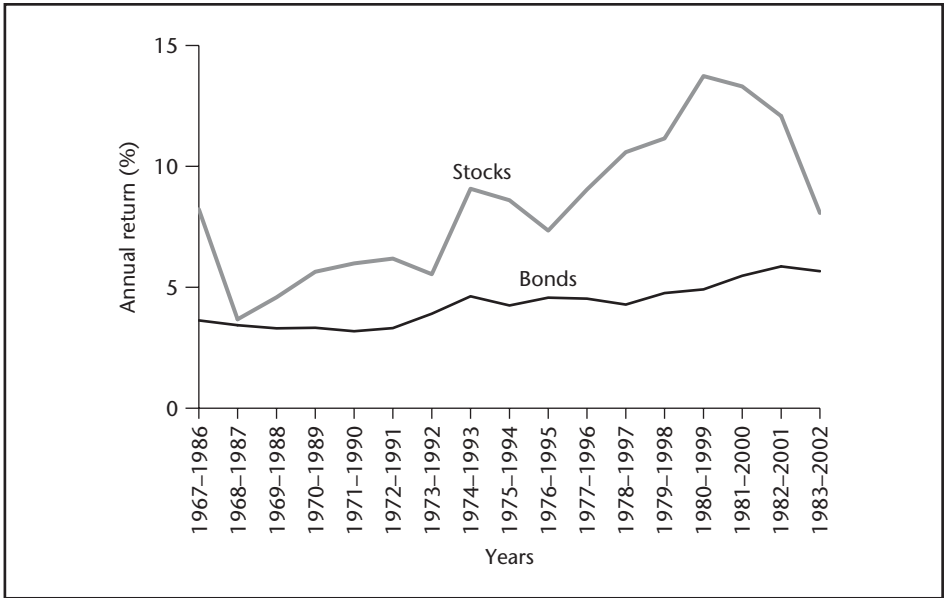


Figure 5.8 Annualized returns of the DAX and the REXP for rolling 20-year periods between 1967 and 2002

Note: For DAX returns, see Stehle *et al.* (2003); for REXP returns for 1967–98, see Stehle (1999), p. 21; REXP returns for 1999–2002 are taken from REXP, Deutsche Bundesbank (2003b), p. 7.

The DAX and REXP values before 1998 are based on back-calculations (Stehle (1999), p. 10).

to €5,019 in real terms if invested in equities, while the same amount invested in bonds only generated €2,321 in real terms. For an equity investment, the real capital growth was thus 204 per cent higher than for a bond investment. A 20-year equity investment also did not record a negative return even once during the period analysed, and thus also consistently outperformed a bond investment by this measure as well.

Time diversification

The issue

The reason for the advantages of equities over bonds in long-term investment horizons may be the ‘time diversification effect’.⁵⁹ Provided that the investment horizon is sufficiently long, years with below-average returns are offset by years with above-average returns,⁶⁰ and there is a very high probability that the expected value can in fact be achieved.

⁵⁹ See Rohweder (2001), pp. 27ff.

⁶⁰ See Kritzman (1994), p. 14.

Table 5.4 Overview of the determinants of the time horizon effect

Investor preferences	Return-generating process	Inclusion of non-investment income	Portfolio rebalancing opportunities
<ul style="list-style-type: none"> ■ Explicit utility function: <ul style="list-style-type: none"> Relative risk aversion Discontinuity^a ■ Ostensibly preference-free approaches^b <ul style="list-style-type: none"> Shortfall probability Drawdown^c Annualized volatility Approach based on option pricing theory/portfolio insurance^d 	<ul style="list-style-type: none"> ■ Random walk ■ Mean reversion ■ Momentum 	<ul style="list-style-type: none"> ■ Aggregate assets as total of investment and human capital ■ Flexibility of labour supply ■ Inclusion of a social security network ■ Consumption financed solely from assets invested 	<ul style="list-style-type: none"> ■ Irrelevance if a risk-free investment possibility is not included ■ Performance enhancement for mean reversion/momentum

^a See Ammann and Zimmermann (2000) p. 416; Kritzman (1994), p. 17; Kritzman and Rich (1998), p. 70; Samuelson (1989), p. 11.

^b 'Ostensibly' because the (implicit) underlying definitions of risk are only compatible with certain utility functions.

^c See Marshall (1994).

^d See Bodie (1995).

The question of whether (and, if so, to what extent) this corroborates the empirical rule that investors with a longer time horizon should hold a higher proportion of equities⁶¹ in their portfolio than investors with a short-term horizon continues to be a matter of controversy in the literature. The 'core question of whether the risk of an equity investment increases, decreases, or remains constant as the time horizon grows'⁶² may receive a different response depending on the assumptions adopted. If the time diversification effect does indeed exist, it implies the efficiency of a growing proportion of equities in the portfolio as the investment horizon increases.

Overview of approaches represented in the literature

Both the existence and the positive or negative characteristics of a time horizon effect cannot be resolved conclusively in isolation from the investor's preferences, the underlying return-generating process, factoring in sources of income other than the assets invested and the admissibility or inadmissibility of interim portfolio rebalancings. Table 5.4 shows an overview of the characteristics of these determinants of the time horizon effect discussed in the following.

⁶¹ The term 'equity' should be seen as a synonym for 'risky asset' in this section.

⁶² Bruns and Meyer-Bullerdiel (2003), p. 54.

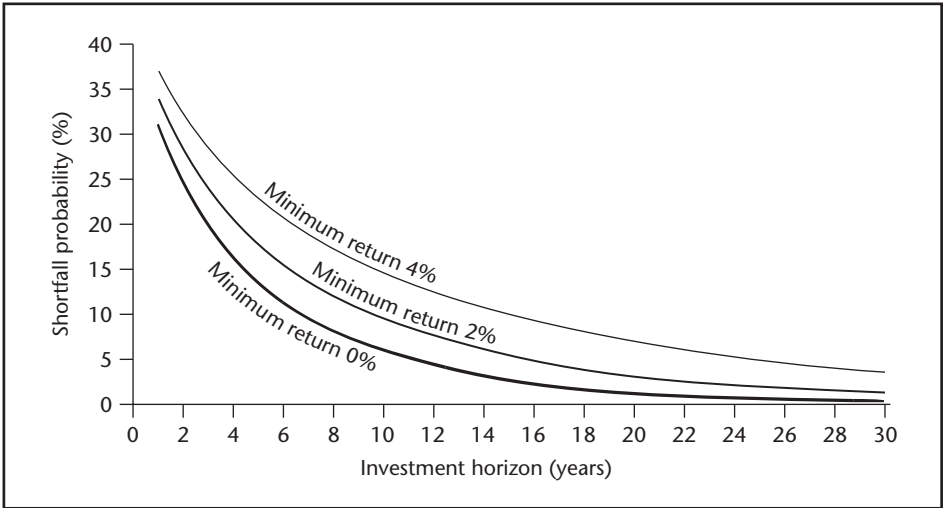


Figure 5.9 Shortfall probability of a DAX equity investment for real minimum returns of 0%, 2% and 4% as a factor of the investment horizon

Source: Albrecht, Maurer and Ruckpaul (2001), p. 486

Ostensibly preference-free approaches

Shortfall probability: Without explicitly implying any utility function, the risk measure of shortfall probability is assumed to be compatible with the preference of typical investors in a number of cases (e.g., stop loss). This measures the probability of falling below a certain minimum return over a specific (multi-period) investment horizon. Assuming stationary and independent (log) normally distributed securities returns, it can be observed that the risk of falling short of a certain minimum return – frequently assumed to be 0 per cent (i.e., nominal capital preservation) – from investments in equities or bonds decreases monotonically with the investment horizon. However, standard parameterization for equity and bond returns produces a considerable difference in the extent of this risk reduction effect. For example, a bond investment exhibits a shortfall probability of very close to 0 per cent even over a medium-term investment horizon, while the shortfall probability for equities is significantly higher than zero even after 20 years.⁶³

Figure 5.9 demonstrates that shortfall probability for equities in terms of real minimum returns slowly falls towards zero over the investment horizon, and that it is still well above zero even after very long periods. The higher the defined target minimum return, the higher that level will be. Note that this is an illustration of real returns: using nominal returns would produce a more favourable trend for equities. The equity return-generating process follows a geometric Brownian

⁶³ See Maurer and Schlag (2003), pp. 9f.

motion that is parameterized on the basis of a (recalculated) DAX time series for the period 1980–2000 adjusted for tax effects and inflation.⁶⁴

The notion that the probability of realizing a nominal negative return is significantly different from zero even for very long-term, 100 per cent equity investments, is termed the *persistence of risk*. Depending on the underlying assumptions, there are different views in the literature of the extent of this persistence. A much discussed study by Salomon Brothers belongs to the upper end of the range, with its probability estimate that US bonds outperform US equities even after 30 (20) years by a factor of 21 per cent (25 per cent).⁶⁵ However, the following constraints should be noted:

- (a) because of the right skew of the final value distribution for equities, there is a high probability that their value will exceed that of the bond investment by a multiple;⁶⁶
- (b) the outcomes are highly sensitive to the level of the underlying risk premium (i.e., higher risk premiums lead to substantially lower equity underperformance probabilities);⁶⁷
- (c) and in reality, portfolio rebalancing represents an opportunity for reducing the probability of extreme losses.⁶⁸

A major criticism advanced by other researchers is that the return model used for the Salomon study includes mean reversion for the bonds, but not for the equities, so that it is more or less inevitable that the long-term shortfall probability of equities versus bonds will be massively overestimated.⁶⁹ This is inevitable because, all else being equal, the spread of the final assets will be lower for mean reversion compared with a random walk.

A follow-up study by Salomon Brothers contains the claim that the persistence of the equity investment risk is largely independent of the return-generating process, but the evidence advanced to support this is relatively thin: the authors cite simulation outcomes from a random walk assumption that do indeed vary only insignificantly from the mean reversion outcomes for a five-year time horizon.⁷⁰ But whereas the emphasis is placed on the 20 and 30 year periods for the mean reversion case, there are no outcomes beyond the five-year horizon for the random walk model.

⁶⁴ See P. Albrecht, Maurer and Ruckpaul (2001), p. 483. A similar study that parameterizes by applying an equally structured (recalculated) DAX time series uses the period January 1973 to December 2001 and reaches similar results (see Maurer and Schlag (2003), p. 8).

⁶⁵ See Leibowitz and Krasker (1988). Based on independently log normal distributed returns and a constant risk premium of 4 per cent p.a. (see Leibowitz and Krasker (1988), pp. 41f).

⁶⁶ See Leibowitz and Krasker (1988), p. 44.

⁶⁷ *Ibid.*, p. 46.

⁶⁸ *Ibid.*

⁶⁹ See Ambachtsheer (1989).

⁷⁰ See Leibowitz and Langetieg (1989), pp. 64–6.

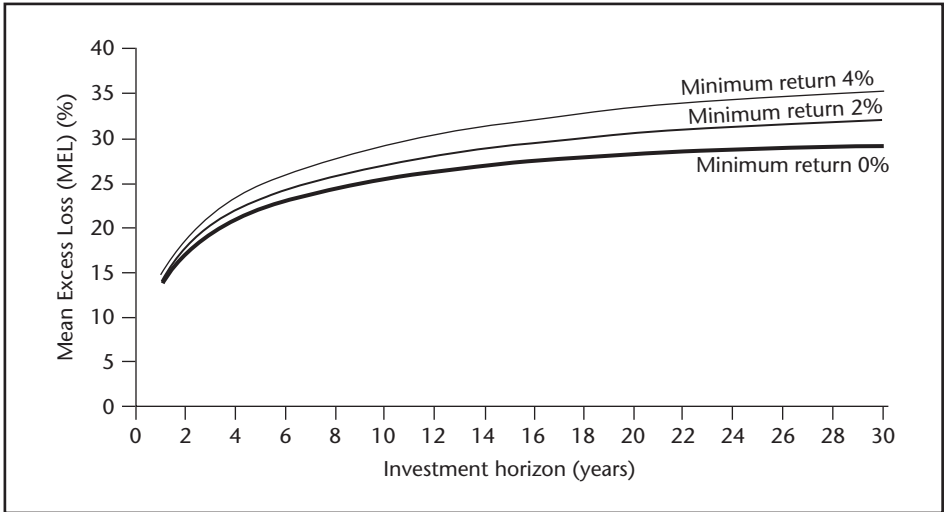


Figure 5.10 Mean excess loss of a DAX equity investment for real minimum returns of 0%, 2% and 4% as a factor of the investment horizon

Source: Albrecht, Maurer and Ruckpaul (2001), p. 487

In turn, another study demonstrates that if real, rather than nominal, capital preservation is defined as the objective, the shortfall probability is more than 2.5 per cent even for a 100-year investment horizon, assuming a risk premium of 5 per cent, a standard deviation of 20 per cent, and that the risk-free rate is exactly that rate needed for real asset preservation.⁷¹

If an investor is willing to accept this shortfall probability even in the long term, this decision may be based on a risk illusion if the investor is not aware that the declining probability of loss as the investment horizon grows is accompanied by a growing potential loss.⁷² This growth in the potential loss over the investment horizon is due to the fact that asset distribution for short investment horizons lies closer to the mean than for long horizons, which are exposed to random fluctuations over a longer period.

The extent of the loss with respect to a specific target minimum return can be quantified by the shortfall expectation (SE). The SE is the product of the shortfall probability and the mean excess loss (MEL),⁷³ where MEL represents conditional SE (i.e., the average value-at-risk in the event of a shortfall).⁷⁴

More realistic equity return model parameterization⁷⁵ shows that although the shortfall probability falls slowly towards zero, the MEL actually increases on a

⁷¹ See T. Albrecht (1999), pp. 40f.

⁷² See Kritzman (1994), p. 15; Kritzman and Rich (1998), p. 67.

⁷³ Synonyms for MEL in the literature are cVaR, mean shortfall and Tail VaR (see Rockafellar and Uryasev (2000b), p. 21).

⁷⁴ See Maurer and Schlag (2003), pp. 6f.

⁷⁵ See n. 64.

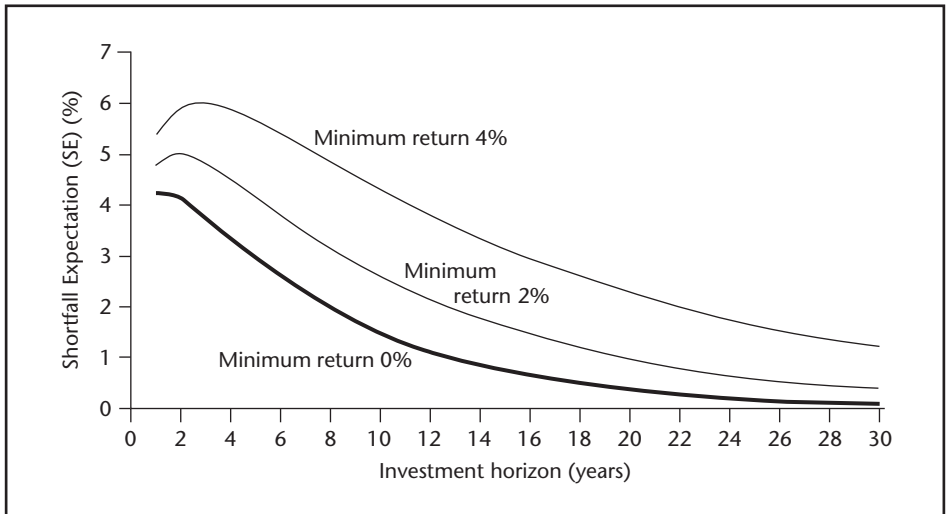


Figure 5.11 Shortfall expectation of a DAX equity investment for real minimum returns of 0%, 2% and 4% as a factor of the investment horizon

Source: Albrecht, Maurer and Ruckpaul (2001), p. 487

diminishing scale. Figure 5.10 shows a graphical representation of this increase in risk over the investment horizon. There is an intuitive assumption that the mean excess loss increases with the required (real) minimum return.

Aggregating the contrary developments of the two risk measures, shortfall probability and MEL, using the SE shows that the risk-mitigating effect of the shortfall probability with a growing investment horizon more than offsets the opposing risk-enhancing effect of the increasing MEL, and that following a temporary increase in the short-term investment horizon range, the SE then decreases on a diminishing scale.⁷⁶ Figure 5.11 shows this trend using an equity return-generating process calibrated by means of real DAX returns.⁷⁷ In the same way as the shortfall probability, the shortfall expectation also reveals a persistence level that is dependent on the selected minimum return.

The weaknesses of the shortfall probability approach are thus, first, that merely observing the probability of a shortfall without quantifying its extent is hardly an appropriate risk measure,⁷⁸ and second, that it is not possible to define a meaningful threshold value whose shortfall must be avoided within the bounds of this model. An acceptable time horizon effect on the basis of the shortfall probability concept is thus possible only if it is assumed that the investor prefers merely to minimize the probability of loss, while being indifferent to the actual loss itself. Falsifying such a time horizon model is trivial because there are investors

⁷⁶ See Maurer and Schlag (2003), pp. 10–12.

⁷⁷ See n. 75.

⁷⁸ See Bodie (1995), p. 19.

for whom the loss determines the utility. This produces an implicit preference dependence of the shortfall probability criterion.

Drawdown criterion: In the same way as the shortfall probability, drawdown is a measure of downside risk, and its development over the time horizon may shed light on the time diversification question. Drawdown quantifies the maximum loss at a certain confidence level as a percentage of the initial capital at the end of the investment horizon.⁷⁹ Assuming stationary and independent log normally distributed returns,⁸⁰ the drawdown criterion suggests a more aggressive (i.e., more equity-heavy) portfolio composition as the investment horizon increases.

This survey design is a modification of the shortfall probability approach and equally ignores the (worst case) shortfall. However, the extent of the loss for the 5 per cent probability case that is evidently classified as negligible⁸¹ would additionally have to be quantified to produce a comprehensive risk estimate.

Annualized volatility: Assuming (log) normally distributed returns and ignoring the compound interest effect, the expected cumulative return rises together with the investment horizon (see Equation 5.1), while the cumulative standard deviation only rises on a diminishing scale (see Equation 5.2). The worst case return (WCR), quantified as the difference between the cumulative return and the cumulative standard deviation weighted by the confidence parameter (see Equation 5.3), decreases initially, but then starts rising monotonically from a certain point (i.e., a certain investment horizon). This rise indicates that for a given confidence level, the cumulative return more than offsets the cumulative volatility risk starting at a certain investment horizon.

$$\text{Cumulative return } \mu_n = \mu \cdot n \quad (5.1)$$

where: μ = Expected annual return
 n = Investment horizon in years

$$\text{Cumulative standard deviation } \sigma_n = \sigma \cdot \sqrt{n} \quad (5.2)$$

where: σ = Annual volatility
 n = Investment horizon in years

$$\text{Worst case return } WCR_n = \mu_n - \lambda \cdot \sigma \cdot \sqrt{n} \quad (5.3)$$

where: λ = Confidence parameter
 σ = Annual volatility
 n = Investment horizon in years

This is illustrated in more concrete terms by the following calculation (based on the aforementioned equations) indicating the greater gains from an investment

⁷⁹ See Marshall (1994), p. 569.

⁸⁰ *Ibid.*, p. 562.

⁸¹ The underlying drawdown parameters are a maximum loss of 10 per cent of the initial capital and a 5 per cent significance (see Marshall (1994), p. 570).

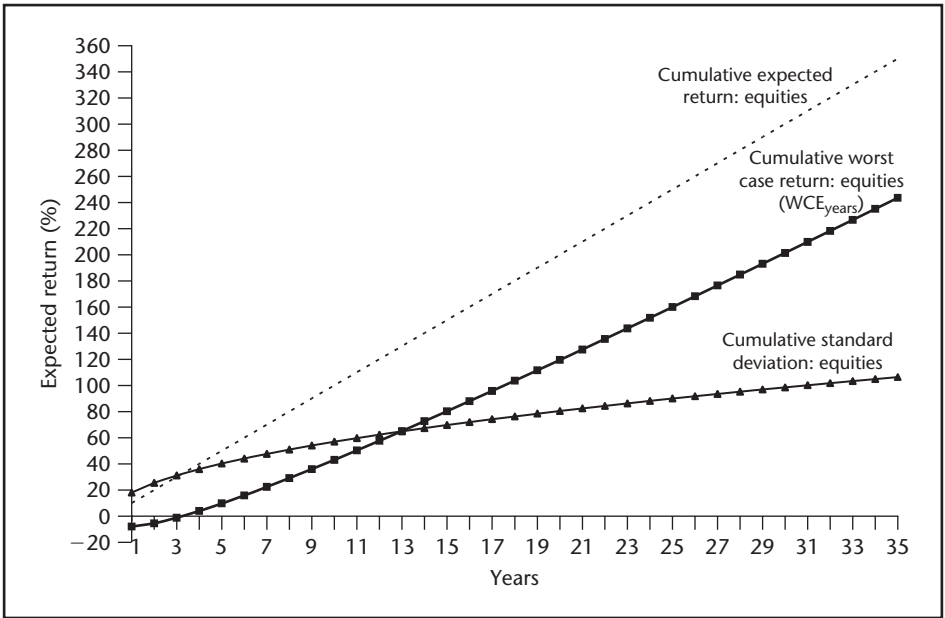


Figure 5.12 Worst case equities scenario over 35 years: calculations based on expected return 10% per annum with 18% volatility, worst case is one standard deviation below the expected return

in equities versus an investment in bonds over a long-term period: an expected return of 10 per cent per annum and a volatility of 18 per cent per annum is assumed for equities, and a 5.5 per cent annual return and 4.5 per cent volatility for bonds. The objective is to identify the minimum investment horizon that is necessary for equities to outperform bonds *in the long term* despite the negative equity scenario described in the following. The scenario adopts a sceptical position on equities by expecting the worst case development for equities, marked by long-term *underperforming* of the aforementioned expected return by one standard deviation (see Figure 5.12), but the best case for bonds (i.e., *outperforming* by one standard deviation: see Figure 5.13).

The solution shows that under these unfavourable conditions, equities need an investment horizon of at least 25 years (see Figure 5.14) to outperform bonds. In this respect, this outcome is clear confirmation for equities as an efficient retirement provision asset because the typical time horizon for retirement planning is well over 25 years.

A risk premium of 4.5 per cent was assumed in the case presented above. The time horizon effect displays a significant sensitivity to the risk premium, which means that the amount of the risk premium plays a major role when assessing the time horizon effect: the higher the risk premium, the lower the risk over longer time horizons of falling short of a risk-free alternative return.

As discussed in the section entitled Historical performance, pp. 230ff., the return and thus the risk premium forecast on the basis of historical time series are

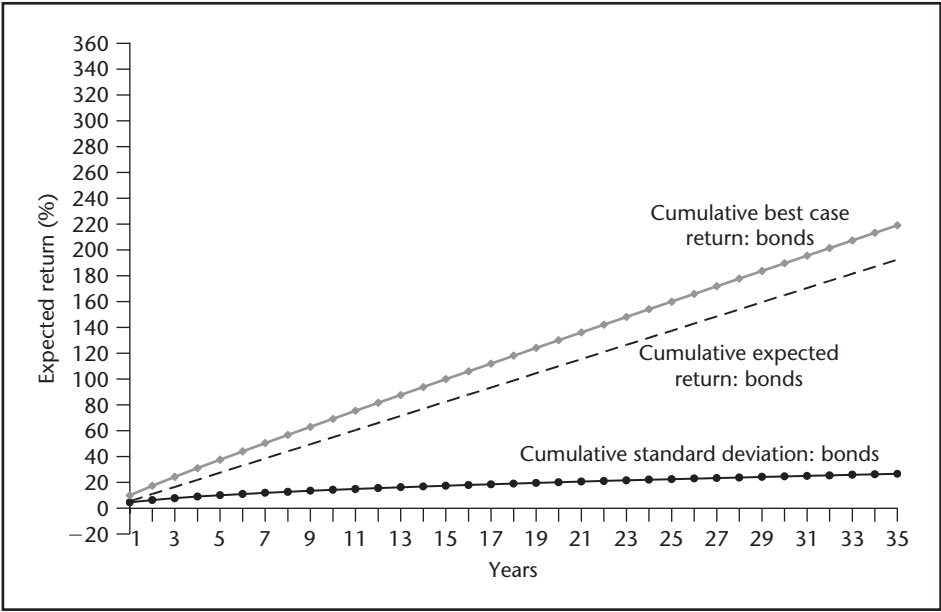


Figure 5.13 Best case bonds scenario over 35 years: calculations based on expected return 5.5% per annum with 4.5% volatility, best case is one standard deviation above the expected return

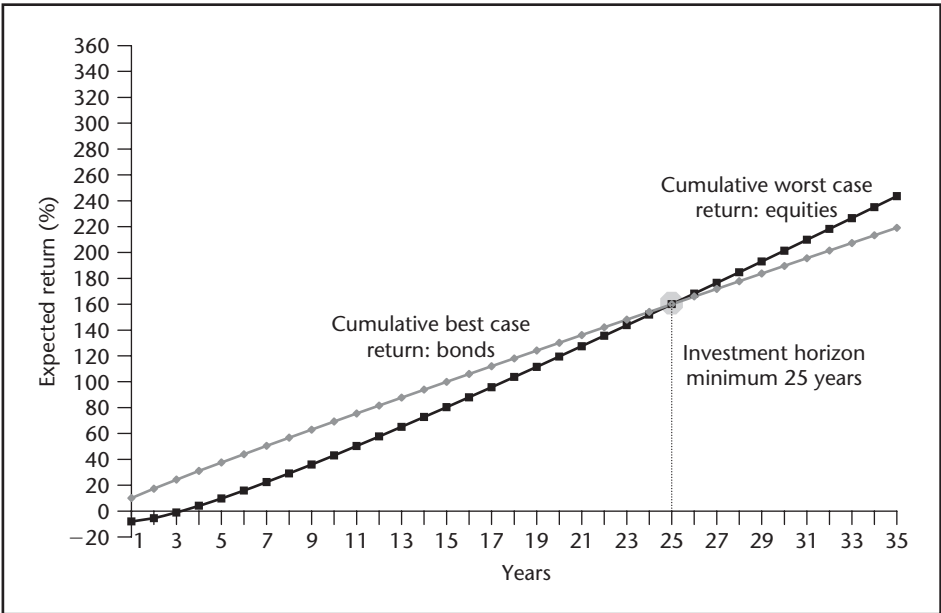


Figure 5.14 Worst case equities versus best case bonds, 35-year horizon

associated with sometimes serious estimation errors. There are no long time series available which in practice represent any adequate protection against such errors. Even slight increases/decreases in the length of time series have a considerable effect on the average return. For example, a one-year reduction of an originally 44-year DAX time series (1954–97) results in a geometric average return that is 1.3 percentage points lower: 10.9 per cent for 1954–97 versus 9.6 per cent for 1955–97. A further reduction by one year to 1955–96 even cuts the geometric average return to 8.9 per cent. A 2.3 per cent or 4.5 per cent time series decrease thus cuts the geometric average return by 11.9 per cent or 18.3 per cent.

Purely historically based return forecasts can thus normally provide only very broad estimation *intervals*. However, the methodological alternative of proposing analytical methods to determine a 'plausible' risk premium is also problematic because of the necessary parameter estimations required, which are subject to considerable uncertainties. The independent parameters to be estimated for such return forecasting models include in particular the utility function and the structure of the various investment forms, while the objective is a market-clearing return.

In the same way as the two risk concepts of shortfall probability and draw-down, using annualized volatility or the best case/worst case comparison ignores the actual amount of any loss, so the use of more complex risk models appears to be advisable.

Approach based on option pricing theory: An approach to the time horizon debate that is rooted in option pricing theory is based on the assumption that as the investment horizon increases, an equity investment would only become less risky if the costs of hedging (such that the investor does not receive less than the risk-free rate) were to decrease as the investment horizon increases. However, the fact that the price of put options – a suitable hedging instrument for this type of strategy – increases the longer the maturity (as shown by arbitrage-free valuation models, such as Black-Scholes) can be interpreted as the counterevidence for time diversification, under both a random walk and a mean reversion assumption.⁸²

This evidence against time diversification based on the concept of portfolio insurance has not gone uncriticized in the literature. For example, the rising costs of hedging as the investment period grows are accompanied by simultaneously rising (return) opportunities from the equity investment that may well more than offset the former. Again, the principle applies that no clear statement can be made as to whether the equity investment becomes more attractive over time or not without factoring in investor preference.

Another criticism of this approach is that the risk definition modelled using option pricing theory, which quantifies risk as realizing hedging costs at less than the risk-free rate, is not proof of a growing investment risk for equities as the time

⁸² See Bodie (1995), pp. 19f. Individual human capital must also be considered in asset allocation, meaning that as a rule, relatively low-risk high human capital in early years is combined with a higher proportion of equities than in later years.

horizon increases, but merely shows that the option price rises together with the cumulative volatility of the underlying.⁸³ This means that the option pricing theory approach does not provide any evidence that time diversification does not exist, but is merely tautological.⁸⁴

An allegedly preference-free option pricing theory-based approach that builds on the above model selects Protected Equity Notes (PENs) as 'evidence' in favour of the time horizon effect. These instruments guarantee a minimum rate of return below (!) the risk-free rate, financed by a participation of less than 100 per cent in price rises. The evidence for the existence of a time horizon effect is that applying Black-Scholes option pricing to longer-term PENs produces significantly higher participation rates than for short-term instruments, and that this price structure can also be observed on actual traded PENs. The preference independence, according to the claim, is because PENs can be constructed from a portfolio of either zero bonds and calls, or equities and puts, so that solely arbitrage considerations play a role.⁸⁵

Similar to the criticism of the portfolio insurance model described above, the preference freedom here is also only alleged, because in fact a utility function is implied that interprets risk solely as falling short of a defined minimum return. Moreover, falling equity investment hedging costs cannot necessarily be derived from participation rates that grow with the time horizon. Because PENs only hedge minimum returns below the risk-free rate,⁸⁶ there are significantly higher opportunity losses (compared with the risk-free rate) as the term increases. These (potential) losses compared with a risk-free investment would have to be added to the budgetary hedging costs.

Explicit utility function: Depending on how the investor's underlying utility function is structured, an increasing, constant, or even decreasing attractiveness of the equity investment can be inferred the longer the investment horizon. This poses the question of which is the right utility function (i.e., the one that most accurately reflects the investor's actual preferences). However, it is evident that no empirically clear answer to this question can be identified.

Preferences and thus utility functions can be classified by the two Arrow-Pratt measures of absolute and relative risk aversion:⁸⁷ equation 5.4 shows absolute risk aversion (ARA) as the change in the marginal utility divided by the marginal utility. ARA is the measure of the risk aversion for a certain level of wealth. The individual is risk-loving/risk-neutral/risk-averse depending on whether ARA is negative/equal to zero/positive.⁸⁸ For example, an investor characterized by

⁸³ The diversification of the final asset rises proportionate to the square root of the time horizon expressed as periods.

⁸⁴ See Kritzman and Rich (1998), pp. 70ff.

⁸⁵ See Merrill and Thorley (1996), pp. 14–17.

⁸⁶ However, this is explicitly noted by the authors (see Merrill and Thorley (1996), p. 15).

⁸⁷ See Arrow (1965); Pratt (1964).

⁸⁸ A risk-loving person prefers a fair lottery to a secure amount equal to the expected value; a risk-neutral person is indifferent in this respect; and a risk-averse person prefers the secure amount.

decreasing absolute risk aversion (the power utility function depicted in equation 5.5 is an example) attaches decreasing importance to a constant absolute loss of wealth as his wealth grows. On the other hand, the quadratic utility function shown in equation 5.6 exhibits increasing absolute risk aversion, while constant absolute risk aversion is featured in equation 5.7 by the negative exponential utility function.⁸⁹

$$ARA = -\frac{U''}{U'} \quad (5.4)$$

where $ARA = \underline{\text{Absolute Risk Aversion}}$
 $U = \text{Utility}$

$$U = \frac{W^\gamma}{\gamma} \quad (5.5)$$

where $\gamma = \text{Constant}$
 $W = \text{Wealth}$
 $U = \text{Utility}$

$$U = W - b \cdot W^2 \quad (5.6)$$

where $b = \text{Constant}$
 $W = \text{Wealth}$
 $U = \text{Utility}$

$$U = 1 - e^{-aW} \quad (5.7)$$

where $a = \text{Constant}$
 $W = \text{Wealth}$
 $e = \text{Euler's number}$
 $U = \text{Utility}$

In turn, relative risk aversion (RRA) is illustrated mathematically by equation 5.8:⁹⁰ the economic interpretation of equation 5.8 lies in the utility gain/loss caused by a percentage wealth gain/loss. For example, constant relative risk aversion (CRRA) means that a wealth loss of x per cent always entails the same absolute loss of utility irrespective of the absolute wealth.

$$RRA = -\frac{W \cdot U''}{U'} \quad (5.8)$$

where $RRA = \underline{\text{Relative Risk Aversion}}$
 $W = \text{Wealth}$
 $U = \text{Utility}$

⁸⁹ See Ingersoll (1987), p. 39.

⁹⁰ See Thorley (1995), p. 71.

Table 5.5 Time horizon effect as a function of the type of relative risk aversion

Type of relative risk aversion	Time horizon effect
Increasing RRA (IRRA)	Inverse; equity component decreases with time horizon ^a
Constant RRA (CRRA)	None; equity component is independent of investment horizon ^b
Decreasing RRA (DRRA)	Positive; equity component increases with investment horizon ^c

^a See Thorley (1995), p. 72.

^b See Samuelson (1969), pp. 240ff.

^c See Thorley (1995), p. 71f.

Investors are frequently assumed to be risk-averse (i.e., their marginal utility diminishes as their wealth increases).⁹¹ There is no single line in the literature on the plausibility of concrete utility functions (i.e., their suitability for adequately modelling typical investor preferences). For example, the logarithmic utility function is often used to illustrate preference. A description using the Arrow–Pratt measures displays decreasing ARA (DARA) for the logarithmic utility function, but constant RRA (CRRA). While the first attribute is largely seen in the literature as the correct interpretation of actually observable preferences, the view is frequently voiced that decreasing RRA (DRRA) is the RRA that is closer to reality.

The connection of risk aversion to time diversification is that, as a rule, different time diversification effects result depending on the RRA attribute. For example, based on a CRRA utility function, it can be shown that the time horizon has no influence on the risk composition of the portfolio. However, this irrelevance (as demonstrated by Samuelson) is only transferable to reality with some qualifications because of the CRRA assumption.⁹² The argument advanced to counter the suitability of the logarithmic utility function chosen by Samuelson for the realistic depiction of typical investor preferences is that it is characterized by constant relative risk aversion, and additionally by too low absolute risk aversion. The fact that this and other utility functions that are equally difficult to reconcile with real investor behaviour are regularly discussed in the literature can probably be put down to the fact that certain utility functions are more frequently selected because they are simpler to understand and more satisfyingly transparent than because they provide the most adequate possible description of practical reality.⁹³

⁹¹ I.e., the second derivative of the utility function is negative.

⁹² Samuelson (1969) assumes (a) maximization of the expected utility of a logarithmic utility function (see *ibid.*, p. 243), as well as (b) a stationary return process with independent probabilities in each period (random walk), (c) that invested and total assets are the same (see *ibid.*, p. 240) and (d) only two investment alternatives, namely the secure and the risky asset. Moreover, the objective is not merely to maximize the final assets, but the typical investor maximizes the utility of his consumption in the individual periods across the investment horizon, whereby consumption is financed solely by the investment assets (see *ibid.*, pp. 240f).

⁹³ See Kritzman (1992), p. 20.

The overview in Table 5.5 shows that depending on the assumptions made on risk preference, all three variants of the time horizon effect are possible (i.e., an equity component that increases, remains constant, or decreases with the time horizon). Samuelson's irrelevance theory only represents the middle of the three cases presented in Table 5.5. Retaining Samuelson's assumption of independence of the return-generating process, as well as the alternative assumption of relative risk aversion, it is possible to demonstrate the existence of a time horizon effect. This combination of DRRA and random walk is particularly important because DRRA is frequently classified in the literature as more plausible than CRRA, and the random walk theory is regularly advanced for equity returns.

Equation 5.9 presents an increasing relative risk aversion-type utility function. In economic terms, it can be interpreted such that the investor funds his consumption costs from other income types in the amount of Z in addition to his invested assets.

$$U = \ln(W + Z) \quad (5.9)$$

where U = Utility

W = Wealth (invested assets)

Z = Income other than invested assets

A DRRA-type utility function is shown, for example, by equation 5.10. The parameter S is interpreted as the minimum consumption below which no shortfall may occur.⁹⁴

$$U = \ln(W - S) \quad (5.10)$$

where U = Utility

W = Wealth

S = Minimum wealth

Another utility function exhibiting DRRA property belonging to the family of hyperbolic absolute risk aversion (HARA) functions is used by Thorley to demonstrate the case for a (positive) time horizon effect (see equation 5.11).⁹⁵

$$U = \frac{(W - \eta)^{1-\gamma} - 1}{1 - \gamma} \quad (5.11)$$

where U = Utility

W = Wealth (invested assets)

η = Constant > 0

γ = Constant

⁹⁴ Samuelson (1994), p. 19, also establishes that such a modified logarithmic utility function results in a (positive) time diversification effect. See also Samuelson (1989), p. 11.

⁹⁵ See Thorley (1995), p. 71.

The combination of the IRRA and DRRA utility functions shown in equations 5.9 and 5.10 respectively has the following practical significance for funded retirement provision: the state pension system is assumed to be income source Z and the subsistence level or the level assuring the standard of living is S , producing a utility function of $U = \ln(W + Z - S)$. Assuming that the state pension at least guarantees a subsistence level or the existing standard of living, an equity component in the pension portfolio that develops in inverse proportion to age can be justified.⁹⁶

Return-generating process and time diversification

Studies on the existence and characteristics of time horizon effects examine three different categories of return-generating processes:

- Random walk/no serial autocorrelation/white noise
- Mean reversion/negative serial autocorrelation/red noise⁹⁷
- Momentum/positive serial autocorrelation/blue noise⁹⁸

The assumption of the efficient market hypothesis that equity returns follow a random walk is not undisputed. Empirical studies support the hypothesis of (at least limited) negative serial autocorrelation: that is, years of low (high) equity returns tend to be followed by years of high (low) equity returns.

- 1 Poterba and Summers (1988) use US and international time series for the periods 1871–1986 (New York Stock Exchange, or NYSE), 1919–85 (Canada), 1939–85 (UK) and 1957–85 (15 other countries) to demonstrate that equity returns display positive (momentum) serial autocorrelation over short time horizons and negative serial autocorrelation (mean reversion) over long time horizons. These transitory return components may explain more than 50 per cent of monthly return changes. The authors advance the hypothesis that mean reversion is attributable more to price distortions caused by noise traders than to changes in fundamental data, such as interest rates or volatility.
- 2 Fama and French (1988) in turn use NYSE time series for 1926–85 to demonstrate in particular that the returns of small caps display significantly negative serial autocorrelation over a horizon of three to five years. An estimated 25–45 per cent of the variation in the 3–5 year returns can be explained by historical returns; the remaining 55–75 per cent is interpreted as the random walk component.

⁹⁶ The life cycle investing concept that builds on this is described on, p. 259.

⁹⁷ See Samuelson (1994), p. 18 and (1989), p. 9.

⁹⁸ Ibid.

- 3 Lee (1990) uses a Standard & Poor's composite time series for 1926–85 to argue that US equity returns are not stationary, but are intertemporally unstable probably because of changes in underlying risk premiums over time. These instabilities express themselves as a periodic mean reversion,⁹⁹ producing a limited time diversification effect that can be significantly amplified by systematic portfolio rebalancing. The reason for the limited nature of the time horizon effect is that the mean reversion rises up to a time horizon of three years, but then falls back. Significant performance improvements can be achieved if these predictable, time-dependent changes in the mean reversion process are used for corresponding portfolio rebalancing.
- 4 Butler and Domian (1991) use a US equity index time series covering 1926–88 to identify instabilities in the return-generating process. They trace sudden changes in volatility and the mean to changes in macro-economic fundamentals and conclude that because of these instabilities, the characteristics of the time diversification effect vary significantly depending on the historical investment period. In contrast to Lee (1990), however, there is no reference to portfolio rebalancing for risk/return optimization.

A modification of the assumptions underlying Samuelson's¹⁰⁰ evidence of irrelevance that there is a negatively serial autocorrelated return-generating process, rather than a random walk, also allows a (positive) time horizon effect for investors with a CRRA.¹⁰¹ The existence of mean reversion thus results in the increased attractiveness of equities. An explanation for this phenomenon is that mean reversion leads to a lower increase in the variance of the final wealth with the time horizon compared with the random walk.

Combined view of preferences and return-generating process

Given that there is no typical investor, the individual differences in risk preferences mean that it can be assumed that a positive/neutral/negative time horizon effect can be viewed as rational depending on the given investor preferences.¹⁰² However, if the return-generating process is not a random walk, but exhibits positive or negative serial autocorrelation, the sort of time horizon effect that applies in the random walk assumption may be amplified or reversed, depending on the autocorrelation attributes (see Table 5.6). Because mean reversion reduces volatility without at the same time reducing the expected value, equities become

⁹⁹ Periodic in the sense that the highest degree of explanation of the mean reversion is around a period of 3 years and does not increase monotonically with the time horizon (see Lee (1990), p. 24).

¹⁰⁰ See n. 92.

¹⁰¹ See Thorley (1995), pp. 72f.

¹⁰² See Stangeland and Turtle (1999), p. 1.

Table 5.6 Time horizon effect (THE) as a factor of type of risk aversion and the return-generating process

Type of relative or absolute risk aversion	Return-generating process		
	Random walk No autocorrelation White Noise	Mean reversion Negative serial autocorrelation Red Noise	Momentum Positive serial autocorrelation Blue Noise
Increasing RRA (IRRA)	Inverse THE	THE	Inverse THE
Constant RRA (CRRRA) ^a			
High ARA	No THE	THE	Inverse THE
Medium ARA	No THE	No THE	No THE
Low ARA	No THE	Inverse THE	THE
Decreasing RRA (DRRA)	THE	THE	Inverse THE

^a High/medium/low ARA represent the utility functions $-W^{-1}$; $\ln(W)$; \sqrt{W} (see Kritzman and Rich (1998), p. 68).
Sources: Based on Stangeland and Turtle (1999), p. 5 and Kritzman and Rich (1998), p. 68

more attractive to risk-averse investors, while the volatility-increasing effect of a momentum process has an opposite reaction.¹⁰³

Inclusion of non-investment income

Efforts to achieve realistic conclusions in the time horizon question have seen repeated calls for the inclusion of income sources not related to the assets invested. If earned income, social insurance payments, welfare benefits, family support, or the possibility of later retirement are integrated with the time horizon model, the consequences of (dramatic) losses from the assets invested are attenuated.¹⁰⁴ For example, based on the assumption that individual total wealth is the product of assets invested and own human capital,¹⁰⁵ it is possible to draw the conclusion that with increasing age, fewer equities should rationally be held in the portfolio, even assuming constant relative risk aversion and a random walk. Assuming that human capital loses value with increasing age, and that assets invested increase due to retirement planning, a lower portfolio equity component with age, measured against total assets, can actually have remained constant.¹⁰⁶ In other words, the individual human capital is generally relatively high when the person is younger, and is also relatively low-risk. An adequate or constant risk level over

¹⁰³ See *ibid.*, p. 6.

¹⁰⁴ See Thorley (1995), p. 73.

¹⁰⁵ Human capital differs from financial capital in particular because of its non-fungibility: it cannot be efficiently capitalized or used as collateral (see Samuelson (1994), p. 17).

¹⁰⁶ See Samuelson (1994) p. 17.

age means that younger people combine their high level of low-risk human capital with a higher proportion of more risky assets (i.e., equities) than older people.¹⁰⁷

A similar approach assumes that the relationship between asset allocation and human capital is that risk tolerance for the assets invested rises proportional to the (ability to influence the) flexibility of the individual's own labour supply. Because labour supply flexibility – which consists primarily of the extent of overtime, starting or stopping a second or third job, and selection of retirement age – is generally higher for younger than for older people, their investment risk aversion is correspondingly lower, so they tend towards a higher equity weighting. That is why it is easier for younger than for older people to compensate for (considerable) investment losses by extending working time at the cost of free time: the ability to choose to work longer and/or harder allows younger people a more equity-heavy asset allocation. Labour supply flexibility creates a kind of insurance against adverse investment outcomes.

In the same way as labour supply flexibility, a social security network can be viewed as this type of insurance. If there is a right to welfare benefits or similar transfer payments in case of need, the investor is no longer confronted with a total risk of loss. On the contrary: the taxpayer can be saddled (at least in part) with the consequences of (extremely) negative return developments. In this context, welfare benefits are thus an incentive to assume excessive risk (moral hazard), because equity gains can be privatized and equity losses (that might jeopardize livelihood) can be socialized. There is thus a time horizon effect in particular for persons who will only claim welfare benefits in extreme cases because of their wealth or income. The investor's distance to the subsistence level thus plays a decisive role in asset allocation.¹⁰⁸ Because of their lower risk of falling below the subsistence level, more affluent individuals therefore tend to have a more pronounced preference for higher variance risk so that they can increase the probability of higher returns.¹⁰⁹

If other sources of income are not included, there is a logical assumption that current consumption during the accumulation phase is financed from the assets invested. In the case of regular withdrawals to finance consumption, it is not the final value of the assets invested that is of interest, but there must be an assurance that sufficient funding is available at each withdrawal point. To implement such a strategy, a risk-free invested portion of the assets invested that diminishes over time can be assumed. The remaining assets invested can then be invested solely with the objective of maximum utility, which can be interpreted economically as retirement planning.

The reduction in the risk-free asset portion means that, all else being equal, the portion of the aggregate assets that is invested in risky instruments used for retirement planning increases over time, producing the impression of an inverse time

¹⁰⁷ See Bodie (1995), p. 20.

¹⁰⁸ *Ibid.*, p. 21.

¹⁰⁹ See Samuelson (1969), p. 239.

horizon effect.¹¹⁰ Any isolated analysis of the retirement planning portion (ignoring the portion used to finance consumption during the accumulation phase) may, however, produce a different (contrary) time horizon effect.

Portfolio rebalancing opportunities

The ability or inability to undertake (regular) portfolio rebalancing represents a further determinant of the existence/characteristics of a time horizon effect. Thus it can be shown that for the comparison of variously risky, non-risk-free assets, the ability to rebalance portfolios without cost during the investment period leads to the irrelevance of the time horizon for the classification of the attractiveness of the different assets. A consequence of this irrelevance in such a situation is that interim changes to the risk characteristics of the portfolio are possible. In particular, if a return-generating process is assumed that does not reflect the random walk but displays serial autocorrelation, the utility gain from portfolio rebalancing is high. For example, it can be shown that the certain degree of predictability of return development that is possible for mean reversion allows a significant performance improvement if portfolio rebalancing is allowed.¹¹¹

Time diversification and asset management standards

The various approaches presented on the time horizon problem illustrate that – at least today – there is no generally accepted answer to the question of whether an equity component that increases with the length of the investment horizon can be classified as efficient. Asset management companies must therefore be urged to disclose their assumptions on time diversification, especially to non-institutional customers and in the case of maturity-dependent asset allocation. Effective, not merely formal, transparency about the assumptions made can only be regarded as established, however, if they are communicated in a form that the recipients will understand. It cannot simply be assumed that average retirement or investment savers will be able to match terms such as risk preference, return-generating process, alternative sources of income, the meaning of human capital and portfolio rebalancing opportunities appropriately to their personal income/wealth/life situation. For example, there may be a certain degree of perception of the principle of ‘risk preference’, but it is highly unlikely that there is any awareness of the problems surrounding relative/absolute risk aversion, or indeed of option pricing theory insurance considerations.

