

**FIRST INITIATIVE  
COLOMBIA – DEVELOPING THE SUPERVISORY AND REGULATORY FRAMEWORK FOR  
COLLECTIVE INVESTMENT SCHEMES**

**Discussion Draft**

**THE SUPERVISION OF THE  
COLLECTIVE INVESTMENT INDUSTRY IN COLOMBIA**

**Project: IDA.F.07.R28**

**Cadogan Financial  
November, 2003**

**The views expressed in this document are those of the consultants and do not represent  
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## THE SUPERVISION OF THE COLLECTIVE INVESTMENT INDUSTRY IN COLOMBIA

### 1. INTRODUCTION

The looming free-trade agreement with the United States, of which financial services will be a key item, makes the need for reform of the collective investment industry all the more urgent. This paper is part of a wider report on the regulation and supervision of collective investment schemes in Colombia. It contains a review of the supervisory structure pertaining to the collective investment industry and deals specifically with supervisory activities conducted by the Superintendencia Bancaria (SB) and the Superintendencia de Valores (SV) in ensuring that all licensed entities comply and continue to comply with the relevant laws and the regulations. Specifically, these activities include licensing, authorisation, monitoring and inspection.

The methodology employed has included the following aspects:

- Identification of local best practices in the Colombian context;
- Use of internationally accepted and regional benchmarks;
- Specific questionnaires and matrices designed to establish current supervisory practice, and
- Meetings with key individuals, both within the supervising entities and externally with market participants

In particular, we would like to thank all those who took the time to meet with us for the courtesy shown and the helpful and positive contribution they made.

This paper seeks to identify:

- Weaknesses in current practice
- Duplicative or unnecessary activity
- Areas in which greater efficiency could improve the regulatory and supervisory grip
- Adequacy of staffing and other resources

Information on supervisory processes was gathered through interviews with senior managers, as it was not possible in the short timeframe to shadow inspectors on the job. Unfortunately, in some cases, supervisors were unable to respond to questionnaires or fill in matrices of requests for information. The facts shown here are correct to the best of our knowledge, and are based on those given to us in documentation and during interviews. We have not in the time available been able to check their accuracy.

The work performed has given rise to a series of recommendations, which will be prioritised and sequenced during the second phase of the project. At this juncture, it must be stressed that the opinions stated here are our own, and do not represent the opinions of either of the Superintendencias, the Ministry of Finance or FIRST Initiative.

## 2. THE CURRENT SUPERVISORY MODEL IN COLOMBIA

At one point it was proposed that a single regime governing all collective investment schemes (CIS), with which all existing CIS schemes would have to come into alignment, should be introduced in Colombia. This would have entailed the consolidation of all CIS supervision within the securities commission. Although this proposal came very close to being accepted, unfortunately it did not ultimately prove acceptable to all parties, so that it was decided to continue with the existing distribution of supervisory responsibilities. Therefore, the banking supervisor continues to supervise Fiduciarios (Trustees) and Pension Fund Administrators and their related investment vehicles, which account for approximately 95% of the total assets of the CIS market. The remaining 5% of the market, consisting of securities funds managed by brokers, investment funds managed by investment management firms and in-house mutual funds managed by companies, are supervised by the securities commission.

In an international context, it is not unusual for the supervision of CIS to be spread over more than one supervisor. The table below shows supervisory arrangements for CIS in seven European countries and the USA.

SUPERVISOR:	Investment Management Companies					Funds				
	Central Bank	Securities Commission	Insurance Supervisor	Integrated Supervision	Other	Central Bank	Securities Commission	Insurance Supervisor	Integrated Supervision	Other
France		√					√			
Germany				√					√	
Ireland	√				√	√				√
Italy	√	√				√	√			
Netherlands		√	√			√				
Spain		√	√				√	√		
UK				√					√	
USA		√					√			

The models closest to the current supervisory arrangements in Colombia are Italy and the Netherlands. However, neither exactly duplicates the Colombian situation. In Italy, both the central bank and the securities commission supervise all fund management institutions and funds. The Bank of Italy is responsible for prudential supervision through off-site and on-site inspections, while Consob is responsible for ensuring transparency and proper market conduct. In the Netherlands, given the size and importance of the insurance sector, there is a separate supervisor for Insurance, while in Colombia the Superintendencia Bancaria (Banking Supervision, SB) carries out this activity. Furthermore, the Netherlands splits the supervision of investment management companies from the supervision of the funds themselves, with the former being supervised by the securities commission or by the insurance supervisor (as appropriate) and the latter being supervised by the central bank. As in Italy, therefore, each entity will have dealings with two supervisors. The advantage of the Dutch and Italian model is that each supervising entity plays to its traditional strengths and

engages in the type of supervision where it has a competitive advantage over the other supervisor.

It should be noted that the table above provides a static picture and that internationally the trend is towards integration. Integration can take various forms. The supervision of a single aspect of financial services may be charged to a single supervisor for all financial entities, as is the case in Australia, Canada and Italy where prudential supervision is carried out by one supervisor (usually the banking supervisor), while market conduct and transparency are assured by another supervisor. Alternatively, a single supervisor may be responsible for an entire sub-industry. In France, for instance, the securities commission is wholly and solely responsible for supervision of all aspects of CIS. Finally, there may be integration at the level of the supervisors themselves so that there is only one supervisor for the entire financial services industry. The Scandinavian countries and the UK are examples of this type of institutional arrangement. Advantages of the various integrated models include more efficient use of resources, better communication and enhanced prestige and credibility vis-à-vis market intermediaries.

## **2.1. Recommendation Relating to the Supervisory Model**

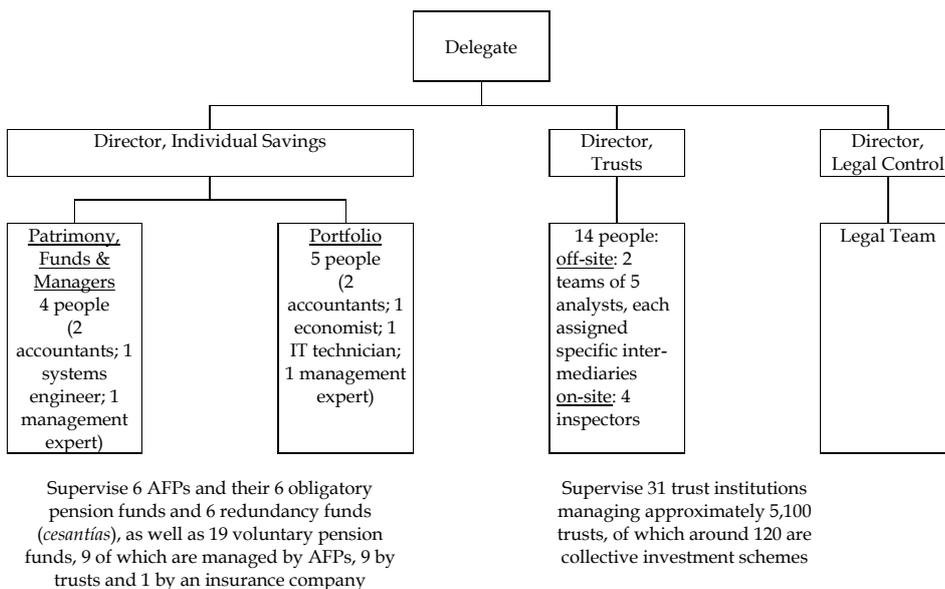
Despite funds under management in the Colombian CIS industry having grown from \$2.3 billion in 1992 to some \$10.9<sup>1</sup> billion at the end of 2002, neither the size of the market nor the existence of five fund vehicles (which are essentially all the same) justifies the existence of two separate supervisors. The intermediaries we spoke to were unanimous in their view that there should be only one supervisor for CIS in Colombia. Although there is no duplication between supervisors, since each authority is solely responsible for a distinct and well-defined group of intermediaries, it is considered that at a macro level having two supervisors for the same activity is a source of inefficiency for Colombia. It is therefore highly recommended that the Colombian government reconsider designating the securities commission as the single supervisor for CIS. A consolidation of CIS supervision would permit a more efficient use and leveraging of resources. It would also ensure sustained consistency in the regulation and supervision of these instruments and the firms that manage and commercialise them. However, there would need to be an institution-building programme in order to prepare the securities commission to assume this increased responsibility.

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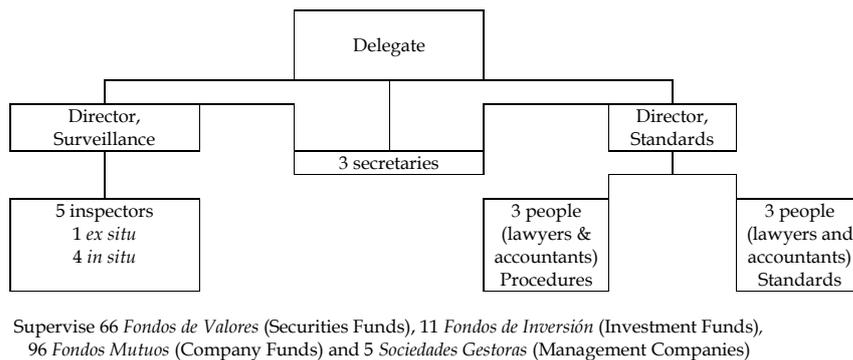
<sup>1</sup> We know that pension funds invest in other types of fund, largely due to a shortage of investment grade instruments on the one hand and the limitations on the percentage of funds that may be held in banks on the other. However, we do not have data relating to this. For all we know, the figure of \$10.9 billion may therefore include some double counting.

### 3. THE SUPERVISORY STRUCTURE

Both the SB and the SV have units wholly dedicated to the supervision of CIS. The delegation responsible for this activity at the SB also oversees part of the social security system related to pensions. For the purposes of this study, only the resources involved in the supervision of voluntary pension funds and trusts have been included in the analysis (although it must be noted that the supervision of the obligatory pension funds and cesantías, which does not form part of this study, is combined with that of voluntary pension funds in a single department). The SB's current resources for supervision of CIS are as follows:



Responsible for supervising *Fondos de Valores* (CIS managed by brokers), *Fondos de Inversión* (CIS managed by Fund Management Companies) and *Fondos Mutuos* (Company Funds), the SV's current resources for supervision of CIS are as follows:



Officials of both the SB and the SV are to be complimented for the diligence and enthusiasm

with which they execute their work. However, the resources available are quite insufficient, in both terms of personnel and technology, for the amount and type of work that is undertaken. The problem appears to be particularly acute at the SV: it is astonishing that there is only one off-site analyst, for example. This shortage of resources is exacerbated by gaps in the supervisory structure which both the SB and SV try to fill themselves. In developed markets, supervisors do not carry out the totality of supervisory functions themselves, but rather rely on other institutions in the market that contribute in varying degrees to the vigilance of financial intermediaries ("third-party supervision"). In a sense, therefore, banking supervisors, securities commissions and other official supervisory organs are "lead supervisors" who outsource supervisory functions to various institutions external to the intermediary and/or offices and mechanisms internal to the intermediary. The supervisory structure therefore consists of the lead supervisor(s) plus all or any combination of the following:

External Institutions	Internal Offices or Mechanisms
associations and/or self-regulation	internal systems of control
custodians	internal auditor
external auditors	compliance officer
insurance companies	
rating agencies	

The outsourcing of some supervisory functions enables the lead supervisor to focus their efforts on supervisory functions which only they are authorised and qualified to conduct. It is recommended, therefore, that the lead Supervisors in Colombia promote the development of other parts of the supervisory structure in order to permit them to better leverage their scarce resources.

### 3.1. Associations and Self-regulation

In developed markets the most important form of outsourcing of supervisory functions is to self-regulating organisations (SROs). In essence, this means that in some markets there is a cascade of supervisory authorities. SROs are themselves authorised, recognised and supervised by the lead supervisor. They then become responsible for conducting "front-line" supervision for supervised entities, working strictly within the framework set by the regulator and lead supervisor. It is considered desirable that SROs participate in supervision in this way because they have the know-how necessary to develop the technical rules as to how markets should function and they have greater flexibility when it comes to adapting such rules to changes as the market evolves.

Often, industry associations develop into an SRO, or partially fulfil the functions of one. One of the areas where their contribution has been particularly important is in the development of business conduct rules. In principal, these are administrative rules that fix the criteria that should govern the relationship between a financial services provider and its clientele, the technical means with which the entity should be endowed in the exercise of its activities and the use of confidential information. In some countries these codes of conduct are set in law, although companies may draw up internal code of conduct in more detail. Spain is an example of a country that has chosen to legislate rules of business conduct, and all financial entities must respect the rules found in Title VII of the *Ley del Mercado de Valores* (Securities Market Law). In other countries, such as France, the SRO or Association may draw up a

fairly exhaustive code of conduct. France's "Mandated Individualised Portfolio Management Professional Ethics" contains a set of 60 rules of conduct. Still other countries empower the regulator to draw up a general list of business conduct rules that serve as a "minimum standard" for individual, detailed codes of conduct elaborated internally by each company. This is the situation in the UK, for example. Compliance with the code of conduct is in all cases mandatory, even where it has been developed by a "voluntary" organisation.

Reviewing the business conduct rules of the collective investment industries in France, Spain, UK and Peru, the areas commonly covered by these codes include the following:

- Maintaining high standards of integrity
- Acting with due skill, care and diligence
- Maintaining high standards of market conduct
- Avoiding wrongful or misleading advertising practices
- Specification of the minimum contents of the contract between the investment management company and the client
- Obtaining information about clients, such as investment objectives
- Supplying to the client any information that will allow the client to make an informed decision
- Avoiding conflicts of interest, and where they do arise give priority to the interest of the clients without prejudicing any of them
- Ensuring that clients' assets are properly protected by segregation
- Maintaining adequate financial resources
- Choosing intermediaries based on objective criteria
- Avoiding "churning" and other forms of market abuses
- Having available at all times the personnel, organisation and equipment suitable for the type of services offered
- Ensuring that staff are properly trained and supervised
- Putting in place restraints on self-dealing by fund managers and abuse of insider information
- Cooperating with the regulator/supervisor and informing the latter of any relevant issues

### 3.1.1. Associations and Self-regulation in Colombia

With regard to collective investment, the fragmentation in the industry is mirrored by an array of associations. There are various associations in Colombia, including the *Asociación Bancaria* (Bank Association), *Asofiduciarias* (Trusts Association) and *Asofondos* (Funds Association). Each of these associations is actively engaged in their own initiatives for the implementation of new regulatory standards, of which there have been a plethora in 2003, including a new, harmonised method of portfolio valuation and the introduction of forward pricing (T=0) for all funds. Unfortunately, it was not possible for us to meet with all of these associations, but it is our impression that *Asofiduciarias* is the strongest and most influential association within the investment management industry. However, on the one hand *Asofiduciarias* only covers fiduciarios and on the other fiduciarios embrace a variety of businesses besides funds ranging from public health service trusts, to road construction and real estate ventures. The absence of a dominant association covering all types of funds raises the spectre of different associations proposing different solutions to their members so that slight differences between the different fund vehicles are perpetuated. This would have to be resolved in order for effective self-regulation to be established. Furthermore, it appears that

the law itself does not provide an adequate basis for self-regulation as according to some interpretations of the Constitution of Colombia, regulation must emanate from the government itself.