Given the lack of corresponding legal requirements, and to promote voluntary best practice, statements of investment principles/policy and fund prospectuses in the wider sense, in other words including instructions/information material on non-investment fund-based savings/pension products with maturity-dependent

¹¹⁰ See Stangeland and Turtle (1999), p. 9.

¹¹¹ See Lee (1990), p. 25.

asset allocation, should not be limited to arguing on the basis of historical time series.

Life-cycle investing

A frequent argument against promoting equities as an efficient retirement provision instrument emphasizes the particular vulnerability of people shortly before retirement to surprising substantial share price losses. Scenarios are regularly discussed that present the devastating extent of the losses suffered by an equity investment beginning at the high-point of the equity boom at the end of the twentieth century.¹¹²

In fact, however, such a description is too simplified and suitable at most for characterizing isolated cases attributable to blatant misadvice or even fraud. But if the regulatory regime contains prudent person rules, the probability that there will be this sort of extreme asset allocation is zero if pension plan management complies with the rules. Ultimately, the requirement of diversification is one of the core conditions of such an investment regime, and both the prudent investor rule and the prudent expert rule demand a prudent level of aggregate risk. With the prudent expert rule, the prudent level of aggregate risk results from the obligatory investment policies and the requirement to act exclusively in the interests of the investors and pensioners.

The life-cycle model is an appropriate investment strategy for ensuring a prudent level of aggregate risk. The rule for investment decisions under the life-cycle model is that retirement savers should invest less in risk assets (i.e., normally equities) with increasing age to ensure an optimum investment. This conclusion results from the assumption that the individual's aggregate capital is the sum of human capital plus financial capital, whose market prices change continuously and stochastically. The need for a decreasing equity component with age is partly because human capital is less risky than equities, and partly because younger people can normally adapt their labour supply more flexibly; this is significant to the extent that the degree of flexibility of the individual's own labour supply changes in proportion to the share of risky financial capital in that individual's aggregate capital. To allow the individual's aggregate capital to attain an adequate individual risk level, younger people therefore generally need a higher equity component because their human capital is less risky than that of older people.¹¹³

Passive portfolio management and prudence

Together with the Efficient Market Hypothesis (EMH), the Capital Asset Pricing Model (CAPM) proposes the superiority of passive investing that tracks

¹¹² See, e.g., Albrecht (2003b), p. 8.

¹¹³ See Bodie (2003), p. 25.

a market index. This superiority rests on the efficiency and diversification of this approach.¹¹⁴ The basis of the efficiency is that a portfolio that complies with the CAPM and the EMH (a differently weighted combination, depending on risk/return preference, of the market portfolio and the riskless asset, which is normally represented by government bonds) represents an optimum solution in terms of its return or its risk to the extent that – all else being equal – no higher return is obtainable for the same risk, or that – again all other things being equal – at least an equally high return cannot be obtained for a lower risk.

In other words, if the market – in the form of the aforementioned combination of market portfolio and riskless asset – cannot be outperformed, why bother investing in active asset managers who try to identify underpriced and overpriced securities? This is why the opinion is often voiced that passive portfolio management is also the most cost-efficient form of investment (due to the lower research and analysis costs of passive portfolio management). As a rule, actively managed funds charge both higher management fees and higher front-end sales loads. An estimate for Germany is that passive funds charge an average management fee of 0.4 per cent to 0.5 per cent, which is less than half the average fee charged by active funds. There is also a bid/offer spread of between 0.1 per cent and 0.5 per cent; this undercuts the front-end sales loads of active funds, which are around the 5 per cent mark, by at least an order of magnitude.¹¹⁵

However, EMH is controversial: empirical data is put forward to argue that purely passive investment may lead to the investor holding extremely risky individual securities issued by companies in danger of bankruptcy. There is a widespread belief, however, that insolvency can be predicted by using screening methods, so purely passive portfolio management is not prudent because prudence requires the application of just such screening procedures, which would result in a portfolio that differs in reality from the market portfolio.¹¹⁶ Passive portfolio management also entails a risk of investor herding that may be conspicuous by overweighting a small number of large caps that are components of popular indices. This herding may also lead to innovative investment strategies being ignored.¹¹⁷

Nonetheless, fiduciaries focus on benchmarking because they believe that they thus satisfy the requirement of prudence by an averagely prudent person under the prudent person/investor rule, since the price performance of a benchmark represented by a broad market index essentially represents the outcome of the transactions of a very large number of averagely prudent persons.¹¹⁸ For fiduciaries subject to the prudent expert rule, however, the situation is more complicated because a stricter measure of prudence applies to them. As experts required to exercise the prudence of a person familiar with such matters, they are required to

¹¹⁴ See Louge and Rader (1998), p. 45.

¹¹⁵ See Ruhkamp (2002).

¹¹⁶ See Louge and Rader (1998), pp. 48f.

¹¹⁷ See Galer (2002), p. 60.

¹¹⁸ See Galer (2002), pp. 59f.

be reasonably aware of the problems surrounding the deficits of passive portfolio management and to act accordingly. A justification that can in turn be advanced for index-tracking portfolio management is that a breach of fiduciary duty and thus a potential personal liability can be assumed if an investment no more than underperforms the market over a longer period without this having led to measures being undertaken by the fiduciary.¹¹⁹

In addition to this problem, there are other reasons why pension fund fiduciaries must provide justification for any decision to opt for passive portfolio management, or at the least they must have ready answers for the following questions.¹²⁰

- 1 *What percentage – if any – of the pension fund will be invested in index funds?* The advantage of index funds is their lower cost; the downside is the inefficiency that exists in certain markets; for example, the market for small caps may be less efficient than the market for large caps, so the small cap market will tend to require active portfolio management. The question of which markets the fund actually invests in will depend on the overarching investment strategy and goals.
- 2 *If index funds are used, which funds will be selected, and what is the relevant market portfolio?* Depending on the pension fund's target risk/return, a variety of markets, and thus of index funds, will be considered. The efficiency of the selected index fund(s) must then be established (i.e., its/their tracking error must be estimated).
- 3 *Should the pension fund management company examine the composition of the index fund to establish that it really does track the specified index? If so, how often?* These review costs may be so great that they substantially reduce the cost advantage of passive portfolio management.
- 4 *Does the use of index funds limit the liability of the pension fund manager for the investments?* An indication to the contrary is that ERISA fiduciaries are largely prohibited from delegating decisions, which would actually be incompatible with investing in index funds because the decision to invest in individual securities is delegated to the index fund manager. A point in favour, on the other hand, is that US courts are increasingly ruling that the portfolio must be treated as a whole, rather than at the level of the individual securities, which increases the legal certainty of passive management.
- 5 *Does the use of index funds affect the extent to which pension fund managers should be involved in the management of the companies whose securities they hold so that they can encourage them to improve share price performance?* Asset managers do not agree on this issue, but intervention is supported by the fact that the exit costs for large-volume securities in the portfolio may be very high due to the

¹¹⁹ Ibid.

¹²⁰ See Louge and Rader (1998), pp. 49–53.

significant market impact of such block sales. Additionally, it may be very difficult to maintain a 100 per cent equity component in certain markets if the manager avoids investing in all corporations not deemed to be optimally managed. Moreover, intervention is an EMH-compliant method of improving investment performance.

Ethically/socially/environmentally responsible investing

Asset management companies' offerings are not driven solely by risk/return aspects, as various aspects of 'responsible' investing also play a role. For example, a combination of any or all of ethically, socially, or environmentally responsible investing may be deployed. The Riester pension reform in Germany established a link to retirement planning by extending the information obligations of the product providers to their customers to any ethical, social and environmental considerations included in the investment policy.¹²¹ Especially for retirement planning, the risk component of ethically/socially/environmentally responsible investing may on no account be ignored so as not to inappropriately reduce the security of the saver's retirement provision. An increased fluctuation risk compared with conventional investments can be demonstrated for the European capital markets.¹²²

ABP,¹²³ Europe's largest pension fund,¹²⁴ has been one of the most prominent representatives of Socially Responsible Investing (SRI) since 2001. However, ABP also complies with the primary objective of risk/return efficiency in that social aspects are only a secondary requirement: ABP's investment principles place the same return requirements on SRI investments as on conventional investments.¹²⁵ For the European market at least, sustainable investment shares recorded almost exactly the same development as conventional shares from early 1999 to early 2004 (see Figure 5.15).

¹²¹ The corresponding annual recurring information obligation is governed by section 7(4) AltZertG as amended by Art. 7 no. 3(c) AltEinkG (corresponding to section 1(1) no. 9 AltZertG as amended by Art. 7 AVmG, which was rescinded by Art. 7 no. 1(a) ee AltEinkG). Under section 7(1) no. 5 AltZertG as amended by Art. 7 no. 1(a) bb AltEinkG, the investor must be notified accordingly prior to signature of contract.

¹²² As a current index for ethically responsible investing, the FTSE4Good Europe-Index has a tracking error of 2.6 per cent compared with the FTSE Europe Index (see Gimbel (2002a)). This means that the differential return between FTSE4Good Europe and FTSE Europe in two out of three years (68.3 per cent) varies by up to 2.6 percentage points from its expected value.

¹²³ Stichting Pensioenfonds ABP (Allgemeen Burgerlijk Pensioenfonds) had around 1.05 million active and approx. 0.7 million pensioners and the same number of former members of the Dutch public sector at the end of 2002, and had pension assets of €135.6 billion at this date (see ABP (2003), pp. 8f). At the end of 2003, growth to €150.4 billion had been recorded (see ABP (2004), p. 1).

¹²⁴ In 2002 in Europe, PGGM (Dutch pension fund for health and social services employees) was in second place, and the British Telecom Group pension fund in third place (see Guerra and Targett 2002). Pension assets at PGGM were €52.9 billion at the end of 2003 (see PGGM, Zeist, o. Jg., p. 2), and £22.8 billion at the BT pension fund (approximately €34.9 billion at 31 Dec. 2002) at the end of 2002 (see BT Group (2003), p. 45).

¹²⁵ See Targett (2002a).

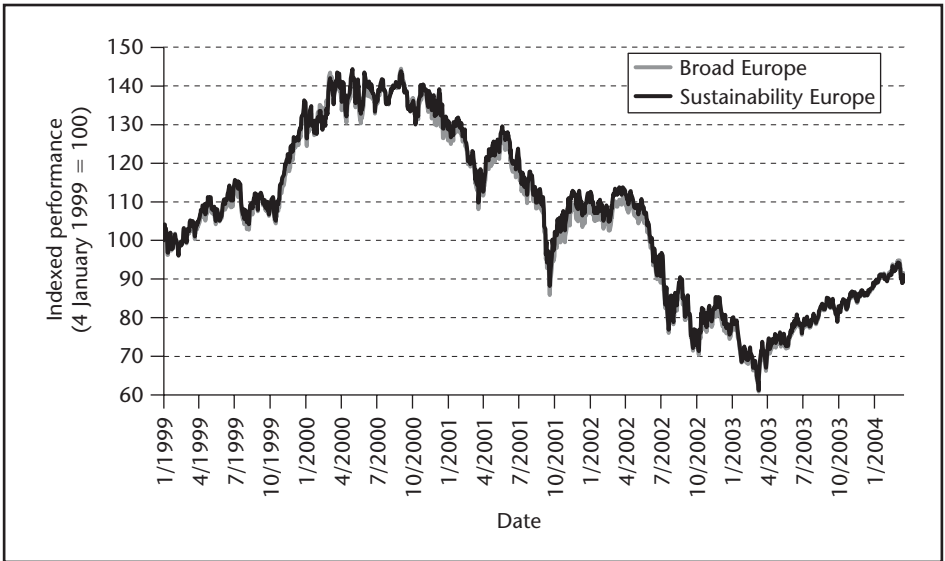


Figure 5.15 Development of the broad equity market compared with sustainable shares in Europe using the DJ Stoxx Broad Europe compared with the DJ Stoxx Sustainability Europe indices, 4 January 1999 to 31 March 2004

Sources: Time series DJ Stoxx Broad Europe from http://www.stoxx.com/incoming_data/hbrbcte.txt; Time series DJ Stoxx Sustainability from http://www.stoxx.com/incoming_data/hsusttpe.txt

The use of financial derivatives

Most common applications of financial derivatives

Three primary applications for derivatives in the fund industry are outlined below.¹²⁶

Hedging: derivatives put managers in a position where they do not have to sell risk positions in anticipation of falling markets, a factor that can cut costs appreciably. Hedging can also be used highly selectively, as in the following examples.

- 1 Market risk alone can be hedged, or the segment (or even the specific security) risk can be hedged. The more selective the hedge (i.e., the narrower the scope), the lower the hedging costs will be.
- 2 The fluctuation margin of the portfolio can be restricted to a defined bandwidth for a certain time period, or a certain (minimum) value can be guaranteed at a particular date.

¹²⁶ See Bossert (2000), pp. 348–74.

- 3 Depending on the fund's risk profile and the fund manager's assessment of the market, symmetric or asymmetric hedging may be used. The first of these strategies, which is normally implemented using futures, has the same effect on opportunities and risks, while the latter, normally implemented using put options, accommodates the intuitive understanding of risk by trying to reduce the downside risk, while at the same time trying to maintain the upside potential as far as possible.

Tactical risk management may be used for the following purposes.

- 1 Anticipatory transactions: especially with pension funds, cash flows occur at certain, previously known dates, in anticipation of which futures or calls can be bought so as to exploit a current attractive market level for investing these cash flows.
- 2 Asset allocation: futures allow the fund manager to quickly and cheaply build up diversified foreign positions (synthetic exposure). This allows the market and currency risks in particular to be separated: if the target currency is the euro, and fund managers expect the US equity market to rise, they can either buy US equity or US equity index futures. In the first case, they also have to bear the euro/US\$ currency risk, which may erode any gain if equity prices actually do rise. Currency futures may reduce this risk, but merely because of the fact that the amount to be hedged is uncertain, they are not ideal. By contrast, if fund managers buy index futures, the funds earmarked for the actual purchase of US equities remain on the euro money market, and the only dollar exposure is the (low) margin payments. If, on the other hand, they expect the dollar to rise against the euro, fund managers will park the money on the US, rather than the euro, money market, establishing a position that is equivalent to a direct equity purchase.
- 3 Isolation and transfer of alphas: if the manager expects the overall market to fall, and at the same time that certain individual securities will outperform the market, the appropriate strategy is to buy the individual shares with a perceived upside and to sell index futures; this hedges the market risk, leaving only the specific security risk, although the portfolio manager has taken a positive stance on this. A real gain will be realized if the securities concerned outperform the market, irrespective of the direction in which it travels. An expectation that submarkets will record different developments can also be implemented in an investment strategy, for instance, if a DJ Euro STOXX-oriented portfolio is hedged using Euro STOXX 50 futures, because the manager expects the mid-sized caps to outperform the large caps (represented by the Euro STOXX 50).

Performance optimization may be used in these instances.

- 1 Cost advantage of derivatives over direct investments: because of its standardization and the low number of different contracts, the futures market in

particular offers substantial market depth and transparency, so the transaction costs – as a rule – are very low. Depending on the study consulted and the derivative analysed, this cost advantage is in the order of 1:2 to 1:25.

- 2 Arbitrage (i.e., exploiting price differences between assets that embody an identical cash flow).
- 3 Writing option positions, normally in the form of selling covered calls (i.e., optioning shares held in the portfolio). The option premium collected on the one hand is offset only by the risk of opportunity losses on the other, if the underlying stock price has risen above the strike price at the exercise date and the shares thus have to be transferred to the buyer. If, on the other hand, the shares were not held in the portfolio (naked position) and the option was exercised, the writer would have to cover (expensively), resulting in actual cash losses.
- 4 Trading strategies: depending on the market assessment – bearish or bullish, sideways, high volatility – a variety of combinations of options and/or equities may be considered.¹²⁷

Legal basis for the use of financial derivatives by UCITS

The amendment in early 2002 to the EU UCITS Directive (UCITS III) now means that derivatives funds are UCITS-compliant. They may invest in derivatives traded on regulated markets and, in certain cases,¹²⁸ in over-the-counter (OTC) derivatives as well.¹²⁹ The full cover of the risks associated with investing in these derivatives by holding assets ‘of the right kind and sufficient in value’¹³⁰ was toned down somewhat in the final Directive, which now says that a UCITS must ensure that ‘its global exposure relating to derivative instruments does not exceed the total net value of its portfolio’.¹³¹

The UCITS Directive requires a risk management process that both enables the risk of each portfolio asset, also expressed as the asset’s contribution to the overall risk profile of the portfolio, to be quantified, and allows the ‘accurate and independent assessment of the value of OTC derivative instruments’,¹³² although it does not describe any methodologies to be applied. In compliance with the ‘Four-Level Approach’ in the Lamfalussy report, the Directive only contains the fundamental provisions, while the corresponding implementing measures are

¹²⁷ See Loistl, Munich/Vienna (1996b), pp. 308ff.

¹²⁸ Art. 19 (1) (g) Directive 85/611/EEC imposes minimum conditions on the counterparties and on the liquidity of OTC derivatives.

¹²⁹ Art. 19 (1)(g) Directive 85/611/EEC.

¹³⁰ Art. 24b (1) European Commission, Com (1998) 449 final (1998).

¹³¹ Art. 21 (3) Directive 85/611/EEC.

¹³² Art. 21 (1) Directive 85/611/EEC.

contained in a Commission recommendation.¹³³ This recommendation on the use of derivatives by UCITS is ‘a first step towards a uniform understanding of risk measurement methodologies ... [for] UCITS’ and harmonizing the fundamental principles of risk measurement.¹³⁴

Specifically, the Commission recommends that ‘“non-sophisticated UCITS”, which have overall less and simpler derivative positions’, should use the commitment approach for market risk assessment, ‘whereby the derivative positions of a UCITS are converted into the equivalent position in the underlying assets embedded in those derivatives’. The application of the delta approach is recommended for options, while the conversion of forwards, futures and swaps ‘should depend on the precise nature of the underlying contracts’. In the case of ‘sophisticated UCITS’, on the other hand, both the value-at-risk approach (a 99 per cent confidence interval, a holding period of one month and a historical volatility estimated based on a maximum time series of one year are recommended) and stress tests should be used.¹³⁵ The obligatory consideration of counterparty risk,¹³⁶ which should not exceed 5 per cent or 10 per cent of portfolio assets for OTC derivatives,¹³⁷ must be quantified using the marking-to-market method stipulated in the Banking Directive.¹³⁸

Especially in view of the extreme development of the equity markets in recent years, these recommendations on risk measurement appear overly simplistic. For example, the value at risk (VaR) approach is based on the assumption of normally distributed returns, something that is not generally reconcilable with reality, because fat-tailed distributions are frequently observed in practice.¹³⁹ Because extreme deviations from the mean occur more frequently in reality than the normal distribution assumption allows, uncritical application of a VaR model runs the risk of systematically and significantly underestimating the probability and extent of potential losses.

However, such (concrete) misgivings do not feature in published EU documents on risk management at either UCITS or pension funds, so it apparently cannot be assumed that the EU will set correspondingly effective standards in the foreseeable future. The European Commission does admit that ‘risk measurement methodologies need further refinement’ and further work is needed to elaborate ‘more advanced and elaborated methods of risk measurement’, but at the same time it makes clear its intention of sticking to the VaR approach and merely supplementing it by best practices in the future.¹⁴⁰

¹³³ European Commission (2004b).

¹³⁴ *Ibid.*, 2nd and 11th recital.

¹³⁵ *Ibid.*, no. 3.

¹³⁶ Art. 21 (3) Directive 85/611/EEC.

¹³⁷ The maximum permitted risk exposure is based on the type of counterparty risk: it is 10 per cent for credit institutions, and otherwise 5 per cent (Art. 22 (1) Directive 85/611/EEC).

¹³⁸ See Directive 2000/12/EC, Annex III, and European Commission (2004b), no. 5.3.

¹³⁹ See Rockafellar and Uryasev (2000a), p. 1,444.

¹⁴⁰ European Commission (2004b), no. 3.4.

Quantitative restrictions

Fixed maximum percentage of fund assets in securities of a single issuer

Funds regulated by the UCITS Directive may not invest more than 10 per cent of their assets in securities, money market instruments, or OTC derivatives of a single issuer,¹⁴¹ except where these debt instruments are state-guaranteed, guaranteed by an international public body,¹⁴² or equally secure,¹⁴³ in which case the ceilings are then 35 per cent and 25 per cent respectively. A ceiling of 20 per cent applies to deposits.¹⁴⁴ In the case of the new index funds allowed by UCITS III,¹⁴⁵ equities of a single issuer can be bought up to a maximum of 35 per cent of the fund assets.¹⁴⁶ Such funds may also buy equities of a single issuer in an amount that would allow them to exercise a significant influence on its management.¹⁴⁷ A general rule to be observed by UCITS, however, is that the voting rights vested in their assets should not allow them to exercise significant influence on an issuer.¹⁴⁸

US laws have exactly the opposite intention, because US investment funds (and pension plans) are explicitly expected to play the role of active institutional investors that should exercise a (positive) influence on the management of their investments.

Before the proposed EU Pension Funds Directive was actually published in October 2000, a study commissioned by the European Commission recommended stipulating a 4 per cent ceiling per issuer, with this restriction also applying to investments in the securities of, and loans to, the pension plan sponsor(s) (self-investment).¹⁴⁹ The final Pension Funds Directive did not follow this recommendation to the letter, but rather the less strict provisions of the draft Directive.¹⁵⁰ A 5 per cent limit on investments in the sponsor was stipulated, accompanied not by any other quantitative single issuer limit, but rather by the qualitative requirement to 'avoid excessive reliance on any particular asset, issuer, or group of undertakings and accumulations of risk in the portfolio as a whole.

¹⁴¹ Art. 22 (1) Directive 85/611/EEC stipulates a 5 per cent limit for this, which may be increased to 10 per cent at the discretion of the Member States (Art. 22 (2) Directive 85/611/EEC).

¹⁴² Art. 22 (3) Directive 85/611/EEC.

¹⁴³ Art. 22 (4) Directive 85/611/EEC.

¹⁴⁴ Art. 22 (1) sentence 2 Directive 85/611/EEC.

¹⁴⁵ As the conditions that must be satisfied by trackable equity or debt securities indices, Art. 22a (1) Directive 85/611/EEC stipulates sufficient diversification, an adequate benchmark for the underlying market and appropriate publication.

¹⁴⁶ The 5 per cent limit in Art. 22 (1) sentence 1 Directive 85/611/EEC applies here too, which can be generally increased by the Member States to a maximum of 20 per cent (Art. 22a (1) Directive 85/611/EEC). If a security highly dominates the underlying market, the upper limit can be increased by the Member State to a maximum of 35 per cent for this issuer (Art. 22a (2) Directive 85/611/EEC).

¹⁴⁷ Art. 22a (1) sentence 1 in conjunction with Art. 25 (1) sentence 1 Directive 85/611/EEC.

¹⁴⁸ Art. 25 (1) Directive 85/611/EEC.

¹⁴⁹ See Pragma Consulting (1999), pp. 20f.

¹⁵⁰ European Commission, Com (2000) 507 final (2000), Article 18(2)(b).

Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration.¹⁵¹ For cross-border pension funds, however, the host state may stipulate a single issuer limit of 5 per cent, or 10 per cent for companies of the same group, if this also applies to domestic pension funds.¹⁵²

The US ERISA imposes restrictions on self-investment; an aggregate maximum of only 10 per cent of pension fund assets may be invested in certain securities or real estate of the sponsor or its affiliates. In addition, the fund may only hold a maximum of 25 per cent of the total volume of a certain securities class of the sponsor, and at least 50 per cent of this total volume must be held by persons who are independent of the sponsor.¹⁵³ Exemptions from these rules (and from other prohibited transactions¹⁵⁴) may only be granted by the US Department of Labor if they are in the interests of the plan participants and beneficiaries and do not infringe their vested rights.¹⁵⁵

Diversification

The fundamental concept of diversification

Diversification, in other words allocating the fund assets to a variety of asset classes or different securities (in the same asset class), is designed to reduce the portfolio risk (quantified as variance) and/or increase the portfolio return. The diversification effect resulting from the correlation characteristics of the individual assets is used for portfolio optimization. An optimal portfolio is constructed by weighting the pool of available assets on the basis of certain specifications, especially for the investment objective and style, which in turn may feature a ban on short selling to achieve a maximum value for the target portfolio in terms of the exchange relationship between risk and return. In practice, such mean/variance optimization is not possible to any degree of precision because the estimate of the input data (i.e., the asset returns and (co)variances), contains corresponding estimation errors. In particular, noticeable variations between the estimated and actual returns significantly influence the optimization outcome.

The mathematical explanation for the diversification effect is that although the portfolio return is the sum of the weighted returns of the individual assets (see equation 5.12), portfolio variance – except for the special case where the correlation is equal to 1 – is smaller than the sum of the (squared) weighted

¹⁵¹ Art. 18 (1)(e) Directive 2003/41/EC; if the sponsor is a member of a group, a maximum of 10 per cent can be invested in the group. If the pension fund is sponsored by a number of sponsors, 'investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification'.

¹⁵² Art. 18 (7) Directive 2003/41/EC.

¹⁵³ Section 407 ERISA.

¹⁵⁴ Section 406 ERISA.

¹⁵⁵ Section 408 ERISA.

individual standard deviations, because it must also consider covariance and correlation terms (see equation 5.13).

$$r_P = \sum_{i=1}^n w_i r_i \quad (5.12)$$

r_P = Portfolio return

r_i = Return on asset i

n = Number of assets in portfolio

w_i = Weighting of asset i in portfolio

$$\sigma_P^2 = \sum_{i=1}^n \sum_{j=1}^n w_i w_j \sigma_{ij} \quad (5.13)$$

$$\sigma_P^2 \leq \sum_{i=1}^n (w_i \sigma_i)^2$$

σ_P^2 = Portfolio variance

n = Number of assets in portfolio

w_i = Weighting of asset i in portfolio

σ_{ij} = for $i \neq j$ covariance of the returns on assets i and j ; for $i = j$ variance of the return on asset i

σ_i = Standard deviation of the return on asset i

Figure 5.16 illustrates the risk reduction that can be achieved in portfolio construction using two assets. Asset 1 has a return of 5 per cent for a standard

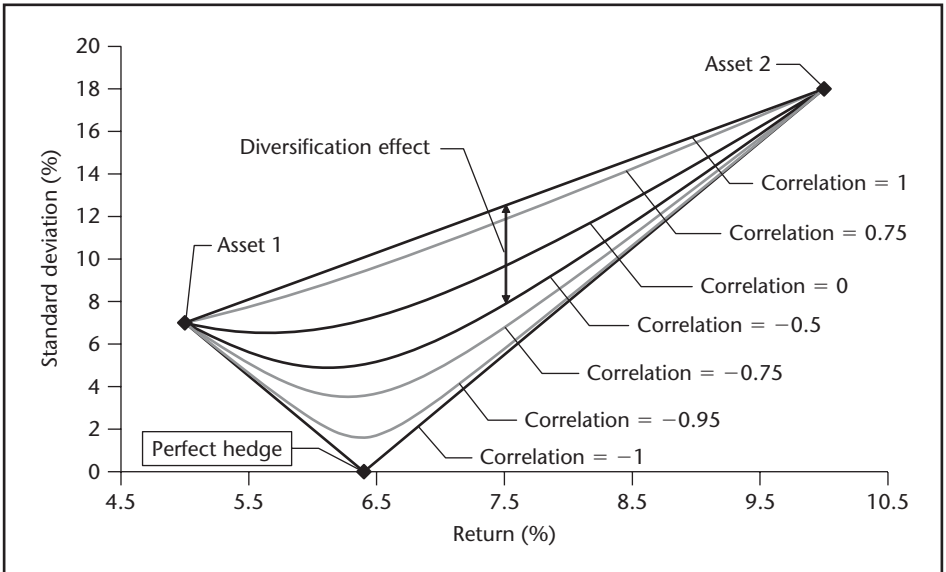


Figure 5.16 Risk/return profile for a portfolio of two assets as a factor of differing correlation coefficients

deviation of 7 per cent, while the same values for asset 2 are 10 per cent and 18 per cent. Assuming that the two assets are perfectly correlated, combining them would not produce any diversification effect, as can be shown in the top line in Figure 5.16. The less the two assets are correlated with each other, the greater the risk-reducing effect of diversification, as can be seen from the increasingly concave portfolio curves. In the case of perfectly negative correlation, the two risky assets can be used to construct a risk-free portfolio (in terms of variance risk), without having to resort to short selling: not all fund sponsors can (for legal reasons) or want to sell short. The extent of the diversification effect for a given correlation and a given return can be seen to be the vertical distance between the corresponding portfolio curve and the portfolio line with a correlation of 1: in Figure 5.16, this is the example shown for a correlation of -0.5 and a return of 7.5 per cent. It can be seen that the imperfect correlation results in a portfolio standard deviation of 7.9 per cent, a reduction of 4.6 percentage points compared with the portfolio standard deviation of 12.5 per cent for perfect correlation.

The portfolio perspective, meaning that risk and return are not analysed for the individual security but on a consolidated basis for the fund as a whole, allows assets to be included in the fund portfolio that would, taken in isolation, appear to be of low quality, provided that their low correlation with the other fund assets leads to a reduction in portfolio risk for an unchanged or higher portfolio return.

Diversification for investment funds and pension plans in the EU

The UCITS Directive defines UCITS as, among other things, funds whose objective is the ‘investment ... of capital raised from the public and which operate on the principle of risk-spreading’.¹⁵⁶ Rules on single issuer limits¹⁵⁷ are operational implementations of this principle. As suggested,¹⁵⁸ an obligation to diversify was included in the Pension Funds Directive.¹⁵⁹

Diversification for pension funds and pension plans in the USA

Diversification as fiduciary duty: At US pension funds, diversification falls under fiduciary duties.¹⁶⁰ Investments in securities or real property of the plan sponsor are generally limited to a maximum of 10 per cent of plan assets.¹⁶¹ However, defined contribution plans enjoy an express exemption from this principle¹⁶² in the event of (concentrated) investment in assets of the sponsor, subject to certain

¹⁵⁶ Art. 1 (2) Directive 85/611/EEC.

¹⁵⁷ Art. 22, 22a, 23, 24 and 26 Directive 85/611/EEC.

¹⁵⁸ See Pragma Consulting (1999), p. 21.

¹⁵⁹ Art. 18 (1)(e) Directive 2003/41/EC.

¹⁶⁰ Section 404(a)(1)(C) ERISA.

¹⁶¹ Section 407(a)(2) ERISA. Only specific qualifying assets of the sponsor are permitted. Securities must either be stock, equity interests in publicly traded partnerships, or marketable obligations (section 407(d)(5) ERISA). Employer real property must consist of several parcels that are mostly geographically dispersed and must be adaptable for more than one use (section 407(d)(4) ERISA).

¹⁶² Section 404(a)(2) and section 407(b)(1) in conjunction with section 407 (d)(3) to (5) ERISA.

conditions being met.¹⁶³ But if plan participants are obliged to invest part or all of their deferred compensation contributions in securities or real estate of the employer, the volume resulting from these contributions must be accounted for as a separate pool that is itself subject to the general 10 per cent limit, unless these contributions do not account for more than 1 per cent of the wage or salary of the employees concerned.¹⁶⁴

Employee Stock Ownership Plans: Employee Stock Ownership Plans¹⁶⁵ are largely exempted from this duty of diversification. ESOPs are special DC occupational pension plans that are obliged to invest their portfolio 'primarily'¹⁶⁶ in shares¹⁶⁷ of the employer.¹⁶⁸ To do this, they may borrow money¹⁶⁹ (normally from commercial banks) or even issue bonds¹⁷⁰ ('leveraged ESOPs'). The benefits must normally be paid to pensioned employees in the form of the plan's employer shares,¹⁷¹ but in certain circumstances they can also be paid exclusively in cash.¹⁷²

If the benefit obligation is satisfied by employer shares, the beneficiary is entitled to a mandatory put option on these shares in respect of the employer in the case of unlisted companies (i.e., the employer is required to pay the fair market value on surrender of the shares).¹⁷³ The ESOP itself can buy the shares rather than the company, but it can never be forced to do so. The ESOP trustee's fiduciary duties require it always to weigh up purchases of employer shares against other investments. However, the sole objective of ESOPs expressly stipulated by law is not their retirement provision function, but rather to broaden the distribution of wealth. Given that in 1999, employees held, through ESOPs, an estimated \$150 billion of the corporate assets amounting to \$4,000 billion at the time, this objective has also been achieved.¹⁷⁴

The introduction of ESOPs can be traced back to 1974 and ERISA, but the legislation has been amended on numerous occasions since then.¹⁷⁵ There were around 11,000 ESOPs in 1999 with 9 million employee participants and a total equity volume of more than \$400 billion. Some 10 per cent of ESOPs are listed

¹⁶³ However, ESOPs are *always* excluded from the diversification requirement where employer shares are concerned (section 407(b)(2)(B)(iii) ERISA).

¹⁶⁴ Section 407(b)(2) ERISA.

¹⁶⁵ ESOPs are defined in section 407(d)(6) ERISA and in section 4975(e)(7) IRC.

¹⁶⁶ The question of whether 'primarily' necessarily means over 50 per cent is not explicitly addressed. In formal interpretative guidance, however, the US Department of Labor states that this is not a momentary, but a long-term analysis (see Department of Labor, 1983).

¹⁶⁷ The share classes in question are common stock (see section 409(l)(1) IRC) or convertible preferred stock (see section 409(l)(3) IRC).

¹⁶⁸ Section 409(a)(2) IRC.

¹⁶⁹ Section 4975(d)(3) IRC.

¹⁷⁰ See Rodrick and Rosen (1999), p. 7.

¹⁷¹ Section 409(h)(1) IRC.

¹⁷² Section 409(h)(2) IRC.

¹⁷³ See n. 171.

¹⁷⁴ See Rodrick and Rosen (1999), p. 8.

¹⁷⁵ *Ibid.*, p. 5.

corporations.¹⁷⁶ ESOPs have the following advantages over traditional pension plans for employers.¹⁷⁷

First, the employees covered by the ESOP are motivated to increase productivity because they are co-owners. Although this argument is often advanced as the prime reason for establishing an ESOP, it certainly has no conclusive scientific backing. However, a study in the 1980s did confirm the motivational effect: the employees surveyed tended to feel more strongly that they were part of their company the greater their equity investment in their employer; they had greater job satisfaction; and staff turnover tended to be lower. These positive findings do not necessarily indicate a general trend, though, because they related above all to those companies that took employee participation seriously and were not merely interested in the tax breaks linked to ESOPs; the more the employees were integrated into corporate decisions and were provided with information, the more striking their positive response to ESOPs.¹⁷⁸

Second, as employee shareholders, employees covered by ESOPs are generally allies when it comes to defending the company against hostile takeovers if they are entitled to exercise the voting rights vested in their shares.¹⁷⁹ Employees covered by ESOPs may (and must in the case of listed companies and, under certain circumstances,¹⁸⁰ of unlisted companies) be entitled to exercise the voting rights vested in the shares held by the ESOP in the form of 'pass-through voting'.¹⁸¹ Where pass-through voting procedures are in place, there is a tendency for employees to vote with management in the case of takeover attempts because they tend to trust existing management to protect their jobs rather than external managers.

As a rule though, voting is a matter for the trustee under its fiduciary duties (the trustee is often the plan sponsor, i.e., the employer). The ESOP bylaws define whether the trustee is independent or has to vote as directed by a plan committee (directed voting). Even in the latter case, however, responsibility to vote in the best interests of the ESOP members rests with the trustee.¹⁸² ESOP plan committees are generally composed of directors, senior executives and/or employees of the company concerned. The members of this committee are self-evidently exposed to conflicts of interests; equally, they are not necessarily familiar with matters of finance and fiduciary duties, which is why this responsibility of the trustee may be significant. There is a view, for example, that trustees should only follow the instructions of the plan committee in the case of important or extraordinary voting matters if, after due consideration, they themselves believe that this would

¹⁷⁶ *Ibid.*, p. 3.

¹⁷⁷ See Louge and Rader (1998), pp. 327–30.

¹⁷⁸ See Rodrick and Rosen (1999), p. 29.

¹⁷⁹ Rodrick and Rosen (1999), pp. 212–14 describes the standard legal precedent on the breach of fiduciary duties during the course of attempts to prevent a hostile takeover using an ESOP.

¹⁸⁰ *Ibid.*, p. 166.

¹⁸¹ *Ibid.*, pp. 14ff describes details of the complicated rules for exercising voting rights applying to ESOPs.

¹⁸² *Ibid.*, p. 371.

not produce a result that would be imprudent or not in the best interests of the ESOP members; otherwise, the 'trustee override' must be invoked.¹⁸³ Such a case is, of course, contentious and should be well thought through by trustees to eliminate any remaining doubts and avoid the possibility of exposure to claims for damages.¹⁸⁴

In the case of pass-through voting, the trustee can only ignore the employees' instructions if it is blatantly obvious that these are in breach of ERISA.¹⁸⁵ The trustee is only released from the obligation to exercise voting rights if an investment manager has been engaged to vote. In this case, the trustee is only required not to implement the investment manager's decisions if he or she is aware – or should be aware – that fraud is involved.¹⁸⁶

What often happens in practice is that ESOPs are used in anticipation of – or in response to – a takeover battle. There is even a view in some quarters that this is often the most attractive feature of ESOPs for companies, and that the motivation argument mentioned above is overrated; these observers also believe that the tax break argument discussed below is also exaggerated because the same effect can be achieved with other instruments, and existing ESOPs mostly do not make full use of the tax advantages available to them.

Another argument advanced in support of this view is that ESOPs frequently end up disadvantaging shareholders – and thus also the ESOP beneficiaries – because they are good at sheltering inefficient management. In addition, management is tempted to influence the ESOP members to follow its line in votes on other matters, although this does not necessarily coincide with the interests of the ESOP beneficiaries.

ESOPs thus encourage conflicts of interest that cannot in practice always be resolved by management in line with its fiduciary duties as plan sponsor. ERISA certainly imposes the obligations of prudence and observance of fiduciary duties for ESOPs. For example, an ESOP fiduciary¹⁸⁷ must act solely in the interests of the plan members¹⁸⁸ although this does not mean that it cannot derive other benefits from an ESOP, but that conflicts of interest must be resolved in favour of the beneficiaries.¹⁸⁹ Moreover, the ESOP trustee must make clear to all involved

¹⁸³ *Ibid.*, p. 165.

¹⁸⁴ *Ibid.*, pp. 175–7.

¹⁸⁵ *Ibid.*, p. 172.

¹⁸⁶ *Ibid.*, p. 161.

¹⁸⁷ The following parties may be fiduciaries: trustee (custodian, receipt of employer contributions and payment of benefits to employees), plan administrator (appointed by the plan sponsor to administer the ESOP; this can also involve self-appointment by the sponsor) and the members of the Plan Investment Committee (see Rodrick and Rosen (1999), pp. 80 and 149).

¹⁸⁸ If the CEO and/or directors of the company concerned are also ESOP fiduciaries, this does not mean that they have to act in the exclusive interest of the ESOP members in all their corporate decisions and subordinate the company's interests to the ESOP members, but that the fiduciary duties only apply if they are administrators of the ESOP. However, such fiduciaries may become indirectly liable if they do not contest certain management decisions as representatives of the shareholders' interests (see Rodrick and Rosen (1999), p. 215f).

¹⁸⁹ *Ibid.*, p. 7.

that when they vote, the employees cannot be subjected to any overt or covert coercion (by management). Trustees must also inspect all information material and presentations to judge whether such coercion exists or not, and their presence at employee meetings to discuss the matter to be voted on is advisable. Finally, they must ensure that individual employees can cast their votes in a secret ballot.¹⁹⁰

Third, tax-deductible employer pension contributions and dividends on own shares held by the ESOP. Deductibility is restricted in that the contributions may account for a maximum of 15 per cent or 25 per cent (depending on the type of ESOP) of the payroll of the employees covered by the ESOP ('covered payroll').¹⁹¹

The main drawback of ESOPs from the perspective of risk/return optimization is that they are largely untouched by the obligation to diversify to the extent that this relates to the purchase and holding of employer shares.¹⁹² Without this exemption, of course, they could not meet their primary purpose of investing in securities of the employer. This means that the majority of the assets saved for retirement are necessarily concentrated in a single investment. Although ERISA contains a general rule that a maximum of 10 per cent of the plan portfolio may be invested in securities of a single company, ESOPs must invest 'mainly' in shares of the sponsor.

To remedy this diversification defect, the (supplementary) occupational pension should never rely solely on an ESOP. In fact, most of the listed companies offering ESOPs also offer additional pension plans.¹⁹³ If these are also *qualifying* plans, complicated rules must be observed that affect the maximum amount of accumulated contributions and benefits and their tax-deductibility. Combinations of a DB or a 401(k) plan with an ESOP (KSOP¹⁹⁴) are very common.¹⁹⁵ It is clear that US lawmakers were in any case fully aware of this lack of diversification in the case of ESOPs because the Internal Revenue Code stipulates that ESOP members who have been members for at least ten years and are at least 55 years old¹⁹⁶ must have an opportunity to diversify 25 per cent of their portfolio within five years.¹⁹⁷ In the sixth year, they then have a one-time opportunity to diversify up to 50 per cent of their portfolio.¹⁹⁸

¹⁹⁰ Ibid., p. 169.

¹⁹¹ Ibid., p. 10.

¹⁹² See section 404(a)(2) in conjunction with section 407(d)(3) ERISA. Rodrick and Rosen (1999), p. 206f uses a number of precedents to describe the conflict – that cannot always be clearly resolved for ESOP fiduciaries – between the duties of diversification and prudence still applying in some cases on the one hand, and the obligation to invest primarily in the shares of the employer company on the other.

¹⁹³ See Rodrick and Rosen (1999), p. 3.

¹⁹⁴ Rodrick and Rosen (1999), pp. 179–90 discusses this ESOP/401(k) combination.

¹⁹⁵ Ibid., pp. 154f.

¹⁹⁶ Section 401(a)(28)(B)(iii) IRC.

¹⁹⁷ Section 401(a)(28)(B)(i) 1st sentence IRC.

¹⁹⁸ Section 401(a)(28)(B)(i) last sentence IRC.

Foreign currency assets

Risk/return characteristics of demographic arbitrage considering the Asian crisis as an example

Emerging markets, especially the very dynamic regions of South-East Asia and China, are of great interest for funded pension institutions in particular: markets that are unsaturated compared with the western hemisphere offer strong economic growth opportunities. Substantial capacity expansion is necessary to be able to satisfy the high level of demand (for goods), and the ability to finance it far outstrips the internal abilities of the countries concerned. In addition to foreign direct investment, the resulting demand for foreign capital is being satisfied by the local capital markets, which are now open to foreign investors within certain limits.

The demographic structure of these countries is also generally more favourable than in the West, because the birth rates are higher and life expectancy is lower.¹⁹⁹ This opens up an opportunity for demographic arbitrage (i.e., exchanging today's supply of scarce capital in the emerging economies for future returns of capital to the retiree generation in the West, generated by the plentiful supply of labour in the emerging economies). An important factor to consider, though, is the limited ability of these countries to absorb (foreign) capital. If capital inflows are not matched by (sufficient) productive investment opportunities, there is a risk of speculative bubbles that are encouraged by poor market transparency, corruption, malpractice and fraud.

The risk/return characteristics of emerging markets can be outlined using the Asian crisis that emerged in mid-1997: for many years, the Tiger States of Eastern and South-East Asia (Thailand, Malaysia, Singapore, Indonesia, the Philippines, South Korea, Taiwan) recorded high growth rates until there was a comparatively sudden recession in the summer of 1997 (see Figure 5.17), albeit not without early warning indications (especially balance of payments deficits – see Figure 5.18 – and high levels of foreign debt in the private sector).²⁰⁰

The trigger was the floating of the Thai baht (THB) by the Bank of Thailand on 2 July 1997, following many years of pegging the currency to a clearly dollar-heavy basket of currencies. From an effectively fixed exchange rate of around 25 baht to US\$1, the Thai currency plunged within half a year to a low of 56.5:1 by mid-January 1998 (see Figure 5.19).

¹⁹⁹ With the Communist Party's 'one child' policy, which is intended to counteract a population explosion that would overstretch the country's resources, China's position is special in that a corresponding population ageing process will be the result.

²⁰⁰ Even if not all of the Tiger economies have the same level of economic development, have (sometimes very) different political systems (or had so before the crisis) and were hit to differing extents by the Asian crisis, the example of Thailand is given here as a representative of all the (South-) East Asian countries that were directly impacted by the crisis because the underlying initial conditions (which led to the emergence of the crisis) and the effects of the crisis ultimately did not differ essentially from country to country.

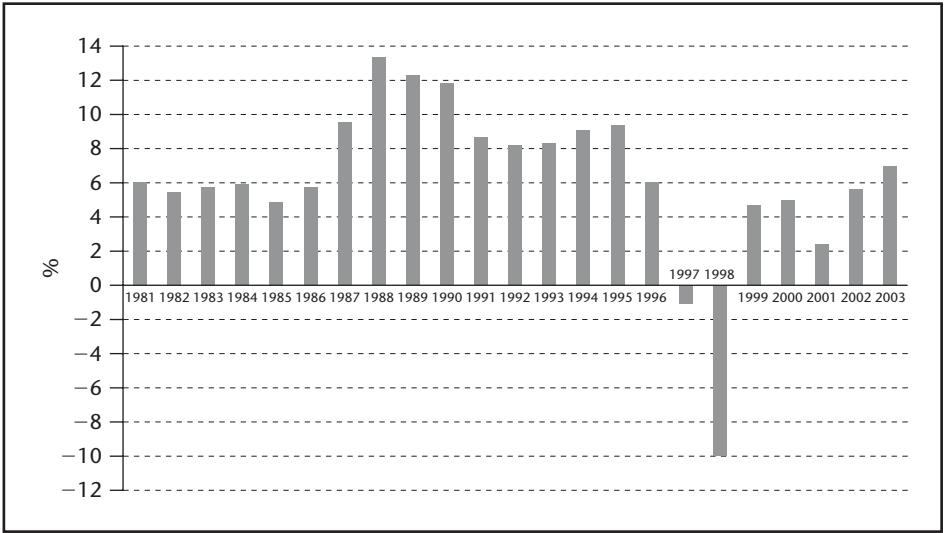


Figure 5.17 Real growth in Thai GDP between 1981 and 2003

Source: Bank of Thailand, <http://www.bot.or.th>

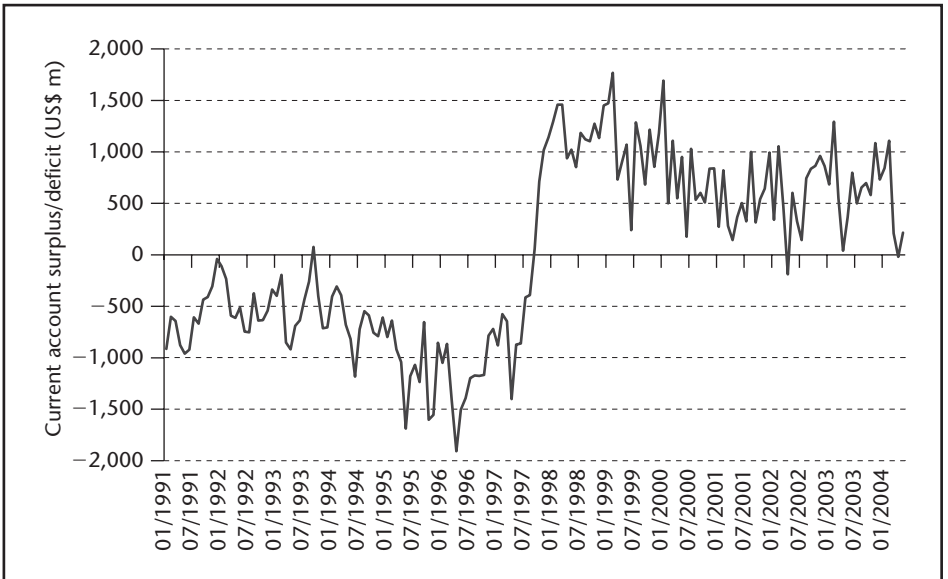


Figure 5.18 Thai balance of payments in millions of US\$ from early 1991 to mid-2004

Note: Price and economic data from Reuters.