In the absence of SROs, the lead supervisors have stepped into the breach and facilitated the elaboration of rules of business conduct, the SB through the *Circular Externa 088 de 2000* (88/2000) and the SV through the *Resolución 70 de 2001* (70/2001). According to 88/2000, it is the responsibility of the *Junta Directiva* (Board) of the financial entities supervised by the SB to elaborate a code of conduct covering confidentiality of information, the use of privileged information and the management of conflicts of interest. 70/2001 requires the entities supervised by the SB to act as a "prudent expert" in the execution of their duties and goes on to list a series of principles to be respected. These include:

- the control, measurement, management and supervision of the risk of the fund;
- the diligent administration of the fund for the sole benefit of the investors;
- the evaluation of investment decision in light of the portfolio as a whole and in accordance with the investment strategy;
- an adequate separation and independence of activities, and
- the fulfilment of operational aspects necessary for the proper administration of the fund.

### 3.1.2. Recommendation Relating to Self-regulation in Colombia

Self-regulation is a complex subject. Full self-regulation involves either the delegation of powers by the regulatory and supervisory body, or a strong unified trade association, which seems unlikely in the short-term given the sturdy independence of all the different forms of fund manager. In order to be viable in Colombia, therefore, self-regulation would require significant structural and cultural adjustment to be achieved over time. However, promoting self-regulation and helping the market evolve towards it is a worthy goal for any regulator/supervisor, and one that accords with IOSCO principles. Although the topic of self-regulation is beyond the scope of this project, we understand that it forms an essential ingredient of a study being conducted in parallel to this one, which aims to raise standards of professionalism across the capital markets as a whole.

Since self-regulation is unlikely in the short to medium-term, it is recommended that the Colombian supervisory authorities publish a Code of Conduct to be adopted by management companies as a condition of licensing. In this respect, it would be useful for the lead supervisors to consider the international examples of business conduct rules presented in this report and begin the work of adapting them to the Colombian context. Combining the requirements for a code of conduct contained in 88/2000 and 70/2001 would be a good start, but would not go far enough. The Principles for the management of CIS developed by CONASEV of Perú could be taken as a best practice, with reference to the French standards on the management and prevention of conflicts of interest, as this is an area of particular sensitivity in Colombia.

### 3.2. Custodians

A custodian is the entity responsible for holding the assets of a fund. Custodians are authorised by the lead supervisor. The identity of the lead supervisor in respect of custodians varies from market to market. As custodians are often banks, this may be the banking supervisor. Banks operating as custodians may not even need a separate licence if

this activity is covered by the banking licence. Alternatively, because custody services are intrinsically related to securities markets operations, the securities commission may supervise these activities. Owing to the high responsibility of custodians for the considerable assets and cash resources of investors directly under their control, it is necessary to maintain expensive infrastructure, arrangements and procedures for the conduct of business to proper standards. Therefore, whether the custodian is a bank or an independent company, requirements for authorisation to operate as a custodian are very strict. Such requirements are broadly similar across markets and include: capital adequacy, suitability of directors and other employees, adequate internal rules and procedures, restrictions on the type of activity the entity may undertake and a good reputation. Although most regimes do not forbid the combination of custodial functions with other activities within the framework of the same organisation, if this is the case, the lead supervisor will have to make sure that the degree of risk to capital is acceptable and that there are systems and procedures in place that prevent conflicts of interest arising or to resolve them in the interests of investors.

In most countries there is a requirement that the custodian be fully separate and independent from the investment management company. This "separation" operates on two levels. First, there must be organisational separation. This can be achieved through either operational separation with different companies having no common ownership at any level, or functional separation with different companies owned by the same parent. If a custodian is a part of a financial group, the lead supervisor will have to establish the list of its affiliates and check whether a custodian is functionally separated and that there are procedures, which resolve conflict of interest situations. Secondly, there must be a legal separation between the assets of the various clients and those of the custodian itself. If assets are ring-fenced in this way, should a custodian go bankrupt or into liquidation, third-party assets kept by the custodian cannot be claimed.

Country	Rules on Separation of Clients' Assets
EU	An asset manager must ensure that a client's assets are separately identifiable from the assets of the firm. If the asset manager is managing an authorised investment fund, he must ensure that the fund's assets are held by an independent custodian, depositary or trustee. A firm that is a custodian, or appoints a custodian on behalf of the client, must perform a reconciliation of the client's account at least twice a year.
USA	An SEC-registered investment adviser with custody of clients' assets is required to provide additional information to clients. For example, the client must be provided with an itemised statement of the securities in the possession of the firm. All such funds and securities of clients will be examined and verified by an independent accountant at least once during each calendar year and without prior notice to the investment adviser. Following the examination, the accountant's report will subsequently be filed with the SEC. (In the case of mutual funds, while the above is strictly the legal requirement, in practice all mutual fund assets are held by custodians.)

In some European jurisdictions, the custodian is responsible, by law and regulation, for checking the overall compliance of fund operations with applicable legal requirements, with the responsibility to bring any irregularities to the attention of the lead supervisor. Essentially, this means a side-by-side accounting and reconciliation of funds, and perhaps even fund valuation too. Specifically, the custodian may assist the lead supervisor by checking the following aspects:

- correct pricing of assets and calculation of NAV;
- investment in eligible asset classes;
- checking whether investment limits have been exceeded
- reconciling cash balances with market transactions and sale and redemption of units;
- payment of the correct amount of dividends to the right people;
- detection of irregular trading practices, including churning, takeover assistance and abuse of privileged information, and
- detection of prohibited operations, including illegal assets and trades between portfolios handled by the same investment management entity.

In order to fulfil their supervisory role, custodians are empowered to request documentation from investment management entities so as to facilitate the reconciliation process. Furthermore, in some jurisdictions custodians must sign off on the accounts of the fund in order to ensure that a regular reconciliation of accounts takes place. Should problems arise and a fund need to be sold or wound up, the custodian could also assist the lead supervisor in this process. Overall, the tasks undertaken by the custodian significantly reduces the burden of reporting handled by the lead supervisor.

### 3.2.1. Custodians in Colombia

At present the role of custodian is not very well developed in Colombia. Some of the larger players, such as Banco Santander and Citibank, have established custodial companies run according to international standards. As there is no mandatory requirement to entrust assets to an independent third-party custodian, these companies largely handle in-house and off-shore business. Subsequently most investment management companies perform the role of custodian themselves. Although there are specific requirements for the separation of clients' assets from those of the investment management company, they are not considered to be strong enough and are difficult to enforce in the absence of custodians performing a supervisory function of vigilance. The system is vulnerable and is fortunate not to have suffered more problems like the current "Multivalores" crisis.

The SV requires the entities it supervises to deposit the assets in their portfolios with a central depository. DCV, part of the central bank, acts as the depository for government securities, while DECEVAL acts as the depository for all other types of securities. DECEVAL in particular seems to be capable of taking on a much wider role and assuming outsourced supervisory functions. It has successfully adapted international models of corporate governance to the Colombian context and has introduced operational methods modelled on those of Spain and Australia, in compliance with the G-30 recommendations and oriented to IOSCO standards. It would be relatively simple to modify its systems so as to permit it to take on some of the vigilance functions described above, especially reconciliation of portfolios and the detection of irregular and prohibited transactions. For the present, DECEVAL has not assessed the possibility of providing portfolio valuation services for funds. Certain conditions would have to be met before this service could be offered, such as an obligation for investment managers to report regularly to the custodian about the totality of the assets of the portfolio, including cash at banks and foreign securities, and not just those held in DECEVAL.