Following a brief recovery, stock market prices – which had already fallen heavily prior to the currency flotation – dropped further and suffered massive losses because of the accompanying huge currency devaluations against the US dollar and the euro. In a sort of domino effect, the crisis was transmitted to Thailand's



Figure 5.19 Exchange rate for the Thai baht compared with the US dollar from early 1994 to mid-2004

Note: Price and economic data from Reuters.

neighbour, Malaysia, to Singapore, the Philippines, Indonesia, South Korea and (to a lesser extent) to Taiwan and Hong Kong as well. The most dramatic effects were felt in Indonesia: one dollar cost around 2,500 rupiahs before the crisis, but at times almost 17,000 after it (see Figure 5.20). The massive economic disruption also led to regime change there.

The development of Thai stock exchange prices clearly shows the conflict of interests between high returns and sustained value growth: although the Thai SET index rose to more than 1,700 in the mid-1990s, it collapsed to around 200 in the wake of the crisis (see Figure 5.21), accompanied by a slide in the value of the baht versus the US dollar of more than 50 per cent.

Restrictions on foreign currency assets in the EU

The rules in many EU Member States imposing ceilings on investments in assets denominated in a particular currency²⁰¹ have become far less important within the euro zone countries. Pension funds should always have sufficiently liquid assets in the currencies in which their liabilities are denominated so that due pension payments can be made.²⁰² The EU prohibits Member States from issuing regulations that require life insurers to invest more than 80 per cent of their

²⁰¹ See European Commission, Com (1997) 283 (1997), table IX.

²⁰² See European Commission, Com (1999) 134 final (1999), p. 15.

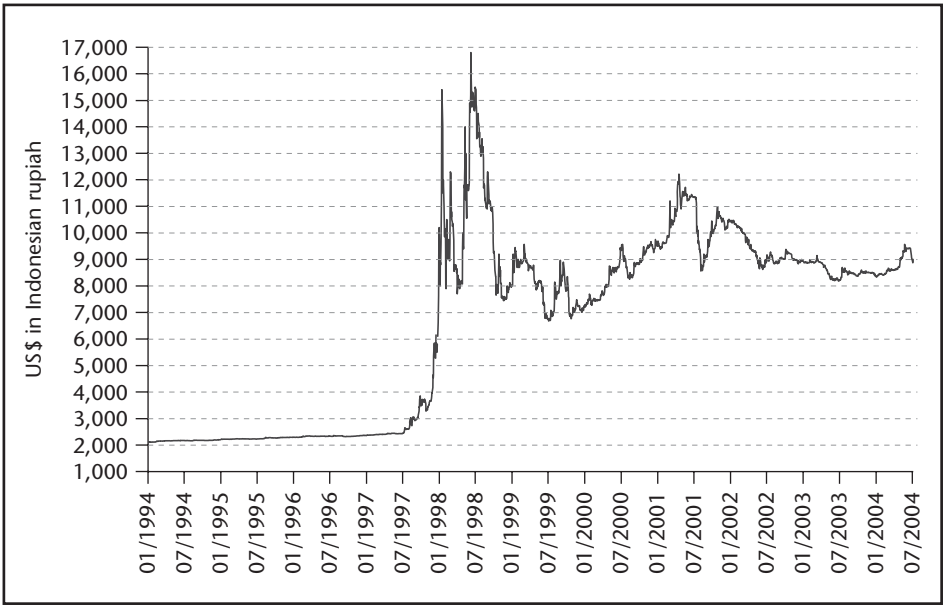


Figure 5.20 Exchange rate of the Indonesian rupiah to the US dollar from early 1994 to mid-2004

Note: Price and economic data from Reuters.

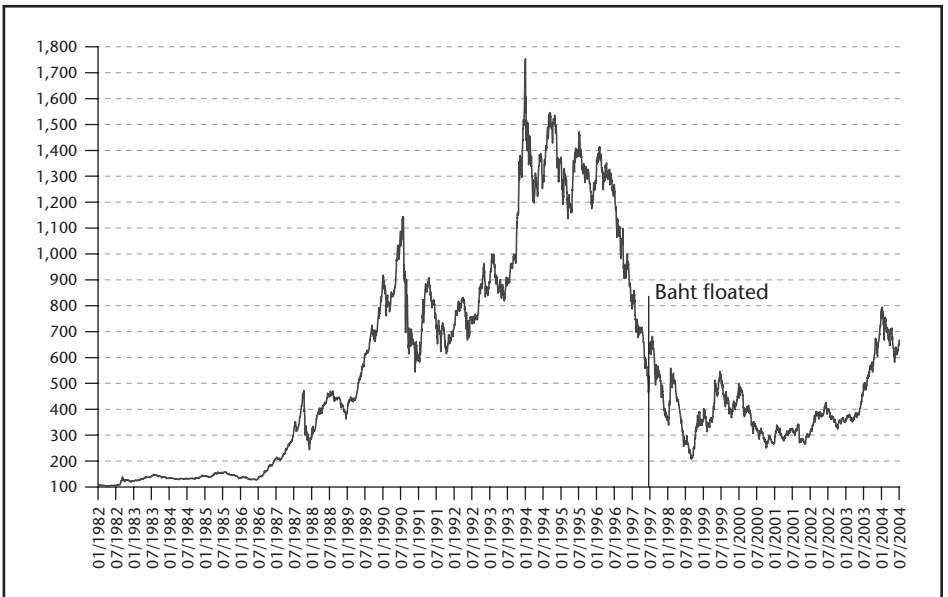


Figure 5.21 Performance of the SET, Stock Exchange of Thailand, index from early 1982 to mid-2004

Note: Price and economic data from Reuters.

assets in a matching currency (i.e., a currency in which the liabilities are denominated),²⁰³ but the currency matching rules within the euro zone were abolished for both occupational pensions and life insurers when the euro was introduced on 1 January 1999.²⁰⁴

During the preparatory phase for the draft Pension Funds Directive, the Commission provided no clear answer as to whether currency matching rules would be needed, preferring instead to await the findings of further studies.²⁰⁵ During the consultations held at the time, some Member States voiced the opinion that both pension funds and life insurers should have to invest 80 per cent of their assets on a matched basis. Others countered by arguing that the long-term nature of pension fund investments means that exchange rate fluctuations are relatively insignificant; the investments in non-EU countries with a sustained need for capital coupled with a high working proportion could represent a significant source of income in the coming decades, and there is therefore no need for such a (far-reaching) matching currency requirement.²⁰⁶

The justification put forward in the 'Rebuilding Pensions' study for rejecting currency matching rules was that they disrupt capital market efficiency, increase risk instead of reducing it, while at the same time preventing opportunities from being seized, and that a board of directors is a much more suitable vehicle for ensuring security. Specifically, the study argued that investments in convertible currencies should be possible largely without any restrictions at all, and that it should be up to the board of directors to decide on modest investments in non-convertible currencies. The factors driving such a decision should be, first, fund-specific aspects,²⁰⁷ and second, the correlation with the fund's other asset classes. If the correlation with the other asset classes is low or even contrary, such assets may well be ideally suited for reducing the risk of the portfolio as a whole.²⁰⁸ What finally emerged – as in the proposed Pension Funds Directive published in October 2000²⁰⁹ – was a stipulation that at least 30 per cent of assets may be invested in non-matching currencies.²¹⁰

Growing importance of investment in foreign currency assets in the USA

The usual reason given for investing in non-US securities is that this strengthens diversification and that the non-US markets, which are seen as less information-efficient, offer opportunities for high active returns. In practice, growing financial market integration and globalization make such investments increasingly easy.

²⁰³ See Art. 20(3) in conjunction with Art. 26 and Annex II point 4 Directive 2002/83/EC.

²⁰⁴ See European Commission, Com (1999) 232 (1999).

²⁰⁵ See European Commission, Com (1999) 134 final (1999), p. 5.

²⁰⁶ See European Commission, Com (1999) 134 final (1999), p. 24.

²⁰⁷ Fund-specific factors are above all the liabilities structure (for DB only), risk aversion and the fund's investment strategy.

²⁰⁸ See Pragma Consulting (1999), pp. IVf.

²⁰⁹ European Commission, Com (2000) 507 final, 2000, Art. 18(6)(b).

²¹⁰ Art. 18(5)(b) Directive 2003/41/EC.

The rising share of international securities in US portfolios is also certainly due to the fact that the relative share of the US capital markets in the global capital markets has shrunk in recent decades, especially as regards equity instruments,²¹¹ so pension funds are more or less forced to 'switch' part of their assets into non-US securities so that they can invest the continuous flow of incoming pension contributions. Before deciding to invest in foreign securities, however, the fiduciary has to clarify or resolve a number of issues.²¹²

- 1 Will the fund invest in industrialized economies or emerging markets? This means either investing in relatively moderate but stable, or strong but highly volatile, economic growth with corresponding price movements.
- 2 Are the markets driven primarily by supply and demand, or more by state regulation/control?
- 3 The performance of foreign markets varies because their risk/return profile differs from that of the domestic market; this is further accentuated significantly by the foreign currency factor. This foreign currency risk increases the opportunity to realize significant active returns because of the assumed informational inefficiency of non-US markets.
- 4 The diversification effect (i.e., reducing risk and/or increasing return by adding international equities) is not unambiguous: certain studies show a low correlation between foreign and US securities, which would support the diversification effect. However, they also established that phases of high volatility are accompanied by rising correlation, meaning that the diversification effect tails off significantly precisely when it is most needed.²¹³ In addition, the apparent good performance of certain foreign indices on a dollar basis is due in part solely to the foreign currency factor; on a local currency basis, a lower return compared with the US market is accompanied by a higher risk (expressed by the volatility).
- 5 The higher cost of trading foreign securities: increasing globalization, improved institutional efficiency (especially in the form of transactional efficiency) and greater trading productivity thanks to the use of state-of-the-art information technology may reduce the cost drawback and also improve the supply of information, but there is still a cost difference.
- 6 Tax treatment: if withholding taxes are deducted abroad, there may be double taxation treaties in force which enable tax exemption or at least a partial refund.
- 7 Differing accounting standards may complicate matters for analysts.

²¹¹ US\$ bonds have maintained their relative share, but also because US\$ bond issues by non-US issuers have risen.

²¹² See Louge and Rader (1998), pp. 332–7.

²¹³ See the discussions of commodities as an asset class in the section on A look at strategic asset allocation, p. 295.

- 8 Foreigners face securities trading restrictions on various non-US markets. For example, SET, the Thai stock exchange, restricts stocks that can be traded by foreigners to the 'Alien Board', with the result that only a smaller number of listed companies can actually be traded. There is a special class of shares tradable by foreigners for these selected companies, and the prices quoted for them normally differ from the corresponding 'domestic' class.
- 9 Recruiting suitable asset managers: even if the fund only invests passively, it still needs expertise in trading practice and market characteristics to ensure that the cost edge offered by passive portfolio management can actually be exploited.
- 10 To avoid squandering resources, the importance of investing in emerging markets for the performance of a pension fund should not be overrated: emerging markets only account for 1 per cent to 2 per cent of global market capitalization, and will therefore only make up a similarly low proportion of the pension fund's portfolio. This means that only a small proportion of the fund manager's time and resources should be devoted to this minor share of the portfolio, because even if such a small component of the portfolio generates an exceptionally high return, its effect on total portfolio return will still be very small; the reverse is also true, of course, as shown by the catastrophic performance of the emerging markets since the late 1990s.

Special criteria for defined benefit plans

Funding requirements for defined benefit schemes

Defined benefit pension plans are faced with the problem of 'funding adequacy' (i.e., the percentage of the plan's assets needed to cover its liabilities). If the market value of the plan's assets is lower than the present value of the plan's liabilities less future contributions, the plan is underfunded; if the reverse is true, it is fully funded or overfunded.²¹⁴

The value of the plan assets is influenced by two factors: the contributions paid in by the employees and/or employers, and by the investment policy.²¹⁵ Certain assumptions must be made so as to be able to quantify the value of the pension plan liabilities.²¹⁶

- 1 The wage/salary growth rate of each member of the pension plan.
- 2 How long will each employee remain part of the workforce from today? Statutory or plan-specific rules governing vesting of the benefits are of particular importance here.

²¹⁴ See Matthes and Klein (2000), p. 294.

²¹⁵ See Louge and Rader (1998), p. 74.

²¹⁶ See Louge and Rader (1998), pp. 79f.

- 3 What is the remaining life expectancy of each employee from the date of retirement?
- 4 What discount rate should be applied from today to the expected benefit payments?

In the wake of the capital markets crisis in the early years of the twenty-first century, pension funds using the traditional DB system are facing massive underfunding problems, both in the USA and especially in the UK.²¹⁷ Because British pension fund portfolios generally have a particularly high equity component,²¹⁸ they were hardest hit in international terms. For example, between 1999 and 2001 alone, the value of British occupational pension assets fell by just on 19 per cent from approximately £842 billion to approximately £684 billion.²¹⁹ In early 2003, underfunding of pension benefits at UK FTSE 100 companies reached £85 billion (approximately €127 billion).²²⁰

At the largest UK pension fund, belonging to the BT Group, pension assets fell from £29.7 billion to £22.8 billion between the end of 1999 and the end of 2002, reducing funding cover from 97 per cent to 92 per cent.²²¹ As did many other British companies, British Telecom responded to the financial top-up obligations this meant for the company by closing its defined benefit pension funds to new employees, among other measures.²²² To eliminate the deficit, BT had to contribute more than £1.2 billion between 2001 and 2003, and it again had to lift its annual 'deficiency payments' in early 2004 by a further approximately 15 per cent. Moreover, on 1 April 2003, the employer contribution to the pension fund was increased by approximately 5 per cent.²²³ Because the BT Group pension fund has a high level of maturity,²²⁴ something that will further increase because it has been closed to new hirings, efficient asset management of the pension fund is very important for analyst ratings, together with the quality of the operating business.

Due to their lower equity components, US pension funds were generally affected to a lesser extent by the fall in equity prices. However, there are also

²¹⁷ In the UK, 80 per cent of pension funds in 2002 were DB plans (see No author given, 2002).

²¹⁸ In 1995, 80 per cent pension fund assets of UK companies consisted of equities that were directly held or held indirectly via investment funds, and only 13 per cent bonds (see BVI (2000d), p. 47). In 2002, estimates put the share of equities in UK pension funds at approximately 70 per cent (see Targett 2002b).

²¹⁹ See No author given (2002).

²²⁰ See Coggan (2003).

²²¹ See BT Group (2003), p. 45.

²²² Since 31 March 2001, new employees have only been able to join the DC 'BT Retirement Plan' (see BT Group, (2003), p. 46).

²²³ In each of the three years from 2001 to 2003, BT paid £200 million p.a. in deficiency payments, plus a total of £629 million in extraordinary contributions for early pensioners. The annual deficiency payment has been £232 million since 2004. The contribution rate was increased from 11.6 per cent to 12.2 per cent (see BT Group (2003), p. 46).

²²⁴ At 31 Dec. 2002, the number of pensioners exceeded that of working employees by 94 per cent (see BT Group (2003), S. 46).

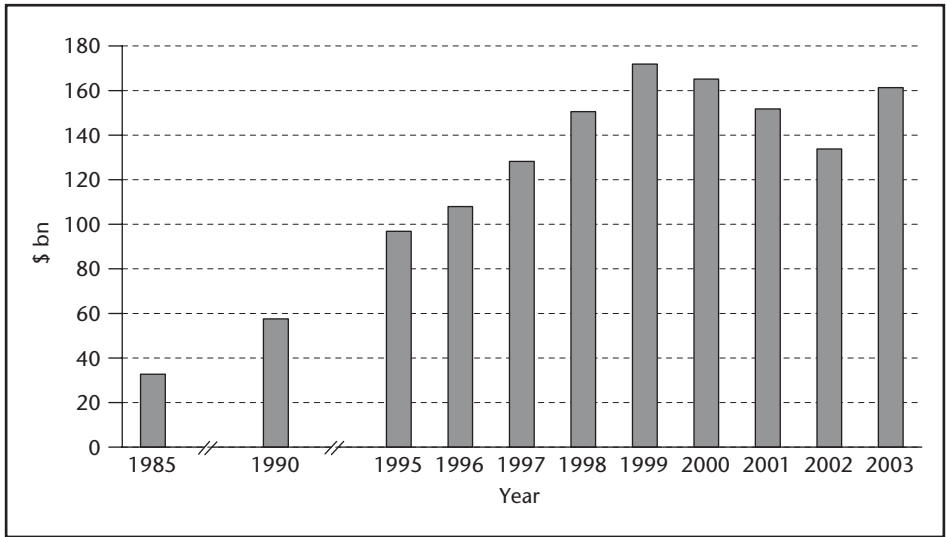


Figure 5.22 Retirement asset value of US pension fund Calpers between 1985 and 2003 (US\$ billions)

Source: Calpers (2004b), p. 1

major pension funds in the USA with equity-dominated asset allocation. One example is Calpers, the largest US pension fund, whose membership is composed of approximately 1.4 million public service employees and pensioners.²²⁵ Strategic asset allocation at Calpers has defined a target equity ratio of 65 per cent since early 2003, and this was substantially exceeded at the end of 2003 with equity investments actually accounting for 68 per cent.²²⁶

At some 20 per cent lower compared with the average UK pension fund, this equity component is certainly a prime reason why the (relative) pension asset losses that also occurred at Calpers between 1999 and 2001 were a good 50 per cent lower than in the UK: Calpers reached its highest year-end asset level of US\$ 171.9 billion at the end of 1999, and recorded losses of just on 12 per cent to US\$ 151.8 billion at the end of 2001. Figure 5.22 shows how further losses of approximately 12 per cent to US\$ 133.8 billion were incurred in 2002, before an increase of almost 21 per cent in the following year almost returned Calpers to its position at the end of 2000. The significant losses in 2000 to 2002 resulted in underfunding in mid-2002 of around 2 per cent to 10 per cent, depending on pension plan member category.²²⁷

²²⁵ See Calpers (2004a), p. 1.

²²⁶ See Calpers (2004b), p. 1. Even when the stock market crisis peaked in 2002, the Calpers equity proportion was only slightly lower: at the end of March 2002, the target equity share was 64 per cent, and the actual equity share was 63.9 per cent (see Calpers, 2002).

²²⁷ Calpers distinguishes between three different categories of pension plan members: state employees, teachers and employees of public institutions (see Calpers (2004b), p. 4).

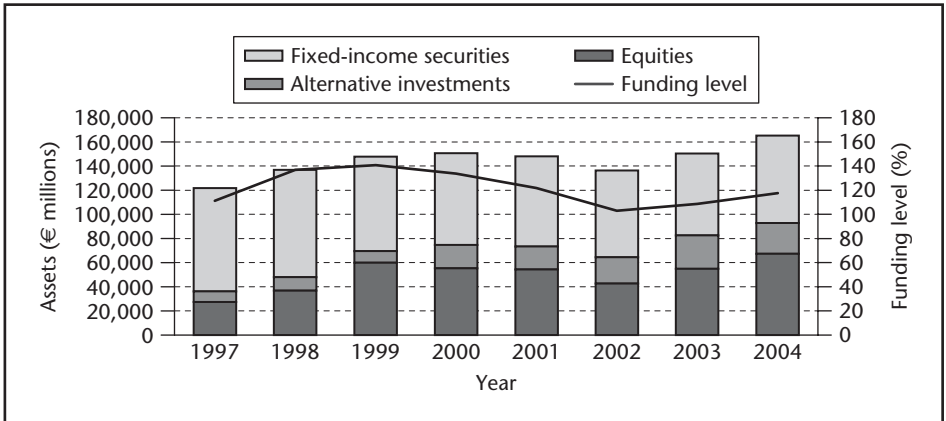


Figure 5.23 Asset allocation and funding development of Dutch pension fund ABP between 1997 and 2004

Notes: Asset Allocation: see ABP (nd).
 Pension assets and liabilities and funding level for:
 1997: see ABP (2002), p. 6.
 1998–2002: see ABP (2003), p. 8.
 2003: see ABP (2004), p. 2.
 2004: see ABP (2005), pp. 8, 52.

The fact that Europe's largest pension fund, APB in the Netherlands,²²⁸ also had substantially lower funding in 2002 to 2004 compared with the equity market boom at the end of the 1990s, despite having significantly lower equity components than its UK or US counterparts, is evidently less to do with massive share price losses than with the very high annual growth rates of its benefit obligations in the past six or seven years (see Figure 5.23). While the loss in the value of the pension assets between the year-end high in 2000 and the subsequent year-end low (so far) in 2002 was 'only' 10 per cent (€14,738 million), liabilities rose by 17 per cent over the same period (€19,333 million). Due to subsequent favourable capital market performance the funding level gained remarkably from year-end 2002 (funding ratio 103 per cent) to year-end 2004 (funding ratio 118 per cent). Nevertheless the funding ratio was significantly higher at the peak of the equity boom, when it stood at 141 per cent at year-end 1999.

Dynamic Minimum Funding

Before adopting the draft Pension Funds Directive, a proposal had been made to the European Commission to include a flexible (Dynamic) Minimum Funding Requirement (DMFR) for DB plans. The argument against a rigid system that requires permanent minimum 100 per cent funding is that the long-term nature of pension plans also allows a temporary, relatively minor underfunding of the

²²⁸ See n. 123 and n. 124, p. 262.

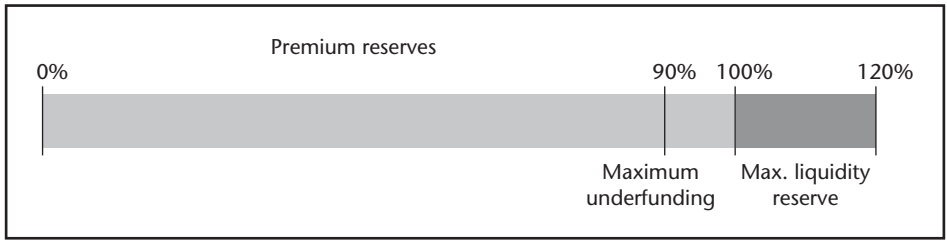


Figure 5.24 Example of a flexible minimum funding requirement with max. 10 per cent underfunding and max. 20 per cent overfunding

benefit obligations. A DMFR is governed by the asset structure/risk profile and the liability structure of the pension fund concerned, and allows both overfunding of the total premium reserves (in the form of a liquidity reserve) as well as slight underfunding.²²⁹ The level of over- or underfunding is expressed as a percentage, which need not be symmetric, of the benefit liability (see Figure 5.24).

On the asset side, the proportion of equities in the total fund assets plays a particularly significant role, while on the liability side, the average age of the participants and the ratio of contributors to beneficiaries (i.e., the maturity of the pension fund) are the key factors.²³⁰

The advantages of such a DMFR are that it can be tailored to individual funds and that short-term fluctuations in contributions can be avoided; this means that there is no need to adjust the contribution level every time the fund's assets fall slightly short of the premium reserves, but rather that contributions are only reduced if the maximum liquidity reserve is exceeded²³¹ or increased if underfunding exceeds the permitted limit.²³²

The proposal included a recommendation that the premium reserves must be measured by an actuary who is independent of the plan sponsor. As a rule,²³³ an additional compulsory solvency margin does not appear to make much sense, because the standard practice of specifying a small percentage of assets does not offer sufficient protection, but only the appearance of protection, and would merely push up the cost of pension provision.

In conjunction with a critical assessment of the prudent man rule, the European Commission draws attention to the existence of modern risk management

²²⁹ See Pragma Consulting (1999), pp. Iff.

²³⁰ See Pragma Consulting (1999), pp. 9f.

²³¹ Instead of contribution cuts, there may be improved benefits, granting contribution holidays or even refunds.

²³² See Pragma Consulting (1999), p. III.

²³³ In the case of funds with guaranteed returns or biometric risks covered by the fund, a solvency range may exceptionally be appropriate. Similar to the case of a DMFR, however, any solvency range should be dynamically structured, e.g., using a value-at-risk model (see Pragma Consulting (1999), p. 13). However, a guaranteed minimum return is viewed as conflicting with the prudent man rule and the fundamental principle of fundability because they are inefficient in practice and hinder optimum asset allocation (see Pragma Consulting (1999), p. 31).

systems, and more explicitly Asset/Liability Management (ALM): this method invests portfolio assets to reflect the nature and duration of the corresponding liabilities and concentrates portfolios on the highest corresponding realizable returns,²³⁴ with the increased risk thereby incurred offset by diversifying the investments into assets that are imperfectly correlated.²³⁵ The limits to this investment freedom for defined benefit pension plans are therefore the nature and duration of the liabilities to the plan members.²³⁶

A central requirement for ALM is that the liabilities must be measured by an independent actuary using accepted actuarial principles.²³⁷ As a model, ALM should be used to capture financial market volatility risks and their impact on fund assets and liabilities²³⁸ and enable a balanced investment (asset) and funding (liabilities) policy that will harmonize the sometimes conflicting goals of contribution minimization, contribution stability and avoidance of underfunding (as far as possible).²³⁹

The recommendation put forward to the European Commission was to incorporate ALM in a code of good practice,²⁴⁰ but it also included a cautionary note that ALM is sensitive to the assumptions made and that the risk of potential manipulation is therefore high; in addition, various representatives of supervisory authorities are against the notion of mandatory ALM.²⁴¹

Asset value/interest guarantees and portfolio efficiency

State-subsidized retirement products frequently feature an investment guarantee. Defined benefit occupational plans in the USA or Germany, for example, are covered by obligatory default insurance funded by the contributions of these benefit plans. Asset value guarantees are obligatory both in Germany and Austria for the new pillar 2 and 3 pension products introduced in recent years.²⁴² The main justification given for the need for investment guarantees for retirement products is that, as a rule, they are designed to provide a basic pension (i.e., 'to ensure a *minimum standard of living* (to be defined individually) for the rest of the person's life') and that in the case of the basic pension, 'the focus should be primarily on the security aspect, especially investment security, and not the potential maximum

²³⁴ See European Commission, Com (1999) 134 final (1999), p. 22.

²³⁵ See European Commission, Com (1997) 283 (1997), p. 10.

²³⁶ See European Commission, Com (1999) 134 final (1999), p. 5.

²³⁷ See European Commission, Com (1999) 134 final (1999), p. 5.

²³⁸ See European Commission, Com (1999) 134 final (1999), p. 22.

²³⁹ See Pragma Consulting (1999), p. 16.

²⁴⁰ See Pragma Consulting (1999), p. IV.

²⁴¹ See n. 239.

²⁴² Pillar 2 in Germany is composed of defined contribution pension plans with a minimum benefit (see n. 488, p. 91), with Riester pension products as the third pillar (see n. 459, p. 88). In Austria, the new severance pay scheme launched in 2002 created a new type of occupational pension provision (see n. 609, p. 110), and the premium-subsidized future provision (see n. 648, p. 115) introduced in 2003 is an additional private pension vehicle.

return'. That is why 'the principle of safety first must apply to the core need for private retirement provision', so 'people seeking retirement products should primarily be interested in the existing product guarantees'.²⁴³

However, this sort of argument in favour of investment guarantees ignores two key aspects: first of all, the proper alternative to 'security' is not 'maximum return', but rather an investment with an efficient risk/return profile. After all, especially in those cases where the income situation during the working phase means that only relatively low savings amounts can be contributed, 'secure', but hence also low, returns may lead to such low levels of pension benefits that the desired basic pension often cannot be achieved at all. There is thus a risk that this 'belief in security' actually harms those individuals it allegedly protects as well as society as a whole: retirement products offering low returns may not be in a position to cover the steadily expanding pensions gap caused by successive benefit cuts in the pillar 1 scheme, so that pensioners may do no more than reach the level of welfare benefits, or even slightly lower, despite the supplementary pension.

Second, the supplementary pension certainly does not ensure the basic pension as defined above, but frequently serves to maintain the standard of living to which the investor is accustomed. However, if subsidized retirement products feature an obligatory investment guarantee, then this type of saver cannot achieve their savings objective efficiently using subsidized products. They are forced to accept a security ideal that is well in excess of their own objectives; it robs them of a more promising investment, thus in turn making it more difficult for them to achieve their savings objective (i.e., they can only do this by incurring a greater financial outlay). Ultimately, it is economically inefficient to prevent retirement savers who are willing and able to assume risk (in the sense that they can ensure their basic pension elsewhere and will thus not be a burden to society at large as potential welfare benefit recipients) from doing so.

Asset value and interest guarantees necessarily lead to overweighting relatively risk-free asset classes because, in the event of underfunding, the product providers and (in the case of pillar 2 pensions) the sponsors are generally obliged to make good any shortfall, and it is only rational that they should wish to avoid this. The fact that demand for guarantee products is strong in German-speaking countries, and not just for subsidized pensions, and that governments stress capital guarantees as a particularly advantageous feature,²⁴⁴ indicates that the average risk aversion of people in these countries is high. But this most certainly does not mean that asset value guarantees make sense for individual retirement savers and/or for the economy as a whole, but rather that it can be assumed that 'risk is misunderstood'.²⁴⁵

²⁴³ Albrecht (2003a), pp. 7f.

²⁴⁴ For asset value guarantees in occupational pension provision in Germany, see, e.g., Federal Ministry of Labour and Social Policy, Berlin (2001) and for private pension provision in Austria, e.g., Federal Ministry of Finance (2003c).

²⁴⁵ Zimmermann and Bubb (2002), p. 13.

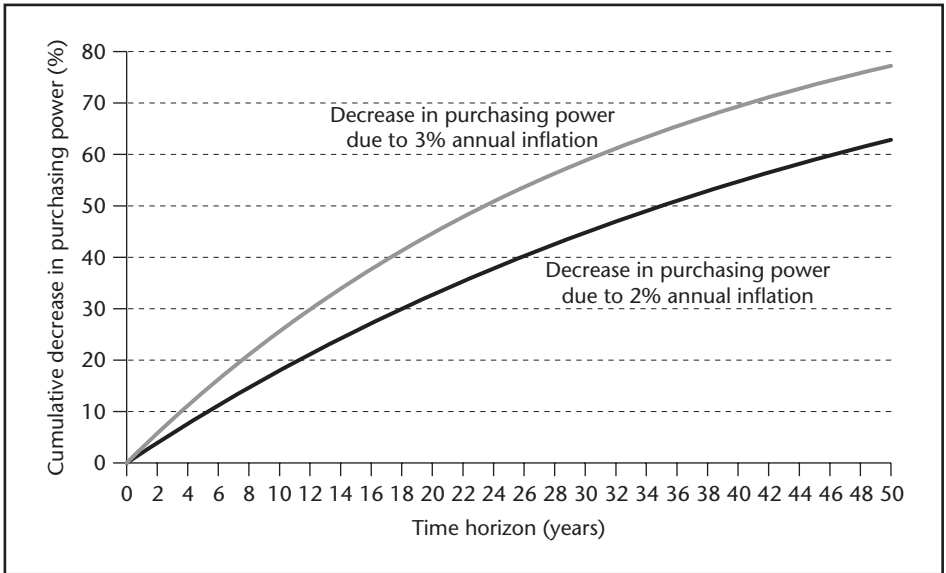


Figure 5.25 Loss in purchasing power due to inflation as a factor of the time horizon

Since asset value guarantees ‘ignore the effects of inflation’, their security effect is ‘a monetary illusion’.²⁴⁶ The cumulative loss in purchasing power due to inflation can assume a considerable magnitude over the sort of long investment horizons that are typical for retirement planning, even if annual inflation rates are relatively low. If a 20-year old were to start saving today using a pension product with a nominal value guarantee, assuming a (constant) annual inflation rate of 2 per cent (3 per cent),²⁴⁷ the retirement assets will suffer a 59 per cent (74 per cent) loss in purchasing power after 45 years if the guarantee kicks in (see Figure 5.25).

This

poses the question of the extent to which ‘nominal/real capital preservation’ represents a rational objective, or whether there is more of a psychological effect that creates particularly strong reluctance to fall below the initial assets. We can suspect that the requirement for capital preservation is frequently imposed only because of inadequate reflection on the logic of such objectives, and not because of future consumption objectives that by chance match the precise level of the assets saved so far.²⁴⁸

In addition to the monetary illusion argument, another factor that runs counter to the logic or feasibility of securing retirement assets against capital market

²⁴⁶ Albrecht (2003b), pp. 5f.

²⁴⁷ Average consumer price inflation in Austria [Germany] (UK) between 1991 and 2004 was 2.22 per cent [2.09 per cent] (2.12 per cent); see Statistik Austria (2005b) and Statistik Austria (2005c) for Austrian Consumer Prices Index figures; Federal Statistical Office (no date/c) for Germany and National Statistics (2005) for the UK.

²⁴⁸ Albrecht (1999), p. 131.

fluctuations by using guarantees is that the economic capital stock as a whole is exposed to non-diversifiable risks which may be transferred from one actor to another, but do not thereby disappear from the system. Because the macro-economic capital can thus never be invested risk-free, capital market actors are needed who are willing and able to bear the investment risks, for which they are rewarded by a risk premium. Insurance companies and pension funds are major institutional investors, and not only in German-speaking countries; they are thus the main pillars of macro-economic savings and, together with their naturally long investment horizons, therefore predestined to assume investment risks. In practice, security-driven quantitative investment rules coupled with guarantees, whose funding must be evidenced *continuously* and not just at maturity,²⁴⁹ result in the extensive avoidance of equity investments by the pension institutions because of the threat of top-up obligations. If a growing proportion of the national income channelled into savings is ostensibly invested risk-free because of an ageing population, the market price of risk will rise if there is no change in the capital stock. As a result, the capital stock is discounted at a higher rate and thus massively devalued, which would be extremely disadvantageous for business and the economy as a whole.

Following the reforms in Germany and Austria in recent years, the incentives for excessive risk avoidance by retirement provision institutions are increasingly less a result of direct quantitative investment restrictions than of obligatory minimum returns, whose funding must also be evidenced regularly over the entire term, leading to an inadequate investment horizon. This in turn results in inefficient pension portfolios, whose average return is too low to provide an adequate pension benefit because the continuous recognition of the guarantee funding cuts the length of the effective investment horizon and leads to massive income shortfalls. Today's investment objectives of pension institutions therefore make little sense. Guaranteeing a certain nominal minimum return is neither possible over the typical time horizon of a pension institution, nor is it economically efficient.

Statutory minimum interest rules, which are strengthened substantially by the need to provide continuous evidence of funding, thus lead to the more or less significant primacy of the security aspect over the return aspect, depending on how pronounced they are. The state encourages pension institutions in this way to focus their investment strategy one-sidedly on this interest barrier. This leads to potential long-term suboptimal investment decisions and to inefficient performance. Despite lower returns because of inefficient investment, ensuring a pension that safeguards the standard of living normally requires unjustifiably high savings amounts.

In the pay-as-you-go system, the question of what are reasonable contributions is inextricably linked to the question of the stability of the inter-generational contract, which may well be terminated if there is a sustained, significant breach

²⁴⁹ In the case of Riester products, for example, a monthly funding statement is required (see n. 529, p. 96).

of the principle of equivalence. Inter-generational fairness means that there is no immediate justification for the fact that people born after around 1970 will have to substantially reduce their consumption during working life compared with the preceding cohorts to be able to afford the radically higher pension contributions needed both to finance people already in retirement and to accumulate their own retirement assets.

The current legal position as regards asset value and interest guarantees for retirement products, coupled with their largely positive perception in the media and the population at large, gives grounds for suspicion that both government and people have not grasped that a pension system whose efficiency depends largely on financial market returns will always entail risk, and that risk-free investments (fixed income investments) are not available over the long time horizons that are typical for retirement planning. Because inefficiencies in a pension system must necessarily be shouldered by the beneficiaries or the taxpayer, there is an urgent need to rethink the obligatory nature of such asset value and interest guarantees.

The fiduciary's responsibility in defined contribution plans

In the case of defined contribution plans as well, which are by definition always fully funded and do not oblige the plan sponsor to pay any guaranteed minimum benefit, the fiduciary is not released from his responsibility to the members, even if (as frequently happens) the members themselves select the investments made by their pension plan ('self-directed' plans). As the fiduciary, the plan sponsor is required to ensure that:²⁵⁰

- the beneficiaries are able to invest in suitable asset classes
- the asset managers offered to the beneficiaries must be prudently selected by the fiduciary
- there is a certain degree of continuous oversight and evaluation of investment performance, as a result of which the asset manager may be changed
- the costs are reasonable and are controlled

The essence of future standard-setting

Quantitative investment restrictions for pension funds that set restrictive upper or lower limits for investments in certain asset classes, countries or currencies are incompatible with risk/return-efficient investment and thus with the prudent person rule, and must therefore be clearly rejected. The long-term nature of retirement planning favours equity investments. By contrast, asset allocation that has a

²⁵⁰ See Louge and Rader (1998), pp. 64f.

one-sided focus on security because of exaggerated risk aversion will most probably result in insufficient retirement assets, and may thus ultimately not meet the need for (social) security in practice. Quantitative investment restrictions hamper or prevent the implementation of both passive and active portfolio management. Investors are thus forced to sacrifice return and assume (unnecessarily) higher risk. These efficiency losses are not negligible. For the long-term investment horizons that are typical for pension funds, even marginal improvements in returns produce an appreciable increase in the future value. Reflecting the prudent person rule, the investment must be oriented to a far greater extent on the structure of the liabilities of (especially DB) pension plans (asset-liability matching).

Quantitative investment restrictions generally aim to impose limits on (international) equity investment and favour (government) bonds. A *risk/return comparison of equities and bonds* is therefore very important.

- 1 Historical performance comparisons of equities and bonds mainly demonstrate the superiority of equities over long observation periods. A large number of such studies of the US, international, or German capital markets show that equities have a superior risk/return profile to bonds for the long investment periods that are typical for retirement planning.
- 2 One of the explanations for this advantage is the concept of time diversification: although there is no uniform opinion on this in the literature, a synopsis of the most common approaches allows the conclusion that the duration of the investment horizon is accompanied by significant risk reduction if realistic assumptions are applied for investor preference and the return-generating process, the availability of sources of income other than investment income and an opportunity for interim portfolio rebalancing.
- 3 The life-cycle approach is an operational implementation of the time diversification hypothesis. Collective retirement plans (pension funds) normally follow this approach by implementing an ALM concept. Because of the individual characteristics of the retirement savers, implementation is associated with high costs for providers of pillar 3 pension products. However, it is not necessary to manage each individual portfolio separately to achieve a high level of efficiency, and it is quite sufficient to offer investment alternatives with different degrees of risk and allow the investor to switch at low or no cost to less risky alternatives with increasing age.

Another problem in terms of investment rules is the liability for securities weightings resulting from active portfolio management where they vary from common benchmarks. The rule in the USA is that *passive portfolio management* also does not provide any unrestricted exemption from liability for poor performance, because the prudent person rule – especially in the form of the prudent expert rule – may make deviations from the benchmark necessary.

Investments in derivatives are normally subject to even stricter restrictions than equities. However, derivatives should not be avoided simply because of a

mistaken understanding of risk because, if suitable strategies are employed, they can increase efficiency without incurring excessive additional risk. Appropriate risk management is of course the *sine qua non*.

For example, futures enable low-cost, diversified exposure to a wide variety of domestic and foreign markets or sectors. In turn, *appropriate diversification* is indispensable for risk/return-efficient investing. Quantitative individual issuer limits do not therefore breach the prudent person rule, but should rather be seen as the operational embodiment of this best practice rule. The recent Enron case shows in particular that a lack of any restrictions on investments in shares (or other assets) of the sponsor of an occupational plan, or to allow these restrictions to be inappropriately lax, is simply irresponsible and a clear breach of the requirements of the prudent person rule. As a rule, such investment limits increase security without sacrificing efficiency.

ESOPs in the USA are a good example of the inefficiency and greater insecurity of pension plans that are not designed primarily for retirement provision. This also applies to the new Austrian retirement vehicle (premium-subsidized future provision), albeit to a lesser extent. If retirement provision is merely a subordinate requirement, the likelihood of building up an adequate level of retirement assets will, all else being equal, be reduced.

The frequently encountered constraints on strategic asset allocation through restrictions on investment in international assets obstruct the search for cross-border opportunities to improve returns and the ability to reduce (total) risk through better diversification. Decisions in this area have a substantial impact on the risk/return profile: it is evident that international asset allocation is the most significant reason for the variation in performance of internationally oriented portfolios.²⁵¹ Emerging markets offer an opportunity for diversification beyond that of the generally highly efficient capital markets in the industrialized countries. However, lower efficiency is not a one-way street – emerging markets also follow the capital market law that higher returns entail higher risk. The capital market risks of various emerging markets, most recently in the 1990s, urgently demonstrate the need for appropriate risk management. Emerging markets are, however, interesting for pension funds from the perspective of demographic arbitrage.

Quantitative investment restrictions, such as currency matching rules, should therefore only be applied with great restraint. Combined with the greatest possibly transparency and a multi-level supervisory or oversight system which ensures that front-line decisions are taken by an effective board, the prudent person rule offers the necessary flexibility for the prudent exploitation of return opportunities on international markets in general and emerging markets in particular, while still offering a high level of security.

Interest and asset value guarantees also impair risk/return efficiency. They lead to overcautious asset allocation and thus ultimately to insufficient retirement assets.

²⁵¹ See Grinold and Kahn (2000), p. 518.

Such guarantees therefore represent indirect quantitative investment restrictions. This problem is exacerbated by the requirement for regular funding evidence because this results in a radical shortening of the effective investment horizon and thus impairs or prevents time diversification. Asset value guarantees offer a poor cost/benefit ratio: the disregard for the considerable loss in purchasing power over long (investment) periods and the inability to eliminate (investment) risk at a macro-economic level are offset only by a degree of psychological reassurance.

DISCLOSURE

Statement of Investment Principles/Policy

Significance

Statement of Investment Principles, Statement of Investment Policy or Investment Policy Statement (SIP/IPS) are all terms that describe investment policies. The pioneer in Europe here has been Switzerland, which has had a positive experience with SIPs since they were introduced in April 1997.²⁵² The EU Pension Funds Directive in turn demands 'a written statement of investment policy principles',²⁵³ reflecting the recommendations during the drafting process.²⁵⁴ The new Austrian occupational funded pension instrument, the new severance pay scheme was designed to be compatible with this requirement. The 'investment policy principles' are a mandatory component of the admission agreement between the sponsor and the staff provision fund administering the retirement benefits.²⁵⁵ The VAG pension funds introduced in Germany on 1 January 2002 as a result of the 2001 pension reform also provide for an obligatory 'statement of investment policy principles'. This must be submitted to the BaFin 'annually or without delay in the case of any material change in the investment policy'. The minimum content includes disclosures 'on the risk measurement method', 'on risk management' and on strategic asset allocation as a function of the 'nature and duration of the retirement benefits'.²⁵⁶ The high level of abstraction of these requirements for investment policy principles is not fleshed out in any detail in the derivative legislation, which merely repeats the wording of the underlying law word-for-word to a very large extent. Because a promised circular²⁵⁷ explaining the details required by the regulator has not yet appeared, key issues are still unresolved. In particular, it is not clear which 'internal investment principles and control processes' will be deemed to be 'suitable' by the BaFin, or the

²⁵² See Pragma Consulting (1999), p. 24.

²⁵³ Art. 12 Directive 2003/41/EC.

²⁵⁴ See Pragma Consulting (1999), p. 45.

²⁵⁵ Section 11(2) no. 2 BMVG.

²⁵⁶ Section 115(3) VAG as amended by Art. 10 no. 4 AVmG.

²⁵⁷ Section 1(2) last sentence PFKapAV.

extent to which 'other organizational measures' represent specific requirements for the establishment and design of the inter- and intra-institutional separation of functions and compliance measures to avoid and monitor potential conflicts of interest.²⁵⁸

In the USA, a funding policy and funding method consistent with the objectives of the pension plan are a mandatory element of any retirement plan under ERISA.²⁵⁹ Although this rule does not represent an express obligation to prepare a written SIP, the US Department of Labor, under whose auspices ERISA operates as a regulatory authority, does recommend it emphatically.²⁶⁰ The SIP is drawn up by the pension fund board/board of trustees. The reasoning behind this division of responsibilities is to avoid conflicts of interest that could arise if the SIP were to be drawn up by asset managers or investment advisers, because they could be tempted to tailor the SIP to the features of their own products instead of to the needs of the shareholders.²⁶¹

Among other things, the reasoning behind an SIP is to generate the following benefits:²⁶²

- 1 An investment policy formulated in an SIP can be supervised and assessed. Distortions in valuation due to selecting the wrong benchmark (meaning that the characteristics of the portfolio and the benchmark do not match) should not arise. Risk/return criteria that are stipulated in advance and easy to audit substantially restrict the scope for excuses in the event of prolonged underperformance.
- 2 An SIP provides arguments or evidence in the event of accusations – or even lawsuits – relating to inadequate asset management.
- 3 Continuity of investment policy does not depend on who the portfolio manager or investment adviser actually is.
- 4 An SIP can serve as an 'anchor' for portfolio managers in times of crisis and help avoid panic-driven decisions because there is an investment policy that has been prepared with the consent or knowledge of the investor, rather than merely arbitrary investment decisions.
- 5 Even when there are no extreme situations on the capital markets, an SIP enables a logical and systematic investment policy, rather than sometimes emotionally driven buy or sell surges when the market booms or collapses.

²⁵⁸ Section 1(2) PFKapAV stipulates that 'compliance with the investment principles by qualified investment management, in particular risk management measures, suitable internal investment principles and control procedures, a prospective investment policy and other organization measures must be ensured'.

²⁵⁹ Section 402(b) ERISA.

²⁶⁰ See Galer (2002), p. 52.

²⁶¹ See Trone *et al.* (1996), p. 106.

²⁶² *Ibid.*, pp. 105f.

A look at strategic asset allocation

The concept of asset allocation will now be explained briefly because it involves the single most important decision in the management of any pension plan²⁶³ and its effects on long-term performance are more significant than those of asset selection.²⁶⁴ The purpose of asset allocation is to enhance efficiency through diversification. Asset allocation in the broader sense has many levels, while asset allocation in the narrower sense only involves diversification at the asset class level.

Asset allocation in the narrower sense is analysed below, and distinguishes between the following primary asset classes:²⁶⁵

- (a) equity instruments (domestic and foreign listed shares of issuers in industrialized countries);
- (b) bonds;
- (c) cash (money-market securities);
- (d) unlisted equity investments such as private equity, venture capital and real estate;
- (e) less common investments such as shares and corporate bonds of issuers in emerging markets, commodities and similar.

The first three are the classic asset classes. The other two are also termed 'alternative investments' in connection with retirement provision.

Managers should only invest in alternative investments offering a high active return²⁶⁶ if the following constraints as against classic asset classes can be accepted: lack of price transparency, high administration/management fees,²⁶⁷ no specific benchmarks²⁶⁸ and frequently a lack of liquidity that may see capital being tied up for the long term. These features – and in particular the lack of benchmarks – demand the use of active management, preferably by external specialists. In concrete terms, this means investing in private equity or hedge funds.²⁶⁹

Commodities may be a suitable instrument for inclusion in the portfolio because they enhance the diversification effect: based on historical data, the

²⁶³ See Louge and Rader (1998), p. 115.

²⁶⁴ See Galer (2002), p. 44.

²⁶⁵ See Louge and Rader (1998), pp. 105f.