However, according to Law 27, DECEVAL is a recorder rather than a controller of transactions. This means that DECEVAL has neither the responsibility nor the authority to

check the validity of the operations. Since the SV has the authority to expand the range of activities DECEVAL is authorised to undertake, it appears that this situation could be changed with a simple resolution from the SV. At the same time it would be necessary to issue a regulation prohibiting DECEVAL's clients from buying, selling or lending securities between their accounts.

### **3.2.2. Recommendations Relating to Custodians**

It is essential that Colombia develop the figure of custodian and require investment managers to place fund assets, separately from those of the firm, with an independent custodian. In practice, this would mean that assets would continue to be held by a central depository, but that the accounts of these assets would be administered by an independent third-party, thereby reducing the risk of misappropriation of client assets. As Peru has recently gone through the process of introducing the figure of a separate and independent custodian into its collective investment market, its experience and solution to this particular problem could serve as a valuable reference point for Colombia.

While it is clear that DECEVAL could assume some third-party supervisory responsibilities, it is not clear that it is the solution to the custodial problem in Colombia. The role of custodian is significantly different from that of a depository, and may be better performed by banks, fiduciarios and other interested entities of good repute with sufficient capital backing. Since custody is an activity which is integral to the smooth functioning of the securities market, it is recommended that, even where custodians are subsidiaries of banks or fiduciarios, the SV supervise this activity (in the same way that it supervises the activities of brokerage houses affiliated to banks). The lead supervisor eventually appointed to supervise custodians should ensure that inspectors from the other lead supervisor have the right of access to the custody and bank records of the funds which they are responsible for inspecting.

### **3.3. External Auditors**

External Auditors are expert professionals who make use of special auditing techniques to verify the compliance of financial statements with standard accounting procedures and to confirm the authenticity and consistency of the data presented. Ideally, an audit is an independent, objective assessment on which the lead supervisor may confidently rely, thus releasing them from the need to conduct their own intensive verification of the accuracy of financial statements submitted to them.

In relation to the interface between auditors and the supervisors of financial markets, the Council of Securities Regulators of the Americas (COSRA) has developed the following standards:

1. Facilitation of supervision and investigation: audit processes should be designed to facilitate the supervision and investigation of market transactions which could potentially violate rules and regulations set by the regulatory authorities.
2. Elements of information of the audit process: auditing processes should access all the important elements of information about operations which could be relevant to detect and investigate prohibited operations.

3. Precise and timely elaboration of audit processes: audit processes should be conducted in a timely manner and should be reasonably precise in order to effectively support the functions of supervision and investigation of the market.

4. Automisation of audit processes: the market authority should make an effort to automate the various facets of the audit process, in order to maximise the efficiency and utility of such processes

Most lead supervisors in developed markets require the certification of financial accounts presented to them by an external auditor. This is so in France, Germany, the Netherlands, Spain, the UK and the US, for example. Often, the audited accounts must include an official statement to the effect that, in the course of their audit, the auditors found the operator and the fund to have been in compliance with the law and regulations. Sometimes, as is the case in France, Germany, Ireland and Italy, for example, auditors are required to report any irregularities to the supervisor. Examples of irregularities include inaccuracies in returns to the lead supervisor, any matters that may influence the solvency of the company and anything that may warrant the qualification or withholding of the audit certificate.

Some lead supervisors require that separate auditors be appointed to the fund management company and the fund(s) managed by that company. This is a best practice in the avoidance of conflicts of interest. It is further required that the lead supervisor be notified of the name and contact details of the auditor. If there have been any doubts raised by the audit report, the lead supervisor may have the right to call upon the auditor to give additional information. This may include the power to summon the auditor to an interview. In the UK, the lead supervisor even has the power to appoint a second auditor to report on the financial statements if not satisfied with the first report.

Whenever a fund management company wishes to change the fund's or its own auditor, then it must inform the lead supervisor. In such circumstances, there is always the concern that the old auditor may have uncovered some malpractice and is being changed to conceal it. Lead supervisors therefore only authorise such changes if the outgoing auditor is prepared to certify that to the best of his knowledge there are no commercial, financial or compliance matters at the operator which should cause concern to the supervisor, that there is no dispute between the operator and the auditor, and that, therefore, the retirement of the auditor in favour of another is purely a commercial matter reached with the full agreement of both parties. The fund management company will have to provide evidence to the lead supervisor that the incoming auditor is appropriately qualified to undertake audits of investment management companies and funds.

Auditors themselves are usually supervised by the Ministry of Finance and/or a professional association. In most other developed markets, liability for their statements is considered a powerful tool for ensuring that auditors work to highest standards of honesty and professionalism. It is unusual for them to be supervised by the lead supervisor for investment management companies and funds. However, subsequent to the Enron scandal, the SEC has now assumed a more active role in supervising audit firms, and Portugal is another example of a country where auditors are supervised by the securities commission.

### **3.3.1. External Audit in Colombia**

In Colombia, external audits of fund management companies and funds are usually

conducted by a *Revisor Fiscal*, which is a special type of auditor for financial entities and assets. Often, the same *Revisor Fiscal* audits both the fund management company and the funds, because he offers them a special deal if he can have all their business. The SB appears to have some power to determine the content of the audit and is using this power to increase the responsibilities of the *Revisor Fiscal*, but the powers of the SV are more limited in this respect. However, anecdotal evidence suggests that these audits are rather superficial in nature and that the lead supervisors cannot confidently rely on them. The root problem is that the *Revisor Fiscal* is not obliged to follow any standard procedures, nor to adopt international standards of accounting. This has resulted in the SB and SV assuming time-consuming quasi-audit responsibilities. The SB, for example, carries out an enormous exercise of verification of end-of-year reports for all fiduciaries. Apparently, they always find some problem or other, and the intermediaries are grateful because the SB's revision of their accounts gives them a sort of seal of approval that is recognised in the market. For its part, the SV devotes a disproportionate amount of time to the approval of the balances of Mutual Funds. These funds, which permit their members to make withdrawals on a quarterly basis, may not distribute any monies until the SV has approved their balance. Although in total Mutual Funds only account for about 1% of the total assets under management in collective investment schemes, they absorb about 80% of the SV's time and efforts.

### 3.3.2. Recommendations Relating to External Auditors

In order to free up valuable resources and permit the SB and SV to better leverage them, the figure of external auditor / *Revisor Fiscal* needs to be developed and strengthened in Colombia. However, this is likely to be a lengthy process and is outside the direct sphere of influence of either the SB or the SV. Where the supervisors can make a high-impact difference in the short-term is in raising the standards required of auditors who work for investment management companies and their funds, and requiring the *Revisor Fiscal* of the investment management company and of the fund(s) to be different. For this to be possible, it will be necessary to endow the SV with the same powers as the SB to dictate required contents of the audit of financial intermediaries and funds. To ensure consistency across the CIS industry, the SB and SV should aim to draw up a standardised set of contents across all five types of investment management companies and collective investment vehicles. These standards should be modelled on internationally accepted principles of accounting wherever possible. Issuing a model set of accounts accompanied by a statement of recommended practice could be a way to do this.

With regard to the supervisory structure, the *Revisor Fiscal* should have the obligation to report irregularities discovered in the course of the audit to the lead supervisor, and the supervisor should have the power to request additional information where necessary. In addition, the investment management company should have to notify the lead supervisor of the name and contact details of the *Revisor Fiscal* of both itself and its fund(s), as well as seek authorisation if it wishes to change its *Revisor Fiscal*. Authorisation should be granted on presentation of an attestation from the outgoing *Revisor Fiscal* that the relationship is coming to an end as a result of commercial reasons and by mutual agreement of the parties, and not for any sinister reason.