²⁶⁶ Because there are no benchmarks, success can be measured as a comparison with opportunity costs, normally in the form of previous investments in liquid securities: a successful private equity programme should produce a return higher than listed alternative securities. This return premium is composed of subpremiums for illiquidity, the frequently high level of gearing and the efficiencies generated by the managers/owners. In concrete terms, this means creating an artificial benchmark based on a liquid index, plus a premium of 3–5 percentage points.

²⁶⁷ On average, the management fees for private equity and hedge funds are around double those for typical equity funds (investing in liquid securities). Profit sharing of between 20 per cent to 30 per cent comes on top of these already high fees.

²⁶⁸ See n. 266.

²⁶⁹ See Cullie and Smith (2001).

Bridge Commodity Research Bureau Index (CRB), which represents the price trend of a commodity portfolio, displays a negative correlation with Standard & Poor's 500 Composite Total Return Index (S&P) of -0.25 , the Morgan Stanley Capital International (MSCI) Europe, Australasia, Far East Index (EAFE) of -0.08 and US treasuries of -0.39 . However, more recent studies indicate that if there are disruptions on the main markets, the correlation between certain markets rises appreciably.²⁷⁰

Defining the optimum mix of asset classes is termed strategic asset allocation. 'Optimum' here means a combination of various asset classes that on average will best meet the required return of the pension plan over the long term, without assuming more risk than appears prudent in view of the risk tolerance of the plan sponsor and the beneficiaries; that is, the return requirements and risk preference of the pension plan on the one hand must be reconciled with the risk/return opportunities of the capital markets on the other. This process is also known as 'constrained portfolio optimization'.²⁷¹

The usual result is the specification of strategic asset allocation as a set of target percentages of the defined asset classes in the overall portfolio, such as 30 per cent long bonds, 60 per cent equities and 10 per cent cash, although a certain permitted tolerance should be defined for these target percentages (for instance, a target percentage for bonds of 30 per cent \pm 5 per cent).²⁷² Once this decision has been taken, its suitability must be continuously reviewed, and the strategy should be modified if necessary.²⁷³

An example of an analytical approach that can be applied to strategic asset allocation is described below.²⁷⁴

- Step 1: Outline of various scenarios relating to future financial market development over the relevant planning horizon (e.g., 5 years). Each scenario is defined by the expected risk/return characteristics of the three main asset classes: equities, bonds and cash (see Table 5.7).
- Step 2: Definition of alternative asset allocations to be evaluated (see Table 5.8).
- Step 3: Calculation of the development of the alternative portfolios (from Step 2) (and the resulting funding situation for a DB plan²⁷⁵) on the basis of the various scenarios (from Step 1; see Table 5.9).
- Step 4: Selection of the suitable asset mix: a variety of models can be used here, some of which are illustrated below. This step puts demands

²⁷⁰ See Peterson (2001).

²⁷¹ See Peterson (2001), pp. 114f.

²⁷² See Peterson (2001), p. 117.

²⁷³ See Peterson (2001), p. 156.

²⁷⁴ See Peterson (2001), pp. 151–6.

²⁷⁵ To be able to calculate pension obligation over- or underfunding, an existing discounted pension obligation of 100,000 is assumed in the case presented; this is 100 per cent covered by the initial value of the portfolio and increases at a constant growth rate of 7 per cent per annum.

Table 5.7 Alternative financial market scenarios

	Equities	Bonds	Cash
<i>Scenario A (high inflation, low growth)</i>			
Expected return	0.0	2.0	6.0
Expected standard deviation	16.0	10.0	3.0
	Equities with bonds	Equities with cash	Bonds with cash
Correlation coefficient	0.0	0.0	0.0
<i>Scenario B (normal inflation and growth)</i>			
Expected return	12.0	5.5	3.5
Expected standard deviation	20.0	8.5	1.0
	Equities with bonds	Equities with cash	Bonds with cash
Correlation coefficient	0.0	0.0	0.0

Source: Louge and Rader (1998), p. 152

Table 5.8 Alternative asset allocations (%)

Asset Allocation No.	Equities	Bonds	Cash
1	85	10	5
2	60	30	10
3	20	70	10

Source: Louge and Rader (1998), p. 152

on fiduciaries because they must understand the model (and in particular the underlying assumptions and the data used), and also because even if they have not developed the model themselves but have delegated this task, they cannot thereby abandon their responsibility.

- Min-max strategy: selection of an asset mix that requires the lowest pension contributions under the worst case scenario. This approach is based on the notion that the plan sponsor (=employer) can increase its contribution in good times without any significant problems, but must minimize its costs in bad times.
- Seeking the lowest possible total contributions, either on average or discounted to the present value.
- Seeking the lowest possible volatility of over-/underfunding.

Step 5: Further considerations:

- Allocation to passive and active management in each individual asset class.
- Rebalancing the portfolio: either at fixed intervals (quarterly or yearly) or if certain bandwidths are exceeded (see above).

Table 5.9 Analysis of alternative asset allocations for the alternative financial market scenarios

Scenario	A Asset allocation no.			B Asset allocation no.		
	1	2	3	1	2	3
Expected return	0.50%	1.20%	2.00%	0.93%	9.20%	6.60%
Expected standard deviation	13.64%	10.06%	7.70%	17.02%	12.30%	7.46%
Expected portfolio value	100.500	101.200	102.000	110.925	109.200	106.600
Expected value of pension obligations	107.000	107.000	107.000	107.000	107.000	107.000
Expected over-/underfunding	-6.500	-5.800	-5.000	3.925	2.200	-400
Maximum overfunding ^{abc}	20.780	14.320	10.400	37.970	26.740	13.940
Minimum overfunding ^{acd}	-33.780	-25.920	-20.400	-30.110	-22.340	-14.740

^a Excluding pension contributions (i.e., growth from capital gains/income only)

^b Return 2 standard deviations above the expected value

^c Assuming normally distributed returns, the actual over-/underfunding is not less than the minimum underfunding with a 97.75 per cent probability, and lies between the minimum and maximum overfunding with a 95.5 per cent probability

^d Return 2 standard deviations below the expected value

Source: Louge and Rader (1998), p. 154

Statement of Investment Principles for pension funds in the EU

Recommendations for the EU Pension Funds Directive urged that SIPs should be required for all pension funds, irrespective of whether they are DB or DC plans, and irrespective of the size of the fund.²⁷⁶ The adopted Directive does indeed require an obligatory 'written statement of investment policy principles',²⁷⁷ although 'small pension institutions' may be exempted by Member States from this obligation (and from the Directive in its entirety).²⁷⁸ The statement of investment policy principles must be made available to the supervisory authorities regularly²⁷⁹ and to the pension fund members on request.²⁸⁰

In terms of content, a suggestion was made to orient the definition of strategic asset allocation on any asset/liability management in place.²⁸¹ The final Directive

²⁷⁶ See Pragma Consulting (1999), p. V.

²⁷⁷ Art. 12 Directive 2003/41/EC.

²⁷⁸ Art. 5 Directive 2003/41/EC.

²⁷⁹ Art. 13(c) Directive 2003/41/EC.

²⁸⁰ Art. 11(3) Directive 2003/41/EC.

²⁸¹ See Pragma Consulting (1999), p. 16.

implemented the recommendation only to stipulate general principles and minimum requirements and to leave more detailed rules to the Member States if they wish. The core elements of the recommended content (i.e., the formulation of the risk policy, the return objectives, strategic asset allocation and self-imposed prudential principles²⁸²), were only partly implemented in the Pension Funds Directive. The requirements for minimum content are remote from the relatively concrete proposals contained in the 'Rebuilding Pensions' study, which called for the following points to be included in the SIP:²⁸³

- (a) the board's risk perception and risk tolerance, including how it will manage and control risk;
- (b) the fund's strategic asset allocation and its return objectives, reflecting any liabilities the fund may have and the market environment at the time the SIP is prepared, and with a three-year time horizon;
- (c) the board's self-imposed prudential principles.

It is regrettable that the Commission did not follow these suggestions in its draft Pension Funds Directive. Because transparency and systematization of the investment process evidently arouse relatively little political interest, only four lines were dedicated to describing the minimum content,²⁸⁴ which was taken over almost unchanged in the final Directive: the statement of investment policy principles must contain 'at least, such matters as the investment risk measurement methods, the risk-management process implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities'.²⁸⁵

Minimum content in the USA

In the USA – where they are termed 'Statements of Investment Policy' or 'Investment Policy Statements' – SIPs have been mandatory under ERISA since 1974.²⁸⁶ Core requirements for an SIP are a written definition of the type of pension plan, the nature of the contributions and their calculation, and the nature of the asset management, in particular the careful drafting and implementation of an investment strategy suited to the pension plan.²⁸⁷

ERISA has now been in force for more than a quarter of a century and is tailored above all to the needs of DB pension plans, which are increasingly losing out to DC plans. In addition, the following, legally non-binding, proposal for designing an SIP from the US perspective may be considered as a suggestion for relevant

²⁸² See Pragma Consulting (1999) p. V.

²⁸³ See Pragma Consulting (1999), p. 24.

²⁸⁴ Art. 12(1) European Commission, Com (2000) 507 final (2000).

²⁸⁵ Art. 12 last sentence Directive 2003/41/EC.

²⁸⁶ See Pragma Consulting (1999), p. 24.

²⁸⁷ See Trone *et al.* (1996), p. 104.

European standards. The proposal calls for the SIP to be structured as follows in six chapters.²⁸⁸

- 1 Objective and background:
 - (a) the SIP is the board's most important tool for monitoring and assessing the pension plan's investment programme;
 - (b) presentation of the groups of individuals covered by the pension plan and of the expected future development of contributions and payouts, plus a list of the individuals involved in the plan's administration.
- 2 Statement of goals (i.e., the interim target and final outcome of the pension plan):
 - (a) general investment goals: assumption of reasonable risk in respect of the portfolio as a whole, and maximization of the return achievable with this level of risk, risk optimization by diversification, cost control;
 - (b) specific investment goals (e.g., whether the plan is a defined contribution or defined benefit scheme).
- 3 Policies and investment principles:
 - (a) risk tolerance;
 - (b) investment horizon;
 - (c) preferred asset classes;
 - (d) expected return: there may be no contradictions between the definition of the policies and the statement of investment goals; for example, the goal of a 5 per cent real return is not consistent with the policy of a maximum 30 per cent investment in equities. The second challenge in this chapter of the SIP is to strike the right balance between sufficient certainty and a reasonable level of residual freedom to invest.
- 4 Permitted securities policies: as with the definition of the investment principles, the objective here is to balance the need for sufficient precision with the avoidance of excessively tight reins for the asset manager. The asset manager's decision-making powers cannot be restricted so much that the sponsor essentially retains discretionary control over investment decisions; on the other hand, it is important to clarify which securities and which asset management practices, such as options writing, securities lending or buying securities on credit, are desired, and in particular which are prohibited.
- 5 Selection of the asset manager:
 - (a) professional qualification and licensing requirements;

²⁸⁸ See Trone *et al.* (1996), pp. 107ff.

- (b) minimum requirements to be met by the asset manager's track record in investment, for instance, compatibility with accepted Performance Presentation Standards;
 - (c) evidence of human and technical resources to cope with the planned volume of investment;
 - (d) character references and undertaking to notify the sponsor of any future problems with the law and/or the executive.
- 6 Oversight:
- (a) regular reports on the market value and composition of the fund assets and the transactions executed during the reporting period, plus review of consistency with the stipulated criteria (see above);
 - (b) regular performance presentations in accordance with defined standards;
 - (c) examination at longer intervals
 - of the technical reserves (applies only to DB systems) and their coverage by fund assets;
 - of the cost of asset management and the fees and commissions incurred.

Preparing and updating the SIP

The board of directors/board of trustees prepares the SIP in the USA. For EU pension funds, a similar arrangement was proposed in the drafting phase for the Pension Funds Directive. Reflecting the situation in the USA, the 'Rebuilding Pensions' study recommended at least an annual review of the content, or a more frequent interim review if circumstances dictate.²⁸⁹ Ultimately, however, no board similar to a US board was established, and neither were any detailed rules stipulated for the procedure for preparing and reviewing the SIP.

The fund prospectus

Prospectuses in the USA

Definition

The Securities Act of 1933 defines a prospectus as a document or radio or television communication which offers securities for sale or confirms their sale. Such written documents or communications are not deemed a prospectus if a full prospectus was made available at the time when the written document was sent or given to the person to whom the communication was made or the information was

²⁸⁹ See Pragma Consulting (1999), p. V.

broadcast, or the written document or broadcast communication indicates from whom a full prospectus may be obtained.²⁹⁰

Access to prospectuses in the USA

US fund investors must be provided with an updated prospectus before or no later than at the time of sale of fund shares.²⁹¹ In addition, the shareholders must be provided with the prospectus within three working days of receipt of a request.²⁹² US investment funds must also send their shareholders updated prospectuses each year.²⁹³

The purpose of this rule is questioned by some experts, who think that few of these prospectuses are actually read because the information that is genuinely new is not clear to the recipients, who would have to read the entire prospectus, including all the information that has not been updated. This is why, in 1999, the SEC considered introducing annual prospectus updates that are designed to provide shareholders every year with a brief outline of material developments or changes in the fund, and thus enhance the effectiveness of communication between funds and their shareholders.²⁹⁴ This proposal was not implemented, however, although it has been put into practice for US pension funds: the 'Summary Plan Description' (SPD) is the equivalent of the investment fund prospectus, and the 'Summary of Material Modifications' is the summary of updates compared with the most recent SPD.²⁹⁵

Fees and expenses

Significance of fees and expenses: Disclosure of fees and expenses is a major component of US fund prospectuses.²⁹⁶ As part of its efforts to educate investors via the Internet, the SEC provides a variety of tools to help them invest in mutual funds. These also help investors rate fund costs (for instance, by using the Mutual Fund Cost Calculator,²⁹⁷ which compares the cost of owning funds for a particular period once the user has entered certain data from the prospectus).²⁹⁸ Another guide to investing in mutual funds available online at the SEC's website contains a section on the importance of fees.²⁹⁹

²⁹⁰ Section 2(a)(10) Securities Act of 1933.

²⁹¹ Section 5(b) Securities Act of 1933.

²⁹² See Instruction on Rule 498(c)(1)(v), 17 CFR 230 and Instruction 3 on Item 1(b) Form N-1A, 17 CFR 274.

²⁹³ Rule 30e-1, 17 CFR 270.

²⁹⁴ See Roye (1999e).

²⁹⁵ See section on Annual report, summary plan description and pension account statement for US pension funds, p. 326.

²⁹⁶ The General Accounting Office revealed deficiencies in the transparency of fee and expense reporting by US investment funds in 2003 (see GAO, 2003).

²⁹⁷ See US Securities and Exchange Commission: <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm>.

²⁹⁸ See US Securities and Exchange Commission (2000h).

²⁹⁹ See US Securities and Exchange Commission (no date/b).

Sales loads: Shareholder fees, sales loads, or sales charges are one-time commissions payable by shareholders on the purchase or sale of fund shares and are used to finance distribution and advertising expenses.³⁰⁰ Sales loads vary considerably, and are sometimes not charged at all ('no-load funds'), but in any case they are limited in the USA to a maximum of 8.5 per cent of the initial investment³⁰¹ (or a maximum of 6.25 per cent if a 12b-1 fee is charged³⁰²). For 'front-end load' funds, the charge is due on purchase of the shares, and for 'back-end' or 'deferred load' funds, it is not payable until the shares are sold although, in the latter case, the level of the charge normally drops the longer the shares are held (usually by 1 per cent a year), until it finally disappears.

Fees and expenses/expense ratio: Funds charge expenses (operating expenses) for services relating to the ongoing operation of the fund.³⁰³ The most important types of expenses are described below.

The *management fee* is the largest single component and compensates the investment adviser for managing and selecting the components of the fund portfolio.³⁰⁴

A *distribution* or *12b-1 fee* (if applicable), is named after 'Rule 12b-1'³⁰⁵ and issued by the SEC in 1980 under the Investment Company Act. Under certain circumstances, an investment adviser can also function as the distributor of its fund's shares. Resulting distribution expenses, such as advertising, issuing costs, compensating sales professionals and printing and sending prospectuses to individuals other than the current shareholders, can be charged directly to the fund on the basis of a written 12b-1 plan (12b-1 fee). This plan must contain all details of the distribution methods and must be approved by a majority of voting shareholders and independent directors (renewed every year).

The not necessarily obvious notion of charging the fund shareholders for distribution, rather than the investment adviser, is justified as follows: it is not only the investment adviser who has an interest in encouraging the growth of the fund (through better distribution, say, by advertising), but also the shareholders because, for instance, economies of scale may result in a cut in the (percentage) management fee.³⁰⁶

The 12b-1 fee is limited by law to a maximum of 0.75 per cent of the average net asset value of the fund if a front-end or back-end sales load is charged, plus a service fee of a maximum of 0.25 per cent of the fund net asset value (NAV).³⁰⁷

Other expenses may be charged for additional services offered to the shareholders, such as toll-free information services, Internet services, and the printing and

³⁰⁰ See NASD Conduct Rule 2830, section (a)(8).

³⁰¹ See NASD Conduct Rule 2830, section (d)(1)(A).

³⁰² See NASD Conduct Rule 2830, section (d)(2)(A).

³⁰³ See Investment Company Institute (1998b), p. 3.

³⁰⁴ See Investment Company Institute (2000a), p. 26.

³⁰⁵ 17 CFR 270: Rule 12b-1, Distribution of Shares by Registered Open-End Management Investment Company.

³⁰⁶ See US Securities and Exchange Commission (2000h), footnote 27.

³⁰⁷ See NASD Conduct Rule 2830, sections (d)(2)(E)(i) and (d)(5).

Table 5.10 Allocation of the cost of investment fund services and components of the expense ratio

Type of service	Funding Method	Included in expense ratio?
1. Investment management (i.e., 'portfolio advice')	Management fee	Yes
2. Administration and recordkeeping	Management fee, fees to service providers	Yes
3. Buying and selling securities	Commissions, bid/ask spreads	No
4. Distribution and marketing	Sales charge, 12b-1 fee, adviser profits	12b-1 fee, yes; otherwise, no
5. Financial advice/planning	Sales charge; 12b-1 fee; separate fee or commission paid to a broker, financial planner, or investment adviser; wrap fee	Sometimes
6. Consolidated statements and other services provided by a 'mutual fund supermarket'	Supermarket receives portion of management fee, 12b-1 fee, or adviser profits	Yes (unless paid from adviser profits)

Source: US Securities and Exchange Commission (2000h), chart 1

mailing of information. Expenses incurred as a result of other services not covered by the management or distribution fee, such as custodial expenses, legal expenses and transfer agent expenses, may also be settled by charging other expenses.³⁰⁸

The resulting total expenses are expressed as a percentage of the total amount invested in the fund to produce the expense ratio (see equation 5.14). However, the sales load or brokerage fees for securities transactions relating to the fund portfolio are never part of the expense ratio. (Equation 5.14³⁰⁹ shows the services included in the expense ratio and those that are not.)

$$\begin{aligned}
 & \text{Management fees} \\
 & + \text{Distribution (12b-1) fees} \\
 & + \text{Other expenses} \\
 & = \text{Total annual fund operating expenses} \\
 & / \text{Net assets} \\
 & = \text{Expense ratio}
 \end{aligned} \tag{5.14}$$

As Table 5.10 shows, the drawback of this way of calculating the expense ratio is that distribution and advertising expenses are only factored into the expense ratio in the case of a 12b-1 plan.³¹⁰ Before the introduction of Rule 12b-1, these

³⁰⁸ See US Securities and Exchange Commission (no date/c).

³⁰⁹ See Investment Company Institute (2000a), p. 28.

³¹⁰ See Investment Company Institute (1998b), p. 4.

costs were either borne by the shareholders through the sales load, or by the investment adviser from its profits. Since the mid-1980s, funds with a contingent deferred sales load combined with a 12b-1 fee have been increasingly supplanting traditional front-end sales load funds.³¹¹

During the course of drafting the Pension Funds Directive, there were also proposals in the EU to require disclosure of an expense ratio or of fee and expense information in another form.³¹² However, the final Directive does not contain any such disclosure requirements. If the Directive is amended, this important issue should be incorporated.

Classes of fund shares: A fund can offer various classes of shares in the same fund. These differ only in the way that costs of the fund are paid, and are typically classified as follows:³¹³

- Class A shares have a front-end sales load
- Class B shares have a 12b-1 fee and a contingent deferred sales load
- Class C shares charge a higher 12b-1 fee but have no sales load

The *Viertes Finanzmarktförderungsgesetz* (German Fourth Financial Markets Promotion Act) that came into force on 1 July 2002 now allows share classes in Germany as well; in other words, the issue of fund shares with differing 'rights in terms of utilization of income, the front-end sales load, the back-end sales load, the currency of the share, the management fee, or a combination of these features'.³¹⁴ Although this innovation would appear to be well suited to reduce the large number of funds and the related high costs, it met with a lukewarm welcome from the German investment fund industry as far as mutual funds are concerned. The probable reason for this is that there was no urgent need for this new rule because of the existing practice of launching share class funds abroad, especially via subsidiaries in Luxembourg or Ireland, and then selling them in Germany.³¹⁵

Content of a US fund prospectus: The obligatory minimum content of a US fund prospectus is governed by the Securities Act of 1933 and the rules issued under that law,³¹⁶ and by the registration forms prescribed by the Investment Company Act of 1940. The prospectus must contain most of the information contained

³¹¹ See US Securities and Exchange Commission (2000h).

³¹² See Pragma Consulting (1999), p. 37.

³¹³ See Investment Company Institute (2000a), p. 26.

³¹⁴ Section 34(1) InvG (replacing the identically worded section 18(2) KAGG as amended by Art. 3 no. 14 FinMFöG 4).

³¹⁵ See PwC (2002), p. 7.

³¹⁶ Rules 420–34 and Rule 481, 17 CFR 230.

in the fund registration statement.³¹⁷ Over and above the information expressly required by law, the prospectus may contain additional information provided that it is not incomplete, inaccurate or misleading, and does not obscure or impede understanding of the required information because of its quality, quantity or manner of presentation.³¹⁸

The core content of the prospectus is the disclosure of the fundamental characteristics and investment risks of the fund in question, emphasizing in particular the investment approach and strategy.³¹⁹ The prospectus should help the average or typical investor, who may not be sophisticated in legal or financial matters, to evaluate the risks associated with the fund in question and to decide whether (or not) to invest in the fund on the basis of a balanced disclosure of the positive and negative factors.³²⁰ The information provided should be as simple and direct as possible and should only include as much information as is necessary to enable the average or typical investor to understand the particular characteristics of the fund.³²¹

The following list provides illustrative examples of the core obligatory³²² content. Certain aspects of the contents of prospectuses are presented using extracts from two selected prospectuses issued by large US fund companies. The first of these is an international equity fund from Vanguard,³²³ and the second is a tax-exempt bond fund from TIAA-CREF.³²⁴

- 1 Legal notices: to include a statement that both the (semi-)annual reports and the SAI include additional information and are available to investors without charge on request.³²⁵
- 2 Risk/Return Summary:³²⁶ in contrast to the other parts of the prospectus, this section may only include the information expressly stipulated (and presented in the following).³²⁷ Apart from the standardized cover page and the

³¹⁷ Section 10(a) Securities Act of 1933; section 7(a) Securities Act of 1933 defines Schedule A of the Securities Act of 1933 as the content of the registration statement. The prospectus is a component ('Part A') of the fund registration statement, which is based on one of the following three registration forms, depending on the fund type involved: Form N-1A, Form N-2 or Form N-3; see the section on Statement of Additional Information, pp. 331ff.

³¹⁸ See General Instructions, C.3.b, Form N-1A, 17 CFR 274.

³¹⁹ See General Instructions, C.1.a, Form N-1A, 17 CFR 274.

³²⁰ See General Instructions, C.1.b, Form N-1A, 17 CFR 274.

³²¹ See General Instructions, C.1.c, Form N-1A, 17 CFR 274.

³²² In principle, the inclusion of non-mandatory information in the prospectus is allowed; an exception to this is the risk/return summary, which may only contain the prescribed content (see General Instructions, C.3.b, Form N-1A, 17 CFR 274).

³²³ See The Vanguard Group (2004).

³²⁴ See Tax-Exempt Bond Fund, in TIAA-CREF (2004). The choice of these two funds was due, first, to the above-average size of the two fund companies, and second, to their very different investment objectives.

³²⁵ See Item 1(b)(1), Form N-1A, 17 CFR 274.

³²⁶ See Items 2 and 3, Form N-1A, 17 CFR 274.

³²⁷ See General Instructions, C.3.b, Form N-1A, 17 CFR 274.

table of contents, the Risk/Return Summary must be placed at the front of the prospectus:³²⁸

- (a) fund investment objectives/goals:
 - Vanguard: long-term capital appreciation.
 - TIAA-CREF: high level of current income that is exempt from regular federal income tax, consistent with preservation of capital.
- (b) principal investment strategies: a summary statement of which strategy or strategies are used to achieve the investment objective(s), stating in particular the primary type(s) of security the fund invests in and any concentration on one or more sectors. A more detailed analysis of the implementation of the investment objective(s) is contained in a separate section of the prospectus where the principal investment strategies are presented.³²⁹
 - Vanguard: investment in common stocks of non-US large-, mid- and small-cap companies that are considered to be undervalued. Diversification by investing in developed and emerging markets in Europe, the Far East and Latin America.
 - TIAA-CREF: 'Investment primarily in investment grade municipal securities, the interest on which is exempt from regular federal income tax ... [R]emaining maturities at the time of purchase from approximately 8 to 12 years ... [U]p to 20 per cent of ... assets [may be invested] in non-investment grade securities.'
- (c) Risk factors: summary of the principal risks to which the fund as a whole is exposed and the circumstances reasonably likely to adversely affect the net asset value and total return of the fund.
 - Vanguard: the following investment risks are described in one or two sentences each: stock market risk, currency risk, country/regional risk, investment style risk and manager risk.
 - TIAA-CREF: the interest rate risk is stated and attention is drawn to the (political) risk of changes in tax rates and policies and their particular effects on the yields and market values of tax-exempt bonds. The high default risk associated with non-investment grade bonds is emphasized.
- (d) Historical performance: a bar chart must be used to show the fund's annual total returns for each of the last ten calendar years of the fund's life (including corresponding numerical information), disclosing the fund's highest and lowest return for a quarter during this period, and a standardized table must be provided to show the (average) annual total returns before and (in two versions) after taxes. All returns must be shown for the most recent, the last 5 and the last 10 calendar years. If the fund has been in

³²⁸ See General Instructions, C.3.a, Form N-1A, 17 CFR 274.

³²⁹ See Item 4(b), Form N-1A, 17 CFR 274.

existence for less than 5 or 10 years, the life of the fund should be used as the analysis period. Funds that have been in existence for more than 10 years may additionally include average annual returns for the life of the fund. The (average) annual returns of a suitable securities market index must also be shown for the same analysis periods.³³⁰

After-tax returns are calculated using the historical highest federal marginal income tax rate, which must be explicitly stated. The (hypothetical) taxes to be shown are taxes on distributions, and also taxes on distributions and redemption.³³¹ The pre-tax return is calculated as the total gain or loss from the increase or decrease in net asset value compared with the previous year plus any gain or loss resulting from any reinvestment of a distribution. This must be based on an initial investment of the net asset value at the beginning of the period (i.e., sales loads are not included) and redemption at the most recent quoted price at the end of the period. Sales loads *are* included when calculating the gain or loss in the case of reinvestment.³³²

- (e) Fee table: since 1988,³³³ a standardized fee table³³⁴ has been an obligatory component of US fund prospectuses. This table must include the fees payable directly by the shareholders ('shareholder fees':³³⁵ see Figure 5.26) and the recurring expenses to be borne indirectly by the shareholders that are paid from the fund assets ('annual fund operating expenses':³³⁶ see Figure 5.27), such as management and any 12b-1 fees.³³⁷

As the example given in Figure 5.28 shows, not all of these types of fee are actually charged in practice. Another striking feature is that the prospectus for the Vanguard International Value Fund does not cite all of the types of fees listed in the Rule that forms the basis in law; on the other hand, it does mention a 'purchase fee'³³⁸ that is not listed in the Rule, although it is not actually charged.

³³⁰ An index is appropriate if it is not administered by an affiliated person of the fund, its investment adviser or principal underwriter, unless it is widely used and recognized. If applicable, the index should be adjusted to reflect the reinvestment of dividends on securities in the index (see Item 2(c)(iii) in conjunction with Instruction 5 on Item 21(b)(7), Form N-1A, 17 CFR 274).

³³¹ See Item 2(c)(iii) and (iv), Form N-1A, 17 CFR 274.

³³² See Instruction 1 on Item 2(c) in conjunction with Instruction 3 on Item 8(a), Form N-1A, 17 CFR 274.

³³³ See US Securities and Exchange Commission (1988).

³³⁴ Both the layout and wording of the fee table are largely regulated; see Item 3, Form N-1A, 17 CFR 274.

³³⁵ Expenses are 'any cost or charge'; see US Securities and Exchange Commission (2000h), footnote 2.

³³⁶ Fees are 'a charge or payment for services'; see US Securities and Exchange Commission (2000h), footnote 2.

³³⁷ See US Securities and Exchange Commission (2000h).

³³⁸ A purchase fee is not a sales load, although it may also be payable on the purchase of fund shares. In contrast to the sale load, the purchase fee does not accrue to financial intermediaries, but rather directly to the fund (see US Securities and Exchange Commission (no date/c)).

- Front-end sales load (as a % of the offering price): the price may be staggered down to the total elimination of the sales load, in particular because of the volume, the existence of accumulation or withdrawal plans, or for particular classes of investors (e.g., reductions for retirement benefit plans). Reductions on the basis of volume are normally structured using the breakpoint concept, i.e., exceeding certain monetary amounts results in the relative reduction in the sales load down to its waiver. Information on any sales load breakpoints must be published in the prospectus (since 1 November 2004).^a
- Contingent deferred sales load: a fee that drops (normally to zero) the longer the fund is held, and that is payable on the redemption of fund shares as a percentage of the offering price or the net asset value at the time of redemption.^b
- Sales load imposed on reinvested distributions.
- Redemption fee: in contrast to the contingent deferred sales load, any redemption fee charged is paid directly to the fund on redemption of fund shares.
- Exchange fee: a fee may be charged for switching between funds of the same fund family.
- Account fee: Some funds charge account fees if the account balance falls below a certain threshold.

Figure 5.26 Shareholder fees to be disclosed in the prospectus

^a See Item 7(a)(2)–(4), Form N-1A, 17 CFR 274; introduced by the US Securities and Exchange Commission (2004b).

^b See Instruction 3 on Item 7(a)(1), Form N-1A, 17 CFR 274.

Source: Item 3, Form N-1A, 17 CFR 274

Management fees	_____	%
Distribution [and/or service] (12b-1) fees	_____	%
Other expenses	_____	%
_____	_____	%
_____	_____	%
_____	_____	%
Total annual fund operating expenses	_____	%

Figure 5.27 Annual fund operating expenses to be disclosed in the prospectus

Source: Item 3, Form N-1A, 17 CFR 274

Because the nature of this fee is not described in any further detail, its mention is more likely to confuse (potential) investors than to assist them. The transparency of the prospectus for the TIAA-CREF Tax-Exempt Bond Fund is not helped by the fact that it is an integral component of a prospectus for an entire family of mutual funds. This means that investors are faced with an unnecessarily high volume of information unless they want to invest in all funds in this family.

Following the schedule of fees and expenses classified as percentages, the absolute amount of the total fees and expenses that would be incurred for an initial investment in the fund of US\$ 10,000 for 1, 3, 5 and 10 years must be shown in worked examples. The example must assume a return of 5 per cent a year and constant operating expenses, although sales loads charged on any reinvested

FEES AND EXPENSES

The following example describes the fees and expenses you may pay if you buy and hold shares of the Fund. The expenses shown under Annual Fund Operating Expenses are based on those incurred in the fiscal year ended 31 October 2003.

SHAREHOLDER FEES (*fees paid directly from your investment*)

Sales Charge (Load) Imposed on Purchases	None
Purchase Fee	None
Sales Charge (Load) Imposed on Reinvested Dividends	None
Redemption Fee	2% ^a

ANNUAL FUND OPERATING EXPENSES (*expenses deducted from the Fund's assets*)

Management Expenses:	0.55%
12b-1 Distribution Fee:	None
Other Expenses:	0.07%
Total Annual Fund Operating Expenses:	0.62%

Figure 5.28 The schedule of fees and expenses of US funds to be disclosed in the prospectus, example taken from the Vanguard International Value Fund

^a The 2 per cent fee applies to shares redeemed within two months of purchase by selling, by exchanging to another fund, or by application of the low-balance account-closure policy. The fee is withheld from redemption proceeds and retained by the Fund. Shares held for two months or more are not subject to the 2 per cent fee.

Source: The Vanguard Group (2004), p. 3

distributions may be ignored if this is expressly indicated.³³⁹ To illustrate the effect of any deferred sales charges or redemption fees charged, a table showing examples for both continued investment in the fund and redemption at the end of the 1, 3, 5 and 10 year periods must also be presented.

Since the brokerage fees for buying and selling instruments in the fund's portfolio are not known from the outset, they are not contained in Figure 5.28, but must be included in any performance-related publicity. In 2003, the US General Accounting Office (GAO) voiced criticism that brokerage commissions and other trading costs do not have to be prominently disclosed to shareholders.³⁴⁰ At present, the brokerage commissions for the past three fiscal years of the fund must only be disclosed in the SAI,³⁴¹ which is only made available to shareholders on request.

In the example presented below, the expense items shown represent only recurring costs, and not transaction-related fees, because neither of the two funds in question charge fees directly to their shareholders if they invest for the stated 1, 3, 5 and 10 year periods. Again, the transparency of the TIAA-CREF prospectus is hampered by the fact that it is an omnibus document for a family of funds.

³³⁹ See Item 3, Form N-1A, 17 CFR 274.

³⁴⁰ See GAO (2003), p. 2.

³⁴¹ See Item 15(a) on Form N-1A, 17 CFR 274.

*Example*³⁴²

This example is intended to help you compare the cost of investing in the TIAA-CREF Mutual Funds with the cost of investing in other mutual funds. This example assumes that you invest \$10,000 in a fund for the time periods indicated beginning on 1 May 2004 and then redeem all of your shares at the end of those periods. The example also assumes that your investment has a 5 per cent return each year and that the funds' operating expenses remain the same. Although your actual costs may be higher or lower, based on these assumptions your costs would be:

	1 Year	3 Years	5 Years	10 Years
International Equity Fund	\$50	\$157	\$274	\$616
Growth Equity Fund	\$46	\$144	\$252	\$567
Growth and Income Fund	\$44	\$138	\$241	\$542
Equity Index Fund	\$27	\$84	\$146	\$331
Social Choice Equity Fund	\$28	\$87	\$152	\$343
Managed Allocation Fund ^a	\$40	\$125	\$219	\$493
Bond Plus Fund	\$31	\$97	\$169	\$381
Short-Term Bond Fund	\$31	\$97	\$169	\$381
High-Yield Bond Fund	\$35	\$109	\$191	\$431
Tax-Exempt Bond Fund	\$31	\$97	\$169	\$381
Money Market Fund	\$30	\$93	\$163	\$368

^a The Managed Allocation Fund itself has no expense charges. However, shareholders in the Managed Allocation Fund will indirectly bear their pro rata share of the fees and expenses incurred by the funds in which the Managed Allocation Fund invests. The expenses shown are based on the fund's allocations during 2003.

Let us now return to the list started on p. 306.

- 3 Fund management: information on the investment adviser(s) and the fund's portfolio manager(s) employed by it/them. The fee paid to the investment adviser(s) for the most recent fiscal year of the fund must also be disclosed.
- 4 Pricing of fund shares: an appropriate explanation is required in particular if the price of the fund is not based on market prices but, for example, on fair value or amortized cost.
- 5 Redemption of fund shares: in particular any redemption charges and restrictions must be explained.
- 6 The fund's policy with respect to dividends and distributions.
- 7 The tax consequences to shareholders of buying, holding, exchanging and selling the fund's shares.

³⁴² TIAA-CREF (2004), p. 18.

Table 5.11 Financial highlights of the Vanguard International Value Fund

	Year Ended 31 Oct.		1 Jan. to 31 Oct. 2001 ^a	Year Ended 31 December		
	2003	2002		2000	1999	1998
Net asset value, beginning of period	\$18.92	\$20.57	\$26.02	\$29.13	\$25.09	\$22.64
<i>Investment operations</i>						
Net investment income	0.48	0.29	0.34	0.55	0.69	0.77
Net realized and unrealized gain (loss) on investments	5.43	(1.65)	(5.78)	(2.74)	4.74	3.64
Total from investment operations	5.91	(1.36)	(5.44)	(2.19)	5.43	4.41
<i>Distributions</i>						
Dividends from net investment income	(0.29)	(0.29)	(0.01)	(0.73)	(0.66)	(1.06)
Distributions from realized capital gains	—	—	—	(0.19)	(0.73)	(0.90)
Total distributions	(0.29)	(0.29)	(0.01)	(0.92)	(1.39)	(1.96)
Net asset value, end of period	\$24.54	\$18.92	\$20.57	\$26.02	\$29.13	\$25.09
Total return ^b	31.72%	-6.81%	-20.91%	-7.48%	21.81%	19.46%
<i>Ratios/supplemental data</i>						
Net assets, end of period (millions)	\$1,511	\$1,086	\$770	\$835	\$1,045	\$806
Ratio of total expenses to average net assets	0.62%	0.65%	0.64% ^c	0.53%	0.59%	0.52%
Ratio of net invest ment income to average net assets	2.46%	1.80%	1.93% ^c	1.94%	2.54%	2.77%
Turnover rate	27%	26%	37%	78%	41%	39%

^aThe Fund's fiscal year-end changed from 31 December to 31 October, effective 31 October 2001.

^bTotal return figures do not reflect the 2 per cent fee assessed on redemptions of shares purchased on or after 27 June 2003, and held for less than two months.

^cAnnualized.

Source: The Vanguard Group (2004), p. 16

8 Financial highlights: based on the audited financial statements for the past five years, significant financial performance data per share as well as certain fund-specific financial indicators must be presented.

Table 5.11 is designed to present per single share how, based on the net asset value of the previous year, the net asset value of the current year was achieved from distributions received by the fund (dividends, interest coupons, interest, etc.), realized and book gains and losses on securities, and distributions to the

shareholders. The net assets at the end of the period, the expense ratio, the ratio of net income to average assets and the portfolio turnover rate must also be disclosed. Because the disclosures presented by the two illustrative US funds are identical, apart from the numerical information, only the table for the Vanguard International Value Fund is shown.

The investor can see at a glance (looking at the development of net asset value or total return) how the fund experienced strong growth in the wake of the bull market at the end of the 1990s, how this growth was then more than eroded by sustained securities price losses in the following years, but how it finally managed to share in the good development on the international equity markets in the most recent year. The dependency of the distribution ratio on equity market cyclicality is also evident. What is also conspicuous is that the expense ratio in recent years is and has been higher than the level during the 1990s, although net assets increased appreciably during this period.

There is room for improvement in the information content of US fund prospectuses because, as things currently stand, there is no requirement for a list of portfolio holdings³⁴³ or to disclose brokerage commissions and other trading costs. Based on a prospectus that only fulfils the minimum legal requirements for this information, investors cannot therefore identify precisely what they are buying and precisely what expenses such a purchase will entail. On the basis of the prospectus, it is possible to assert that the fund product is inadequately defined. However, the fund does have the latitude to include this information *voluntarily* in the prospectus and/or the SAI, as the legally required information does not represent a conclusive minimum standard.³⁴⁴

At the end of the 1990s, the US SEC completed its 'Plain English' campaign³⁴⁵ and implemented it in a rule:³⁴⁶ this involves a controversial attempt to make prospectuses and other information material designed for shareholders more comprehensible to the average investor, in particular a requirement that principal investment strategies and the risks of the investing process should be summarized in easily understandable form.³⁴⁷ Form N-1A, the immediate legal basis for fund prospectuses, contains the instruction that the front and back cover pages and the Risk/Return Summary must be worded 'in plain English under Rule 421(d) under the Securities Act'.³⁴⁸ The aim is to turn prospectuses into

³⁴³ This list is only prescribed for annual (Form N-CSR; 'Certified Annual Shareholder Report') and semi-annual reports (Form N-SAR; 'Semi-Annual Report'). Funds must also now file a Quarterly Schedule of Portfolio Holdings with the SEC (Form N-Q; section 249.332, 17 CFR 249 and section 274.130, 17 CFR 274; introduced by the US Securities and Exchange Commission (2004a)). These documents, as well as fund prospectuses, must be obtainable free of charge from the management company or via the Internet (using the SEC's electronic data management system, EDGAR).

³⁴⁴ See above (see General Instructions, C.3.b, Form N-1A, 17 CFR 274).

³⁴⁵ US Securities and Exchange Commission (1999f) describes in detail the Plain English rules to be followed.

³⁴⁶ Rule 421, 17 CFR 230.

³⁴⁷ See US Securities and Exchange Commission (1999b).

³⁴⁸ Item 1(a), Item 1(b), Item 2 and Item 3 on Form N-1A, 17 CFR 274.

documents that will actually be used by the investors.³⁴⁹ Although the principle behind this requirement is generally to be welcomed, it has met with the following criticisms.³⁵⁰

- 1 The investment adviser and the fund board could lose legal certainty because although they may be stilted, the formulations that are tried and tested (including in court) have to be abandoned, with a consequent fear of litigation.
- 2 There is a risk that the explanation of the investment strategy (e.g., relating to the hedging or duration policy) will be unclear.
- 3 Trying to simplify complicated terms may clash with the need for adequate disclosure.

Profile prospectus (summary prospectus)

In 1998, the SEC introduced a new disclosure document, the 'Profile',³⁵¹ which is much shorter than the prospectus (it is also termed a 'Summary Prospectus' in the underlying rule)³⁵² Since then, investors have been able to buy a fund after merely studying the profile, or they may also consult the full prospectus if they wish.

A profile contains a summary of selected information from the prospectus. Specifically, the following nine items are obligatory in the sequence shown.

- 1 Fund objectives/goals: this item must correspond to its counterpart in the prospectus.³⁵³
- 2 Principal investment strategies: a reference to additional information contained in the (semi-)annual reports must be included.
- 3 Risk factors: in the same way as in the prospectus,³⁵⁴ a narrative description of risks and a risk/return bar chart and table for the fund's annual returns must be included.
- 4 Fee table: this item must correspond to its counterpart in the prospectus.³⁵⁵
- 5 Fund management: information on the asset adviser(s) and portfolio manager(s) but, in contrast to the prospectus, no information on their fees.
- 6 General information on purchase of fund shares: in particular, information on the amount of any sales load, including any breakpoints and waivers.

³⁴⁹ See Investment Company Institute (np, 1997), p. 14.

³⁵⁰ See US Securities and Exchange Commission (1999b).

³⁵¹ See US Securities and Exchange Commission (1998a).

³⁵² Rule 498(a)(2), 17 CFR 230. Section 10(b), Securities Act of 1933, provides the legal basis for the profile: The SEC is also authorized to issue derivative legislation (as it did in Rule 498) to permit the use of (simplified) prospectuses that omit or summarize information contained in the (full) prospectus (prospectus under section 10(a), Securities Act of 1933).

³⁵³ See Item 2(a) on Form N-1A, 17 CFR 274.

³⁵⁴ See Item 2(c) on Form N-1A, 17 CFR 274.

³⁵⁵ See Item 3 on Form N-1A, 17 CFR 274.

- 7 General information on sale of fund shares.
- 8 Fund distributions and tax information.
- 9 Other services.

Prospectuses in the EU

The UCITS Directive, which previously only required publication of a full prospectus, now also requires publication of a simplified prospectus under the revised Directive, UCITS III.³⁵⁶ These prospectuses must be published³⁵⁷ in one of the official national languages³⁵⁸ and filed with the regulatory authorities.³⁵⁹ EFAMA (formerly FEFSI), the European Fund and Asset Management Association, provides model simplified prospectuses on its home page for an equity, a bond and money market fund.³⁶⁰ Potential investors must be provided with the full prospectus on request,³⁶¹ and the simplified prospectus before the conclusion of the contract.³⁶² The simplified prospectus is thus clearly oriented on the US concept of the profile. Publicity inviting investors to buy shares in the fund must also indicate where the prospectuses can be obtained.³⁶³

The essential elements of the prospectuses (both full and simplified) must always be kept up-to-date³⁶⁴ and they must enable investors to make an informed judgement about any investment in the funds;³⁶⁵ their minimum content is defined by a series of schedules.³⁶⁶ As a rule, the fund rules or investment company's instruments of incorporation must be annexed to the full prospectus.³⁶⁷ The accounting information in the prospectus must be audited by persons authorized to audit accounts, and the auditor's report and any qualifications must be reproduced in full.³⁶⁸

The European Commission justifies the introduction of simplified prospectuses as follows: to enable investors to make an informed judgement about any

³⁵⁶ Art. 27 (1) 1st indent Directive 85/611/EEC.

³⁵⁷ Ibid.

³⁵⁸ Art. 47 Directive 85/611/EEC.

³⁵⁹ Art. 32 Directive 85/611/EEC.

³⁶⁰ http://www.efama.org/50Standards/Standards_documents/EFAMA_Documents/Model_Prospectus_Eur_Stock_Funds, http://www.efama.org/50Standards/Standards_documents/EFAMA_Documents/Prospectus_Eur_Bond_Fund, http://www.efama.org/50Standards/Standards_documents/EFAMA_Documents/Model_Prospectus_Eur_Money_Mkt_Funds.

³⁶¹ Art. 33 (1) sentence 2 Directive 85/611/EEC.

³⁶² Art. 33 (1) sentence 1 Directive 85/611/EEC.

³⁶³ Art. 35 Directive 85/611/EEC.

³⁶⁴ Art. 30 Directive 85/611/EEC.

³⁶⁵ Art. 28 (1) Directive 85/611/EEC.

³⁶⁶ Schedule A in the Annex to Directive 85/611/EEC applies to full prospectuses; for simplified prospectuses, Schedule C in the Annex to Directive 85/611/EEC applies.

³⁶⁷ Art. 29 (1) Directive 85/611/EEC; exceptions to the rule are defined in Art. 29 (2) Directive 85/611/EEC.

³⁶⁸ Art. 37 Directive 85/611/EEC.

investment in the fund (as described above), it was originally believed that they should be provided with a large volume of detailed information. This opinion was revised in recent years because the Commission came round to the view that the information requirements of the original UCITS Directive did not take sufficient account of the needs of the average investor, and that effective investor protection can better be achieved through clear and simple core information.³⁶⁹ As a consequence, the simplified prospectus should 'be structured and written in such a way that it can be easily understood by the average investor'.³⁷⁰

This has seen the European Commission fall into line with the demands of the European investment fund industry, as well as keeping abreast of developments in several Member States (e.g., France³⁷¹) and in the USA, which has already introduced simplified prospectuses.³⁷²

To specify in greater detail the minimum content of simplified prospectuses harmonized in the single market, the European Commission issued a recommendation³⁷³ at the end of 2004³⁷⁴ because the UCITS Directive itself only contains relatively abstract requirements in this respect.³⁷⁵ Prior to this, the then European fund industry's lobby group, FEFSI (now EFAMA), also published corresponding recommendations.³⁷⁶ The following presentation of the core minimum content of the simplified prospectus draws on both recommendations.

First of all, these must be a brief presentation of the UCITS: information on the management company, the depositary, the auditors and the financial group promoting the UCITS. The following investment information is required.

- 1 Investment objective(s): the Commission recommends in particular a discussion of any guarantees offered by third parties and an indication, where relevant, if the UCITS is intended to track an index/indices.³⁷⁷ FEFSI, on the other hand, recommends that a distinction should be made with regard to the fund's objectives between, say, current income or long-term capital growth.
- 2 Investment policy: the Commission recommends disclosing the asset classes designated for the fund in question, whereby bonds should be classified into government and corporate bonds, together with their rating and duration requirements. If derivatives are used, their objective should be indicated (investment policy or hedging). If appropriate, the industries, geographic or

³⁶⁹ European Commission, Com (1998) 451 final (1998), p. 9.

³⁷⁰ Art. 28 (3) Directive 85/611/EEC.

³⁷¹ See BVI (2000b), p. 26.

³⁷² See European Commission, Com (1998) 451 final (1998), p. 10.

³⁷³ A recommendation is a non-binding communication to the Member States (and in some cases to citizens of the EU) in which a certain course of action is suggested. Recommendations are therefore of purely political significance.

³⁷⁴ See European Commission (2004a).

³⁷⁵ See Schedule C in the Annex to Directive 85/611/EEC.

³⁷⁶ See FEFSI (2002).

³⁷⁷ See European Commission (2004a), no. 1.1.

market segments on which the fund focuses must be indicated, together with the strategy pursued. For index funds, the fact that the fund tracks an index must be indicated, as well as the strategy pursued to achieve this. If the fund uses tactical asset allocation with frequent portfolio adjustments, this fact must be stated.³⁷⁸ The FEFSI recommendation includes a description of the manner and method by which the fund manager plans to achieve the defined investment objective, as well as a short description of the types of securities and other asset classes in which the fund invests.

- 3 Risk profile: the Commission believes that the 'brief assessment of the fund's risk profile'³⁷⁹ should include a qualitative 'brief and understandable explanation' of market risk, credit risk, settlement risk, liquidity risk, currency risk, custody risk and asset or market concentration risk,³⁸⁰ as well as a quantitative volatility-based risk indicator.³⁸¹ FEFSI, on the other hand, does not recommend quantitative risk indicators, but emphasizes the importance of narrative descriptions of the principal risk factors associated with an investment in the fund (in other words, not merely general disclosures: for example, that the value of the shares may fluctuate).
- 4 Historical performance: the Commission recommends that past performance should be 'presented using a bar chart showing annual returns [before taxes] for the past 10 full consecutive years [or if the UCITS has been in existence for fewer than ten years, for as many years as are available]'.³⁸² If the fund is managed using a benchmark and/or a recurring performance fee is charged, its performance should be presented in the same form. There is also a recommendation to require the presentation of cumulative (average) performance over the life of the fund or over certain (multi-year) shorter periods. In the same way as the presentation of annual returns, the cumulative (average) performance of a benchmark should be included, where appropriate.³⁸³ If the performance data does not include subscription and redemption fees, attention should be drawn to this fact.³⁸⁴ The FEFSI recommendations are largely the same as the Commission's. A graphical presentation of annual returns for the past 10 years is not restricted to a certain type of chart. In the same way as the Commission, the disclosure of average performance over the past 3, 5 and 10 years is recommended. Front-end/deferred sales charges should generally be ignored, although the reinvestment of any (gross) distributions should be assumed. Optionally, an appropriate securities market index or a publicly available benchmark may be included in the graphical presentation but, in

³⁷⁸ See European Commission (2004a), no. 1.2.

³⁷⁹ Schedule C in the Annex to Directive 85/611/EEC.

³⁸⁰ European Commission (2004a), no. 1.4.2.1.

³⁸¹ See European Commission (2004a), no. 1.4.3.

³⁸² European Commission (2004a), no. 1.5.1.

³⁸³ European Commission (2004a), no. 1.5.2.

³⁸⁴ European Commission (2004a), no. 1.5.3.

contrast to the Commission, there is no special reference to index funds or index-related fees.

- 5 Profile of the typical investor for whom the fund is designed: under the FEFSI recommendation, the recommended minimum holding period, the capital experience the investor should have, and the investor's recommended risk tolerance (e.g., the share of the investor's total portfolio that can be reasonably invested in the fund in question) should be spelled out in some detail.

Next, the following economic information is required.

- 1 Tax aspects: the Commission recommends providing information about the tax regime applicable to the UCITS in its home Member State.³⁸⁵ FEFSI also recommends describing the tax regime in the home Member State, but specifies that information should be provided about any asset or income/withholding taxes on distributions or capital gains, although no detailed descriptions of individual taxation scenarios should be provided because of the lack of uniformity of tax systems within the EU and of the personal tax situation of the investors.
- 2 Entry/exit commissions payable by the shareholder (i.e., front-end and back-end sales loads) and other fees and expenses, classified into those payable directly by the shareholder and those charged to the fund's assets. In particular, the Commission calls for the calculation of a standardized Total Expense Ratio (TER). This shows the ratio of total operating costs to average UCITS net assets. As in the case of the comparable US Expense Ratio, the total operating costs underlying the TER should exclude transaction costs (in particular brokerage fees) and entry/exit commissions (sales loads).³⁸⁶ In addition, the standardized portfolio turnover rate should be disclosed and an indication should be given of 'the existence of fee-sharing arrangements and soft commissions'.³⁸⁷ FEFSI also thinks that disclosing a TER is appropriate and, like the Commission, recommends calculating it exclusive of brokerage fees and sales loads.
- 3 Trading information: buying/selling shares, any rules for switching, any dividends and price publication, contact details.
- 4 Additional information: an indication of the possibility of obtaining, free of charge, the full prospectuses and the most recent annual and half-yearly reports, prior to signature of contract.

The following additional content rules apply to both prospectuses for the new fund types introduced by 'UCITS' III,³⁸⁸ accompanied by the rule that funds

³⁸⁵ See European Commission (2004a), no. 2.1.

³⁸⁶ See European Commission (2004a), Annex I.

³⁸⁷ European Commission (2004a), no. 2.2.1.

³⁸⁸ In addition to disclosure in the prospectuses, this must also be disclosed in the fund rules, in the instruments of incorporation of the UCITS and in all its advertising materials.

whose portfolio composition or portfolio management techniques means that they have a high volatility must include a prominent statement drawing attention to this characteristic:³⁸⁹

- (a) *index funds* must contain a prominent statement drawing attention to the fact that the strategy of the UCITS is to track a certain index;³⁹⁰
- (b) *funds of funds* must disclose the maximum expected fees of the fund of funds and its subfunds,³⁹¹ together with a prominent statement drawing attention to its policy of investing partly or in full in other UCITS;³⁹²
- (c) funds that invest partly or fully in *bank deposits* must include a prominent statement drawing attention to this characteristic;³⁹³
- (d) funds that invest partly or fully in *derivatives* must include a prominent statement indicating whether this derivative trading is for the purpose of hedging or to meet investment goals,³⁹⁴ as well as the possible outcome of the use of derivatives on the risk profile.³⁹⁵

Reports to shareholders and other information sources

Annual and semi-annual reports to investment fund shareholders and supervisory authorities in the USA

US investment funds are required to provide their shareholders³⁹⁶ (and the SEC)³⁹⁷ with at least semi-annual reports. A distinction is made between two types of semi-annual report: first, the audited³⁹⁸ semi-annual report aimed primarily at shareholders³⁹⁹ on the basis of Form N-CSR⁴⁰⁰ (Certified Shareholder Report),

³⁸⁹ Art. 24a (3) Directive 85/611/EEC.

³⁹⁰ Art. 24a (2) Directive 85/611/EEC.

³⁹¹ Art. 24 (3) Directive 85/611/EEC.

³⁹² See n. 390.

³⁹³ See n. 390.

³⁹⁴ In this case, a prominent statement drawing attention to this investment policy must be included in the prospectus (Art. 24a (2) Directive 85/611/EEC).

³⁹⁵ Art. 24a (1) Directive 85/611/EEC.

³⁹⁶ Section 30(e) Investment Company Act of 1940 and Rule 30e-1, 17 CFR 270; the report must be transmitted to shareholders within 60 days of the end of the reporting period (see Rule 30e-1(c)).

³⁹⁷ Section 30(a) and (b) Investment Company Act of 1940 and section 13(a) Securities Exchange Act of 1934; the report must be filed with the SEC within 10 days of its transmission to the shareholders (see Rule 30b2-1(b), 17 CFR 270).

³⁹⁸ Section 30(g) Investment Company Act of 1940 and Rule 30a-2, 17 CFR 270.

³⁹⁹ A copy must be filed with the SEC (see section 30(b)(2) Investment Company Act of 1940) within 10 days of its transmission to the shareholders (see Rule 30b2-1, 17 CFR 270).

⁴⁰⁰ Section 249.331, 17 CFR 249 and section 274.128, 17 CFR 274; introduced by the US Securities and Exchange Commission (2003c).

and second, the unaudited semi-annual report on Form N-SAR⁴⁰¹ (Semi-annual Report) aimed primarily at the SEC. The SEC uses the latter primarily for its examination and compliance functions.⁴⁰² The content and design of the report to be filed on Form N-SAR is stipulated with greater precision than that for Form N-CSR reports, because Form N-SAR must be completed with greater precision,⁴⁰³ while Form N-CSR is actually a form in name only and is really a guide to preparing the report.⁴⁰⁴ Since the far-reaching revision of capital market legislation in 1996, the SEC has had the authority to issue rules supplementing the semi-annual reports to shareholders by information that it believes is in the public interest or necessary to protect investors.⁴⁰⁵

Form N-CSR is one of the ways the SEC has implemented the Sarbanes–Oxley Act, which was passed in July 2002 in response to the Enron accounting scandal. The objective of the Sarbanes–Oxley Act was to impose improved corporate governance to restore confidence in the quality and accuracy of published corporate financial data. This resulted in particular in the following innovations for reporting by investment funds.

- 1 The executive officers and principal financial officers must now certify the reports to shareholders and the establishment and effectiveness of internal control systems.⁴⁰⁶ Negligent or deliberately false certification can be punished by a fine and/or imprisonment of up to US\$1 million and/or up to 10 years, or up to US\$ 5 million and/or up to 20 years.⁴⁰⁷

⁴⁰¹ Section 274.101, 17 CFR 274; Form N-SAR must be filed within 60 days of the end of the reporting period (see Rule 30a-1 and Rule 30b1-1, 17 CFR 270).

⁴⁰² See US Securities and Exchange Commission (2003b).

⁴⁰³ See General Instruction E(1), Form N-SAR.

⁴⁰⁴ See General Instruction C(1), Form N-CSR.

⁴⁰⁵ See section 30(f) Investment Company Act of 1940, inserted by section 209 NSMIA.

⁴⁰⁶ Among other things, the principal executive officer(s) and/or principal financial officer(s) must certify that based on their knowledge, the annual report is not misleading in that it does not contain any untrue statement of a material fact or omit to state a material fact. They must also certify that the financial condition of the investment company is presented fairly in all material respects, and that the signing officers have established internal controls that are effective in ensuring the provision of material information relating to the investment company to the signing officers. In addition, they must certify that they have disclosed to the auditors and the audit committee of the board of directors all significant deficiencies of the internal controls and any material cases of fraud involving the management or employees. Section 302 Sarbanes–Oxley Act of 2002 prescribes both the statutory content standards and also the (very tight) deadlines for implementation through SEC rules. One month after the Sarbanes–Oxley Act came into force, the SEC adopted a corresponding new rule for investment companies (Rule 30a-2, 17 CFR 270); see US Securities and Exchange Commission (2002a). It adopted another new rule around one year later to shift the content-related part of the certification provisions to Item 10(a)(2) Form N-CSR (see US Securities and Exchange Commission (2003g)). A subsequent rule added the new Item 9 on Form N-CSR and renumbered Item 10 as Item 11 (see US Securities and Exchange Commission (2003h)).

⁴⁰⁷ See Rule 30a-2(b), 17 CFR 270 in conjunction with section 1350 18 USC, Part I, Chapter 63 ('Failure of corporate officers to certify financial reports'), introduced by section 906 Sarbanes–Oxley Act of 2002.

- 2 A disclosure is also required about whether a code of ethics has been adopted for the principal executives,⁴⁰⁸ and if not, why not.⁴⁰⁹

The first item on Form N-CSR is a copy of the actual report to shareholders.⁴¹⁰ The content of the annual report is more detailed than that of the semi-annual report. The main obligatory components of this annual or semi-annual report to the shareholders are presented in the following, whereby items 1–8 must be included in both reports, while the remaining items need only be disclosed in the annual report.⁴¹¹

- 1 Balance sheet and statement of operations: these must be audited for the annual report,⁴¹² but need not be audited for the semi-annual report.⁴¹³ In addition to the total net asset value of the portfolio investments to be reported in the balance sheet,⁴¹⁴ disclosures relating to the securities and other assets held in the portfolio are also mandatory.⁴¹⁵ Schedules containing the securities and derivatives held in the portfolio (and sold short) are an obligatory component of the annual report, semi-annual report and Statement of Additional Information. They are then classified by the relationship of the securities issuer to the fund (i.e., into affiliated issuers and unaffiliated issuers) as well as by the degree of detail of the schedules (i.e., into full statements and summaries).
 - (a) Schedule of investments in securities of unaffiliated issuers:⁴¹⁶ a complete schedule is compulsory for annual reports, but since May 2004⁴¹⁷ it can be replaced in semi-annual reports by a summary if the complete version is filed with the SEC or made available to shareholders every quarter on Form N-CSR⁴¹⁸ or in the quarterly schedule of portfolio holdings (Form

⁴⁰⁸ This relates specifically to the following persons: the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions (Item 2(a) Form N-CSR; introduced by the US Securities and Exchange Commission (2003c)).

⁴⁰⁹ The SEC was required by section 406(a) Sarbanes–Oxley Act of 2002 to impose Item 2(a) Form N-CSR.

⁴¹⁰ See Item 1, Form N-CSR.

⁴¹¹ Rule 30e-1(a), 17 CFR 270, prescribes the information required in the fund registration form as the content of the report. Specifically, this relates to Item 21 on Form N-1A, Item 23 on Form N-2, or Item 27(a) on Form N-3, each 17 CFR 274. The other information normally relates only to Form N-1A, but the content of the two other forms is similar.

⁴¹² According to Item 21(b)(1), Form N-1A, 17 CFR 274, audited financial statements under 17 CFR 210 are part of the annual report to be prepared under Rule 30e-1, 17 CFR 270.

⁴¹³ Under Item 21(c)(1), Form N-1A, 17 CFR 274, financial statements under 17 CFR 210 are part of the semi-annual report to be prepared under Rule 30e-1, 17 CFR 270.

⁴¹⁴ See Rule 6-04, 17 CFR 210.

⁴¹⁵ The schedules required by Regulation S-X are listed in Rule 6-10(c), 17 CFR 210, and their detailed content is prescribed in Rules 12-12 to 12-14, 17 CFR 210.

⁴¹⁶ See Schedule I, 17 CFR 210: 'Investments in securities of unaffiliated issuers'. Content and layout prescribed by Rule 12-12, 17 CFR 210.

⁴¹⁷ Reform by the US Securities and Exchange Commission (2004a).

⁴¹⁸ See Item 6, Form N-CSR.

N-Q).⁴¹⁹ Specifically, the complete versions must be filed on the new Form N-Q for the first and third quarters of the fiscal year, and on Form N-CSR for the second and fourth quarters.

- (b) Schedule of investments in and advances to affiliates:⁴²⁰ the definition of an affiliate corresponds to that applied to transactions between the funds and its affiliated persons.⁴²¹
- (c) Quarterly schedule of portfolio holdings (Form N-Q⁴²²): this must be filed with the SEC no later than 60 days after the end of the first and third quarters of the fund's fiscal year.⁴²³ As a consequence of the Sarbanes–Oxley Act, the correctness of the information contained in the report⁴²⁴ and the effectiveness of the internal disclosure controls and procedures⁴²⁵ must be certified.
- (d) Summary schedule of investments in securities of unaffiliated issuers:⁴²⁶ this must list the 50 largest issues and any other issue whose value exceeds 1 per cent of the net asset value.
- (e) Graphical or tabular presentation of the fund's portfolio assets:⁴²⁷ since May 2004,⁴²⁸ the portfolio assets⁴²⁹ must be classified using tables or charts by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity⁴³⁰). The categories should be selected in a way that reflects the investment objectives of the fund.

The SEC believes that this form of presentation, combined with the newly introduced summary information, represents a significant increase in user-friendliness compared with the previous aggregated portfolio presentation, especially in the case of broadly diversified funds.⁴³¹

⁴¹⁹ For the annual report, see Instruction 1 on Item 21(b)(1), and for the semi-annual report, see Instruction on Item 21(c)(1) on Form N-1A.

⁴²⁰ See Schedule III, 17 CFR 210: 'Investments in and advances to affiliates'; content and layout prescribed by Rule 12-14, 17 CFR 210.

⁴²¹ For a definition of affiliated persons, Rule 6-02(a), 17 CFR 210, refers to section 2(a)(3) Investment Company Act of 1940; see section on Affiliated transactions and self-dealing, pp. 176ff.

⁴²² Section 249.332, 17 CFR 249 and section 274.130, 17 CFR 274 (each introduced by the US Securities and Exchange Commission (2004a)), prescribe Form N-Q as the 'Quarterly schedule of portfolio holdings'.

⁴²³ See Rule 30b1-5, 17 CFR 270.

⁴²⁴ See Rule 30a-2, 17 CFR 270.

⁴²⁵ See Rule 30a-3(b), 17 CFR 270.

⁴²⁶ See Schedule VI, 17 CFR 210: 'Summary Schedule of investments in securities of unaffiliated issuers'; content and layout prescribed by Rule 12-12C, 17 CFR 210.

⁴²⁷ See Item 21(d)(2) on Form N-1A, 17 CFR 274.

⁴²⁸ See n. 417.

⁴²⁹ The basis of presentation is either net asset value or total investments. These two variables may diverge, for example in the case of loan-financed securities purchases.

⁴³⁰ '[R]easonably identifiable categories (e.g., industry sector, geographic region, credit quality, or maturity)'; Item 21(d)(2) on Form N-1A.

⁴³¹ See US Securities and Exchange Commission (2004a), section II.B.3.

- 2 The financial highlights (see p. 312) to be included in the prospectus must also be presented in both the annual⁴³² and the semi-annual report.⁴³³
- 3 Remuneration paid in the period to the following persons:⁴³⁴
 - (a) directors and members of advisory boards: the aggregate remuneration and any special compensation paid;
 - (b) officers: aggregate remuneration;
 - (c) affiliated persons of directors and officers: remuneration paid to each person.
- 4 Information⁴³⁵ on changes in and disagreements with accountants, if applicable.⁴³⁶
- 5 Expense example:⁴³⁷ since May 2004,⁴³⁸ the amount of ongoing costs actually incurred must be presented for an investment of US\$1,000. These relate solely to expenses paid indirectly by shareholders, such as management fees, and distribution (12b-1) fees and other expenses normally charged as a percentage of net asset value. The ending account value⁴³⁹ and the expenses paid during the period must be presented for an investment of US\$1,000. The ending account value and the costs must be presented first, on the basis of the actual return for the period assuming reinvestment of any distributions, and second, on the basis of an assumed rate of return of 5 per cent per year (before expenses). The second method is designed to enhance the comparability of costs across funds and overlaps to a certain extent with the illustrative data contained in the obligatory fee table in the prospectus,⁴⁴⁰ but without presenting exactly the same information. The common feature of the two illustrative calculations is that they are both based on a standardized initial investment and an assumed rate of return of 5 per cent per year. However, the illustrative calculation in the prospectus is based on an initial investment of US\$ 10,000 and, in addition to the ongoing costs, it also contains transaction costs on the expense side that must be paid directly by the shareholder.
- 6 Statement regarding availability of the quarterly schedule of portfolio holdings.⁴⁴¹

⁴³² See Item 21(b)(2), Form N-1A, 17 CFR 274.

⁴³³ See Item 21(c)(2), Form N-1A, 17 CFR 274.

⁴³⁴ See Item 21(b)(3) for the annual report, and Item 21(c)(3) for the semi-annual report, each Form N-1A, 17 CFR 274.

⁴³⁵ Information on accountants in accordance with Item 304, 17 CFR 229.

⁴³⁶ See Item 21(b)(4) for the annual report, and Item 21(c)(4) for the semi-annual report, each Form N-1A, 17 CFR 274.

⁴³⁷ See Item 21(d)(1) on Form N-1A, 17 CFR 274.

⁴³⁸ See n. 417.

⁴³⁹ The beginning and ending value for the semi-annual report must relate to the most recently completed fiscal half year, and for the annual report to the second half of the fiscal year under review.

⁴⁴⁰ See the section on Content of a US fund prospectus, pp. 308ff.

⁴⁴¹ See Item 21(d)(3) on Form N-1A, 17 CFR 274.

- 7 Statements regarding availability of the written proxy voting policies and procedures, and of the proxy voting record.⁴⁴²
- 8 Information on the approval of an advisory contract, if applicable:⁴⁴³ in a similar way to the disclosures in the SAI (see p. 205), material factors and the resulting conclusions that formed the basis for approval of the advisory contract must be presented. The main difference compared to the SAI is that the basis for approval of the current contract must always be discussed there, while the presentation in the (semi-)annual report is contingent in that it must only be included if a contract was approved during the period under review.
- 9 Management information: this item also corresponds to the disclosures to be included in the SAI and the Proxy Statement (see the section entitled Extended disclosure requirements, p. 201).⁴⁴⁴
- 10 A statement that the SAI includes additional information about the fund directors.⁴⁴⁵
- 11 Management's Discussion of Fund Performance (MDFP):⁴⁴⁶ since 1993,⁴⁴⁷ a narrative explanation of the factors – in particular market conditions and the investment strategies and techniques used by the investment adviser – that materially affected the fund's performance in the most recently completed fiscal year must be published. Until May 2004, there was an option to publish the MDFP either in the prospectus⁴⁴⁸ or in the annual report.⁴⁴⁹ Because publication in the annual report, rather than in the prospectus, had established itself in practice, and the components of the annual report are also subject to Sarbanes–Oxley certification,⁴⁵⁰ the SEC abolished the prospectus publication option in May 2004,⁴⁵¹ and the MDFP is now an obligatory component of the annual report.

The other main components of Form N-CSR that are not contained in the report to shareholders are given below.

- 1 Code of ethics for executives:⁴⁵² in addition to a statement as to whether such a code has been adopted or not, and if not, why not, the following two events

⁴⁴² See Item 21(d)(4) and Item 21(d)(5) on Form N-1A, 17 CFR 274.

⁴⁴³ See Item 21(d)(6) on Form N-1A, 17 CFR 274.

⁴⁴⁴ Item 21(b)(5) on Form N-1A, 17 CFR 274, requires the management information prescribed for the SAI in accordance with Item 12(a)(1) on Form N-1A.

⁴⁴⁵ See Item 21(b)(6) on Form N-1A, 17 CFR 274.

⁴⁴⁶ See Item 21(b)(7) on Form N-1A, 17 CFR 274.

⁴⁴⁷ See US Securities and Exchange Commission (1993).

⁴⁴⁸ See former Item 5 on Form N-1A, 17 CFR 274.

⁴⁴⁹ The previous legal position required a corresponding statement to be included in the prospectus if this information was published in the annual report (see Item 1(b)(1) on Form N-1A, 17 CFR 274). This statement must now always be included.

⁴⁵⁰ The certification under section 302 Sarbanes–Oxley Act of 2002 prescribed by Rule 30a-2, 17 CFR 270.

⁴⁵¹ See n. 417.

⁴⁵² See Item 2, Form N-CSR.

related to the code must be disclosed if they have occurred during the period under review: first, amendments to the code, and second, waivers that have allowed executives to depart from the provisions of the code. The code itself must be filed as a schedule to Form N-CSR and must also be published on the fund's website.

- 2 Audit committee and financial expert:⁴⁵³ the fund must disclose whether it has at least one financial expert serving on its audit committee. If no financial expert is a member, it must explain the reasons; otherwise, the name of the financial expert must be disclosed, together with whether he or she is independent.⁴⁵⁴
- 3 Principal accountant fees:⁴⁵⁵ the fees paid for the last two fiscal years must be disclosed, and certain information on the obligatory pre-approvals by the audit committee for services provided by the accountant must also be included.⁴⁵⁶
- 4 Composition of the audit committee:⁴⁵⁷ the fund must disclose whether such a committee has been established and, if so, its members must be identified.
- 5 Schedule of investments in securities of unaffiliated issuers⁴⁵⁸ this schedule is required only if it is not included in the report to shareholders. This will be the case only if the semi-annual report to shareholders contains a summary.
- 6 Internal controls and procedures:⁴⁵⁹
 - (a) conclusions by the principal executive and principal financial officers regarding the effectiveness of disclosure controls and procedures. These controls and procedures are effective only if they are designed to ensure that information required to be disclosed is recorded, processed, summarized and reported within the stipulated time periods. In particular, they must ensure that the information to be disclosed is accumulated and communicated to management to allow timely decisions on matters requiring disclosure.⁴⁶⁰
 - (b) if applicable, any material changes in internal control over financial reporting.⁴⁶¹

⁴⁵³ See Item 3, Form N-CSR; section 407 Sarbanes–Oxley Act of 2002 required the SEC to prescribe this disclosure.

⁴⁵⁴ A financial expert is independent if he or she is not otherwise a member of the fund board or of committees other than the audit committee.

⁴⁵⁵ See Item 4, Form N-CSR.

⁴⁵⁶ A more detailed presentation of the related disclosure requirements is contained in the section on Investment fund auditors in the USA, p. 369.

⁴⁵⁷ See Item 5, Form N-CSR; introduced by the US Securities and Exchange Commission (2003f).

⁴⁵⁸ See Schedule I, 17 CFR 210, and Item 6, Form N-CSR.

⁴⁵⁹ See Item 10, Form N-CSR.

⁴⁶⁰ See Rule 30a-3(c), 17 CFR 270.

⁴⁶¹ For a definition of 'internal control over financial reporting' see Rule 30a-3(d), 17 CFR 270.

Annual report, summary plan description and pension account statement for US pension funds

ERISA includes a range of disclosure requirements to pension plan members and the regulator (Department of Labor). For example, plan members are entitled to:⁴⁶²

- (a) have a copy of the summary plan description;
- (b) inspect the most recent annual report;
- (c) have an individual pension account statement indicating the total benefits accrued. The amount of non-forfeitable (vested) pension benefits or the earliest date on which the benefits will become non-forfeitable (vested) must be indicated separately.⁴⁶³

The annual report must also be filed with the regulator,⁴⁶⁴ who must publish it.⁴⁶⁵ The regulator is also entitled to require additional information that it believes necessary for it to exercise its regulatory duties.⁴⁶⁶

The summary plan description must be made available to each employee who becomes a participant in the plan, or in the case of modifications within a defined period, or on request at any time,⁴⁶⁷ and any modifications of the previous version must be disclosed separately in a 'Summary of Material Modifications'.⁴⁶⁸

Similar to the plain English approach, the summary plan description must be written in such a way that it can be understood by the average pension plan member.⁴⁶⁹ The pension plan administrator is responsible for ensuring that the wording and structure is tailored to the level of comprehension and education of the average employee covered by the plan. Technical jargon and long, complex sentences must be limited or avoided completely, examples and graphical presentations should be used for illustration, and cross-references and a table of contents should be included.⁴⁷⁰ The items to be included in the summary plan description are prescribed in detail, including, for example, whether the plan is a defined contribution or defined benefit plan.⁴⁷¹ A standard statement on employee rights under ERISA, in particular which documents are obligatory and how and where they may be obtained, must be included.⁴⁷²

⁴⁶² Section 101(a) ERISA.

⁴⁶³ Section 105(a) ERISA.

⁴⁶⁴ Section 104(a)(1) and 101(b)(1) ERISA.

⁴⁶⁵ Section 106(a) ERISA.

⁴⁶⁶ Section 104(a)(2)(B) and 104(a)(6) ERISA.

⁴⁶⁷ Section 104(b)(4) ERISA and EBSA, 29 CFR 2520,104b-2.

⁴⁶⁸ Section 104(b)(1) ERISA.

⁴⁶⁹ Section 102(2) ERISA.

⁴⁷⁰ Section 102.2(a) EBSA, 29 CFR 2520,102-2.

⁴⁷¹ Section 102.3(d) EBSA, 29 CFR 2520,102-3; for defined contribution systems, its subtype must be disclosed, i.e., whether it is e.g. a 401(k) plan or an ESOP.

⁴⁷² Section 102.3(t) EBSA, 29 CFR 2520,102-3.

While the annual report must be filed with the regulatory authority, it need only be made available to plan members for inspection by the pension plan administrator, together with the current summary plan description.⁴⁷³ It must be audited and certified by an accountant⁴⁷⁴ and, in the case of DB plans, supplemented by an actuarial statement.⁴⁷⁵

The required content includes a statement of assets and liabilities of the plan, aggregated by categories and valued at their current value, together with the corresponding prior-year values. The assets must also be identified by issuer, maturity date and rate of interest, if applicable. The schedule to the annual report must contain a statement of receipts, disbursements and contingent liabilities for the fiscal year in question, as well as a list of transactions involving an affiliate ('party in interest') of the pension fund. Such transactions must be disclosed by identifying the affiliate and describing the asset to which the transaction relates, together with its current value, price, rental, or interest rate.⁴⁷⁶

Instead of a conventional annual report, pension plans with more than 100 members can meet their disclosure obligations using an annual report form (Form 5500 Annual Return/Report of Employee Benefit Plan), an auditor's report and a summary annual report.⁴⁷⁷ Form 5500, which can be filed electronically with the Department of Labor,⁴⁷⁸ consists of a main part covering the material characteristics of the pension plan and a number of standardized financial schedules presenting detailed information on aspects of the plan.⁴⁷⁹ These schedules relate in particular to a statement of assets and liabilities and a statement of income and expenses, actuarial information, service provider information, a schedule on uncollectable loans, fixed income, or lease receivables (normally because of insolvency), and a schedule of benefits paid by the plan and the plan's asset cover (only for defined benefit plans).⁴⁸⁰ Certain transactions in the fiscal year must also be classified: first, transactions with 'parties in interest',⁴⁸¹ and second, 'reportable' transactions. These are transactions in which an asset is bought, sold, leased or rented, or a loan is extended or raised whose value exceeds 5 per cent of plan assets. The same reportable limit applies to a series of transactions which may involve different assets and which had the same counterparty or were in conjunction with the same person. In particular the counterparty, a brief description

⁴⁷³ Section 104(b)(2) ERISA.

⁴⁷⁴ Section 103(a)(3) ERISA.

⁴⁷⁵ Section 103(a)(4) in conjunction with 103(d) ERISA.

⁴⁷⁶ Section 103(b)(2) and (3) ERISA.

⁴⁷⁷ Sections 104(a)(3) and 110 ERISA authorize the US Secretary of Labor to issue regulations prescribing alternative disclosure methods. The corresponding regulations are contained in EBSA, 29 CFR 2520.103 and 2520.104.

⁴⁷⁸ Section (f) EBSA, 29 CFR 2520,103-1.

⁴⁷⁹ Section (b) EBSA, 29 CFR 2520,103-10 defines the main content of the individual schedules. They are fleshed out by explanations on individual schedules issued by the US Department of Labor and updated once a year (section (c) EBSA, 29 CFR 2520,103-10).

⁴⁸⁰ Section (b)(1) EBSA, 29 CFR 2520,103-1.

⁴⁸¹ Section (b)(3) EBSA, 29 CFR 2520,103-10.

of the asset, the current value, the price, rental, or interest rate, and the net gain or loss must be disclosed.⁴⁸²

The summary annual report must be made available to plan members within nine months of the end of the fiscal year.⁴⁸³ Both the structure and the wording are prescribed,⁴⁸⁴ and the information to be included for the plan is taken from the annual report and Form 5500 and its schedules.⁴⁸⁵ Various statements of rights are obligatory in addition to the quantitative information.

With its extensive disclosure requirements, ERISA clearly follows the philosophy that the security and financial performance of pension plans cannot be achieved by government-prescribed asset allocation, either directly using an exhaustive enumeration of permitted asset classes and their volumes or indirectly using nominal value or interest guarantees, but rather through far-reaching transparency offering the regulator, plan members and the interested public an opportunity to identify when intervention – in whatever form – appears to be necessary. In conjunction with the fiduciary duty expressed by personal liability, this results in an effective set of instruments for achieving risk/return-efficient pension plans that also offer a comparatively high level of security. The only fly in the ointment, though, is the complexity of the rules, and not just those relating to disclosure requirements. As well as ERISA, there is a whole range of rules and guidance from the Department of Labor (and the IRS) that forms the legal basis for the disclosure requirements to be satisfied by pension fund administrators. In particular, the often unclear hierarchy of laws and rules unnecessarily adds to the complexity and density of the regulatory regime. A clear division into principles to be regulated by statute law and detailed provision to be implemented by rules would be desirable.

Annual and semi-annual reports to UCITS shareholders in the EU

The UCITS Directive requires publication of an annual and semi-annual report within certain time limits from the end of the relevant reporting period,⁴⁸⁶ and the filing of these reports with the supervisory authority.⁴⁸⁷ These reports must be audited by one or more persons empowered by law to audit accounts in accordance with the Eighth Council Directive (84/253/EEC).⁴⁸⁸ The annual and semi-annual (half-yearly) reports must be provided free of charge to shareholders

⁴⁸² EBSA, 29 CFR 2520,103-6.

⁴⁸³ Section (a) and (b) EBSA, 29 CFR 2520,104b-10 in conjunction with section (b)(1) EBSA, 29 CFR 2520,104b-1.

⁴⁸⁴ However, if the plan administrator does believe that further information not contained in the standard format is necessary for fair presentation, it can attach a separate annex for additional explanations (section (d)(2) EBSA, 29 CFR 2520,104b-10).

⁴⁸⁵ Section (d) and Annex EBSA, 29 CFR 2520,104b-10.

⁴⁸⁶ Art. 27 Directive 85/611/EEC.

⁴⁸⁷ Art. 32 Directive 85/611/EEC.

⁴⁸⁸ Directive 84/253/EEC.

on request.⁴⁸⁹ A stipulated minimum content for the annual⁴⁹⁰ and semi-annual report⁴⁹¹ aims to allow investors 'to make an informed judgement on the development of the UCITS and its results'.⁴⁹² The annual report consists primarily of a statement of assets and liabilities, the disclosure of the number of shares in circulation, a form of income statement ('statement of development of assets') presenting in particular income from investments, distributions, management, custodian and other fees, and a comparative table showing total net asset value and net asset value per share over the past three years.⁴⁹³ There is no provision for qualitative disclosures, such as a schedule of transactions involving potential conflicts of interest. Funds of funds must also include information on the 'business' of their subfunds in the annual and semi-annual reports.⁴⁹⁴ In particular, the maximum amount of management fees that will be charged for the fund of funds and the target funds must be disclosed in the annual report.⁴⁹⁵

Regular disclosure obligations of IORPs

During the preparatory and consultation phase for the Pension Funds Directive there was a recommendation to the European Commission that the requirements for regular reporting to members and regulators of pension funds (IORPs) should be stricter than is the case for UCITS. For example, disclosures should include not only the annual report, but also the SIP, any existing ALM study and an actuarial valuation of the plan liabilities, where the latter two reports are available. The members of pension funds should also be entitled to receive additional information on request as well as be informed where and how it may be obtained. Especially in view of the trend towards growing simplification of the information documents (above all in the form of the simplified UCITS prospectus) such a provision appears to be necessary and appropriate.⁴⁹⁶ In particular, the annual report must be seen as an absolute obligation on the part of any pension fund because the provision of adequate information to investors is a core security element of asset management standards. In this respect, the former legal position in many EU countries that pension funds were under no obligation to provide the annual report to members⁴⁹⁷ was highly questionable.

The disclosure obligations set out in the final Pension Funds Directive are less extensive than the proposals, although the Preamble to the Directive states that the annual accounts and annual reports 'are an essential source of information

⁴⁸⁹ Art. 33 (2) Directive 85/611/EEC.

⁴⁹⁰ Art. 28 (5) Directive 85/611/EEC.

⁴⁹¹ Art. 28 (6) Directive 85/611/EEC.

⁴⁹² Art. 28 (5) Directive 85/611/EEC.

⁴⁹³ Schedule B, Annex I Directive 85/611/EEC.

⁴⁹⁴ Art. 19 (e) 3rd indent Directive 85/611/EEC.

⁴⁹⁵ Art. 24 (3) Directive 85/611/EEC.

⁴⁹⁶ See Pragma Consulting (1999), p. VII.

⁴⁹⁷ See Pragma Consulting (1999), p. 35.

for members and beneficiaries of a scheme'.⁴⁹⁸ The rule is that pension funds need only provide their members with information on request. This principle is bypassed in only two cases: members must receive, first, 'within a reasonable time, any relevant information regarding changes to the pension scheme rules',⁴⁹⁹ and second, 'on retirement ... the appropriate information on the benefits which are due and the corresponding payment options'.⁵⁰⁰

Members must receive, on request, the annual accounts, the annual report,⁵⁰¹ the statement of investment policy principles⁵⁰² and 'detailed and substantial information' on the target level of retirement benefits, the 'range of investment options' for defined contribution schemes, and information on the arrangements for the transfer of pension rights in the event of termination of the employment relationship.⁵⁰³

Only the supervisory authorities need to be provided with other information, in particular 'asset-liability studies', 'actuarial valuations' and the 'reports by the persons responsible for auditing the annual accounts'.⁵⁰⁴ The supervisory authority is also empowered to require 'all the documents necessary for the purposes of supervision'.⁵⁰⁵

The standardized disclosure obligations to pension fund members in the Pension Funds Directive represent no more than a modest minimum standard that is unlikely to satisfy the information requirements of educated citizens. The need for improvement here is shown in particular by the fact that the content standards for the annual accounts and annual report are very low compared with the US ERISA solution. Instead of specifying a concrete, structured minimum content, the Pension Funds Directive limits itself to the abstract requirement that the 'annual accounts and the annual reports shall give a true and fair view of the institution's assets, liabilities and financial position'.⁵⁰⁶

There is thus no provision for any standardized disclosure to pension plan members of changes in the plan's financial position over and above the annual accounts and annual report. Such an information obligation would be very welcome, however, especially for defined contribution systems, since the benefit risk is borne by the plan members and not by the sponsor of the fund. Applying the principle that greater risk must be accompanied by greater disclosure, there is thus a greater need for information in the case of DC systems than for DB

⁴⁹⁸ Recital 20 Directive 2003/41/EC.

⁴⁹⁹ Art. 11 (2)(b) Directive 2003/41/EC.

⁵⁰⁰ Art. 11 (5) Directive 2003/41/EC.

⁵⁰¹ Art. 11 (2)(a) Directive 2003/41/EC.

⁵⁰² Art. 11 (3) Directive 2003/41/EC.

⁵⁰³ Art. 11 (4) Directive 2003/41/EC.

⁵⁰⁴ Art. 13 (c) Directive 2003/41/EC thus implements most of the regulatory requirements to notify the supervisory authority that were already outlined by the European Commission in the early drafts of the Directive (see European Commission, Com (1999) 134 final (1999), p. 21 and p. 23).

⁵⁰⁵ Art. 13 (c) Directive 2003/41/EC.

⁵⁰⁶ Art. 10 Directive 2003/41/EC.

funds.⁵⁰⁷ One possibility would be a summary of key fund data over the past five years, including information on current asset allocation and market trends, and on the macro-economic environment relevant for the fund,⁵⁰⁸ in much the same way that US investment funds include the MDFP in their reports to shareholders. ERISA, too, provides a suitable target level of information here in that US pension funds are required to disclose details of their asset allocation at the fiscal year-end and to compare it with the previous year, allowing pension plan members to make the link between any exceptional investment gain or loss by their fund and the special features of, or changes in, asset allocation.

Another information deficit relates to the costs to be borne by the fund and hence by its members. Compared with the regulatory density that applies to other key points, this aspect gets short shrift, as it is only covered in the annual report available on request. The European Commission had originally been recommended to require the disclosure of expense ratios or other 'precise information on all costs incurred otherwise'.⁵⁰⁹ This proposal was not included, and neither was the recommendation to establish a counterpart to the simplified prospectus introduced by UCITS III for investment funds. Equally, the suggestion that the annual report should include an executive summary, a glossary, graphs and other statistical illustrations to make it more accessible to pension fund members was not adopted in the Directive. Another proposal was that the information should be user-friendly. This aimed to avoid information overload in much the same way as the Plain English requirement for US investment funds.⁵¹⁰ In view of the efforts to ensure the greatest possible transparency so as to strengthen the security of a fund, and also in view of the lead taken in these areas by US pension and investment funds, neglecting these disclosures seems to be a gap that must urgently be filled by asset management standards.

Statement of Additional Information

In addition to the prospectus and the (semi-)annual reports, in the USA the SAI is the third primary source of information for (potential) investment fund shareholders; it must be prepared and made available by the fund or its adviser. Investment companies must register their shares under the Securities Act of 1933 and/or the Investment Company Act of 1940.⁵¹¹ There are three different registration forms, depending on the type of fund involved: Form N-1A⁵¹² for open-end management investment companies, Form N-2⁵¹³ for closed-end management investment companies, and Form N-3⁵¹⁴ for separate accounts registered

⁵⁰⁷ See Pragma Consulting (1999), p. 36.

⁵⁰⁸ See Pragma Consulting (1999), p. 35.

⁵⁰⁹ Pragma Consulting (1999), p. 37.

⁵¹⁰ See Pragma Consulting (1999), pp. 35f.

⁵¹¹ See section 6 Securities Act of 1933 and section 24 Investment Company Act of 1940.

⁵¹² Section 274.11A, 17 CFR 274; section 239.15A, 17 CFR 239.

⁵¹³ Section 274.11a-1, 17 CFR 274; section 239.14, 17 CFR 239.

⁵¹⁴ Section 274.11b, 17 CFR 274; section 239.17, 17 CFR 239.

as management investment companies. A common feature of all three versions of the fund registration statement is that they are divided into three parts: Part A contains the information to be published in the prospectus, Part B the information to be published in the SAI and Part C other information.

The purpose of the SAI is to provide additional information that the SEC 'has concluded is not necessary ... or for the protection of investors ... but that some investors may find useful'.⁵¹⁵ In addition to the minimum required contents, which are presented in the following illustrative list, the SAI may also contain other information that is not expressly required. As with the prospectus, this applies with the proviso that such information is not incomplete, inaccurate, or misleading and does not obscure or impede understanding of the information because of its nature, quantity, or manner of presentation.⁵¹⁶

The main contents of the SAI are:⁵¹⁷

- (a) a description of the fund strategy/strategies and risks;
- (b) fund policies, including (for borrowing and lending) any concentration of investments in a particular industry or industries, purchase/sale of real estate and/or commodities;
- (c) policies and procedures with respect to the disclosure of the Fund's portfolio;
- (d) information on directors, officers and other affiliated persons⁵¹⁸ (among other things, the salaries/compensation of each member of the board of directors and certain other officers and affiliated persons must be disclosed);
- (e) information on the investment adviser and other service providers;
- (f) brokerage selection and brokerage commissions;
- (g) tax treatment of the fund;
- (h) standardized performance data, including the disclosure of certain tax effects;
- (i) financial statements, including the schedule of fees.

The SAI, which was introduced by the SEC in 1983,⁵¹⁹ established a phased or modular information concept: the (full) prospectus is a summary of material fund data and must be provided to (potential) investors before or at the time of sale of fund shares, while the SAI contains additional details based on those in the

⁵¹⁵ US Securities and Exchange Commission (no date/a) and General Instructions, C.2.(b) on Form N-1A, 17 CFR 274.

⁵¹⁶ See General Instructions, C.3.b, Form N-1A, 17 CFR 274.

⁵¹⁷ See Items 9 to 21 on Form N-1A and Items 14 to 23 on Form N-2 and Items 16 to 27 on Form N-3, 17 CFR 274.

⁵¹⁸ For a detailed description of the disclosure requirements in the SAI relating to the members of the board of directors, see the section on Extended disclosure requirements, pp. 201ff.

⁵¹⁹ See US Securities and Exchange Commission (1983).

prospectus, and is available only on request.⁵²⁰ The profile, introduced in 1998, extended this structure by a third, but merely optional, source of information for shareholders.

Conclusion on US investment funds' disclosure instruments

US investors have a total of six statutory disclosure instruments at their disposal, of which four (prospectus, SAI, report to shareholders, Form N-PX) are obligatory, one is conditionally obligatory (Form N-Q), and one is optional (profile). The first three of the instruments shown below can be classified as prospectuses or similar documents:

- prospectus
- profile
- SAI
- annual and semi-annual reports to shareholders
- annual report of proxy voting record (Form N-PX)
- schedule of investments in securities of unaffiliated issuers: if the semi-annual report only contains a summary of these investments, the complete schedule must be made available separately for the first and third quarters (Form N-Q)

In view of the wealth of information this brings, the question arises of the extent to which the latter can effectively reach average investors without any particular expertise in financial or legal matters. It cannot simply be assumed that it is generally known that the prospectus and the SAI belong together at a conceptual level, that the profile is a summary of the prospectus (Figure 5.29 illustrates the content relationships and the structural hierarchy), and that only the reports to shareholders and Form N-Q are required to include a disclosure of fund assets.

In particular, the three-stage structure of the prospectus in the wider sense, with the profile, the prospectus itself and the SAI, is at any rate incompatible with the notion of optimum education of (potential) investors. Because only the profile need be provided before shares are sold, common sense alone dictates that it can be assumed that a significant proportion of investors do not read the prospectus provided with the purchase contract confirmation, and neither do they request and study the SAI or the (semi-)annual reports.

This situation results in a clear conflict with the SEC's claim that a prospectus contains 'essential' information about the fund that will assist investors in deciding whether to invest.⁵²¹ If this information quality does actually exist, the logical consequence would be to require in all cases the provision of the prospectus *before*

⁵²⁰ The fund must send the SAI to the investor within three days of receiving a request; see Instruction on Rule 498(c)(1)(v) 17 CFR 230 and Instruction 3 on Item 1(b) Form N-1A, 17 CFR 274.

⁵²¹ US Securities and Exchange Commission (1998b), Summary.

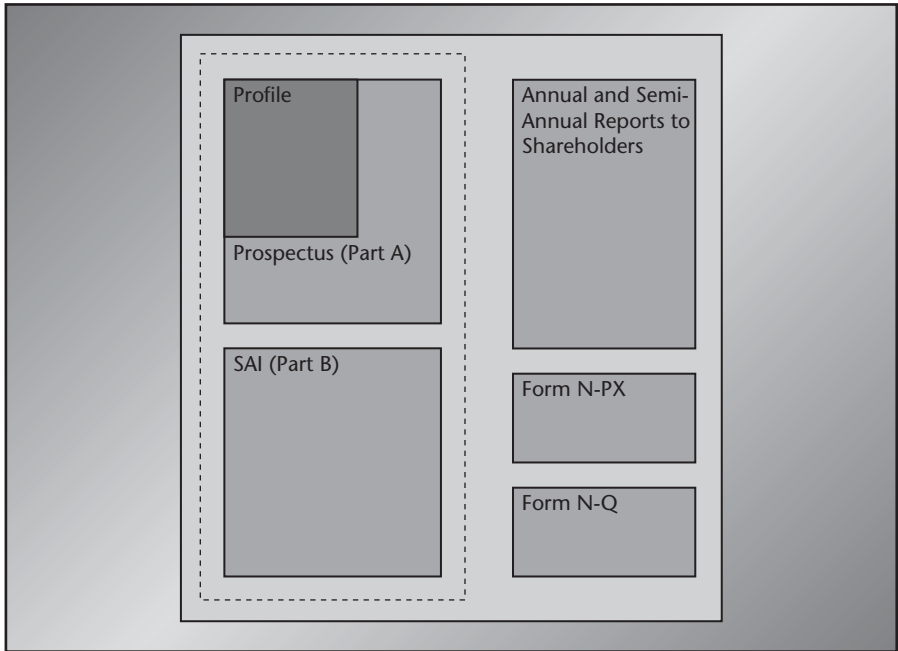


Figure 5.29 Statutory disclosure instruments for US investment funds

any purchase of fund shares. However, by introducing the profile as a condensed form of the prospectus, the SEC evidently seems to believe that prospectuses also contain non-essential information. If this were not the case, the statement in one of the SEC's rules that the profile 'is intended to be a standardised summary of key information in the fund prospectus'⁵²² has to be seen as contradicting the claim that the prospectus contains 'essential' information, because one of the qualities of such essential information is that it cannot be further abridged without losing material content.