It is not recommended that the SB or the SV take over the supervision of external auditors. This would divert them from their main role of safeguarding the prudential stability of the market and of providing market transparency and investor protection. However, one solution that some supervisors in other jurisdictions have imposed that might prove

interesting in Colombia is only to permit funds to be audited by firms that are approved (as opposed to licensed) by it.

### 3.4. Insurance Companies

Insurance companies do not have any obligation to report information concerning investment management companies and their funds to the lead supervisor of such activities, although financial intermediaries may be required to report any insurance claims they make to the lead supervisor, as is the case in the US. However, insurance companies indirectly provide a level of support to the supervisory structure because they subject intermediaries to strict due diligence and analysis to determine their susceptibility to operational risk. The US is the most developed market with regard to compulsory insurance cover for the operating risks of fund management companies. According to the Investment Company Act 1940, the Securities and Exchange Commission (SEC) has the power to require:

"...any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe."

This niche in the insurance market only developed in the 1980s. At that time, there were no companies offering appropriate products. As a result a captive insurance provider, ICI Mutual, was formed especially to provide insurance services to the investment management industry. There are basically three types of insurance policies provided:

1. The Fidelity Blanket Bond covers for losses incurred as a result of:
  - Employee theft
  - Third party fraud
  - Various other types of event
2. The Directors and Officers (D&O) Bond protects directors and officers against losses from:
  - Lawsuits
  - Regulatory investigations
3. The Errors and Omissions (E&O) Bond protects directors and officers against claims made against them for:
  - Negligent acts
  - Errors omissions
  - Other wrongful acts (including those committed by employees in the course of their employment)

ICI Mutual only insures companies that meet certain underwriting criteria and disclose information to them regarding the following:

- Internal control guidelines
- Trading policy

- Brokers
- The number of employees working in the compliance and internal audit departments
- Details of the directors and their background
- Details of past SEC/NASD inspections

Premiums normally depend on the rating ascribed to the following factors:

- Type of fund, fund manager, beneficiaries and sponsors/investors
- Number of funds
- Assets under management (total and per fund)
- Domicile(s) of a) the fund(s) b) the beneficiaries and c) the fund managers
- Claims history
- How the fund is marketed and to whom
- Sectors of investment (including sector and type of companies)
- Which financial instruments are used
- Whether the fund manager is a public or private company, and if public, where it is listed
- Where the fund is registered
- Each fund's performance during the last 3-5 years
- Copy of the original prospectus
- List of the board of directors and their origin - whether they are from the investment managers, or are non-executive, etc.
- Major shareholders - whether the shareholders private individuals or institutional investors

Other major developed markets, including France, Germany, Ireland, Italy, Netherlands, and Spain do not have a compulsory insurance requirement, although most companies would, for reasons of commercial prudence, take out professional indemnity (or errors and omissions) insurance cover. Instead, these markets have investor compensation schemes, which operate in a similar fashion to a deposit insurance scheme in the banking market. However, there are incipient investment management insurance markets in these countries, which are likely to grow in importance over time if counter proposals to the new Basel capital requirements are accepted. These requirements, which now include an assessment of operational risk, have excited much controversy. With regard to fund management activities, many leading experts agree that since investment management companies are not subject to the same systemic risks as credit institutions, it would be more appropriate to cover operational risks with insurance policies than with higher capital requirements.

#### **3.4.1. Investment Management Insurance in Colombia**

As yet, this type of insurance does not exist in Colombia, although there are some professional indemnity products that could serve as the basis for the future development of investment management insurance products.

#### **3.4.2. Recommendation Relating to Insurance**

Creating a new investment management insurance product to cover operational risk could be a win-win for the investment management companies, the insurance sector and the supervisors. Investment Management companies would have an incentive to ensure the best possible management of their operational risk so as to keep their insurance premiums as low

as possible, but would have the security of knowing that they were covered should anything go wrong. The insurance sector would have the opportunity to develop a new market, while supervisors would have the comfort of an extra source of vigilance over the entities they supervise.

Both superintendencias could work with the insurance sector to develop an investment management insurance product. The SB is particularly well-placed to do this as it also supervises the insurance companies. Although developing a new product from scratch may seem to be a daunting task, it should be remembered that twenty years ago this product did not exist in developed markets either. Colombia can benefit from the experience of the developed markets, and in particular the US, which is the leader in this domain.

### 3.5. Rating Agencies

Other than the ratings they accord, Rating Companies do not have any obligation to report information concerning investment management companies and their funds to the lead supervisor of such activities. However, in a similar way to insurance companies, rating companies indirectly provide a level of support to the supervisory structure because they subject intermediaries to strict due diligence and analysis in order to determine which rating investment management companies and/or their funds should be assigned.

It is important to bear in mind that the rating of funds and investment management companies is not a common practice in developed markets because it is considered confusing and misleading. Most attempts to apply credit ratings to funds fail because they involve rating the underlying assets of the portfolios. Since these can and do change the rating is always out of date. Instead, funds in developed markets such as the UK and the US must issue risk warnings, possibly using some form of graphic to indicate where they are on the risk spectrum. They may state in their prospectus that in accordance with their investment strategy they will only invest in AAA securities and so on, and possibly show their position graphically in a "style matrix" similar to the one below:

ASSET DURATION			ASSET QUALITY	
Short	Medium	Long		
				High
				Medium
			Low	

Investors in developed markets focus more on performance evaluation and are assisted in this by a mature and critical financial press, which may from time to time publish rankings based on criteria such as yield.

#### 3.5.1. Rating Agencies in Colombia

There are two rating agencies in Colombia, each with its own rating methodology and scales. Three ratings are accorded with respect to collective investment: a credit risk rating is accorded to the fund; a market risk rating is accorded to the fund and a solvency rating is accorded to the management company. The public appear to think that the ratings are an indication of how well the fund is managed, confusing them with performance evaluations, which of course none of them are. Some ratings are designated by letters and others with numbers. Unfortunately, the existence of three ratings causes confusion, complicated still further by the existence of two separate scales for each rating, which means there are essentially six different rating scales for the investor to understand. Fund managers add to the confusion by picking and choosing which rating to publicise, usually the most favourable. Ratings, therefore, hinder rather than assist the investor in comparing investment alternatives.

The fact that almost all funds were caught out by the TES crisis in the summer of 2002, despite healthy market risk ratings, is indicative of weak methodology in measuring market risk. Furthermore, only a day before the Multivalores crisis erupted, the fund had received a AAA credit risk rating, calling into question methods for analysing the composition of the portfolio. Unfortunately, it seems there is limited scope for abolishing the rating of funds and investment management companies in Colombia. Certain funds, such as pension funds, can only invest in investment-grade securities on the one hand, while facing restrictions as to how much money they can keep on deposit at banks on the other hand. Since there is a shortage of financial instruments in which to invest in Colombia, many pension funds invest in other funds. To make themselves attractive as investments for pension funds, funds must therefore be rated AAA.

### **3.5.2. Recommendations Relating to Rating Agencies**

The rating system does not seem to provide useful information to either the supervisors or the investors. Since it is ultimately the investors who pay for the costs of the rating exercise, a rating which is meaningless or confusing is a waste of money. If Colombia insists on continuing to require that funds and investment management companies be rated, then the whole system needs to be rethought. There is a total disconnect between what the ratings signify and what investors want and need them to signify. If some sort of rating is needed then the kind of system employed by a firm like Morningstar whose methodology takes into account several factors such as the past returns made by the fund and the volatility and risk of such returns might be better. In addition to this, clear categorisation of funds according to their risk/return strategy would help. For example, Fund A aims for maximum growth or return with some risk while Fund B expects a lower return from a conservative investment policy, and so on. As it is beyond the scope of this project to give advice as to exactly how the system should be changed, it is recommended that the SB and the SV seek technical assistance to conduct a study of this topic.