One solution to this apparently inconsistent disclosure concept could be to eliminate one of the three prospectus types by integrating it into one or both of the remaining documents. A practical model for such a concept is the UCITS, with simplified and full prospectuses.

Performance Presentation Standards

Definition

The function of Performance Presentation Standards (PPS) is to ensure the fair presentation of returns and risks to (prospective) investors/clients.

⁵²² Instruction 1 on Rule 498(a)(2), 17 CFR 230.

Investors – especially institutional ones – are supported in their effort for effective procedures to assess the value of active portfolio management services rendered by ‘their’ asset managers. The asset managers in turn use PPS as an instrument to justify their management fees by quantifying their investment skill in a standardized manner.⁵²³ Addressees of PPS are also investment consultants.

There are two dimensions to PPS: guidelines on *performance measurement* are the basis for the *analysis of performance and its attribution*. In addition to the aspect of evaluating asset management services, performance analysis and attribution help to reveal undesirable developments or potential for improvement in the areas of portfolio and risk management. Performance analysis examines the reasons for particularly good or bad performance by presenting those components that have contributed to portfolio return in quantitative form. The crucial question from the investor’s point of view is whether the particular asset manager under consideration actually adds value to the portfolio. In particular, the question is examined whether (bad) luck or the portfolio manager’s skill (or lack of it) have driven the performance of the portfolio. This in turn is based on the underlying assumptions that such skills actually exist,⁵²⁴ that they remain stable over time and that their existence can be demonstrated by the realization of exceptional returns.⁵²⁵

Those portfolio managers who have realized an above-average return (against the market) are divided into two groups: those who were simply lucky, and those whose good performance is the result of superior skills or techniques.⁵²⁶

Especially for investment funds’ retail clients, PPS are an important safeguard against improper and/or misleading performance related advertising.

AIMR PPS, GIPS and PPS for IORPs

In 1993 the first version of the Association for Investment Management and Research (AIMR) PPS⁵²⁷ as the first comprehensive US set of rules governing performance presentation met with worldwide approval. Driven by this success and the need for comparability of performance results between different countries, the Global Investment Performance Standards (GIPS) were established a few years later. The GIPS committee (now Investment Performance Council, or IPC) sponsored by AIMR (now the CFA Institute) and comprised of various key industry groups from Europe, North America, Asia, Australia, New Zealand and South Africa finalized the first version of the GIPS in 1999.⁵²⁸

⁵²³ See Farah (2002), p. 2.

⁵²⁴ CAPM and the Efficient Markets Hypothesis in its (semi-)strict form must at least be qualified, as although these models permit out- and underperformance, they classify them purely as luck or bad luck.

⁵²⁵ See Grinold and Kahn (2000), p. 478.

⁵²⁶ Ibid, p. 479.

⁵²⁷ AIMR (1999a).

⁵²⁸ See CFA Institute (2005), pp. *if*.

However, the committee did not succeed in establishing a real single standard. There is no need to abolish country-specific local regulatory or legal requirements and well-established practices when adopting the GIPS as the 'Country Version of GIPS' (CVG). The CVG-approach allows the GIPS to be supplemented by the above-mentioned country-specific rules. In case of a conflict between these two sets of rules this conflict has to be disclosed and compliance with the country-specific laws or regulations takes priority over the GIPS. February 2005 saw the release of a second, revised version of the GIPS. Among other improvements the revised GIPS are intended to abolish the existing CVGs and replace them by one uniform standard.⁵²⁹

Unfortunately, the European Commission did not ultimately adopt the recommendation to include minimum standards on performance measurement in the Pension Funds Directive. The proposal had included both a comparison of the return with performance-related benchmarks,⁵³⁰ and the possible disclosure of quantitative measures of risk. The first step would be to use the Sharpe ratio and the information ratio as a minimum, followed by more complex risk measures at a later stage, such as value-at-risk.⁵³¹ In view of the efforts that were needed to establish GIPS, it appears sensible to examine whether these standards would also be suitable for EU pension funds.⁵³²

The BVI Code of Ethics and PPS

The BVI code of ethics that came into effect on 1 January 2003 obliged investment companies to comply with 'recognised standards for the calculation method, the appropriate time period applied and the selection of suitable comparative indices (benchmarks)' when publishing performance information.⁵³³ The actual methods used to calculate return are thus not specified. In particular, the (non-)inclusion of expenses and fees is not governed with any precision: there must be an indication of whether front-end or back-end sales loads are charged⁵³⁴ and the 'expenses (excluding transaction costs) charged to the fund' must be published in the annual report and in published 'sales documents and advertising' as a percentage of fund assets. The new *Investmentmodernisierungsgesetz*⁵³⁵ (German Investment Modernization Act) has required disclosure of a total expense ratio since 2004.⁵³⁶ The details on how the total expense ratio must

⁵²⁹ See CFA Institute (2005), pp. iif.

⁵³⁰ See Pragma Consulting (1999), p. 35.

⁵³¹ See Pragma Consulting (1999), p. VII.

⁵³² See Pragma Consulting (1999), p. 40.

⁵³³ BVI (2004a), Principle II, point 3, p. 5.

⁵³⁴ Ibid., Principle II, point 5, p. 5.

⁵³⁵ For information on the structure of the *Investmentmodernisierungsgesetz*, see n. 560, p. 100.

⁵³⁶ This total expense ratio must be reproduced in the annual report and the simplified prospectus, and its calculation methodology must be documented in the full prospectus (section 41(2) InvG).

be calculated presented are covered by derivative legislation⁵³⁷ and are thus not solely a matter for the code of ethics. The BVI code of ethics thus means that cost transparency requirements are considerably lower than in the US. There is no requirement for obligatory, standardized cost and fee schedules in tabular form, and neither have any rules been published to date on any reinvestment of distributions or on the tax effects of investing in the fund. There is no mention of any quantitative risk parameters; instead, there is a requirement for qualitative, generally worded indications of price fluctuation and investment concentration risks.⁵³⁸

The BVI code of ethics is more concrete when it comes to relative performance comparisons: wherever possible, 'suitable comparative indices' must be selected and 'if appropriate', 'published comparative indices' must be disclosed.⁵³⁹ 'Misleading return comparisons and promises' are prohibited and the 'underlying assumptions must be disclosed'; in addition, the 'establishment of corresponding standards for comparative performance measurement must be supported'.⁵⁴⁰

GIPS and the German DVFA PPS

DVFA PPS versus GIPS

DVFA PPS are based on the GIPS, but stricter requirements were stipulated for a number of points. Investment return is broken down into several individual return components that are analysed separately (see Equation 5.15).⁵⁴¹ These components will not be analysed in detail below; the aim is rather to present the core features of DVFA PPS. Attention is drawn to the relevant literature⁵⁴² for an exhaustive treatment of DVFA PPS and a general discussion of the problems involved in performance analysis.

$$\begin{aligned}
 & \text{Management return} \\
 & + \text{Market return} \\
 & - \text{Management fees} \\
 & = \text{Investment return}
 \end{aligned}
 \tag{5.15}$$

⁵³⁷ The finance ministry has the authority to issue derivative legislation, and it may delegate this authority to the BaFin (section 41(3) InvG).

⁵³⁸ See BVI (2004a), Principle II, point 2, p. 5.

⁵³⁹ Ibid., Principle II, points 3 and 5, p. 5.

⁵⁴⁰ Ibid., Principle II, point 6, p. 5.

⁵⁴¹ See Fischer (2001), p. 175.

⁵⁴² Fischer (2001) provides a comprehensive overview of the guidelines and recommendations in DVFA PPS and also discusses other international PPS and additional related topics, presenting numerous practical examples.

Measuring return

As with GIPS⁵⁴³ and AIMR PPS, the measurement of return is based on the *time-weighted return*, which requires the portfolio to be valued after each cash flow. This is not always the case in practice, which is why approximation methods are allowed, although valuation should be performed at least monthly. Market prices must be used for this valuation, and the prices should always be drawn from the same source.

The GIPS postulate similar requirements. They provide for a gradually shorter frequency of valuations depending on the period covered: for periods prior to the year 2001 there is a quarterly minimum frequency; for periods between 1 January 2001 and 1 January 2010 valuations have to be performed at least monthly, as in the case of DVFA PPS. Starting with 1 January 2010, all large external cash flows have to trigger a valuation procedure.⁵⁴⁴

The DVFA PPS also recommend (but do not require) the use of the *gross return*⁵⁴⁵ to ensure better comparability with benchmarks: this is the return gross of management fees and taxes (with the exception of foreign withholding taxes).⁵⁴⁶ The reasoning behind this recommendation is that these costs are not deducted from benchmarks, and that the net return is therefore a poor standard for measuring investment performance.

When presenting performance in accordance with the GIPS, disclosure is needed about whether gross return or net return is used,⁵⁴⁷ in any case, trading expenses have to be deducted.⁵⁴⁸ Furthermore it is *recommended* that non-reclaimable withholding taxes be deducted.⁵⁴⁹ *Net return* is defined as return after trading expenses and management fees. Optionally other fees are also deductible if this is disclosed properly.⁵⁵⁰

Measuring risk

Difficulties in establishing watertight definitions mean that it is much more difficult to measure risk than it is to measure return. DVFA PPS are not limited to the presentation of historical quantitative risk resulting from time series analysis, but also cover the areas of corporate management, trading and research; these all influence future performance and entail risks.⁵⁵¹ The investor's total risk can be broken down into the following constituent parts.

⁵⁴³ See section 2.A.2, CFA Institute (2005).

⁵⁴⁴ See section 1.A.3, CFA Institute (2005).

⁵⁴⁵ DVFA PPS also allow the use of net return, although this is linked to the recommendation that the average management fees should also be disclosed.

⁵⁴⁶ See Fischer (2001), p. 211.

⁵⁴⁷ See section 4.A.6, CFA Institute (2005).

⁵⁴⁸ See section 2.A.5, CFA Institute (2005).

⁵⁴⁹ See section 2.B.1, CFA Institute (2005).

⁵⁵⁰ See section 4.A.16, CFA Institute (2005).

⁵⁵¹ See Fischer (2001), p. 231.

- 1 *Absolute risk* measures the probability that the future return of the portfolio/fund will deviate from the historical mean, and is expressed by the following variables, among others:
 - (a) *volatility* as a measure of absolute risk is particularly important for those investors who have invested much or even all of their assets in the portfolio or fund concerned;
 - (b) for bond portfolios, *duration* is a key measure of sensitivity to interest rate changes;
 - (c) *value-at-risk* is becoming increasingly important for asset management.⁵⁵²
- 2 *Relative risk* measures the probability that the future return will deviate from the benchmark:
 - (a) *the tracking error* is the (empirical) standard deviation of the active return. The active return is the difference between the returns of the portfolio/fund and benchmark returns.⁵⁵³ Selecting the wrong valuation sources can distort the results.⁵⁵⁴
 - (b) *beta* measures the sensitivity of the portfolio return against the market return, or in practice more commonly the benchmark return.
- 3 If the concept of performance is interpreted not simply as the (differential) return, but rather as the *risk-adjusted return*, the performance measurement criteria can be structured as presented in Figure 5.30.
- 4 The *dispersion of returns within a composite* quantifies the probability that the historical return of a portfolio assigned to the composite deviates from its average return. The GIPS demand the disclosure of at least one dispersion measure.⁵⁵⁵ Measures deemed appropriate include 'high/low, inter-quartile range, and standard deviation (asset weighted or equal weighted)'.⁵⁵⁶
- 5 *General risks* measure the effect of non-market-specific risks, such as:⁵⁵⁷
 - (a) the possibility that the management company's ownership structure may change;
 - (b) or the possibility that the composition of the management or analyst team may change. The current version of the GIPS does not contain any disclosure requirements associated with such general risks.

⁵⁵² The risk measure of *default probability* follows a concept similar to value-at-risk, but instead of calculating a maximum loss from a given probability and period (as with VaR), it aims to compute a default probability from a given loss and period (see Fischer (2001), p. 251).

⁵⁵³ See Grinold and Kahn (2000), p. 49.

⁵⁵⁴ For the significance of consistent price sources, see the section on Measuring return, p. 338.

⁵⁵⁵ See sections 4.A.26 and 5.A.1.d, CFA Institute (2005).

⁵⁵⁶ CFA Institute (2005), p. 44.

⁵⁵⁷ See Fischer (2001), pp. 291f.

	Total risk	Systematic risk
Standardized risk (ranking possible)	Sharpe ratio ^a	Treynor ratio ^b
Absolute differential return against the 'passive portfolio' (no ranking possible)	Differential return ^c	Jensen's alpha ^d
'Synthesis' (ranking possible)	Risk-adjusted return ^e	Market risk- adjusted return ^f

Figure 5.30 Classification of various measures of performance by risk measure used and application

- ^a The Sharpe ratio of a portfolio is the quotient of its differential return (actual portfolio return less comparative return; because the risk-free rate is normally used as the comparative return, the differential return normally corresponds to the excess return) and its aggregate risk, expressed by its standard deviation; see Sharpe (1966).
- ^b The Treynor ratio (also known as reward-to-variability ratio) is calculated in the same way as the Sharpe ratio, with the difference that the denominator is portfolio beta (systematic risk) rather than volatility (see Treynor 1965).
- ^c Calculation follows the same principle as Jensen's alpha, but the return of a portfolio with the same total risk (i.e., the same volatility) calculated using CAPM is deducted from the return of the portfolio/fund (see Elton, and Gruber (1995), p. 641f).
- ^d Jensen's alpha is the difference between the actual return of the portfolio/fund and the return of a portfolio with the same systematic risk (i.e., the same beta) calculated using CAPM (see Jensen, 1968).
- ^e The risk-adjusted return is calculated as the difference between the return of the portfolio/fund scaled to market risk (i.e., volatility of the market portfolio) and the return of the market portfolio (see Modigliani and Modigliani (1997), p. 47).
- ^f The calculation of the market risk-adjusted return follows the method used in the case of the risk-adjusted return. The only difference lies in the risk measure applied. Instead of scaling the fund/portfolio to the market portfolio's total risk it is scaled to its systematic risk (i.e., beta). Thus the fund's/portfolio's beta is (de)leveraged to 1 (see Wilkens and Scholz (1999), p. 310f).

Source: Fischer (2001), p. 280

The GIPS *recommend* the disclosure of quantitative risk measures and cite the following examples: 'beta, tracking error, modified duration, information ratio, Sharpe ratio, Treynor ratio, credit ratings, value at risk (VaR) and volatility'.⁵⁵⁸

Minimum periods to be presented

Compliance with the DVFA PPS requires historical performance to be presented for at least a five-year period; if this is not possible because the portfolio/composite has been in existence for a shorter period, the presentation must cover

⁵⁵⁸ See section 5.B.2, CFA Institute (2005).

the entire period since inception. Rates of return for periods of less than one year may not be annualized.⁵⁵⁹

The GIPS' requirements are stricter as they demand the disclosure of additional annual performance data up to 10 years after presenting the minimum 5 years of performance data in the same manner as required by the DVFA PPS.⁵⁶⁰

Relative performance comparison

GIPS and DVFA PPS stipulate the use of benchmarks.⁵⁶¹ The relative performance of the portfolio and a previously selected benchmark (normally an index) is compared.⁵⁶² This aims to measure management performance (i.e., the ability of a portfolio manager to vary the portfolio structure within the limits of the investment policies).⁵⁶³ A comparison is reasonable only if the portfolio and the benchmark are based on the same price source, and the times when the prices are determined also coincide.⁵⁶⁴ Benchmarks can be well-established 'plain vanilla' equity and bond indices, but also customized benchmarks (i.e., self-constructed benchmarks); these are useful for balanced (hybrid) funds that invest in both equities and bonds.⁵⁶⁵

Regulations in the USA

The SEC's role in PPS

The SEC has issued a regulation obliging fund managers to publish performance data in a standardized format. Over the years, the SEC has staked out the bounds of permitted publicity and advertising through no-action letters, the publication of interpretations of laws and regulations, and enforcement actions. The industry is highly critical of the fragmented nature of these pronouncements and is calling for all the relevant rules to be concentrated in a single interpretative release. This would not only assist clarity, but would also eliminate inconsistencies and could produce more generally applicable rules, rather than the current case-by-case rulings.⁵⁶⁶

⁵⁵⁹ See Fischer, Lilla and Wittrock (2000), points 3.7.1 and 3.7.2.

⁵⁶⁰ See section 5.A.1, CFA Institute (2005).

⁵⁶¹ For GIPS see section 5.A.6, CFA Institute (2005).

⁵⁶² Selecting a benchmark is strategic asset management and is thus not a part of the measurement of management performance, because the portfolio manager is not responsible for taking decisions at this level.

⁵⁶³ See Fischer (2001), p. 74.

⁵⁶⁴ Consistent price sources for securities are more difficult to achieve than for currencies; DVFA PPS do not address this problem.

⁵⁶⁵ See Fischer (2001), pp. 101–103.

⁵⁶⁶ See US Securities and Exchange Commission (2000f).

Ex-post performance advertising

Fund (distribution) companies, the financial press and financial advisers frequently advertise and recommend investment funds on the basis of their past performance. The fact that this advertising strategy evidently also results in historical performance data being the primary factor influencing purchase decisions by non-institutional investors for or against a particular fund⁵⁶⁷ generally leads to suboptimal capital allocation: fees, which may undoubtedly have a tangible effect on the expected performance, are therefore only rarely given the attention they deserve.⁵⁶⁸ The secondary importance attributed to price competition is certainly also due to the relative lack of transparency of the fee structures,⁵⁶⁹ but also results in the superior allocative function of price rarely being used.

Although most empirical studies conclude from this that historical performance is not suitable for predicting future performance,⁵⁷⁰ the SEC has not introduced any advertising ban on past performance data, relying instead on regulation by means of formal requirements and its own measures to teach people to become 'educated' investors. One example of the latter is the SEC's guide to mutual fund investing, which includes a warning that there is more to selecting funds than merely comparing past performance.⁵⁷¹

The SEC requires any document containing performance information to carry a legend that performance data represents past performance, and may not reflect future investment returns. Investment returns and the principal value of the fund will fluctuate, and fund shares may be worth more or less at redemption than at purchase. In view of this generally uncontroversial statement, the SEC – and others – consequently pose the question of why advertising using historical performance data is allowed in the first place, if there is a generally held view that such information does not permit any forward-looking conclusions to be drawn.⁵⁷²

The essence of future standard-setting

Statements of investment principles should categorically be included in European standards for the area of disclosure requirements for pension products. The minimum content of standards should require a description of the investment strategy, including strategic asset allocation and the associated expected return for a typical investment period, as well as disclosures on risk tolerance and risk management techniques. The SIP again highlights the lack of any board similar to the US board of directors for investment funds. Because of its particular

⁵⁶⁷ See Sandler (2002), pp. 128f.

⁵⁶⁸ See Bogle (1999), pp. 68ff.

⁵⁶⁹ See Heinemann *et al.* (2003), p. 74.

⁵⁷⁰ See Galer (2002), p. 61.

⁵⁷¹ See US Securities and Exchange Commission (no date/b).

⁵⁷² See Hunt (1997).

status – its members include both insiders, but also external directors to protect investors' interests because of the mandatory quota for independent directors – this body is the ideal author of an SIP.

For investment funds, the prospectus is the most important statutory communication instrument directed at investors. In the USA, fund prospectuses are subject to highly detailed content requirements. The basic information, which is also required in Europe, includes the presentation of the risk/return profile (including a standardized presentation of historical performance) and of the investment objectives, as well as the investment policies applied to achieve them. A positive aspect here is the standardized presentation of fees and expenses (fee table and illustrative examples), and mandatory disclosure of the expense ratio, allowing (potential) investors to easily compare different fund companies. Moreover, disclosure of the annual portfolio turnover rate allows the transaction costs to be estimated. However, certain information that is certainly important for any investment decision is missing. For example, a schedule of investments is only stipulated as part of the reports to shareholders (and on Form N-Q), the explicit costs (brokerage commissions) resulting from portfolio transactions need only be disclosed in the SAI, and information on the effective independence of the independent members of the board is obligatory only for the SAI and/or proxy statement and/or the annual report. In addition, comparability of the expense ratio is limited because it does not contain sales loads, brokerage commissions, or other securities trading costs.

The profile, introduced in 1998 as a condensed alternative to the prospectus, is not compatible with the philosophy of the prospectus in the wider sense, which has existed since 1983 in two parts: the prospectus itself (Part A) and the SAI (Part B). The prospectus (Part A) has been designed by the lawmakers and the SEC to contain all fund-related information necessary for an investment decision, while the SAI by definition is not designed to contain all information relevant for a decision. So, either the profile is missing decision-useful information, or the prospectus itself is actually overburdened with content. If the latter case is true, slimming down the prospectus by shifting non-essential content to the SAI would be both consistent with the SEC's design concept and investor-friendly.

The EU UCITS Directive is more consistent in this respect because, unlike the US with its three documents (prospectus, SAI, profile), it only provides for two documents (full and simplified prospectuses) that do not pose any hierarchical contradictions. The EU's content provisions are highly abstract compared with the US rules, giving the Member States substantial leeway. Because the EU's efforts to harmonize the capital markets are not yet complete, it is highly likely that the future will see regulatory measures over and above UCITS III and the 2004 prospectus recommendation unless the financial services industry pre-empts them with its own effective standards. The US rules on the prospectus, profile and SAI provide two valuable notions: first, they represent a system of standardization of most of the information that is relevant to investors and are focused on the interests of investors, and second, their (at least partially) exaggerated infatuation

with detailed rules for every conceivable case means that they serve as a warning against overregulation.

Regular reporting to shareholders is also extremely important for investment fund transparency. In the USA, the following two portfolio-related issues deserve particular attention:

- (a) different types of portfolio statements: securities of affiliated and unaffiliated issuers, summaries and schedules, graphical or tabular breakdowns by asset class, region, and so on;
- (b) a qualitative narrative assessment of fund performance (Management's Discussion of Fund Performance) saves investors from having to rely to a large extent on speculation in this area, because no performance analysis and attribution is possible merely on the basis of lists of investments without any knowledge of the transactions that have occurred during the year.

In contrast to their EU counterparts, which are based purely on profit and loss considerations, US reports also contain comprehensive information on the internal organization and internal procedures of the fund and its adviser. This includes personal information about the directors and officers, a code of ethics, auditors' fees, publication of proxy voting policies and the actual proxy voting record, and finally explanations of the investment advisory contract, the audit committee and internal controls and procedures.

US pension fund reports are also highly regulated in the same way as US investment fund reports. Although the extent of the pension fund disclosure requirements is in need of reform, they do represent a high level of transparency provided that the reader is able to understand them. This liberal concept, although it is not a trivial matter for pension investors, must be contrasted with the approach taken, for example, in Germany and Austria, which seek to ensure the security of retirement investment plans not primarily through transparency, but rather by using inefficient, albeit superficially easily understandable, interest and asset value guarantees. Given the objective of achieving the greatest possible retirement assets, the US concept has clear advantages, even if the disclosure requirements are in need of reform (to slim them down).

In the EU, the Pension Funds Directive relies on transparency to ensure security to a far lesser extent than ERISA and the US Investment Company Act, although the experts engaged by the Commission (unsuccessfully) recommended very far-reaching disclosure requirements. The ALM study and actuarial reports, for example, need only be filed with the regulator, and are withheld from investors and beneficiaries in a highly 'nanny state' approach. Similar to UCITS, only financial data is contained in the obligatory (semi-)annual IORP reports. There is no provision for the sort of qualitative information that is allocated much space and therefore importance in the USA. The structure of the quantitative data is also in need of improvement, as there are no specific rules for the standardized

disclosure of (management) expenses, heavily restricting the ability to compare different fund providers.

The problem of how to present historical performance in particular could be solved using established Performance Presentation Standards. Establishing dedicated standards in this area would certainly lead to acceptance problems, although certain additions to existing PPS might still be needed to better suit the specific features of pension funds, especially DB plans. This would also help eliminate consumer protection objections about (misleading) fund advertising.

Control and Enforcement of Rules and Regulations

BOARD OF DIRECTORS

The board's significance in the USA and the EU

Board of directors as the shareholders' watchdog in the USA

US Congress designed the Investment Company Act to 'place the unaffiliated [fund] directors in the role of "independent watchdogs" ... who would furnish an independent check upon the management of investment companies ... [and] entrusted to the independent directors ... the primary responsibility for looking after the interests of the funds' shareholders'.¹ They represent the interests of the shareholders, which take precedence over the interests of all other parties. The shareholders therefore rely on the directors and their independence to ensure the integrity of the fund.²

UCITS still lacking an authority equivalent to the US fund board

Even after the UCITS III amendment, the UCITS Directive does not provide for any effective control for investment funds in the form of a board of directors or supervisory board designed primarily to represent investor interests. This means that the Directive does not stipulate any direct controls or approval requirements even for various activities within the fund or its management company, and for transactions with the management company, that are associated with (potential) conflicts of interest. This gives the national regulators greater responsibility (at least in theory), but their ability to exercise this is restricted in practice because

¹ US Supreme Court (1979).

² See Levitt (np, 1999b).

the number of supervisory officials needed to oversee investment funds is many times lower than the number of funds they have to supervise.

The UCITS Directive, however, does not prevent the Member States from regulatory measures at the national level regarding supervisory structures internal to management companies or investment funds respectively. The authorities of the supervisory board (or any functionally similar body) can be enhanced to create a board equipped with duties and responsibilities akin to the design of US fund boards. Besides the national regulators and/or legislators the Member States' industry representatives can seize the opportunity to use this regulatory leeway. It is up to the asset management industry to set standards which exceed minimum requirements set by laws. Self-regulation (i.e., non-legislative measures such as codes of conduct put in place by the industry) can be used to enhance the effectiveness and efficiency of the internal corporate governance structure of investment management companies. An often cited argument against self-regulation is its tendency to create only paper tiger-like manuals, as self-regulatory structures normally lack the power and authority to impose effective sanctions against wrongdoers. If the industry, however, does not provide for effective enforcement, regulatory intervention by the means of laws and/or mandatory regulations will inevitably follow.

Recent self-regulatory activities in Germany are an example of the asset management industry's awareness for the need for enhanced fund governance. The Working Group on Corporate Governance for Asset Managers chaired by Professor Wolfgang Gerke presented their Corporate Governance Code for Asset Management Companies in April 2005. One of the Code's crucial features is the specification of the duties, responsibilities and the composition of the asset management companies' supervisory board. If there is no supervisory board (e.g., in the case of a one-tier board structure), the Code addresses an 'equivalent committee'.³ The main tasks of the board's members are to ensure the management board's compliance with the rules and regulations safeguarding the investors' interests 'including appropriate risk management and risk controlling',⁴ the setting-up of an audit committee⁵ and regular examinations of its own efficiency.⁶

The board's design offers some features to allow for a 'watchdog' role. Although the Code in its brevity and simplicity is far away from the detailed rules and regulations governing fund boards in the USA, it is a first step in providing an internal oversight body that represents the interests of fund investors. The general clause to protect the investors' interests is supplemented by the board members' obligation to disclose conflicts of interest and the need for pre-approval on transactions or business relations between a board member and the management company.⁷

³ German Working Group on Corporate Governance for Asset Managers (2005), paragraph 2.

⁴ *Ibid.*, paragraph 2.1.1.

⁵ *Ibid.*, paragraph 2.1.4.

⁶ *Ibid.*, paragraph 2.3.

⁷ *Ibid.*, paragraph 2.2.

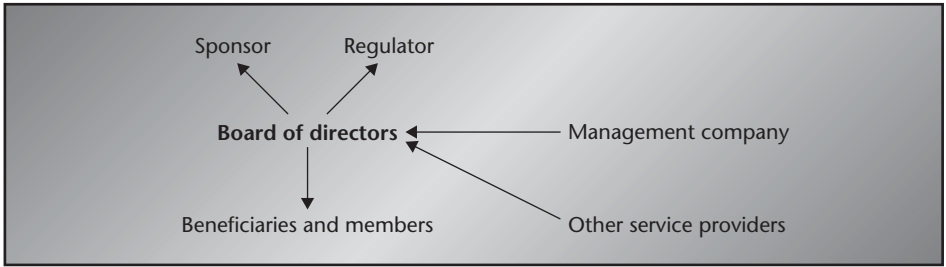


Figure 6.1 The board of directors in the responsibility matrix

Source: Pragma Consulting (1999), p. 45

The effectiveness and credibility of the board's role as the investors' representative is supported by the requirement for at least one independent board member. There are no detailed rules on incompatibility as in the USA, but only the requirement to be 'independent of the [management] company's owners, any affiliated entities or business partners'.⁸ In addition to this rather abstract definition of independence, the lack of formal procedures for the independent directors' nomination and the stipulation about their compensation are limit their practical impact.

The 'Rebuilding Pensions' study included an urgent recommendation to the European Commission to establish a (partially independent) board of directors for European pension funds as the 'highest authority of the pension fund'.⁹ Despite this, the Commission failed utterly to address the issue of institutionalizing this authority in either the preparatory documents for the Pension Funds Directive¹⁰ or in the draft Directive published in October 2000, so the final Directive does not provide for it either. If the Directive is amended at some point in the future, a board of directors should be specified as an obligatory executive body with the status shown in Figure 6.1. The arrows in the figure coming from the board signify board responsibility to the entity concerned, while arrows pointing to the board signify that the originating entity is responsible to the board.

Organizational structures

It is quite common in the USA for funds not to have their own exclusive board, but for an individual fund board to oversee a whole family of funds, although the structures themselves may vary.¹¹

- 1 In a pooled board structure, all members of the board oversee the entire family of funds.

⁸ Ibid., paragraph 2.1.3.

⁹ Pragma Consulting (1999), p. 45.

¹⁰ These documents are: European Commission, Com (1997) 283 (1997); European Commission, Com (1999) 134 final (1999); European Commission, Com (1999) 232 (1999).

¹¹ See Investment Company Institute (np, 1999), p. 7.

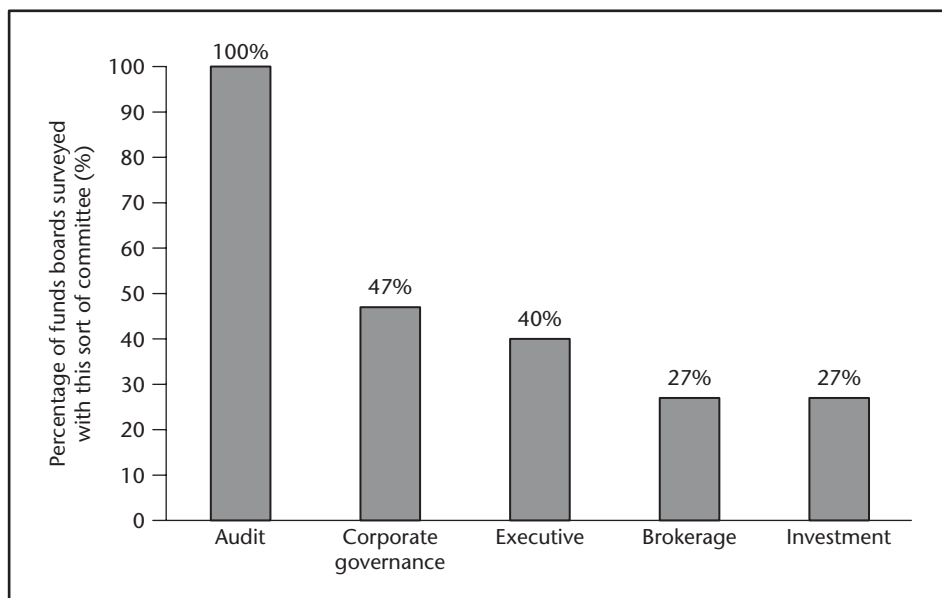


Figure 6.2 Common types of US fund committees

Source: Management Practice Inc. (1998)

- 2 In a clustered board structure, the board is split into different groups, each of which is responsible for specific, defined groups of funds with similar features. For example, (all) bond and (all) equity funds may be supervised by two different groups of board members.

The purpose behind this bundling of responsibilities is one of business efficiency (i.e., to avoid unnecessary duplication of the same duties to be exercised at all – or at least most – of the funds in a family, such as meetings, shareholder servicing, or audit matters). The organization can also (and additionally) be structured along functional lines, with certain matters being dealt with in committees, rather than by the board as a whole. In the USA, these committees normally meet separately from the full board meetings; independent director representation is usually very high on these committees and, in some cases, they are composed entirely of independent directors.

A 1998 survey produced a result for typical fund committees in the USA which is shown graphically in Figure 6.2. The audit committee plays an important role because it is almost always established in practice, despite there being no legal obligation to do so. It is also the only committee that is subject to disclosure obligations in reports to shareholders. The fact that this committee has been established must be disclosed, together with the names of its members. The fund must also disclose whether it has a financial expert serving on the committee (in which case this member must be identified, together with a disclosure of whether he or she

is independent), or the reasons why no financial expert has been appointed must be disclosed.

Compensation

In the USA, the fund board – not the investment adviser – sometimes sets the compensation of its members. The ICI recommends that independent directors be allowed to set the appropriate compensation for serving on fund boards.¹² The law prohibits directors from receiving shares of the fund as compensation.¹³ The reason for this prohibition is that prior to the Investment Company Act, funds paid for services provided to them by agreeing to transfer a certain number of shares at a certain date in the future. This practice may have resulted in the dilution of shareholder interests if the value of the shares appreciated by the time they were payable by the fund, and the compensation paid exceeded the value of the service provided. The service provider was essentially thus able to acquire shares at less than their net asset value, and thus received preferential treatment over the other shareholders.¹⁴

Subject to certain conditions, however, the SEC now permits a similar compensation arrangement that more closely aligns the interests of independent directors and shareholders:¹⁵ The practice of many funds to require, or at least to encourage, their directors to invest part of their compensation in shares in the fund(s) does not cause dilution, and the SEC therefore has no objections. The same applies to direct compensation by shares, as long as a fixed net asset value is agreed in advance rather than a fixed quantity of shares, thus preventing the directors from receiving preferential treatment over other shareholders.

Transactions requiring approval in the USA

The Investment Adviser Act of 1940 and SEC regulations issued on the basis of this law require the approval of a majority of independent directors for the following transactions.

*Contracts with the investment adviser (investment advisory contract)*¹⁶ and *the principal underwriter*¹⁷ must be re-approved each year by the independent directors.¹⁸ The directors are required in this context to obtain from the investment

¹² See Investment Company Institute (np, 1999), p. 21.

¹³ Section 22(g) Investment Company Act of 1940.

¹⁴ See US Securities and Exchange Commission (1999c).

¹⁵ Ibid.

¹⁶ Section 15(a) Investment Company Act of 1940.

¹⁷ Section 15(b) Investment Company Act of 1940.

¹⁸ As a rule, the investment adviser approves this contract as the original sole shareholder. After a maximum of two years, annual approval/rejection is then a matter for the independent directors (see US Securities and Exchange Commission (2000h), footnote 23).

adviser (and to review) all reasonable information necessary for assessing the agreements contained in the investment advisory contract, and the investment adviser in turn is required to provide this information.¹⁹ The directors can also consult external experts to supplement the information provided by the investment adviser. Advice from an independent counsel is also possible.²⁰ The information provided should enable the review of the advisory fee, the services provided by the investment adviser and the profitability of the fund to the adviser.²¹

The SEC would like to strengthen the position of the independent directors by – among other things²² – allowing them to terminate the investment advisory contract without requiring the approval of the other directors (at present, the approval of the full board is required²³).²⁴ The ICI is calling for independent directors to be allowed to meet separately from the rest of the board in matters relating to the advisory contract.²⁵

*Selection of the fund's independent public accountant.*²⁶

*If one or more exemptive rules are exercised, the selection and appointment of new independent directors must be undertaken by the existing independent directors, who must also account for at least 75 per cent of board members.*²⁷

Approval of the distribution fees paid from the fund's assets (to be renewed at least once a year) in the case of 12b-1 plans. The directors must not only approve, but also regularly review, the 12b-1 plan, and they may also terminate the 12b-1 plan at any time without penalty.²⁸ When deciding these matters, the independent directors must in particular establish whether it can be reasonably assumed that payment of these distribution fees by the fund will benefit the fund and its shareholders. The adopting release to Rule 12b-1 contains a number of criteria that directors should use to evaluate the admissibility of 12b-1 plans.²⁹ A 12b-1 plan should not be viewed by the directors as a permanent arrangement: Rule 12b-1 'essentially requires fund directors to view a fund's 12b-1 plan as a temporary measure even in situations where the fund's existing distribution arrangements would collapse if the rule 12b-1 plan were terminated.'³⁰ The basis of the evaluation criteria referred to above is that a 12b-1 plan should typically aim to be used for a relatively short period, to respond to a particular distribution problem or to respond to

¹⁹ Section 15(c) Investment Company Act of 1940.

²⁰ See US Securities and Exchange Commission (2000h).

²¹ Ibid.

²² See the section on Initiatives to improve mutual fund governance, p. 194.

²³ Termination is possible at any time with notice of 60 days.

²⁴ See Roye (1999a).

²⁵ See Investment Company Institute (np, 1999), p. 15.

²⁶ Section 31(a)(1) Investment Company Act of 1940.

²⁷ See n. 22.

²⁸ See Investment Company Institute (np, 1999), p. 19.

²⁹ Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414,45 Fd. Reg. 73.898, 73.904 (28 Oct., 1980); cited in US Securities and Exchange Commission (2000h), footnote 29.

³⁰ See US Securities and Exchange Commission (2000h).

special circumstances such as net redemptions by shareholders. Today's 12b-1 plan practice, however, is normally far removed from this original intention, which resulted from the situation of the US mutual fund industry in the late 1970s. Nowadays, 12b-1 plans are used as a substitute or supplement for sales loads so as to pay for continuing advertising and distribution costs. These plans also helped establish the following hitherto unknown distribution methods in the 1970s which presuppose that 12b-1 plans were a permanent, rather than a temporary arrangement.³¹

- 1 Shares of a single fund are offered in several classes, with some classes defined (partly) by a 12b-1 fee. If 12b-1 plans are viewed as a merely temporary measure, however, the associated fund class would have to be wound up if the plan is terminated.
- 2 Funds that are primarily distributed through fund 'supermarkets'³²: many of these funds have a 12b-1 plan that pays the commissions to the fund supermarket; this plan should also therefore be seen as a permanent arrangement.
- 3 Some investment companies borrow money from banks or the capital markets using their expected future 12b-1 revenue as collateral. The issue of asset-backed securities whose backing consists of future 12b-1 revenue is a similar practice.

*Approval and oversight of affiliated securities transactions.*³³

*Establishing the fund's fidelity bond.*³⁴

*Establishing whether participation in joint insurance contracts is in the fund's best interests.*³⁵

The entire fund board (i.e., all directors, not just the independents) also has the following responsibilities.

- 1 Approval of the fund's valuation methods: the directors must review and approve the guidelines used by the investment adviser to value the fund's assets. If a pricing error occurs, it is the board's responsibility to decide on any corrective action to be taken.³⁶

³¹ Ibid.

³² 'In a typical fund supermarket, the sponsor of the program – a broker-dealer or other institution – offers a variety of services to a participating fund and its shareholders. The services include establishing, maintaining, and processing changes in shareholder accounts, communicating with shareholders, preparing account statements and confirmations, and providing distribution services. For the services that it provides, the sponsor charges either a transaction fee to its customer or an asset-based fee, generally ranging from 0.25 per cent to 0.40 per cent annually of the average value of the shares of the fund held by the sponsor's customers. The asset-based fee is paid by the fund, its investment adviser, an affiliate of the adviser, or a combination of all three entities.' (See US Securities and Exchange Commission (2000h), footnote 134.)

³³ Rules 10f-3, 17a-7, 17a-8 and 17e-1, 17 CFR 270.

³⁴ An insurance policy or (bank) guarantee against embezzlement or other breaches of trust. See also Rule 17g-1, 17 CFR 270.

³⁵ Rule 17d-1, 17 CFR 270.

³⁶ See Investment Company Institute (np, 1999), p. 17.

- 2 Approval of investment objectives and policies.³⁷
- 3 An SEC amendment to the regulatory regime for investment funds in 2003 requires the disclosure of both the proxy voting policies and the proxy voting record. The procedure for adopting these policies is not specified either by law or by the SEC, and should therefore logically be a matter for the fund board.³⁸
- 4 Monitoring investments in derivatives.³⁹
- 5 Monitoring fund liquidity.⁴⁰
- 6 Approving custody agreements.⁴¹
- 7 Approving brokerage allocation policy.⁴²
- 8 Oversight of the fund's investments and performance: the performance of the fund is evaluated on the basis of the factors stated in the prospectus (investment objectives, strategies and risks) so that a more detailed examination can be made if, for instance, the fund is performing much worse than comparable funds. The directors are also responsible for reviewing whether the managers are complying with these policies contained in the prospectus.⁴³
- 9 Authorizing the merger of two or more funds.⁴⁴
- 10 Declaring dividends in accordance with the fund's investment policies and objectives.⁴⁵

Oversight of internal fund procedures in the USA

Some typical significant procedures whose oversight forms part of the fund board's duties are presented below to give an insight into the complexity of this prudential regime.

First, best execution: one of the fiduciary duties of both the management company and the executing broker/dealer⁴⁶ is to obtain the best possible total costs for the client under the circumstances for each securities transaction.⁴⁷ Total costs

³⁷ See Investment Company Institute (2000a), p. 37.

³⁸ *Ibid.*

³⁹ *Ibid.*

⁴⁰ *Ibid.*

⁴¹ See US Securities and Exchange Commission (1999c).

⁴² *Ibid.*

⁴³ See Investment Company Institute (np, 1999), pp. 14f.

⁴⁴ See n. 41.

⁴⁵ See n. 41.

⁴⁶ The SEC emphasizes that broker/dealers who (negligently) cause or help another institution to breach a fiduciary duty to an investor make themselves liable for criminal charges of aiding and abetting or inciting fraud (see US Securities and Exchange Commission (1998c).

⁴⁷ The duty of best execution is based on the general statutory obligations of an agent of unrestricted loyalty and reasonable care to its principal, but it has been spelled out in more specific terms by special capital market laws.

in this context cover not only the fees and commissions paid (these are the least problematic because they are both the most transparent costs, and are normally relatively insignificant) but, above all, the market impact; in other words, they are mainly a question of the quality of execution.⁴⁸ A low fee makes little sense if the price paid is higher than the market price.⁴⁹ Market impact also depends on the discretion of the broker/dealer, because if the broker/dealer lets it be known on the market that a large order is about to be executed, the result will almost automatically be a higher cost of execution.⁵⁰ In addition to the independent directors, portfolio managers also play a major role in ensuring best execution because their compensation, reputation and ratings depend on their performance, which is determined – among other things – by the level of transaction costs they can achieve.⁵¹

Second, soft dollar arrangements: the independent directors have a fiduciary duty to establish – and this often means asking the investment adviser some tough questions – whose interests are served by any soft dollar arrangements, and whether they are really in the shareholders' best interests; whether they can be used to reduce direct costs to the fund; and whether the investment adviser can use them to secure research.⁵² The soft dollar arrangements should also be considered as part of the regular review of the investment advisory contract. It is evident that in practice, investment advisers comply to a widely varying degree with their duty to provide comprehensive information to the directors in this context,⁵³ compliance is unsatisfactory in many cases, and it is frequently assumed (wrongly) that all that is needed is a copy of the registration form, which is updated at least annually.⁵⁴

Third, directed fund portfolio brokerage: this is a problem related to soft dollars and refers to the widespread practice of compensating broker/dealers for selling investment fund shares not in cash, but by orders to buy and sell securities for the fund. Selling expenses thus do not reduce the profit from the management fee (at least in practice), but are borne indirectly by the shareholders. This means that broker/dealers who also sell the fund's shares are frequently engaged.⁵⁵ Because it can be assumed that the broker/dealers incur costs from their distribution services that they offset through implicitly or explicitly charged transaction costs, this may lead to infringements of the requirement for best execution and thus to

⁴⁸ Other quality characteristics are the value of any research services provided under soft dollar arrangements, order execution efficiency, the assumption of financial risks and response times to the principal (see US Securities and Exchange Commission (1998c).

⁴⁹ See US Securities and Exchange Commission (1999a).

⁵⁰ See US Securities and Exchange Commission (2000d).

⁵¹ See US Securities and Exchange Commission (1999a).

⁵² *Ibid.*

⁵³ For a summary of the information usually required or provided in this context, see US Securities and Exchange Commission (1998c).

⁵⁴ This is the 'Form ADV' (see the section on Disclosure of all material facts by US fund investment advisers, p. 219). See also US Securities and Exchange Commission (1998c).

⁵⁵ See US Securities and Exchange Commission (1999a).

financial losses to the shareholders. However, the SEC now sees this approach to broker/dealer selection as entailing significant conflicts of interest and as being capable of damaging the fund and its shareholders; in a rule issued in October 2004, it banned funds from compensating broker/dealers for selling shares through securities transaction orders.⁵⁶

By contrast, an SEC order from 1981 allowed fund advisers in the past to allow the sales aspect to flow into broker/dealer selection, if this decision criterion was disclosed and best execution was ensured. The SEC attributes its change of mind to a review it conducted in 2004 which found that exchanging distribution services for brokerage commissions is now much more widespread and professionally organized than was the case in the 1980s.⁵⁷

In addition to violations of the requirement for best execution, negative effects for shareholders may arise from the incentive for excessively frequent portfolio transactions. Transparency on distribution costs for (potential) shareholders also diminishes, something that broker/dealers who act as fund distributors and are compensated by brokerage commissions may use to their advantage by recommending funds to their clients that are most profitable to the broker/dealers because of the commissions, rather than those that best meet their clients' investment needs.⁵⁸

However, the SEC did not go so far as to completely ban broker/dealers who sell shares from executing portfolio transactions when it revised the rules on fund portfolio brokerage. They may still be used if the fund or its investment adviser has approved policies and procedures designed to ensure that broker/dealer selection is not affected by distribution services. Because the practical implementation of this rule poses problems, the fund board must shoulder a high level of responsibility: the majority of board members, including a majority of independent directors, must approve these policies and procedures.⁵⁹

Fourth, personal investing by persons involved in fund management: a code of ethics⁶⁰ is obligatory for persons whose affiliation with the fund gives them particular opportunities for self-dealing in fund transactions. The directors must adopt, approve, administer and disclose the code of ethics.⁶¹ De facto weaknesses in the oversight of the code often encountered in practice result from the fact that the number of individuals to be covered by the code is very large, and the cost of administering it is therefore often unrealistically high.⁶²

⁵⁶ See Rule 12b-1(h)(1), 17 CFR 270, introduced by the US Securities and Exchange Commission (2004e).

⁵⁷ See US Securities and Exchange Commission (2004e), p. 54,728.

⁵⁸ See US Securities and Exchange Commission (2004e), p. 54,729f.

⁵⁹ See Rule 12b-1(h)(2), 17 CFR 270, introduced by the US Securities and Exchange Commission (2004e).

⁶⁰ See Rule 17j-1 (c), 17 CFR 270.

⁶¹ Details of these duties involving directors are addressed in the section on Regulation of self-dealing transactions/code of ethics, p. 181.

⁶² See US Securities and Exchange Commission (2000d).

Personal liability of fund directors in the USA

Although directors may believe that they are acting in the best interests of the fund and its shareholders, they are still continuously exposed to the hazard of personal liability. The negative side-effects of this legally exposed status of the directors is that qualified individuals are deterred from becoming fund directors, and also that directors are deterred from taking potentially controversial decisions. The SEC tries to counter these undesirable consequences by allowing funds to advance legal fees to their directors under certain circumstances because, even if a lawsuit stands little chance of success, defending it can be a very expensive business.⁶³ This may not clash, however, with the provision of the Investment Company Act prohibiting funds from releasing directors from their liability to the fund itself and to its shareholders in the event of criminal intent, bad faith, gross negligence, or reckless disregard of their duties (known collectively as 'disabling conduct').⁶⁴

Before any advance is paid, the SEC therefore insists that the fund board either ensures that the advance can be repaid in the event of an adverse court ruling (e.g., by way of insurance or collateral provided by the director) or that it must reasonably believe that the director has not been involved in disabling conduct and that the director will therefore be entitled to indemnification. This belief must either be formed by a majority of independent directors, or be based on a written opinion by independent legal counsel.⁶⁵

Fees and expenses

The role of the fund board

For controlling fees and expenses the US regulatory regime relies primarily on a dual system comprising the following instruments:⁶⁶

- 1 *Disclosure*: the requirement of uniform disclosure of fees and expenses is designed to enable investors to make informed decisions.
- 2 The *independent directors* on the fund board: their duty is to resolve conflicts of interest that could result in unreasonably high fees and expenses in the interests of the shareholders. Merely disclosing the level of management fees in the fund prospectus does not discharge the directors from their duty to negotiate them when approving or renewing them in the investment advisory contract, and to ensure that the shareholders benefit from the economies of scale resulting from the growth in the volume of fund assets.

⁶³ See US Securities and Exchange Commission (1999c).

⁶⁴ Section 17(h) Investment Company Act of 1940.

⁶⁵ See US Securities and Exchange Commission (1999c).

⁶⁶ See US Securities and Exchange Commission (2000h).

The SEC is thus not empowered by law to adjudicate on what is a reasonable level of fees. However, the SEC can take action against the investment adviser if the adviser breaches its fiduciary duty in conjunction with fees and expenses.⁶⁷

The full board is responsible for the ongoing oversight and review of fees, and is required by law to safeguard shareholders' interests. Any increase in fees requires the approval of a majority of shareholders and independent directors.⁶⁸

The SEC has pointed out that although fund performance is unpredictable, the impact of fees is certainly not, and that a 1 per cent annual fee will reduce the final account balance after 20 years by 17 per cent.⁶⁹ Elsewhere, the SEC justifies an investigation into the fee situation in the US fund industry by stating that: 'The focus on fund fees is important because they can have a dramatic impact on an investor's return'.⁷⁰

In general terms, the impact of higher fees (expressed by the expense ratio) on the future value after a certain holding period produces the sort of picture shown in Table 6.1. This shows the future value of a one-time initial investment of 25,000 monetary units after a holding period of 10, 20, 25 and 40 years, with two different returns assumed (5 per cent per year and 9 per cent per year). These two return scenarios are subjected to various expense ratios (from 0 per cent to 2 per cent in 0.5 per cent steps) to illustrate the impact of higher fees on the absolute future value ('Future value' columns), and the percentage shortfall of the future value as against a zero fee scenario ('Shortfall' columns). It can be seen that, assuming a realistic 40 year investment phase (for the pension) and an expense ratio of 1 per cent, the future value is one-third lower than for a zero fee scenario. If the expense ratio were twice as high, the shortfall would be more than half!

What is often observed in practice is that although the fund volume has multiplied over time, the fees have certainly not fallen (if at all) to the extent achievable by economies of scale. According to a study by the US Investment Company Institute, there was only a very small reduction in the expense ratios of the 100 largest US equity funds between 1980 and 1997 (see Table 6.2), although the net asset value grew by a factor of around 20 over the same period.⁷¹ The expense ratio of all equity funds studied actually grew by 12 basis points between 1980 and 1997, from 0.76 in 1980 to 0.88 in 1997.⁷²

An SEC study shows that the expense ratios of equity and bond funds (both the unweighted average expense ratio and the asset-weighted ratio: see Table 6.3) rose between 1979 and 1992. The average expense ratio remained relatively stable in the 1990s.⁷³

⁶⁷ *Ibid.*, footnote 18.

⁶⁸ See Investment Company Institute (2000a), p. 27.

⁶⁹ See US Securities and Exchange Commission (1999a), statement by the then SEC Chairman Arthur Levitt.

⁷⁰ US Securities and Exchange Commission (2000h).

⁷¹ See US Securities and Exchange Commission (1999a).

⁷² See Investment Company Institute (1998b), p. 12.

⁷³ See US Securities and Exchange Commission (2000h).

Table 6.1 Impact of return, expense ratio and holding period on the future value of a fund investment

Return %	Expense ratio %	Year 0	Year 10		Year 20		Year 25		Year 40	
			Future value	Shortfall %	Future value	Shortfall %	Future value	Shortfall %	Future value	Shortfall %
5	0.00	25,000	40,722		66,332		84,659		176,000	
	0.50	25,000	38,731	5	60,005	10	74,688	12	144,024	18
	1.00	25,000	36,829	10	54,254	18	65,849	22	117,739	33
	1.50	25,000	35,010	14	49,029	26	58,020	31	96,153	45
	2.00	25,000	33,273	18	44,284	33	51,089	40	78,443	55
9	0.00	25,000	59,184		140,110		215,577		785,236	
	0.50	25,000	56,291	5	126,745	10	190,186	12	642,574	18
	1.00	25,000	53,525	10	114,597	18	167,680	22	525,300	33
	1.50	25,000	50,882	14	103,561	26	147,743	31	428,992	45
	2.00	25,000	48,358	18	93,539	33	130,093	40	349,980	55

Table 6.2 Operating expense ratios in 1997 of the 100 largest equity funds established prior to 1980

	1980	1997
Average	0.82	0.70
Sales-weighted average	0.70	0.56
NAV-weighted average	0.62	0.57
Median	0.75	0.72

Source: Investment Company Institute (1998b), p. 13

However, this rise in the expense ratio does not necessarily mean an increase in total shareholder costs (see below), because it is due primarily to a change since the 1970s in the way in which distribution and advertising expenses are deducted: many funds have reduced⁷⁴ or abolished their front-end sales loads which, as explained above, are not factored into the calculation of the expense ratio, but are included in the calculation of total shareholder costs, as described below; these loads have been replaced by an annual 12b-1 fee. This is now included in the calculation of the expense ratio.⁷⁵ Tables 6.4 and 6.5 demonstrate this quantitative

⁷⁴ The average front-end sales load fell from 8.5 per cent in 1979 to 4.75 per cent in 1999 (see US Securities and Exchange Commission (2000h).

⁷⁵ See US Securities and Exchange Commission (2000h).

Table 6.3 Expense ratio growth 1979–1999 for all classes of fund shares

	Unweighted average expense ratio (%)	Weighted average expense ratio (%)
1979	1.14	0.73
1992	1.19	0.92
1995	1.30	0.99
1996	1.32	0.98
1997	1.33	0.95
1998	1.35	0.91
1999	1.36	0.94

Source: US Securities and Exchange Commission (2000h), Table 2

Table 6.4 Classes of no-load funds

Year	Number ^a		Assets ^b		Expense ratio ^c %
	Absolute	% ^d	Absolute	% ^d	
1979	201	39	\$15,451,000,000	30	0.75
1992	763	31	\$254,441,000,000	26	0.80
1995	2,380	36	\$916,401,000,000	44	0.76
1996	2,506	36	\$1,076,530,000,000	45	0.75
1997	2,576	37	\$1,384,483,000,000	46	0.72
1998	3,229	38	\$1,751,804,000,000	49	0.68
1999	3,418	38	\$2,259,836,000,000	51	0.72

^a See US Securities and Exchange Commission (2000h), Table 3

^b See US Securities and Exchange Commission (2000h), Table 4

^c See US Securities and Exchange Commission (2000h), Table 5

^d No-load and load funds together amount to 100 per cent

trend away from load funds and towards funds with 12b-1 fees, and also illustrate the changes in the expense ratios of these two types of funds between 1979 and 1999. The 'Number' columns in Table 6.4 and Table 6.5 record the fund *classes*, (i.e., where funds offer two or more classes, each fund class is counted separately in the 'Number' columns).

In addition, funds with higher management fees have significantly increased their market share over the past 20 years on the back of their more sophisticated strategic asset allocation. This trend can be seen as a further reason for the growth in the expense ratios: international and speciality funds, as well as equity funds, which are generally more expensive to manage than bond funds, captured market

Table 6.5 Classes of load funds

Year	Number ^a		Assets ^b		Expense ratio ^c %
	Absolute	% ^d	Absolute	% ^d	
1979	316	61	\$36,204,000,000	70	0.72
1992	1,720	69	\$728,162,000,000	74	0.96
1995	4,302	64	\$1,158,001,000,000	56	1.17
1996	4,459	64	\$1,293,730,000,000	55	1.17
1997	4,415	63	\$1,617,017,000,000	54	1.14
1998	5,184	62	\$1,807,092,000,000	51	1.12
1999	5,483	62	\$2,196,776,000,000	49	1.17

^a See US Securities and Exchange Commission (2000h), Table 3

^b See US Securities and Exchange Commission (2000h), Table 4

^c See US Securities and Exchange Commission (2000h), Table 5

^d No-load and load funds together amount to 100 per cent

Table 6.6 Volume and percentage share of total US mutual funds taken by individual fund types

Year	US bond funds		US equity funds		International funds		Speciality funds	
	\$m	%	\$m	%	\$m	%	\$m	%
1979	17,037	33	34,618	67				
1992	522,049	53	363,861	37	65,083	7	31,610	3
1995	732,472	35	999,772	48	273,956	13	68,200	3
1996	776,106	33	1,196,436	50	317,676	13	80,042	3
1997	856,279	29	1,664,553	55	374,760	12	105,907	4
1998	990,132	28	2,056,137	58	391,574	11	121,053	3
1999	944,435	21	2,705,494	61	564,215	13	242,470	5

Source: US Securities and Exchange Commission (2000h), Table 8

share between 1992 and 1999 (see Table 6.6). These more expensively managed funds consequently record higher expense ratios (see Table 6.7).

There are other explanations for this growth in expense ratios.

- 1 Older funds are larger and therefore benefit from economies of scale (see below). However, a large number of new funds have been launched in recent years; because they are still small, their expense ratio is greater than that of the more established funds.⁷⁶

⁷⁶ See US Securities and Exchange Commission (2000h), Table 10.

Table 6.7 Expense ratios of individual US fund types (%)

Year	US bond funds	US equity funds	International funds	Speciality funds
1979	0.70	0.74	–	–
1992	0.82	0.95	1.36	1.31
1995	0.84	0.98	1.31	1.37
1996	0.84	0.96	1.31	1.34
1997	0.83	0.91	1.24	1.35
1998	0.80	0.88	1.18	1.30
1999	0.80	0.90	1.18	1.36

Source: US Securities and Exchange Commission (2000h), Table 9

2 There has been a trend recently towards creating new, smaller fund classes whose expense ratio is greater because they offer no or lower economies of scale.⁷⁷

The ICI proposes ‘total shareholder costs’ as a measure of the cost to a shareholder of investing in an equity fund.⁷⁸ It is composed of the operating expenses, including any 12b-1 fees, plus the annualized sales loads.⁷⁹ This figure is thus comparable with the fee and expense information required to be disclosed in all US prospectuses. Between 1980 and 2002, the period covered by the study, the total shareholder cost ratio for equity funds fell from 2.25 per cent in 1980 to 1.25 per cent in 2002 (i.e., by around 45 per cent: see Figure 6.3). For bond funds, the total shareholder cost ratio fell by 42 per cent between 1980 and 2002 (from 1.53 per cent to 0.88 per cent), and for money market funds it fell by 38 per cent from 0.55 per cent to 0.34 per cent.⁸⁰ This fall was driven primarily by a decline in distribution expenses (12b-1 fees plus sales loads),⁸¹ coupled with a trend over the survey period towards investors buying funds with lower costs (especially no-load funds).⁸²

Some funds define ‘breakpoints’ (in fund size). If these breakpoints are exceeded, the fees are reduced to a certain level.⁸³ The underlying reasoning is that there are economies of scale in the fund industry, as demonstrated by an ICI study.⁸⁴

⁷⁷ Ibid., Table 11.

⁷⁸ See Investment Company Institute (1998b), p. 1.

⁷⁹ Annualization of sales loads is a problem because the actual individual holding periods and the loads actually paid (which are often reduced by rebates) are unknown (see US Securities and Exchange Commission (2000h)).

⁸⁰ See Investment Company Institute (2004), p. 2.

⁸¹ See Investment Company Institute (1998b), p. 2.

⁸² See Ibid., p. 10.

⁸³ See US Securities and Exchange Commission (1999a).

⁸⁴ See Investment Company Institute (1998b), p. 2.

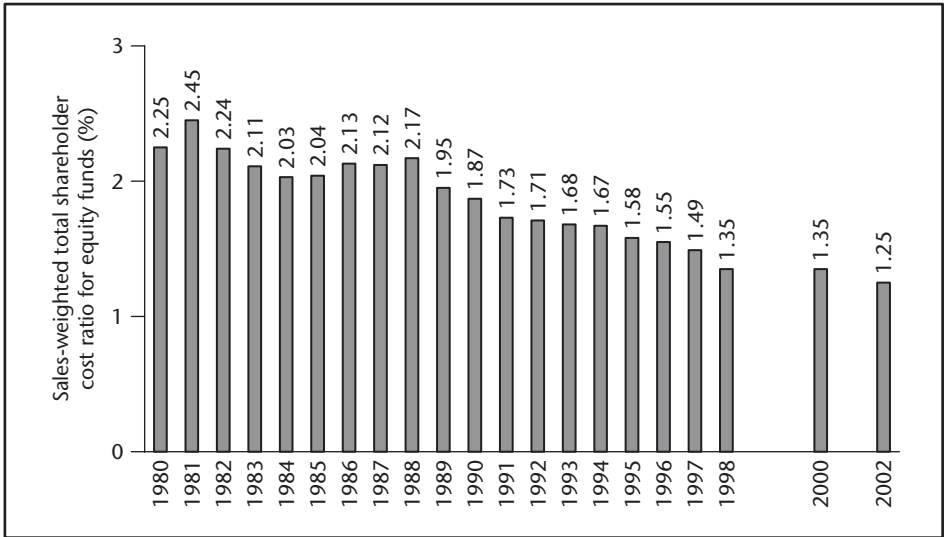


Figure 6.3 Sales-weighted total shareholder cost ratio for equity funds (per cent), 1980–2002

Sources: Data for 1980 to 1997, see Investment Company Institute (1998b), p. 2; for 1998, see Investment Company Institute (2000a), p. 30; for 2000 and 2002, see Investment Company Institute (2004), p. 2

The SEC has also looked at the issue of economies of scale. A study covering the period 1997–99 examined the advisory contracts of the 100 largest US mutual funds⁸⁵ for breakpoint clauses and concluded that 76 of these 100 contracts contained some sort of breakpoint agreement. The contracts of all 100 funds were classified into five types by their fee structure, and Table 6.8 presents the detailed results for the following five classes.

1 Funds with breakpoints:

- (a) breakpoints based on total assets: as total assets rise, the percentage management fee declines when fixed asset breakpoints are exceeded;
- (b) breakpoints based on fund family assets: similar to above, but based on fund family assets rather than portfolio assets;
- (c) breakpoints based on portfolio assets plus a performance fee: a management fee as described in (a) above is supplemented by an additional fee that varies with fund performance.

2 Funds without breakpoints:

- (a) funds with a single, all-inclusive fee not tied to fund assets;
- (b) funds with at-cost fee arrangements.

⁸⁵ These 100 funds accounted for 47 per cent (\$1.4 trn) of the volume of all equity and bond funds in the USA in 1997, 45 per cent in 1998 (\$1.5 trn) and 45 per cent in 1999 (\$2 trn).

Table 6.8 Fee structure of the 100 largest US funds showing breakpoints between 1997 and 1999

Contract type	Number of funds	Total assets 1999		Average number of breakpoints	Average fee for <i>n</i> th breakpoint in basis points		Average assets for <i>n</i> th breakpoint in \$bn		Funds with assets above last breakpoint		
		\$bn	%		First	Last	First	Last	Number	Assets in \$bn	% assets of this contract type
1(a)	47	855.2	41	6	65	41	0.5	10	34	318.2	37
1(b)	21	506.3	25	37	52	22	3	1,200	0		
1(c)	8	113.9	6	4	27.5	11.3	0.15	10	5	41.1	36
2(a)	19	376	18		65 (low = 24, high = 100)						
2(b)	5	204.7	10								
Σ	100	2056.1	100								

Source: US Securities and Exchange Commission (2000h)

There is a frequently voiced view that fund fees are too high. Advocates of this view argue that the economies of scale which can be realized through asset growth are not passed on to the shareholders, for instance in the form of appropriate breakpoints. This view is supported by the fact that not all funds provide for breakpoints (Table 6.8 shows that 28 per cent of the 100 largest US funds had no breakpoints at all between 1997 and 1999), and that many funds that have already agreed breakpoints have assets above the last breakpoint (Table 6.8 again shows that around a quarter of the funds with breakpoints surveyed have assets in excess of the last breakpoint); all else being equal, fees will not therefore be cut further if the portfolio assets record additional growth. The counterargument advanced is that shareholders get more for their money today than in the past, in the form of additional services and an offering that has been extended by, for example, international and speciality funds.⁸⁶

Structuring of performance fees

Performance fees are common at the largely unregulated US hedge funds. A 1 per cent management fee plus a 20 per cent profit share is standard. This is an asymmetric structure, where the investment adviser takes a share of the profits but does not participate in losses. These are contrasted with incentive fees in the form of 'fulcrum fees', where the fee increases if the fund outperforms its benchmark, and decreases if it underperforms it; no minimum or base fee is charged.⁸⁷ However, some people think that looking at just the return and ignoring the risk is an inadequate way of structuring performance fees,⁸⁸ and they recommend a comparison with both the performance and the implied risk of the benchmark index.

Appropriate level of fees and expenses in the USA

One of the duties of independent directors is to review and approve (or disapprove) the investment advisory contract every year; this contract also includes an agreement on the type and amount of fees, which fall under the investment adviser's fiduciary duty.⁸⁹ When evaluating the appropriateness of the fees, the directors must be guided by a court ruling in a key case on fees, the Gartenberg case.⁹⁰ The judge in this case ruled that fees may not be so disproportionately large that they have no relationship to the services provided and could not have been a result of arm's-length negotiations, otherwise the investment adviser would be in breach of fiduciary duty. This standard is very vague, and needs to be put into

⁸⁶ See US Securities and Exchange Commission (2000h).

⁸⁷ See US Securities and Exchange Commission (1999a).

⁸⁸ See remarks by Ken Scott in US Securities and Exchange Commission (1999a).

⁸⁹ Section 36(b) Investment Company Act of 1940.

⁹⁰ US 2nd Circuit Court of Appeals (1982).

more concrete form by the factors that underlie the assessment by the independent directors, as outlined below.⁹¹

- 1 The quality of the services provided by the investment adviser: first, the quality of the investment process (the expertise of the people involved, the research process, compliance responsibilities, performance statistics, and so on), and second, the quality of other services provided by the investment adviser, such as the range of funds on offer (international funds, speciality funds, etc.) or the quality of fund statements.
- 2 The cost to the investment adviser of performing services for the fund and the payments received by the adviser should be compared to provide an estimate of the investment adviser's profit.
- 3 A comparison with the fees (and corresponding performance⁹²) of other funds is also advisable.⁹³
- 4 The scope for economies of scale if the fund grows.⁹⁴
- 5 'Fall-out' benefits⁹⁵ that may accrue to the investment adviser from its business relationship with the fund.⁹⁶

Although they are not so important in practice, directors must also review and approve the fees charged by other service providers to the fund (for example, the distributor and the custodian).⁹⁷

The Investment Company Act does not provide explicit answers to some questions, as shown below.

- 1 Allocation of the costs and payments of a fund complex to the individual funds: for example, all funds use research and back office services to a differing degree.
- 2 Enforcement in practice of the fundamental prohibition on including distribution and advertising expenses when estimating profit: distribution expenses can only be charged to the fund if there is a 12b-1 plan and here, too, the independent directors have a particular fiduciary duty of examining whether it is reasonably likely that the shareholders will benefit if the fund shoulders these costs. Introducing a 12b-1 plan, however, needs the approval of the shareholders, the board and its independent directors. The fund in question must also have a majority of independent directors.⁹⁸ If there is no 12b-1 plan, the SEC prohibits these expenses from being included, although they are nonetheless incurred.

⁹¹ See US Securities and Exchange Commission (1999a).

⁹² See US Securities and Exchange Commission (2000h).

⁹³ See Investment Company Institute (np, 1999), p. 16.

⁹⁴ See n. 92.

⁹⁵ Ancillary remuneration (e.g., in the form of soft dollars).

⁹⁶ See n. 92.

⁹⁷ See n. 93.

⁹⁸ See Rule 12b-1(c)(1), 17 CFR 270.

If the Gartenberg case (see above) is taken in isolation, then mere efforts by the independent directors to examine whether the fees are reasonable appear to suffice. But if the independent directors are seen above all as the representatives of the shareholders' interests, they must be bound by the more far-reaching responsibility of doing all they can to negotiate the lowest possible fee with the investment adviser. These two views can be viewed as extremes between which the independent directors move in practice.

Quite apart from this legal perspective, there is also the view of the economist that excessive fund fees may be prevented by the behaviour of (potential) shareholders:⁹⁹ assuming that the market for mutual funds is competitive, investors will inevitably switch from overpriced funds to cheaper ones. This is rarely seen in practice, though, both because the cost of fund switching is too high, and also because investors apparently often make non-rational decisions. The switching costs consist largely of the deferred capital gains tax that will be triggered if the shares are sold.

High costs due to the fragmented European market for mutual and pension funds

Laws, fund rules, or fund instruments of incorporation must prescribe the remuneration and expenses that the management company is able to charge to the fund and the method used to calculate these costs.¹⁰⁰

In Europe, fee structure arrangements with breakpoints are less a topic of discussion than in the USA because the European fund industry is far more fragmented than its US counterpart. The UK Sandler report expressly assigns responsibility for efficiency losses due to missing economies of scale to this fact.¹⁰¹ On average, European funds are only one-sixth the size of American ones.¹⁰² According to an EU commission's estimate, €5 billion could be saved annually if the average size of European investment funds matched the average size of US mutual funds.¹⁰³ For an average UK investment fund, for example, profitability and sustainable earnings are assumed for a fund volume of £25 million and £40 million respectively; the underlying assumptions here are that the fixed and variable costs of an average fund are £400,000 and 0.00026 per cent of fund assets, and that a management fee of 1.5 per cent is charged. Although this cost/income situation appears at first sight to be highly advantageous, it does not help many funds because they are too small. The assets of £240.5 billion managed by UK funds are distributed unevenly over the 2,139 funds: although the mathematical

⁹⁹ See US Securities and Exchange Commission (1999a).

¹⁰⁰ Art. 43 Directive 85/611/EEC.

¹⁰¹ See Sandler (2002), p. 171.

¹⁰² At the end of 2002, the volume of investment funds in the USA was more than double that in Europe (US\$ 7.5 billion in the USA versus US\$ 3.4 billion in Europe), although there are only about a third as many funds in the USA compared to Europe (8,172 US funds; 25,559 European funds); see FEFSI/PricewaterhouseCoopers (2003).

¹⁰³ See McCreedy (2005a), p. 2.

average fund size is £112 million, 55 per cent of all funds do not even exceed the £40 million mark.¹⁰⁴

The main reason for the relative small size of funds in Europe is the cross-border tax barriers that stand in the way of a single market for investment funds and the utilization of corresponding economies of scale. Calls for 'tax neutrality'¹⁰⁵ are based on the expected economic efficiency gains: the elimination of tax barriers would promote the process of concentration in the European fund industry. Foreign competition exerts pressure on domestic investment companies to cut costs, ultimately leading in particular to a reduction in the number of funds on offer and an increase in their average volume. All else being equal, a larger average fund volume would cut fixed costs in the fund industry. Provided that there is a largely functioning competitive situation, it is likely that the cost advantages would be passed on (at least in part) to the investors in the form of lower fees. Again, all else being equal, lower transaction costs enhance the efficiency of capital allocation and thus have a positive effect on economic growth.¹⁰⁶

In the light of this, it is hardly surprising that tax rules which are probably not compatible with the Single Market have met with growing resistance from the European Commission. The EU launched infringement proceedings¹⁰⁷ against Germany because the *Steuersenkungsgesetz* (German Tax Reduction Act) of October 2000¹⁰⁸ taxed dividends paid by German funds at only half the tax rate levied on dividends paid by foreign funds.¹⁰⁹ The situation was only defused by the *Investmentmodernisierungsgesetz*¹¹⁰ (Investment Modernization Act) at the end of 2003.¹¹¹

In early 2003, the European Commission also considered taking action against France, which had introduced a tax-privileged savings vehicle in the form of a personal equity savings plan called *Plan d'Épargne en Actions* (PEA)¹¹²

¹⁰⁴ See Tassell (2003).

¹⁰⁵ 'Tax neutrality' means equal treatment in terms of taxation and any state support measures (see Heinemann *et al.* (2003), p. 20).

¹⁰⁶ See Heinemann (2003), pp. 490f.

¹⁰⁷ The basis is alleged suspected infringement of the freedom of services (Article 49 EC Treaty) and capital movement (Article 56 EC Treaty): see Newton (2001), pp. 7f.

¹⁰⁸ Act on Reducing Tax Rates and to Reform Corporate Taxation (German Tax Reduction Act – StSenkG) of 23 Oct. 2000, BGBl no. 46 dated 26 Oct. 2000.

¹⁰⁹ See European Commission, IP/02/1924 (2002).

¹¹⁰ For information on the structure of the *Investmentmodernisierungsgesetz*, see n. 560, p. 100.

¹¹¹ Equal tax treatment of domestic and foreign funds was implemented in Articles 2 (InvStG) and 3 (amendments to the EStG) of the *Investmentmodernisierungsgesetz*.

¹¹² Capital gains and investment income from the PEAs, introduced in 1992, are tax-free (for a minimum holding period of 5 years) up to a maximum amount (currently €120,000), but are subject to a 10 per cent social security contribution. Until the end of 2002, the investment companies and funds acting as investment vehicles were required to be 60 per cent and 75 per cent invested in French equities respectively; from early 2003, these limits apply to shares of corporations with their principal domicile in the EU. However, there is still a requirement to invest in French investment companies and funds; non-French UCITS, even if they satisfy these limits, are not permitted. See Lemosof (2002), pp. 122f.

that may invest only in French funds. The Commission also investigated discriminatory tax regimes in the UK, Austria¹¹³ and Denmark.¹¹⁴

In view of this legal situation, all that foreign fund providers can do is to establish subsidiaries in those countries with discriminatory tax regimes so that they themselves can operate as 'domestic' providers.¹¹⁵ Ultimately, fund investors must therefore shoulder the additional costs this creates, rather than being able to use economies of scale (passed on to them through breakpoints) to increase returns.

Discriminatory tax treatment of funded pensions provided by institutions located in other Member States is another area of concern for the European Commission. Several Member States have been subjected to infringement proceedings initiated by the Commission in order to support the creation of an effective internal market for retirement provisions.¹¹⁶ Breakpoints are addressed indirectly by the Commission, which notes that tax discrimination prevents institutions operating EU-wide from realizing economies of scale through centralized pension provision; such savings could be used for a substantial reduction in management expenses.¹¹⁷

The essence of future standard-setting

A US-style fund board could be used, at least in part, as a model for the supervisory board or board of directors for investment and pension funds, especially as regards general rights and obligations under fiduciary duty. Where it is less appropriate, however, is because of the numerous individual rules and regulations in the US, based on a mass of individual cases and therefore highly opaque, which is also why US fund boards frequently need their own legal counsel. The supervisory board or board of directors should function as an independent oversight body that effectively represents the interests of the shareholders or pension plan members, particularly in respect of the management company and/or the plan sponsor. The efficiency of independent directors depends on their positioning

¹¹³ The rule until 31 March 2003 was that (distributed and similar) income from foreign investment funds (that were publicly offered and had a tax representative and paying agent in Austria) was subject to the full personal income tax rate (maximum of 50 per cent), while domestic investment funds had a definitive tax rate of 25 per cent. Then on 7 March 2003, the Austrian Constitutional Court ruled that the taxation of investment income from foreign investment funds was unconstitutional because foreign investment funds were excluded from the scope of the law on definitive taxation, and rescinded the corresponding provision in section 97 EStG 1988 effective 31 March 2003 (VfGH ruling G 278/01 – 7). Since 1 Jan. 2001, capital gains on shares held by investment funds are also taxed at the rate of 5 per cent. For Austrian funds, this tax is deducted by the custodian bank; for foreign funds, it is deducted as part of the income tax assessment procedure. To ensure this tax assessment, a 'safeguard tax' of 2.5 per cent of the redemption price of the foreign fund may be applied (see Kathrein & Co., 2000).

¹¹⁴ See Gimbel, Mawson and Guerrero (2003).

¹¹⁵ See Targett (2002c).

¹¹⁶ See the Section on Harmonized EET taxation of retirement provision, p. 19.

¹¹⁷ See European Commission, IP/03/179 (2003).

within the organizational structure. As these structures differ widely, the concrete solution is up to the local expertise.

The independent directors of US investment funds are entitled not to renew the investment advisory contract in many cases, and this is a highly effective instrument for dealing with blatant conflicts of interest involving the investment adviser. However, actually terminating the contract appears to be too radical in almost all cases, partly because many shareholders have decided to invest in that particular fund on the strength of the investment adviser's reputation. In practice, therefore, the numerous oversight duties and pre-approval rights of the board members, which were significantly extended by the reforms between 2001 and 2004, are extremely important.

The position of ERISA trustees, who are comparable with independent directors because both offices are bound by the underlying principle of fiduciary duty, is of greater practical relevance in this respect because investment advisers are switched frequently at ERISA funds, giving the trustees a strong bargaining position, especially when it comes to negotiating fees.¹¹⁸

While the complexity of the detailed regulation of the rights and obligations of (independent) directors in the USA has accelerated appreciably in recent years, this authority – which is so central to US funds – has not even been established in Europe. Despite corresponding urgent recommendations by the European Commission's expert advisers, the Pension Funds Directive did not institutionalize a board of directors or supervisory board for EU occupational pension plans similar to the US board.

The general trends, away from quantitative and towards qualitative investment rules, and also towards greater transparency for fund and pension plan investors, are ensuring that the environment in Europe for establishing such boards is favourable in the medium term. For example, it is conceivable that in a pension fund regime governed by the prudent person rule, the regulators will be unable to exercise any effective oversight function that is primarily designed to safeguard the interests of pension plan members without support. The pension plan-specific management of control and decision-making activities needed to do this necessarily overextends the authorities. There are thus legitimate expectations that the Pension Funds Directive and/or the UCITS Directive will be revised accordingly. The following specific points relating to the supervisory board or board of managers, and in particular its independent members,¹¹⁹ should be governed by standards.

- 1 The organizational structure of a board overseeing several funds.
- 2 Compensation: to ensure the closest possible harmonization in practice of the board's and the shareholders' interests, at least partial payment in the fund's

¹¹⁸ See US Securities and Exchange Commission (1999b).

¹¹⁹ Various recommendations on this issue, which will not be repeated here, are contained in the section on The essence of future standard-setting, p. 218.

shares should be considered. Independent directors should be responsible for determining their own compensation, and the greatest possible degree of transparency should prevent abuse or allegations that the directors are helping themselves to the fund's assets.

- 3 Arrangements concerning the personal liability of board directors have the same aim. The situation in the USA is more of an example of how not to do it in this respect, because US directors are frequently confronted with wholly exaggerated lawsuits that often end in out-of-court settlements to avoid long, expensive court cases and the potentially damaging media coverage that would ensue, even if the claims appear to be unjustified from a European perspective. Although this environment is highly profitable for the lawyers, it also increasingly deters highly qualified candidates from joining fund boards, negatively impacting the quality of the board and adversely affecting shareholders' interests.
- 4 Regulation of the delegation of functions: the extensive delegation of core competencies must be prohibited, as the board would otherwise lose its *raison d'être* and would be unable to act as the front-line watchdog safeguarding investors' interests. Where the delegation of functions is permitted, there must be a clear procedure for the delegation process, ongoing oversight of the delegated functions and minimum standards for the expertise and integrity of the entities to whom functions are delegated. Specifically, these relate in particular to disclosure requirements that allow both regulators and investors to gain a picture of the nature and extent of the outsourcing, as well as the definition of fiduciary duties to be met by the delegators, considering that they are otherwise personally liable. The definition of strategic asset allocation as the overarching core function of the asset manager(s) should also be a matter for the board itself. External service providers should be limited to an advisory role only (i.e., they may not be permitted to take the actual decisions themselves).
- 5 Certain transactions that entail (potential) conflicts of interest should be made contingent upon the approval of the board or of its independent members. US boards have extensive powers here, but the different legal system and historical development, combined with the different structure of the US and European financial industry in general, and the pension and investment fund industries in particular, mean that these powers cannot simply be copied in the EU.
- 6 Similar to point 5, particularly sensitive areas should be expressly subject to supervision by the board, although here too, the EU cannot simply take over the US rules unchanged for the same reasons given in 5.
- 7 The problem of the fees, especially those charged by the management company, does not fit easily into either of the preceding two categories: standards must establish whether the role of the board should be limited to merely reviewing fees, or whether it should also be responsible for actually negotiating the fees (as the shareholders' representative) with the management company, rather similar to the role of unions representing employees in pay negotiations.

The preceding two chapters, which like the present chapter draw conclusions for future EU standards,¹²⁰ contain numerous detailed proposals on the more general issues outlined in points 5 and 6 above.

SUPERVISORY AUTHORITY

Responsible authorities in the EU and the USA

EU authorities

In the case of cross-border distribution of mutual funds, the supervisory authorities of the EU Member State in which the fund is domiciled ('home' Member State) are primarily responsible.¹²¹ It is up to the individual EU Member States to designate the supervisory authorities responsible and to equip them with the necessary powers.¹²² In addition, however, the authorities of another ('host') Member State where the fund is distributed are also involved, because the fund must provide them with substantial documentation, and they are entitled to prohibit distribution under certain circumstances. UCITS III reinforces the home country supervision principle, and information obligations are satisfied by notifying the authorities in the home Member State,¹²³ which in turn forwards the information to the authorities in the host Member State.¹²⁴

The supervisory authorities in the home Member State are also primarily responsible for taking action in the event of breaches of laws or regulations,¹²⁵ but for certain matters¹²⁶ (or in urgent cases),¹²⁷ the supervisory authorities in the host Member States are also able to take action.

The supervisory authorities of the EU Member States are required to collaborate closely.¹²⁸ In practice, the comitology committees that support the Commission in implementing Single Market rules are very important in the field of regulatory cooperation.

US authorities

The SEC is the sole federal regulatory and supervisory authority for investment funds.¹²⁹ As a departure from this principle, however, funds affiliated with banks

¹²⁰ See 'The essence of future standard-setting on pp. 188; 218; 222; 290; 342.

¹²¹ Art. 4 (1) Directive 85/611/EEC.

¹²² Art. 49 Directive 85/611/EEC.

¹²³ Art. 6a Directive 85/611/EEC.

¹²⁴ Art. 6b (2) Directive 85/611/EEC.

¹²⁵ Art. 52 (1) Directive 85/611/EEC and Art. 6c (3) to (5) Directive 85/611/EEC.

¹²⁶ Art. 52 (2) Directive 85/611/EEC.

¹²⁷ Art. 6c (8) Directive 85/611/EEC.

¹²⁸ Art. 50 (1) Directive 85/611/EEC, Article 50 (2) to (4) Directive 85/611/EEC as amended by Directive 95/26/EC and Art. 52a Directive 85/611/EEC.

¹²⁹ See Investment Company Institute (np, 1997), p. 14.

are regulated by a number of authorities at both federal and state level. For example, a fund affiliated with Bankers Trust is supervised by the SEC, the Federal Reserve of New York and the New York State Banking Department, as Bankers Trust is a New York State chartered bank.¹³⁰ Almost 23,000 investment advisers were registered with the SEC in 1997 and, statistically, an investment adviser was only examined once every 44 years.¹³¹ As a consequence of the relevant legislative reform in 1996 (National Securities Markets Improvement Act, or NSMIA), this quite unacceptable situation has improved appreciably.¹³²

Supervision and regulation of ERISA pension funds are shared by the Federal Department of Labor and the Department of the Treasury. This necessarily causes inefficiencies in practice, although numerous ERISA paragraphs require both departments to coordinate their activities.

A priori and a posteriori controls in the EU and the USA

Authorization/registration and continuing oversight in the EU

A distinction must be made between two different approaches to oversight: a priori control is equivalent to licensing, while a posteriori control denotes the continuing oversight of the (fund) management process. UCITS must be authorized by the 'competent authorities'¹³³ of the EU Member State in which they are domiciled. This authorization is valid for all Member States.¹³⁴ The authorization of UCITS consists of authorization of the management company and approval of the fund rules and the custodian (depository).¹³⁵ Thus commencement of business activity by an investment fund or an investment company is contingent upon approval of the custodian by the competent supervisory/regulatory authority.¹³⁶ Any change in the management company or custodian, and any changes in a mutual fund's rules or the instruments of incorporation of an investment company, must be approved by the competent authorities.¹³⁷ Any authorization applies to all EU Member States ('single European passport' concept).¹³⁸

The amended UCITS Directive lays down minimum requirements that must be satisfied for a management company to be authorized.¹³⁹ These conditions

¹³⁰ See US Securities and Exchange Commission (1999b).

¹³¹ See Investment Company Institute (np, 1997), p. 4.

¹³² See the section on Authorization and continuing oversight in the USA, p. 375.

¹³³ Art. 1a no. 8 Directive 85/611/EEC.

¹³⁴ Art. 4 (1) Directive 85/611/EEC.

¹³⁵ In the case of an investment company its instruments of incorporation and their custodian must be approved. According to Art. 1 (3) Directive 85/611/EEC, UCITS can be established 'either under the law of contract (as common funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies)'.

¹³⁶ Art. 4 (2) Directive 85/611/EEC.

¹³⁷ Art. 5 (4) Directive 85/611/EEC.

¹³⁸ Art. 5 (1) Directive 85/611/EEC.

¹³⁹ For the withdrawal of authorization, see Art. 5a (5) Directive 85/611/EEC.

are based on the corresponding provisions of the Investment Services Directive applicable to investment services firms,¹⁴⁰ and include sufficient initial capital,¹⁴¹ the integrity and expertise of at least two directors,¹⁴² the submission of a business plan including the management company's organizational structure,¹⁴³ no links with persons preventing the exercise of supervisory functions,¹⁴⁴ and disclosure of the investments and suitability of shareholders or partners.¹⁴⁵ The application procedure may not exceed six months, and reasons must be given if an application is rejected.¹⁴⁶

Once authorization has been granted, the management company must comply with the conditions for authorization at all times, not just at the date of authorization.¹⁴⁷ Continuing prudential supervision is the responsibility of the home Member State in the case of cross-border distribution.¹⁴⁸ Qualifying holdings in the management company are subject to the corresponding provisions of the Investment Services Directive. These require the purchase/sale or increase in/reduction of qualifying holdings to be notified, and the supervisory authority may oppose such transactions if it believes that the purchaser does not meet the requirement for 'sound and prudent management'.¹⁴⁹ The supervisory authorities can also take action at a later date to put an end to a situation where the influence exercised by a qualifying shareholder or partner is likely to be prejudicial to sound and prudent management. These measures include injunctions, sanctions against directors and managers, or suspension of the voting rights of the shareholders or partners in question.¹⁵⁰

An authorization process had been proposed for EU pension funds (although it was not ultimately implemented in this form) that was tied to the following requirements.

- 1 The responsibility, professional qualifications and reputation of the fund managers must satisfy strict criteria.¹⁵¹
- 2 The professional qualifications and integrity of the members of the board of directors must also be examined.¹⁵²

¹⁴⁰ See Art. 3 to 6 Directive 93/22/EEC.

¹⁴¹ Art. 5a (1) 1st indent Directive 85/611/EEC.

¹⁴² Art. 5a (1) 2nd indent Directive 85/611/EEC.

¹⁴³ Art. 5a (1) 3rd indent Directive 85/611/EEC.

¹⁴⁴ Art. 5a (2) Directive 85/611/EEC.

¹⁴⁵ Art. 5b (1) Directive 85/611/EEC.

¹⁴⁶ Art. 5a (3) Directive 85/611/EEC.

¹⁴⁷ Art. 5d (1) Directive 85/611/EEC.

¹⁴⁸ Art. 5d (1) Directive 85/611/EEC.

¹⁴⁹ Art. 9 (1) Directive 93/22/EEC.

¹⁵⁰ Art. 9 (5) Directive 93/22/EEC.

¹⁵¹ See European Commission, Com (1999) 134 final (1999), pp. 20f; Pragma Consulting (1999), pp. 7 and 30.

¹⁵² See Pragma Consulting (1999), p. VI.

- 3 The instruments of incorporation and the plan rules must be submitted to the supervisory authority.¹⁵³
- 4 Additionally in the case of DB schemes, there is a need for evidence that the liabilities are properly valued,¹⁵⁴ a requirement that also applies to ongoing disclosure duties.
- 5 Additionally in the case of DC schemes, there is a need for evidence that the different degrees of risk related to the different investment choices are well documented and are understood by the members prior to their decisions.¹⁵⁵
- 6 The independent actuary must also be approved by the supervisory authority.¹⁵⁶

It is up to national law to provide only registration instead of authorization for IORPs without cross-border activities.¹⁵⁷ The Pension Funds Directive sets certain ‘conditions of operation’ which are not explicitly referred to as authorization procedures, but these conditions largely match the proposals described above.

- 1 Point 1 above was incorporated to the extent that the managers of the pension fund must demonstrate their reliability. What appears rather questionable is that professional qualifications and experience are not always necessary, but that advisers with appropriate professional qualifications and experience can be employed as an alternative.¹⁵⁸
- 2 As there is no fund board, point 2 above does not apply.
- 3 Point 3 above was incorporated in the Pension Funds Directive in that each Member State must ensure that pension funds have ‘properly constituted rules regarding the functioning of any pension scheme ... and members have been adequately informed of these rules’,¹⁵⁹ and that the members are informed of the conditions of the pension fund, in particular the rights and obligations of the parties involved in the fund.¹⁶⁰
- 4 Because the technical provisions must be computed by an appropriately qualified expert,¹⁶¹ and regular funding must be ensured for defined benefit plans,¹⁶² Point 4 above has been largely satisfied.

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*, p. III.

¹⁵⁷ Art. 9 (1) (a) Directive 2003/41/EC. Art. 20 (2) Directive 2003/41/EC links cross-border activities to prior ‘authorization’.

¹⁵⁸ Art. 9 (1) (b) Directive 2003/41/EC.

¹⁵⁹ Art. 9 (1) (c) Directive 2003/41/EC.

¹⁶⁰ Art. 9 (1) (f) (i) Directive 2003/41/EC.

¹⁶¹ Art. 9 (1) (d) Directive 2003/41/EC.

¹⁶² Art. 9 (1) (e) Directive 2003/41/EC.

5 The Pension Funds Directive stipulates that the members must be 'sufficiently informed' about the existence, nature and distribution of 'financial, technical and other risks' associated with the pension fund.¹⁶³ In conjunction with the obligation to provide members with a 'statement of investment policy principles' on request, point 5 above was thus incorporated in the Pension Funds Directive.

Pan-European standardization of the conditions of operation is hampered by a clause that is open to substantial interpretation; it allows each Member State to 'make the conditions of operation of an institution located in its territory subject to other requirements, with a view to ensuring that the interests of members and beneficiaries are adequately protected'.¹⁶⁴ Since there is no definition of 'adequately protected', and the 'other requirements' are not specified in any further detail, this clause may lead to regulatory arbitrage by IORPs and sponsors respectively.

Pension funds must fulfil the conditions stipulated for their operation on a continuous basis, in the same way as UCITS.¹⁶⁵ In the case of cross-border IORPs the ongoing supervision is as a rule the responsibility of the home Member State regulator.¹⁶⁶ As an exemption from this principle of home-country supervision the host Member State regulator is responsible for the supervision of compliance with the host Member State's (i) labour and social law relevant to the field of occupational pensions and (ii) requirements for information to be given to the members and beneficiaries of an IORP.¹⁶⁷

IORPs must also report regularly to the regulator (and in some cases to the pension fund members).¹⁶⁸ The regulators are able to carry out on-site inspections at both the pension fund manager and its subcontractors,¹⁶⁹ and are entitled to take 'any measures ... which are appropriate and necessary to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries'.¹⁷⁰

Authorization and continuing oversight in the USA

Depending on their size, investment advisers in the USA must be registered with the SEC (if the assets under management exceed \$25 million) or the securities regulator of the state in which they are domiciled. The NSMIA of 1996 abolished the formerly common duplicate registration of investment advisers with both

¹⁶³ Art. 9 (1) (f) Directive 2003/41/EC.

¹⁶⁴ Art. 9 (3) Directive 2003/41/EC.

¹⁶⁵ Art. 14 (4) (b) Directive 2003/41/EC.

¹⁶⁶ See Recital 36 Directive 2003/41/EC and CEIOPS (2005), p. 13.

¹⁶⁷ Art. 20 (9) Directive 2003/41/EC.

¹⁶⁸ Under Art. 13 (c) Directive 2003/41/EC, these reports include in particular the annual accounts and annual report (content requirements set out in Art. 10 Directive 2003/41/EC), the statement of investment policy principles (content requirements set out in Art. 12 Directive 2003/41/EC), actuarial valuations and asset-liability studies.

¹⁶⁹ Art. 13 (d) Directive 2003/41/EC.

¹⁷⁰ Art. 14 (2) Directive 2003/41/EC.

the state regulator and the SEC, and around 8,000 advisers were registered with the SEC and a further 12,000 with state regulators in 2000. This clear division of responsibility has cut the inspection cycle for SEC-registered advisers to five years, instead of the previous 15 to 20 years,¹⁷¹ which clearly helps investor protection.

The regulatory regime in the EU

Light regulation, detailed supervision

The European Commission advocates a streamlined, more modern regulatory apparatus as the best solution for the fast moving financial services market. It believes that structured collaboration between national supervisory authorities is sufficient to ensure financial stability.¹⁷²

The 'Rebuilding Pensions' study also recommended a system of light regulation combined with more detailed supervision, similar to the current situation in the Netherlands.¹⁷³ This would see the board of directors being able to act in accordance with criteria it has itself defined – in compliance with all prudential principles – instead of being constrained by detailed regulations. This means observing qualitative fiduciary duties rather than having to obey detailed rules. The supervisory arrangements aim to protect shareholders without burdening the fund with unnecessary, counterproductive and expensive obligations and restrictions.¹⁷⁴ Such a system is attractive both because it conforms with the general goal of liberalization (with certain constraints, such as responsibility, accountability and SIPs), and also because of the impossibility in practice of EU-wide harmonization of detailed regulations.¹⁷⁵ Consequently, the authorization requirement should be less important than the disclosure requirement, particularly as the latter is a recurring requirement, in contrast to the former.¹⁷⁶

Enforcement

Supervisory authority's measures to deal with irregularities regarding UCITS

The rule for investment funds and management companies is that their authorization can be withdrawn if they have 'seriously and/or systematically infringed the provisions adopted pursuant to [the UCITS] Directive'.¹⁷⁷ In the case of infringements of legal or regulatory provisions governing the cross-border distribution of

¹⁷¹ See US Securities and Exchange Commission (2000c).