In the short term, the lead supervisors could mitigate some of the confusion that currently exists by issuing clear guidelines to investment management companies as to how they can and cannot use these ratings in their publicity. In addition, each supervisor could publish a list on their web pages of the comprehensive range of ratings assigned to the entities and funds they supervise, together with a simple explanation as to what each one signifies. Furthermore, some guidance should be given as to how funds' performance data is presented in the press. If investors had reliable performance data, perhaps they would not

commit the error of relying on credit and other ratings as a proxy for this. At present yield data is not published in a consistent format, so that each fund in the list can choose whether to show yield on a daily, weekly, monthly, annual or any other basis of their choosing. Each fund vehicle may publish different data to the others. For example, some types of fund publish net asset value, while others do not. The end result is that the data cannot be compared and the investor is left bewildered. There is more to disclosure than publishing data. If data is published in a misleading and confusing way, then it becomes misinformation rather than information. It is essential to work with members of the press to help them understand such issues, so that the press itself can set stricter standards and can become an ally of the supervisor in building the public's awareness about financial markets in general and CIS products in particular.

### 3.6. Internal Systems of Control

The Organisation for Economic Co-operation and Development (OECD) has recently distilled a set of principles from diverse national practices dealing with internal mechanisms for directing the relationships of managers, directors, shareholders and stakeholders. Building on the OECD initiative, the Basel Committee for Banking Supervision (BCBS)<sup>2</sup> has adapted these general principles into a set of eight simple principles of corporate governance specifically for the banking industry. In turn, these principles are increasingly being applied to other financial services companies besides just credit institutions. Of particular relevance to this project is BCBS principle 5, which requires "*strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances*". Since this is an area of particular concern to Colombian authorities, it is worth exploring in some detail.

A properly functioning system of organisation and procedure control is essential for a financial services company to effectively manage and control its operations and to conduct business in an orderly manner. Historically, the internal control process was a mechanism for reducing instances of fraud, misappropriation and errors, but more recently its reach has become more extensive to include all the various risks faced by financial firms. A system of effective internal controls is therefore today considered to be a critical component of management and a foundation for the safe and sound operation of the financial system as a whole. A system of strong internal controls can help to ensure that the goals and objectives of a financial firm will be met, that the firm will achieve long-term profitability targets, and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the financial firm will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage the firm's reputation.

While the board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained, it is the task of senior management to develop the details of these systems. These "details" include processes that identify, measure, monitor and control risks incurred by the firm and an organisation structure that clearly assigns responsibility, authority and reporting relationships. All personnel in the firm should understand their role and be fully engaged in internal control actions. Furthermore, internal control should be an integral part of the daily activities of a financial firm – it is not a policy or procedure that is performed at a certain point in time, but

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<sup>2</sup> Basel Committee on Banking Supervision, (1999)

rather an ongoing process.

The scope and particulars of a system of effective organisation and procedural controls required by a financial firm to conduct business in a sound and prudent manner depend on:

- the nature and activity of each of its departments;
- the volume of business handled;
- the size and complexity of transactions;
- the degree of risk associated with each area of operation;
- the degree of centralisation and delegation of authority, and
- the effectiveness of information technology installed.

As a result of analysis of problems related to significant losses of banks in the past, the BCBS has outlined a framework for internal control systems in banking organisations, which could be extrapolated to other types of financial entity. This framework aims to prevent or enable earlier detection of the problems that lead to such losses. Common forms of internal control include:

- management oversight,
- risk recognition and assessment,
- control activities,
- segregation of duties,
- information and communication, and
- monitoring activities and correcting deficiencies.

### **3.6.1. Management oversight**

Management oversight includes not just general principles of corporate governance, such as the board of directors providing guidance to and oversight of senior management, but also management activities such as review sessions and a system of approvals and authorisations. Management reviews consist of discussions of management reports that compare actuals to budget so as to gauge how the financial firm is progressing towards its goals. Questions that senior management generate as a result of this review, and the ensuing responses of lower levels of management, represent a control activity which may detect problems such as control weaknesses, errors in financial reporting or fraudulent activities. A system of approvals and authorisations for transactions over certain limits restricts who may approve certain operations and, by use of the “four eyes” principle, ensures that an appropriate level of management is aware of the transaction or situation.

### **3.6.2. Risk Recognition and Assessment**

Financial services companies are in the business of risk taking. Consequently it is imperative that, as part of an internal control system, these risks are being recognised and continually assessed. An effective internal control system requires that the material risks that could adversely affect the achievement of the financial firm’s goals are being recognised and continually addressed. This assessment should cover all risks facing the bank: credit risk,

market risk, interest rate risk, liquidity risk, operational risk<sup>3</sup>, legal risk and reputation risk. It should also include a thorough analysis of both internal factors (such as the calibre and preparation of personnel, staff turnover and organisational complexity) and external factors (fluctuating economic conditions, the impact of new product introductions and technological advances, for example). In addition, internal controls need to be periodically revised to appropriately address any new or previously uncontrolled risks. The risk assessment can be conducted by modelling how various scenarios affect the cash flows and earnings of financial instruments and transactions, as well as considering an array of possible problems ranging from customer misunderstanding to operational failure. At a minimum, a comprehensive set of controls to monitor risk should include the development and implementation of:

- an appropriate and effective asset/liability management safeguard (for banks), and controls of on-balance sheet structure and off-balance sheet items;
- sound, conservative valuation policies and procedures, and
- secure information technology, including access protocols and disaster recovery plans.

### 3.6.3. Control Activities

Control activities take many forms, including, but not limited to, the following:

- appropriate activity controls for different departments or divisions (e.g. detailed performance and exception reports) which will be the subject of probing question and answer sessions;
- physical controls such as restricting access to and conducting periodic inventories of tangible assets, including cash and securities;
- establishing and checking for compliance with exposure limits, for example limits for issuers and other counterparties, that reduce concentration of risk;
- a system of verification of transaction details and periodic reconciliation, such as comparing cash flows to account records and statements, may identify activities and records that need correction;
- maintenance of adequate documentation and records, and
- conducting spontaneous, independent checks on performance.

### 3.6.4. Segregation of duties

Where banks have suffered catastrophic losses, failure to make adequate provision for separation of duties has been one of the major reasons. Segregation of duties essentially means ensuring that personnel are not assigned conflicting responsibilities and organising duties so that one person's work acts as a complimentary check on another's. For example, assigning responsibility for both the front and back office of a trading function to one individual gives that person access to assets of value and the opportunity to manipulate financial data for personal gain or to conceal losses. Consequently, certain duties within a financial services company should be split, to the extent possible, among various individuals in order to reduce the risk of manipulation of financial data or misappropriation of assets.