¹⁷² See European Commission, Com (1998) 625 (1998), p. 2f.

¹⁷³ An example of a contrasting regime, e.g. detailed regulation combined with light supervision, is currently provided by Ireland (see Pragma Consulting (1999), p. 33).

¹⁷⁴ See Pragma Consulting (1999), p. 33.

¹⁷⁵ *Ibid.*, p. VI.

¹⁷⁶ *Ibid.*, p. 34.

¹⁷⁷ Art. 5a (5) (e) Directive 85/611/EEC.

UCITS, the regulatory authority of the Member State where the infringement has occurred (the host Member State) initially requires the UCITS in question to put an end to its irregular situation. If this does not have the necessary effect, the regulatory authority in the host Member State notifies that of the home Member State, which must then 'at the earliest opportunity, take all appropriate measures to ensure that the management company concerned puts an end to its irregular situation'. If the measures taken by the notified regulatory authority prove inadequate or are not available, the regulatory authority in the host Member State may, after (merely) informing the regulatory in the home Member State, 'take appropriate measures to prevent or to penalise further irregularities'. The severest measure is to prohibit further business activities. If the matter is particularly urgent, the regulatory authority in the host Member State may 'take any precautionary measures necessary to protect the interests of investors'. In such cases, the Commission must also be informed, and it may decide to amend or abolish the measures taken. The management company concerned is able to appeal to the courts against any form of intervention in all cases.¹⁷⁸ If the management company delegates functions to third parties, this does not limit its liability.¹⁷⁹ Neither does this affect the liability of the custodian (depository), which may also not discharge its liability by entrusting some or all of the assets in its safekeeping to third parties.¹⁸⁰

To sum up, it is clear that the Member States have significant latitude for concrete intervention and penalties, and investors do not enjoy uniform EU-wide protection in this respect. What would also be desirable would be an EU-wide electronic information system open to the public that offers a history of regulatory intervention for each management and fund company. At present, only certain measures, in particular the withdrawal of authorization, need be reported by the regulatory authorities to the European Commission, which in turn must report every two years to the UCITS Contact committee, or to its successor the ESC.¹⁸¹ Neither the ESC nor CESR, the committee of regulators responsible for UCITS, is publicly accountable (e.g., by publishing annual reports), as they report only to the European Commission.¹⁸²

The European regulatory regime thus relies much more heavily on the regulators than on the markets. In the USA, on the other hand, the opposite holds true, in that the transparency resulting from disclosure obligations is used as a highly effective and efficient instrument for disciplining financial services providers. In Europe, too, it should not be left largely to the regulators in future to supervise the fund industry. Instead, the power of the markets should be used, as in the USA. In addition, a board comprised largely of independent directors along the lines of the US fund board that acts as a supervisory authority positioned between

¹⁷⁸ Art. 6c (3) to (8) Directive 85/611/EEC.

¹⁷⁹ Art. 5g (2) Directive 85/611/EEC.

¹⁸⁰ Art. 7 (2) Directive 85/611/EEC.

¹⁸¹ Art. 6c (9) and (10) Directive 85/611/EEC.

¹⁸² For example, CESR is required only to file an annual report with the Commission (Art. 6 Art. 8 European Commission, Decision 2001/527/EC, 2001).

(potential) investors and the regulator(s) would be a valuable addition to the regulatory and enforcement regime.

Supervisory authority's measures to deal with irregularities regarding IORPs

During the course of drafting the Pension Funds Directive, the European Commission's advisers proposed a multi-stage procedure.¹⁸³ In the event of irregularities, the supervisory authority should initially try to clarify the matter through discussions and on-the-spot checks and then inform the sponsor, or in a further step the public through press information at the expense of the fund, if that does not work. If the situation is still not resolved, fines or the suspension of tax exemption should be enforced. If even that does not work, the supervisory authority should become involved in the management of the fund and, in extreme cases, may even take charge itself. In the event of serious misconduct by certain persons, such as directors and their advisers, or the directors and officers of the sponsor, the supervisory authority should be able to apply sanctions, such as withdrawing the licence, removing one or all members of the board of directors, or initiating court proceedings.¹⁸⁴

The final Pension Funds Directive does in fact contain a range of options for regulators to intervene, but does not stipulate any multi-stage procedure. Although measures with (widely) varying consequences are available, far-reaching intervention is possible if less extensive measures have not produced an (adequate) effect. In addition, the measures themselves and the infringements that trigger them are formulated in abstract terms, presumably to give the Member States (substantial) freedom to implement them in accordance with the principle of subsidiarity. In particular, for cross-border pension funds, this may produce a tricky situation where certain conduct by the management company is permitted in one Member State, while in another it may result in regulatory intervention.

One example of this lack of precision of the regime governing intervention is that the supervisory authority is permitted to take 'any measures including, where appropriate, those of an administrative or financial nature ... which are appropriate and necessary to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries against the pension fund as an institution or against the persons running it'.¹⁸⁵

A minimum level of precision results from the fact that:

- (a) the Directive *specifies* that in particular when the institution has failed to establish sufficient technical provisions or has insufficient assets to cover those reserves, or if it does not hold the regulatory own funds, the regulator may 'restrict or prohibit the free disposal of the institution's assets';¹⁸⁶

¹⁸³ See Pragma Consulting (1999), p. 41.

¹⁸⁴ *Ibid.*, p. VIII.

¹⁸⁵ Art. 14 (2) Directive 2003/41/EC.

¹⁸⁶ *Ibid.*

(b) and that ‘to safeguard the interests of members and beneficiaries’, the regulator may transfer the powers of the pension fund ‘wholly or partly to a special representative who is fit to exercise these powers’.¹⁸⁷

‘On-site inspections at the institution’s premises and, where appropriate, on outsourced functions’ are one of the mildest possible measures,¹⁸⁸ while the severest possible measure is to prohibit or restrict the activities of a pension fund.¹⁸⁹ However, the pension fund must be able to appeal the measures it has taken to the courts.¹⁹⁰

Conscious focus on the board of directors as the primary supervisory authority in the USA

In the USA, the Investment Company Act and the SEC regulations based on this law produced a regulatory structure where the SEC delegated the enforcement of many supervisory duties to the directors, making them the ‘first line enforcers of this regulatory regime’.¹⁹¹ For example, if the directors think that the investment adviser is in violation of the Investment Company Act, they can notify this to the SEC, which can then launch an investigation.¹⁹²

The essence of future standard-setting

The regulatory regime for EU funds faces the following challenges.

- 1 Light regulation combined with detailed supervision is recommended as a *desirable feature of the regulatory regime* because this would enable greater flexibility in the fast-moving financial services market without having to abandon the need for security. A supervisory board or board of directors based on the US fund board as the primary authority endowed with appropriate powers – upstream from the regulator – would make a significant contribution to implementing this regime. In the USA, the status of the fund board has been upgraded in recent years by SEC rules. In addition to extending the rights and obligations (in particular) of the (independent) directors, the extension of the disclosure requirements applicable to directors increased transparency about the board members. This aims to allow investors to evaluate the effective independence of ‘their’ directors.

¹⁸⁷ Art. 14 (3) Directive 2003/41/EC.

¹⁸⁸ Art. 13 (d) Directive 2003/41/EC.

¹⁸⁹ Art. 14 (4) Directive 2003/41/EC.

¹⁹⁰ Art. 14 (5) Directive 2003/41/EC.

¹⁹¹ US Securities and Exchange Commission (1999b).

¹⁹² See US Securities and Exchange Commission (1999b).

- 2 The issue of a level playing field for *authorization*: in theory, the first UCITS Directive adopted in 1985 was supposed to introduce a single market for investment funds, with authorization in one EU Member State allowing distribution throughout the EU. In practice, though, there were still many barriers to doing this, and it was the goal of UCITS III to eliminate them. The 'European passport' for UCITS is now designed to establish EU-wide authorization, and stipulates standardized minimum conditions for authorization to achieve this objective. However, completion of the Single Market for UCITS will not be possible without accompanying changes in tax laws. There is a need not for tax harmonization, but 'merely' for the elimination of rules that discriminate against foreign funds. A number of Member States have made reforms to their tax laws recently because of sustained pressure from the European Commission.
- 3 The standardization of *continuing supervision* and improved coordination of the regulators in the individual Member States was introduced with the new regulatory and supervisory authority committees. In the USA, problems of multiple responsibilities of supervisory authorities have been rolled back in recent years and, in most cases, the SEC is now the sole regulatory authority. In addition to the question of responsibility, the content-related question must also be resolved, in particular the reporting obligations to be satisfied by the management companies. The mandatory use of electronic communication media (Internet, leased lines, etc.) would significantly support effective supervision that would not drown in a sea of paper.

THE MANAGEMENT COMPANY'S COMPLIANCE DEPARTMENT

The importance of compliance

Compliance means complying with all laws applicable to the fund, as well as all relevant rules and regulations issued by all government institutions and related professional associations. The compliance system should be an integrated, self-contained system providing permanent control, and should not merely consist of reviews at greater or lesser intervals.

The SEC believes that the great success of the fund industry in the twentieth century was due above all to the fact that it has demonstrated integrity and professionalism.¹⁹³ The industry, represented by the ICI, agrees with this view but thinks that the comprehensive regulation of the industry by the Investment Company Act has been the key to gaining the confidence of investors, which in turn has driven the success of the industry. The ICI stresses that the fund industry was always willing to collaborate to ensure that laws, regulations and voluntary standards help protect investors.¹⁹⁴

¹⁹³ See Richards (1999).

¹⁹⁴ See Investment Company Institute (np, 2000), p. 19.

The SEC and the mutual fund industry thus share a common purpose of protecting investors and their interests: the SEC due to its statutory position, and the fund industry in order to safeguard and strengthen its business. To achieve this objective, the members of a fund's compliance department have a front-line role.¹⁹⁵ A compliance department can be seen as an instance that is located upstream of the fund board, and which relieves it of some of its work and prevents it from being drawn into micro-management of daily fund operations, in contravention of the concept and purpose of the Investment Company Act of 1940. Directors often rely on the support they receive from the compliance department to fulfil their oversight role. Compliance officers should therefore have direct access to the board so that they can bring problems to its attention.¹⁹⁶ However, the board cannot reduce its compliance responsibilities by delegating them.

Information technology plays a key role in routine compliance work, with portfolio transactions (both the fund's and its managers' private transactions) being monitored by software, and contact with the supervisory authority being maintained electronically.¹⁹⁷

Some fund industry members see the establishment and continuous operation of a compliance department as nothing more than a cost factor, rather than as an asset or competitive advantage in an increasingly opaque market of financial service providers and investment opportunities. However, excellent compliance offers an opportunity for standing out from the crowd in this packed market. Nevertheless, even the SEC admits that a good compliance system *alone* is not enough to retain or acquire new clients if performance targets are missed.¹⁹⁸

Although ignoring or failing to comply with compliance standards may cut a fund's costs in the short term, these minimal cost savings are out of all proportion in the longer term to what can be disastrously high costs of non-compliance; the SEC terms this 'pay now or pay a lot more later'.¹⁹⁹ Compliance failure often leads to negative publicity that can permanently damage reputations and thus erode the customer base. This in turn hurts profits, and is often accompanied by a raft of individual lawsuits. In other words, non-compliance can result in a bleak future for both the fund and the management company.²⁰⁰

Legal basis for compliance

The amended UCITS Directive refers to compliance in that it requires the management company to institute 'adequate internal control mechanisms'.²⁰¹ One of the justifications given for these control mechanisms is the need to ensure that the

¹⁹⁵ See Richards (1999).

¹⁹⁶ See Investment Company Institute (np, 1999), p. 17.

¹⁹⁷ See US Securities and Exchange Commission (2000g).

¹⁹⁸ Roye (1999b).

¹⁹⁹ Ibid.

²⁰⁰ Ibid.

²⁰¹ Art. 5f (1) Directive 85/611/EEC.

assets of the funds are invested and managed in accordance with the fund rules or the instruments of incorporation and the legal provisions in force. The details of these and other rules, including those relating to internal administration and accounting, are a matter for the EU Member States.²⁰²

In the USA, federal securities laws require the establishment and maintenance of a compliance system. Failure to have such a system is itself a violation of the law, even if no 'accident' has happened. If a firm fails to supervise its employees, the SEC can launch a 'failure to supervise' case.²⁰³ The SEC does, in fact, repeatedly launch failure to supervise cases. In the recent past, these have involved the matters described below; one feature common to all of them is that the breaches only happened because of a lack of (or poor) supervision by senior executives or the compliance department.²⁰⁴

- (a) abusive trading practice in which advisers or their employees improperly benefit from positions held for their clients;
- (b) undisclosed trading of securities of companies affiliated with the adviser;
- (c) ignoring the best execution requirement: undisclosed engagement of a broker who was also a creditor of the adviser so as to repay debt through brokerage fees;
- (d) systematic misleading of investors by a member of the adviser's sales force about the content, size and number of shareholders of the fund;
- (e) investments in risky derivatives in breach of the disclosed investment strategies.

In addition to the inevitable cease-and-desist orders and high penalties imposed by the SEC, a frequent consequence of such violations is a ruling by the SEC that the adviser must send a copy of the SEC's order to its clients. Advisers can also be required to hire independent consultants to review their compliance procedures and make recommendations, which the advisers must generally follow.²⁰⁵

Design

Compliance is a two-stage system²⁰⁶ comprising²⁰⁷ the following points.

1 Preventing violations, or preventive compliance:

- (a) a general rule is that procedures must be adopted, and a system for implementing these procedures must be installed, that can be reasonably

²⁰² Art. 5f (1) Directive 85/611/EEC.

²⁰³ Roye (1999b).

²⁰⁴ Ibid.

²⁰⁵ Ibid.

²⁰⁶ See Richards (1999).

²⁰⁷ See Roye (1999b).

expected to prevent (preventive compliance) or detect (detection compliance) breaches of the relevant laws;

- (b) compliance should be anchored throughout the entire organization, and not just in the compliance department, which is why all relevant employees should be regularly updated on changes in the legal (and other regulatory) environment.
- 2 Identifying and remedying violations, or detection compliance: the following matters must be considered in addition to those given in point 1 above:
- (a) ensuring that compliance officers have adequate authority and resources, both to detect and to remedy, is crucial to the effectiveness of a compliance system (this authority may also not be (de facto) restricted as regards the 'high-flier' portfolio managers);
 - (b) compliance must start investigations if inappropriate conduct is suspected; if necessary, they must be able to take further measures and should not simply let the whole matter rest.

Areas where violations that are supposed to be prevented or detected by a compliance system occur frequently include the following.²⁰⁸

- 1 The duty to obtain best execution for clients.
- 2 Any soft dollar arrangements: do the transactions fit within the 28(e) 'safe harbor' and are they disclosed adequately to the clients?
- 3 Valuation of client assets.
- 4 Advertising: is it reviewed prior to publication? Is performance data properly presented (i.e. returns net of fees and expenses)?
- 5 Are employees' personal securities transactions monitored and recorded?

The essence of future standard-setting

Without compliance, as the integrated, permanent control of internal procedures with the primary objective of protecting the interests of investors, all other rules are more or less worthless, because 'paper is patient', as the old German saying goes. The best fund rules, prospectuses (including SIPs), codes of ethics, legal provisions and so on are of little value without supervision, in the same way that laws which are not enforced do not contribute to the rule of law. The fund board alone does not have the human resources – or the mission – to cope with this function, because it is expressly designed not to be involved in day-to-day management. The compliance department can thus be seen as a control body that is positioned upstream of the board, and it too needs to be governed by

²⁰⁸ Ibid.

standards. When designing such standards, the emphasis should be less on cost and more on the understanding that skimping on the compliance system may jeopardize the continued existence of the fund and its management company if things go seriously wrong because of the legal consequences and the loss of public confidence.

Rules governing the framework of compliance should at least adhere to the following principles:

- 1 The obligation to establish and maintain a compliance system is fundamental.
- 2 The compliance department must have sufficient authority and resources to allow it to do its job properly. For example, there must be both formal and informal lines of communication between the compliance officers and the fund board; the compliance officers must have the power to investigate anybody in the event of suspicious behaviour, and they must have sufficient human and technical resources.
- 3 IT is a suitable tool for monitoring and documenting both the fund's portfolio transactions and the personal transactions of the portfolio managers and other persons. The aim at the fund level, for instance, is to ensure the proper valuation of the fund assets, as well as compliance with the SIP, the best execution requirement and soft dollar guidelines; for the portfolio managers, it can be used to detect front running and insider offences. IT is also suitable for complying with the routine reporting requirements to the supervisory authority.

SHAREHOLDERS

Reporting perceived irregularities to the supervisory authority in the case of UCITS and IORPs

The recommendation that members of EU pension funds should be able to notify the supervisory authority if they think there have been irregularities²⁰⁹ was not incorporated in the Pension Funds Directive, and neither did the proposal that compensation arrangements should be stipulated for UCITS shareholders²¹⁰ find its way into UCITS III, where such compensation systems are mentioned only as an option open to the Member States.²¹¹

The right to sue personally liable board directors

The Investment Company Act allows shareholders (and the SEC) to bring actions against the directors of the fund, as well as other persons affiliated with the fund,

²⁰⁹ See Pragma Consulting (1999), p. VI.

²¹⁰ Art. 5h European Commission, Com (1998) 451 final (1998).

²¹¹ Art. 6a (3) and Art. 6b (2) Directive 85/611/EEC.

if they are in breach of their fiduciary duty.²¹² Under certain conditions, a fund may advance costs incurred by its directors for lawsuits.²¹³ The SEC thinks that this rule is obsolete and needs updating, so it wants to revise the conditions under which advances (and/or insurance) can be paid and define them more clearly.²¹⁴

Directors are subject to state law duties of care and loyalty:²¹⁵ the duty of care requires that directors act in good faith and with the degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position. The business judgement rule is applied, which protects directors from liability for wrong decisions as long as they acted in accordance with the aforementioned requirements.²¹⁶ They are also obliged to establish sound procedures for overseeing and reviewing the performance of the investment adviser and others that perform services for the fund, and to obtain all adequate information that they need.²¹⁷

The duty of loyalty requires directors to exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization.²¹⁸ For example, they cannot themselves exploit (business) opportunities that properly belong to the fund.²¹⁹

These duties taken together make the fund directors fiduciaries and impose fiduciary duties on them.²²⁰

The essence of future standard-setting

Giving shareholders an opportunity to exercise control over 'their' fund should be seen in terms of providing additional support to the control exercised by their elected representatives, the board of directors, or as an emergency measure in the event of (culpable) failure. In practical terms, rules or standards in this area will be relatively unimportant because the average investor has a limited capacity to handle information because of a lack of professional knowledge and very indirect information channels. Intervention by shareholders would only be necessary in any case if the compliance department, the fund board and the regulator have all failed in their duties, which is unlikely to happen if the standards described in the previous chapters are established.

²¹² Section 36 Investment Company Act of 1940.

²¹³ Section 17(h) Investment Company Act of 1940 prohibits a fund from indemnifying a director from disabling conduct.

²¹⁴ See Roye (1999a).

²¹⁵ See US Securities and Exchange Commission (1999c); and US Securities and Exchange Commission (1999a).

²¹⁶ See US Securities and Exchange Commission (1999c).

²¹⁷ See Investment Company Institute (2000a), p. 35.

²¹⁸ See U.S. Securities and Exchange Commission (1999c).

²¹⁹ See US Securities and Exchange Commission (1999a).

²²⁰ See Investment Company Institute (2000a), p. 35.

Guidelines for the following problems could be useful.

- 1 There has to be a way for shareholders to report irregularities to the fund board or the supervisory authority. Guidelines on investor compensation would back up this instrument.
- 2 If the board of directors fails to discharge its duty to represent shareholder interests or only does so inadequately, not only the regulator but also the shareholders should be able to take legal action. However, the threshold for bringing such actions should be set quite high so as to avoid the exaggerated, opportunistic lawsuits often encountered in the USA.
- 3 In the above context, there should be rules setting out the extent to which directors can receive legal costs from the fund.
- 4 Fund shareholders should be able to exercise the same level of influence as ordinary shareholders of publicly traded companies, not only for investment companies but also for funds managed by investment advisers. The practical significance of this should not be overestimated, but shareholders are also able to form pressure groups or join an investor interest or protection association, and thus increase their influence. It should also be expected that as mutual funds become increasingly popular (especially for retirement provision), the level of professional knowledge of the investing public will also rise, as will its interest in exercising direct influence.

OTHER PARTIES INVOLVED IN SUPERVISION

Obligations of auditors

Investment fund auditors in the USA

The 2002 Sarbanes–Oxley Act also resulted in a number of regulatory consequences for auditor independence after the Enron scandal had dramatically illustrated weaknesses in this area. The importance to investment funds of the relevant reforms to capital markets and accounting law is that investment funds/companies are now also defined as enterprises. Of course, this also applies to investment advisers and principal underwriters, as well as to their affiliates.

The Sarbanes–Oxley Act aims to avoid or manage conflicts of interests. Specifically, the Sarbanes–Oxley Act introduces the following main precautions to ensure auditor independence:

- (a) restrictions on the provision of non-audit (advisory) activities by auditors by means of prohibitions and pre-approval requirements;²²¹

²²¹ Non-audit activities are either completely prohibited (see section 10A(g) Securities Exchange Act of 1934 as amended by section 201 Sarbanes–Oxley Act of 2002 for an illustrative list of activities affected) or require preapproval by the Audit committee (see section 10A(h) and (i) Securities Exchange Act of 1934 as amended by sections 201 and 202 Sarbanes–Oxley Act of 2002).

- (b) reduction in incentives to issue biased auditors' opinions by introducing a one-year 'cooling-off' period for cases where auditors switch to a senior executive position at a company they audited previously;²²²
- (c) avoidance of excessively close ties between auditors and audited entities by the imposition of upper limits on audit partner audit engagements (auditor rotation);²²³
- (d) strengthening collaboration between auditors and the audit committee.²²⁴

In addition to such requirements and prohibitions, the Sarbanes–Oxley Act also imposes disclosure requirements. To allow the shareholders an independent assessment of the independence of the auditor, the annual report or the proxy statement²²⁵ must disclose the services provided by the main auditor and the fees paid for the following four categories of services, classified separately for each of the past two fiscal years:²²⁶

- audit fees
- audit-related fees
- tax fees
- all other fees

In addition, certain non-audit services provided by the auditor to the investment adviser or its affiliates must be pre-approved by the audit committee.²²⁷ The audit committee's pre-approval policies and procedures must be disclosed in the annual report together with the percentage rate of services that were actually pre-approved (based on the aggregate fees paid to the auditor), broken down by the four categories of services listed above.²²⁸

²²² See section 10A(l) Securities Exchange Act of 1934 as amended by section 206 Sarbanes–Oxley Act of 2002.

²²³ The lead audit partner having primary responsibility for the audit may only provide audit services for the (investment) company concerned for a maximum of five years (see section 10A(j) Securities Exchange Act of 1934 as amended by section 203 Sarbanes–Oxley Act of 2002).

²²⁴ If the board of directors has not established an audit committee, its responsibilities are assumed by the entire board of directors (see section 3a(58) Securities Exchange Act of 1934 as amended by section 205(a) Sarbanes–Oxley Act of 2002). The auditors are now required to report to the audit committee, in particular as regards any critical accounting policies used in the financial statements and all alternative accounting treatments discussed with management (see section 10A(k) Securities Exchange Act of 1934 as amended by section 204 Sarbanes–Oxley Act of 2002).

²²⁵ Not all funds or companies are required to adopt and publish proxy statements. If they are, however, the annual report can be limited to references at the appropriate points to information contained in the proxy statement, instead of repeating it (see General Instruction D on Form N-CSR).

²²⁶ See Item 4 (a) to (d) on Form N-CSR; Item 4 was introduced by the US Securities and Exchange Commission (2003d).

²²⁷ See Rule 2-01(c)(7) 17 CFR 210.

²²⁸ See Item 4 (e) on Form N-CSR.

Auditors of UCITS and IORPs in the EU

Auditors of UCITS have a duty to report promptly to the supervisory authority certain matters of which they become aware during the performance of their functions:²²⁹

- Breaches of rules and regulations relating to the authorization and continuing business of the fund
- Matters that might affect the continued existence of the fund
- Disclaimer or qualification of the audit opinion

Contrary to the original proposal, no secondary compliance duties were imposed on the auditors of EU pension funds. The original recommendation was to oblige auditors to verify the following:²³⁰

- (a) the effectiveness of the fund's internal control system in guaranteeing a high level of security for the beneficiaries;
- (b) actual compliance by the management company with the prescribed procedures.

Obligations and rights of actuaries

As well as being audited, EU pension funds must be reviewed by an actuary. An actuary is required because, as a rule, European pension funds are structured as defined benefit plans, or as a hybrid DC form with a minimum benefit. The guaranteed benefits in the form of future pension payments are quantified by the actuary in a prudent²³¹ calculation of the technical provisions.²³² The rule for the assets needed to cover these liabilities is that even temporary underfunding is prohibited.²³³ An exception applies to non-cross-border pension funds, which may be allowed for a limited period to have insufficient assets to cover the technical provisions provided that a recovery plan meeting certain criteria has been adopted.²³⁴ Apart from this special case, the rule is that the supervisory authority 'may also restrict or prohibit the free disposal of the institution's assets

²²⁹ Art. 50a Directive 85/611/EEC as amended by Directive 95/26/EC.

²³⁰ See European Commission, Com (1999) 134 final (1999) p. 23.

²³¹ '[T]he minimum amount of the technical provisions shall be calculated by a sufficiently prudent actuarial valuation' (Art. 15(4) (a) Directive 2003/41/EC).

²³² '[A]ll technical provisions [must be] computed and certified by an actuary or ... by another specialist in this field ... on the basis of actuarial methods recognized by the competent authorities of the home Member State' (Art. 9(1) (d) Directive 2003/41/EC).

²³³ Art. 16(1) Directive 2003/41/EC.

²³⁴ Art. 16(2) Directive 2003/41/EC.

when ... the institution has failed to establish sufficient technical provisions ... or has insufficient assets' to cover them.²³⁵

The actuary sets limits on the pension fund's investment strategy when calculating the technical provisions, at least indirectly, because the amount and structure of the calculated liabilities must be matched to a large extent by corresponding assets. Maturity in particular (in other words, the ratio of pensioners to contributing pension plan members) materially affects the level of technical provisions, and thus the type and maturity of the assets.²³⁶

Due to this material effect of technical provisions on asset allocation, and especially on the portfolio weighting of bonds versus equities, it would be logical to harmonize the actuarial computation methods and (at least some of) the assumptions applied throughout the EU. Without harmonization concerning valuation of liabilities, harmonized, liberal investment rules are certainly not an effective means of implementing investment freedom or the prudent person rule in practice. The assumptions for interest rates and inflation are particularly important for the level of technical provisions. The convergence to a large extent of these economic benchmarks in the euro zone should make this sort of harmonization much simpler.

Another factor that significantly affects the level of liabilities is the mortality tables that are applied. However, mortality estimates are unlikely to be harmonized throughout the EU (at least in the foreseeable future), because there are still significant differences in the longevity of citizens in different Member States. Efforts should be made, though, to establish fund- or group-specific mortality tables (e.g., because teachers live much longer than mineworkers).²³⁷

However, the Pension Funds Directive does not provide for this sort of harmonization, leaving the calculation of technical provisions to 'national legislation' that must only satisfy relatively abstract minimum requirements. For example, the interest rates must be 'chosen prudently', and must take into account the (future) yield on the assets actually held by the pension fund 'and/or the market yields of high-quality of government bonds'. The requirements for mortality (biometric) tables are merely that they must be 'based on prudent principles, having regard to the main characteristics of the group of members and the pension schemes, in particular the expected changes in the relevant risks'.²³⁸

To sum up, one of the main deficits of the Pension Funds Directive thus lies in the extensive freedom given to Member States in the computation of the technical provisions. There was evidently massive resistance by the Member States to any restriction on their powers in this respect. Where this relates to the aspect that is of long-term importance for plan members and pensioners (i.e., risk/return-efficient retirement provision) this is difficult to understand because the Commission was apparently seeking no more than harmonization at a relatively low level.

²³⁵ Art. 14(2) a) Directive 2003/41/EC and Art. 16(3) Directive 2003/41/EC.

²³⁶ See European Commission, Com (1999) 134 final (1999), p. 23.

²³⁷ See Pragma Consulting (1999), pp. 12f.

²³⁸ Art. 15(4) Directive 2003/41/EC.

The proposal by the Commission's main advisers was for the supervisory authority and/or the corresponding professional association to stipulate a regulatory framework that should have the objective of ensuring that valuation is prospective, coherent and realistic, that it avoids considerable over- or underfunding and results in a level of premiums that is appropriate for the fund in question and stable over as long a period as possible. All material methods and assumptions – apart from mortality tables – should be standardized at EU level, although actuaries there should still have the freedom to depart from these EU standards and to be fund-specific if this is necessary or useful. However, the actuaries would have to account for such departures to a board of directors (which was ultimately not institutionalized in the proposed form) and the supervisory authority.²³⁹

Another weak point in the regulation of the rights and obligations of actuaries is that their reporting obligations are low. The proposal that actuaries should also have reporting obligations to a board of directors and the supervisory authority in the same way as auditors was not incorporated. This would have seen them required to notify any irregularities they have detected, such as wilful misconduct, omissions, malpractice, or just sloppy management.²⁴⁰ In fact, though, as there is no obligatory board of directors or supervisory board along the lines of the US fund board, the Pension Funds Directive does not stipulate any reporting requirements to such a body, and even the relationship with the supervisory authority is limited to it having the powers and means 'to obtain regularly ... actuarial valuations and [the underlying] detailed assumptions'.²⁴¹

The duties of the custodian in the European Union

UCITS custodians

The general principle is that 'a unit trust's assets must be entrusted to a depository for safe-keeping'.²⁴² In turn, the depository (custodian) can only be an institution that is subject to public control and able to furnish sufficient financial and professional guarantees,²⁴³ although it is up to the EU Member States themselves to decide which institutions are eligible.²⁴⁴ The directors of custodians must be

²³⁹ See Pragma Consulting (1999), pp. III and 13.

²⁴⁰ See Pragma Consulting (1999), pp. III and VI.

²⁴¹ Art. 13 (c) Directive 2003/41/EC.

²⁴² Art. 7 (1) Directive 85/611/EEC; Art. 14 (1) Directive 85/611/EEC prescribes the custodian/depository requirements for investment companies.

²⁴³ Art. 8 (2) Directive 85/611/EEC; Art. 15 (2) Directive 85/611/EEC prescribes obligatory public control for custodians/depositories of investment companies.

²⁴⁴ Art. 8 (3) Directive 85/611/EEC; Art. 15 (3) Directive 85/611/EEC contains the same provisions for the custodians/depositories of investment companies.

'of sufficiently good repute [and] ... sufficiently experienced ... in relation to the type of UCITS to be managed'.²⁴⁵

The custodian has to be located in the same EU Member State as the management or investment company.²⁴⁶ In contrast to UCITS there is no European passport for custodians. Therefore the scope of the internal market for investment funds is restricted in practice. In its Green Paper on post-FSAP regulation of UCITS the EU Commission clarified its position, that liberalizing cross-border arrangements for custodians would only be practical after 'further harmonisation of the status, mission and responsibilities' of the custodian and the management company.²⁴⁷ The cost advantages to be gained by economies of scale can only be realized after mastering the corresponding challenges to effective supervision and investor protection resulting from splitting the supervision of the management company and the custodian between different Member States.

The UCITS Directive imposes a range of prudential duties on the custodian. For example, it must ensure compliance with laws, the fund rules and the instruments of incorporation of the management company relating to:

- the issue, sale, repurchase, redemption and cancellation of fund shares²⁴⁸
- the calculation of the value of the fund shares²⁴⁹
- the instructions of the management company to it²⁵⁰
- the utilization of the fund's income²⁵¹

Despite use of the term 'depository', a custodian may delegate actual custody of the assets to a third party, although this does not affect its liability.²⁵² The Commission itself noted in 2004 that, in some Member States, 'depositories may appoint a global sub-custodian'.²⁵³

The Commission is aware that the regulation of custodians by UCITS III has not approached the level of detail that would be necessary for an efficient Single Market and effective investor protection. In a Communication relating to custodians, the Commission voices the criticism that neither the organization nor the internal controls or scope of liability of custodians are regulated by EU law, and that 'in particular no reporting obligation to the competent authorities is required'.²⁵⁴

²⁴⁵ Art. 4 (3) Directive 85/611/EEC.

²⁴⁶ Either the registered office or an establishment of the custodian has to be located in the Member State in question (Art. 8 (1) Directive 85/611/EEC).

²⁴⁷ European Commission, Com (2005) 947 (2005), p. 7.

²⁴⁸ Art. 7 (3) (a) and Art. 14 (3) (a) Directive 85/611/EEC.

²⁴⁹ Art. 7 (3) (b) Directive 85/611/EEC.

²⁵⁰ Art. 7 (3) (c) Directive 85/611/EEC.

²⁵¹ Art. 7 (3) (e) and Art. 14 (3) (c) Directive 85/611/EEC.

²⁵² Art. 7 (2) and Art. 14 (2) Directive 85/611/EEC.

²⁵³ European Commission, Com (2004) 207 (2004), p. 8.

²⁵⁴ European Commission, Com (2004) 207 (2004), pp. 2f.

It therefore recommends examining the following four areas and modifying the regulatory framework if necessary.²⁵⁵

- 1 Prevent conflicts of interest between the custodian and the fund on the one hand and the custodian and the management company on the other. The first of these can be regulated by
 - (a) limiting the permitted transactions and activities affecting the interests of the fund that the custodian and its affiliates may undertake;
 - (b) establishing and continuously monitoring Chinese walls in the management company;
 - (c) and through controls by the supervisory authority.
 Managing the second type of conflicts of interest requires regulation:
 - (d) of the permitted legal and financial relationships between the two institutions involved;
 - (e) of the internal controls at the custodian;
 - (f) and thus of the establishment and continuous monitoring of Chinese walls;
 - (g) as well as of the delegation of functions by the management company to affiliates of the custodian.
- 2 Clarify or standardize the extent of the custodian's liability: since 1985, the UCITS Directive has merely stated that the national law of the home state of the management company governs liability. The custodian is generally liable for 'unjustifiable failure to perform its obligations, or its improper performance of them'.²⁵⁶
- 3 Measures to harmonize the public supervision of custodians, with authorization and operating conditions in particular requiring greater convergence. Specifically, this relates in particular to capital requirements and the definition of eligible depositary institutions, whereby the Commission recommends 'credit institutions and investment firms'.
- 4 Enhanced disclosure requirements about the custodian, and the following matters in particular, could be disclosed to investors:
 - (a) the (explicit and possibly hidden) costs attributable to the custodian;
 - (b) the organization of the custodian, in particular in terms of active and passive delegation of functions, including preventive safeguards against conflicts of interest and opportunities for redress measures;
 - (c) the custodian's liability.

IORP custodians

The recommendation put forward during the drafting stage for the Pension Funds Directive, that the custodian should be able to report perceived anomalies to the

²⁵⁵ See European Commission, Com (2004) 207 (2004), pp. 10–13.

²⁵⁶ Art. 7 and Art. 16 Directive 85/611/EEC.

supervisory authority,²⁵⁷ was not implemented in the draft Directive published in October 2000²⁵⁸ and was not incorporated in the final Directive.

The essence of future standard-setting

Fund supervision standards should also govern the rights and obligations of the following groups.

- 1 *Auditors* and the *actuaries* required for defined benefit pension funds must satisfy certain suitability criteria – which should be harmonized as far as possible – and should also be subject to reporting duties to both the fund board and the supervisory authority. More far-reaching oversight obligations (for instance, relating to the effectiveness of the compliance system) could be introduced using asset management standards. Accounting and actuarial rules applicable to pension plans should be harmonized, or at least coordinated, to facilitate comparability by investors and prevent distortions of competition. Another area to be regulated is cooperation by auditors and actuaries with the board of directors or supervisory board. Because the (effective) independence of these oversight bodies is a key condition for the effectiveness of their control activities, it must be assured first, by rules governing conflicts of interests, and second, by disclosure requirements.
- 2 The *custodian/depositary* should also have certain oversight functions over the independent management company and be subject to reporting requirements.

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

Since 1983, the International Organization of Securities Commissions (IOSCO) has acted as the coordinating and standard-setting forum for national financial market regulators.²⁵⁹ In early 2005, IOSCO had 181 regulatory authorities as its members, including the SEC, the UK's Financial Services Authority (FSA), the German BaFin and the Austrian Financial Market Authority (FMA).²⁶⁰

Its main achievements in recent years have been:

- (a) to adopt three objectives and thirty principles of securities regulation (IOSCO Principles);²⁶¹
- (b) to adopt a Multilateral Memorandum of Understanding to simplify international cooperation in the areas of information exchange and mutual assistance;²⁶²

²⁵⁷ Pragma Consulting (1999), p. VI.

²⁵⁸ European Commission, Com (2000) 507 final (2000).

²⁵⁹ See IOSCO (no date/a).

²⁶⁰ See IOSCO (no date/b).

²⁶¹ See IOSCO (2003a).

²⁶² See IOSCO, Istanbul (2002a).

(c) to adopt a methodology for assessing the degree of (legal) implementation of the IOSCO Principles in the individual member countries (IOSCO Assessment Methodology).²⁶³

In the field of investment funds, IOSCO has adopted general principles governing regulation²⁶⁴ and supervision,²⁶⁵ and has also issued statements in various working papers that address a wide number of issues:

- valuation of fund shares²⁶⁶
- conflicts of interest, in particular self-dealing, lending, securities issue and brokerage transactions with affiliates of the fund, soft commissions and personal investing by fund employees²⁶⁷
- delegation of functions²⁶⁸
- proxy voting and commitment to good corporate governance²⁶⁹
- simplified prospectuses: minimum standards for design, content and availability, and actual provision prior to sale as best practice²⁷⁰
- regulatory risk for investment funds: individual risk classification of fund managers on the basis of inherent business risk and control risk²⁷¹

At EU level, the committees of supervisory authorities established by implementing the Lamfalussy report²⁷² in accordance with the comitology procedure are the counterpart to IOSCO. Because the single financial services regulator principle has not spread throughout all EU Member States, there is currently a division into securities, banking and insurance/pension fund supervision.²⁷³ The national supervisory authorities responsible for each area, or the relevant single financial services regulators, are the members of the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). In contrast to IOSCO, these committees are entitled to be involved in regulatory affairs (at EU level).

²⁶³ See IOSCO (2003b).

²⁶⁴ See IOSCO (1994).

²⁶⁵ See IOSCO (1997).

²⁶⁶ See IOSCO (1999).

²⁶⁷ See IOSCO, Sydney (2000).

²⁶⁸ See IOSCO (2000).

²⁶⁹ See IOSCO, Istanbul (2002b).

²⁷⁰ See IOSCO, Istanbul (2002c).

²⁷¹ See IOSCO (2002a) and (2002b).

²⁷² See Committee of Wise Men (2001).

²⁷³ See the section on The Lamfalussy process: the Four-Level Approach, pp. 25ff.

Summary of Findings

We have established the following solutions to the questions posed in Chapter 1 of the study.¹

First, pension reforms in recent years, including in Germany and Austria, have demonstrated a clear trend: although contributions have remained largely stable in state pay-as-you-go systems because they are in any case at a level that has impaired economic growth and employment, (future) benefits, especially for younger generations, have been cut substantially. In Austria in particular, the sacrifices that pensioners have had to make have been negligible, and those in work today aged 35 and over (i.e., not merely those approaching pensionable age) only face a slow deterioration in benefits (depending on their age and year of retirement). The younger generations, on the other hand, must expect increasing pay-as-you-go contributions and appreciable additional contributions to funded supplementary pension systems, accompanied by substantial cuts in pay-as-you-go pensions.

This imbalance, which breaches the principle of inter-generational fairness, results in an urgent need – especially for people aged under 35 – for efficient state-subsidized pension products so as to minimize the clearly predictable pension gap.

Less ‘painful’ measures to solve the pay-as-you-go crisis, such as increased child allowances (which are already very generous in Germany and Austria at least) or related measures to increase the female labour force participation rate, as well as higher immigration or even wider public sector deficits, are not feasible alternatives either because they are ineffective – even counterproductive – or because they are politically impossible to push through.

Experience in particular in the USA, where funded pensions have been the primary system of choice for many decades, demonstrate the effectiveness of private and occupational pension plans.

As well as exploiting the very attractive long-term capital market returns (and especially those for equity instruments) for retirement provision, greater

¹ The order of these solutions corresponds to the numbering of the questions on pp. 2f.

independence from political decisions is another point in favour of pillar 2 and 3 funded systems. Tampering with contributions, and in particular benefits, for short-term political gains is much more difficult with funded systems, which are normally required to disclose the level and structure of assets invested, than with state pay-as-you-go systems, which do not have any personal assets, or at least assets attributable at company level, but merely theoretical benefits whose computation is relatively easy to modify. It is much more difficult politically for governments to change the (tax) law to lay their hands on invested retirement assets than to push through parametric reforms to the pay-as-you-go system, whose quantitative effects on the individual are often almost impossible for most people to understand. In other words, funded systems are available to a far lesser extent as a funding instrument for government measures that have no actuarial justification or may even have nothing to do with pensions, and that should properly be financed from tax revenue.

To answer question 2, the crisis in the pay-as-you-go pension system is making funded occupational and private pensions even more important. With the Financial Services Action Plan now almost completely implemented and the single European currency well established, the single European capital market has become substantially wider and deeper in recent years. Together with the increasingly growth-focused savings behaviour, competitive pressures from the USA and the possibility that legislation will be at least in part unsuited to dealing with practical problems, these are the major factors motivating the development of asset management standards by the EU fund and pension industries.

As for question 3, EU legislation that could be used to form the basis for developing future standards includes the UCITS Directive governing investment funds and companies, and the Pension Funds Directive adopted in mid-2003. At national level in German-speaking countries, the Riester pension products and the VAG pension funds introduced in Germany in 2002, and the new pillar 2 and 3 products introduced in Austria in 2002 and 2003 (the new severance pay scheme and the premium-subsidized future provision retirement vehicle), need to be examined. These new forms of retirement planning in Germany and Austria are certainly steps in the right direction, but are in urgent need of redesign to incorporate qualitative investment rules that can actually be implemented, substantially enhanced disclosure requirements and an internal oversight body similar to the US fund board.

In the USA, the Investment Company Act, Investment Adviser Act, Securities Act and Securities Exchange Act govern investment saving. These laws are supplemented by a significant number of secondary rules and decisions adopted by the SEC. The SEC's efforts towards the end of the 1990s to strengthen the role of fund board directors, and the subsequent accounting scandals at Enron, Worldcom and others, as well as the market timing affair uncovered in 2003, resulted in numerous SEC rules and regulations with a substantial impact on investment fund disclosure requirements and internal control systems (focusing on independent fund board members). This highly dynamic form of regulating investment saving by responding promptly to current capital market challenges

gives the USA a considerable competitive edge over the EU at present. It is not clear whether the regulatory and supervisory authority committees established under the comitology procedure will result in any appreciable acceleration of the EU regulatory process for financial services. At national level, the UK most certainly leads the way, as the UK's Financial Services Authority acts with the same verve as the SEC.

For retirement planning, the 1974 ERISA and the Internal Revenue Code form the legal basis in the USA. The underlying principles of fiduciary duty and the prudent expert rule facilitate a retirement provision system that is focused largely on qualitative requirements.

Turning now to question 4, standards can be classified at the highest level of regulatory abstraction by the objective of either controlling management or investment risk, or of overseeing and enforcing rules and regulations. The next level is characterized by more detailed functional aspects such as investment rules, separation of functions and disclosure requirements.

As regards questions 5 and 6, the structure of the previous answer produces the following picture for management risk:

- 1 Investment rules are designed to regulate transactions involving conflicts of interest. Self-dealing by investment and pension funds as well as soft commissions and personal investing by persons who can control the fund's investment decisions must be heavily restricted and effectively monitored, documented and disclosed. Details are effectively defined in a code of ethics. At present, this area is effectively controlled only in the USA.
- 2 In the area of the institutional and organizational separation of functions to avoid potential conflicts of interest resulting from multiple responsibilities that could damage the interests of investors, the EU can boast more effective regulation than in the area of investment rules, with custodian independence playing a large role. However, rules on proxy voting and on shareholder activism must be expanded or actually established. Measures in the latter area are designed to require and promote good corporate governance, so as to increase the returns generated from the securities of the issuers concerned and to reduce risk.
- 3 In the USA, the rules on disclosing conflicts of interests have been substantially extended in recent years from a starting point that was in any case at a considerably higher level than in Europe. For investment funds in particular, investors can rely on a wealth of disclosable information on the internal organization and the business and equity relationships of the fund and its investment adviser (and their affiliates), and on their directors, officers and portfolio managers.

For investment risk, the situation is as follows:

- 1 Investment rules have been the most hotly debated area of asset management standards in the EU. In recent years, the restrictive quantitative investment rules that predominated until the late 1990s have been increasingly replaced by

qualitative criteria, supplemented by a small number of less restrictive quantitative investment rules, on the back of the introduction of the euro and the need for growth-oriented investments to fund adequate (supplementary) pensions. Overemphasizing the security aspect while largely ignoring the return objective is the primary characteristic of traditional quantitative investment rules. Although there has been a greater awareness in recent years in Europe of the problem of inefficient asset allocation dominated by (government) bonds, the freedom of investment linked to qualitative criteria that has long been demanded by experts is often met no more than formally in practice. Obligatory interest and asset value guarantees whose funding must also be evidenced on a regular basis generally hamper or prevent the effective implementation of freedom of investment. In the USA, on the other hand, retirement investment has followed primarily qualitative investment rules for a good three decades now, and compared with Europe equities account for a significantly greater share of asset allocation.

- 2 Disclosure standards must be enhanced in the EU, especially in the following areas:
 - (a) There is a need for the obligatory preparation and updating of a standardized Statement of Investment Principles as the pension fund counterpart to investment fund prospectuses.
 - (b) The introduction of 'simplified prospectuses' by UCITS III is a welcome move. The full prospectuses could be used for extended disclosure requirements along the lines of US prospectuses or the US Statement of Additional Information. In particular, standardized information on fees and expenses, including tables of illustrative expenses over defined periods, would make a major contribution to improved cross-fund comparability, which in turn would encourage competition. Annual transaction costs should also be highlighted.
 - (c) Established Performance Presentation Standards should form the basis for performance-related advertising.

The following points relate to standards for overseeing and implementing rules and regulations:

- 1 A board of directors or supervisory board with a structure similar to a US fund board should be institutionalized for both investment and pension funds.
- 2 The division of functions and responsibilities between such a board of directors/supervisory board and the regulator should follow the EU principle of subsidiarity. The board would assume many of the regular oversight duties, allowing the regulator to concentrate on extremely important cases

and to address to a greater extent the further development of the regulatory framework to meet the needs of the markets and investors.

- 3 Adequate compliance systems in the form of an integrated, permanent internal control authority are an indispensable instrument for ensuring that investor protection rules are actually implemented.
- 4 Shareholders and pension plan members should have standardized facilities for drawing the attention of the board of directors or supervisory board and of the regulator to any irregularities. The recipients of this information should in turn be required to respond to such issues within defined periods.
- 5 The auditors, the actuaries needed for defined benefit pension plans and the custodian should be subject to notification duties above and beyond their core control activities, requiring them to report irregularities not directly associated with their own area of activities to the board of directors/supervisory board and/or the regulator.

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