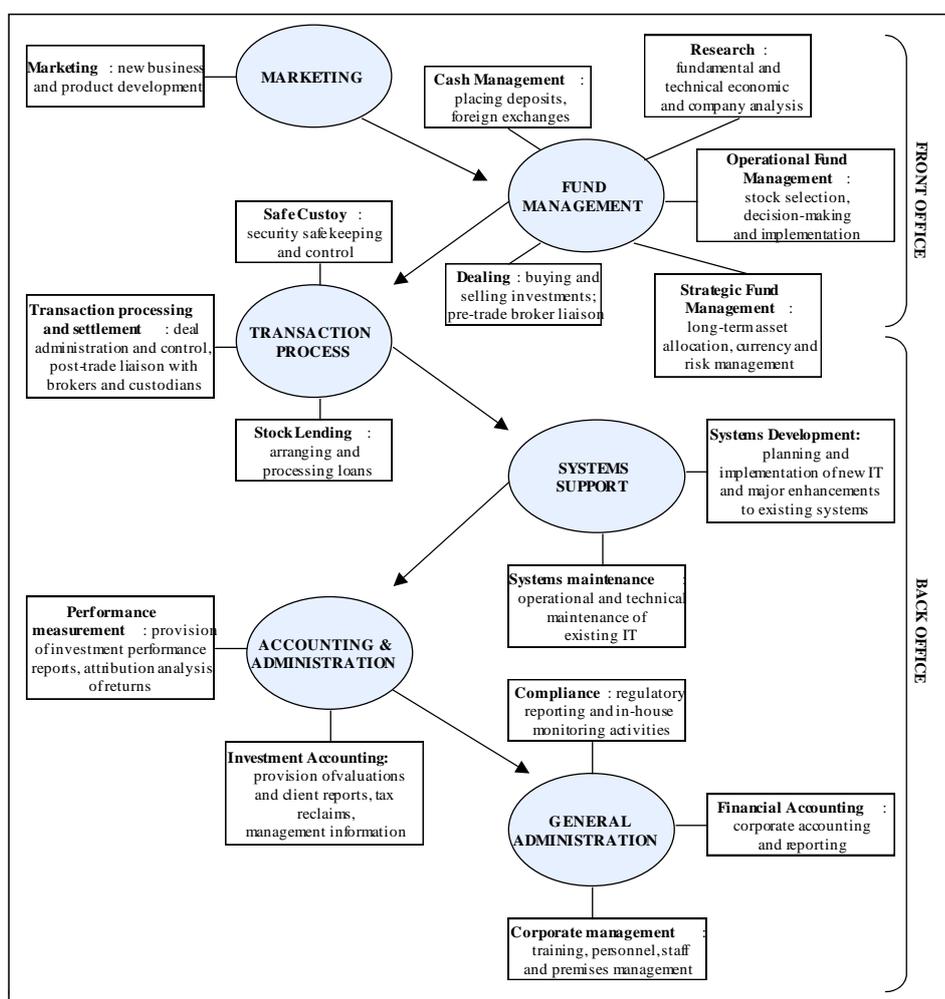
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<sup>3</sup> having reliable IT systems that cover all significant activities of the financial services company and that are secure and supported by appropriate contingency arrangements.

Conflicts of interest can occur at all levels of the financial services entity. Examples to avoid include:

- managing both customer and proprietary portfolios;
- undertaking fund management activities and custodial activities within the same legal entity;
- being responsible for the custody of and accounting for assets;and
- approval of the disbursement of funds and performing the actual disbursement, and
- input of a transaction and authority to process a voucher to adjust it without further approval.

Areas of potential conflict should be identified, minimised, and subject to careful monitoring by an independent third party. Segregation of duties should be reinforced with clearly defined and appropriate levels of delegation of authorities.



SOURCE: British Invisibles, PWC, 2000

The above diagram shows how such segregation is achieved in the CIS industry in the UK. It should be noted that there is a clear differentiation between fund management companies on the one hand and brokerage companies on the other, borne out of the philosophy that asset management should be the sole object of investment management companies. Structurally, even where there is a broking business and a fund management business as part of the same financial conglomerate, they would be completely separate legal entities. Consequently, there is a clear differentiation between and specialisation of the role of fund manager and that of broker or trader, leading to a higher degree of professionalism of both. Fund managers do not perform trades. Rather, they focus on investment strategy asset allocation and portfolio structure. Orders for trades are passed to third-party brokers with whom they regularly liaise for updates on the markets. The situation of fund managers performing trades is anomalous not only from the point of view of segregation of duties, but also because trading is an activity with a very short-term focus, while fund management usually has a longer-term focus. It should also be noted that not only is the custodian separate from the fund manager, but that in 80% of the cases it is not even a member of the same corporate group.

### **3.6.5. Information & Communication**

Managers need comprehensive financial, operational and compliance data, relevant to decision making, that is reliable, timely, accessible and provided in a consistent format. This necessitates the development of an effective management information system, including appropriate accounting and record keeping controls. In addition, all personnel need ready access to the information they need to do their job. Comprehensive documentation that clearly sets out the bank's organisation and procedural controls forms an important part of this information.

However, information alone is not enough. Indeed, without effective communication, information is useless. It is crucial that there are effective channels of communication and that the organisation structure of the financial services company facilitates an adequate flow of information upwards, downwards and laterally. This is important not only to unify and motivate staff to carry out the firm's strategy to reach its objectives, but also to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities.

### **3.6.6. Monitoring activities and correcting deficiencies**

Since financial services is a dynamic, rapidly evolving industry, financial services firms must continually monitor and evaluate their internal control systems in the light of the changing internal and external conditions, and must enhance these systems as necessary to maintain their effectiveness. It is normally the responsibility of the internal audit function to carry out a comprehensive audit of the internal control system to ensure that all areas of the firm are in compliance and to determine that existing policies and procedures remain current. This will involve reviewing policies and procedures, reviewing documentation, discussing operations with various levels of bank personnel, observing the operating environment and testing transactions. Internal control deficiencies, whether identified by the business line itself,

internal audit or other control personnel, should be reported to the appropriate management level in a timely manner and addressed promptly. (Material internal control deficiencies should, of course, also be reported to senior management and the board of directors.) Internal audit should prepare regular reports for the board and senior management summarising all control issues that have been identified during the period under review. Issues that appear to be immaterial when looked at in isolation may well point to trends that could, when linked, become a significant control deficiency if not addressed in a timely manner.

### 3.6.7. Internal Controls in Colombian Financial Entities and Recommendations

Anecdotal evidence suggests that in general internal control systems in investment management companies are weak, particularly in brokerage houses where trading and portfolio management activities seem to be carried out within the same management structure. There are some regulations in Colombia which provide a good basis for developing effective systems of internal controls for financial services companies, in particular regulations 88/2000 and 70/2001 referred to earlier in this report. However, 88/2000 is oriented to credit institutions and has yet to be officially adapted to the needs and specific nature of investment management companies, while 70/2001 does not go far enough in setting out guidelines for this type of activity. Financial Services Companies need more guidance as to what constitutes an effective and acceptable system of internal controls. The SB and SV need to work on this aspect together in order to assure a harmonised and consistent approach to this important matter.

Of particular concern is the segregation of duties between traders and fund managers, which is very poor at present. This is in part due to a weak differentiation between the role of fund manager and that of trader, as well as an under-development of the role of fund manager itself. A Colombian fund manager is essentially a sort of an enhanced trader, but an exclusive trader working for a investment management company. The problem is particularly acute in brokerage houses, who manage the *Fondos de Valores* vehicle, and the asset management companies (*Sociedades de Administradoras de Fondos de Inversión*, "SAFIs"), who manage the *Fondos de Inversión* vehicle. Far from having investment management as their sole object, brokerage houses are permitted to carry out at least 11 different types of business<sup>4</sup>. Ironically, SAFIs, who are the only companies whose sole object it is to manage funds, are the most disadvantaged in the CIS market compared to the other types of fund management entities and the fund vehicles they manage. As it is, we find traders in fund management companies and fund managers in broking companies, although to be fair, in the better companies there is a separation of sorts of business lines and fund managers and traders are not necessarily co-located. Ideally, however, there would be a complete legal separation of the trading and fund management function. This would entail the traders being taken out of the SAFIs and put in the brokerage houses, and the fund managers being taken out of the brokerage houses and put in the SAFIs, as well as all of the discriminatory restrictions against SAFIs and their funds being removed in the new regulation. Only then could the role of fund manager blossom to its fullest professional potential.

### 3.7. Internal Auditor

In developed markets, the role of internal auditor within a financial services company is very

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<sup>4</sup> For a complete list, see the section of this report on regulation

important. Indeed, it is considered to be one of the principal structures of corporate governance, the others being the board and the senior management. There is a separation of powers between these three structures, similar to that which exists in the political arena, with each one acting as a check and balance on the others.

<b>STRUCTURE</b>	<b>Senior Management</b>	<b>Audit</b>	<b>Board</b>
<b>POLITICAL EQUIVALENT</b>	<i>“Executive”</i>	<i>“Judicial”</i>	<i>“Legislative”</i>
<b>ROLE</b>	The doers	Monitor the doers to ensure what is done is done according to the law, that standards are met and that ethical principles are observed.	Oversee senior management and audit; set the firm’s general direction, strategy and policies, and approve the financial accounts and capital spending

Adequate internal controls within financial services institutions must be supplemented by an effective internal audit function that independently evaluates the control systems within the organisation. The US Institute of Internal Auditors defines the function of internal audit as follows:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”<sup>5</sup>

It is important that Internal Audit reports directly to the highest levels of management of the bank, so that its reports may not be influenced by other levels of management that may also be superior to it. Indeed, Internal Audit should report directly to the President. Furthermore, Internal Audit should report not only to Senior Management, but also to the board, or its Audit Committee. Thus, the board may receive unbiased information on the operations and performance of the firm from Internal Audit, which acts as an independent check on the information received from senior management.

The Internal Audit function should ensure that the financial services company has established:

- an adequate system of internal controls to ensure a well-ordered and prudent conduct of business;
- a system for relating risks to the firm’s capital level;
- processes for identifying and adequately controlling the risks incurred in pursuing its business objectives;

<sup>5</sup> Quoted in Basel Committee on Banking Supervision, (2000), p.2

- processes that ensure the integrity, reliability and timeliness of submission of both financial information and management information, and
- plans, policies and procedures in compliance with laws, regulations and supervision standards.

None of the firm's activities or entities may be excluded from the internal audit department's scope of investigation. Specifically, the Internal Audit function will be responsible for conducting the following tasks:

- Drawing up the annual internal audit plan, with timelines and budget, and giving due consideration to the type of audits that will be conducted (see below) and the need to include enough slack to be able to deal with unexpected situations and developments that may arise
- Examining and evaluating the adequacy and effectiveness of the internal control systems
- Reviewing the application and effectiveness of the risk management procedures and risk assessment methodologies
- Reviewing of the management and financial information systems, including the electronic information system and electronic marketing and sales service
- Reviewing the accuracy and reliability of the accounting records and financial reports
- Reviewing the firm's system of assessing its capital in relation to its estimate of risk (which differs from its risk management system in that the latter focuses on the review of business strategies developed to maximise risk/reward trade-offs)
- Testing both transactions and the functioning of specific internal control procedures
- Examining the adherence to legal and regulatory requirements, and codes of conduct
- Testing the integrity, reliability and timeliness of regulatory reporting
- Carrying out audits and special investigations
- Communicating results of audits, issuing audit reports and certification of inspection, and following-up on results of audits
- Maintaining a record of audits performed and reports issued
- Liaising with external auditors and supervisory authorities as necessary, and ensuring the work of the internal audit department does not duplicate their work

There are basically four main types of audit:

1. Financial audit - to verify the reliability of the accounting system and information, and of the resulting annual accounts
2. Compliance audit - to verify compliance with laws, regulations, policies and procedures
3. Operational audit - to verify the quality and appropriateness of the systems and procedures, to analyse the organisational structures with a critical mind, and to evaluate the adequacy of methods and resources
4. Management audit - to assess the quality of the management function in the framework of the firm's objectives

The financial services company's internal audit function must be independent of the activities audited, as well as from the every day operations of the firm and the selection or implementation of internal control measures. The need for independence and impartiality does not necessarily exclude the possibility that the internal audit department is involved in advising or consulting. However, this should be ancillary to its primary function of examining and evaluating the firm's internal control systems and should not preclude internal auditors from analysing and criticising internal controls that have been put in place

by senior management on their advice.

When selecting staff for the internal audit function, account should be taken of the growing technical complexity of financial services companies' activities and the increasing diversity of tasks that need to be undertaken by the internal audit department as a result of developments in the financial sector. Specifically, candidates should be able to demonstrate the sufficient up-to-date knowledge of auditing techniques and financial services activities, as well as the analytical capacity to collect, examine and evaluate information, and to communicate efficiently at all levels of the organisation. In financial services companies in developed markets, staff from other departments are often assigned to the internal audit department for a defined period, say 1-2 years, and then re-assigned either to their previous department or to another one. The firm benefits from this because the staff member "knows" the organisation, while the employee benefits from gaining a broader understanding of how a financial services company operates. However, these temporary internal auditors should not audit activities or functions they performed in the recent past (because of the conflict of interest).

### **3.7.1. Internal Auditors in Colombia**

Some of the larger firms, particularly subsidiaries of foreign financial services entities such as Skandia and Santander, have appointed internal auditors under their own initiative. However, anecdotal evidence suggests that this role is uncommon in Colombia.

### **3.7.2. Recommendations Relating to Internal Auditors**

It is recommended that for larger financial services firms the figure of internal auditor and the creation of an audit committee be compulsory. To ensure consistency between the supervisors, there should be a single definition of a "large" firm, and this should be decided by the SB and SV in relation to assets under management.

### **3.8. Compliance Officer**

The Compliance Officer of a financial services entity has a key role in two areas: first, ensuring compliance with law and regulation, and second, articulating organisational values and ethics. This person is therefore responsible for assuring the integrity of the organisation, its processes and all personnel (including members of the Board of Directors) by:

- Ensuring that all transactions and business practices conform to relevant laws and regulations.
- Identifying and considering relevant standards and best practices of ethical behaviour, developing rules, procedures and processes for their implementation; recommending them for approval by the appropriate level of authority, and then promoting them within the firm.
- Enhancing the level of awareness among personnel of the firm's commitment to such standards and best practices of ethical behaviour, and developing, implementing and monitoring associated training programmes.

- Preparing a compliance manual, laying out specific rules of action describing relevant laws and regulations as well as providing procedural guidelines and specific examples of conduct that must be followed by all directors and employees. (This requirement is optional.)
- Conducting investigations of allegations of misconduct in accordance with the internal procedures for handling such incidents.

In this context, due regard should be paid to:

- conflicts of interests: ensuring that personnel properly manage actual and potential conflicts of interest in respect to the firm's handling of operations and investments;
- confidentiality: ensuring that appropriate confidentiality standards are applied to the use of commercially sensitive and confidential information acquired by the firm in the context of its operations and activities and protecting the flow of such information within the firm and between the firm and third parties; developing systems and procedures designed to ensure such confidentiality; and monitoring the implementation of such systems and the application of such procedures.
- corruption: promotion of the firms's standards and initiatives against money laundering and corrupt practices.

The compliance function has to be highly visible, unquestionable in its independent role and needs to command the necessary respect and authority in dealing with the most senior managers in the financial services firm and its Board of Directors. In the US model, therefore, the Compliance Officer reports directly to the President. However, the Compliance Officer also provides the Audit Committee with information about his/her work on an annual basis or more frequently as needed, in particular if there is any unresolved difference of opinion involving the President and the Compliance Officer. In their day-to-day work, the Compliance Officer works closely with and draws upon the resources of a number of departments within the firm, including specifically:

- The Office of the General Counsel, who gives advice on legal matters and assists in the interpretation and monitoring of the firm's Code of Conduct. In addition, the Office of the General Counsel assists the Compliance Officer in the training of personnel in integrity matters.
- The Risk Management Vice Presidency, who monitors integrity and reputation risks in firm's activities.
- The Internal Auditor, whose functions are distinct but complementary to those of the Compliance Officer.
- The Human Resources Department, who assists the Compliance Officer in the training function and in promoting personnel awareness of the integrity standards expected of them.

Outside of the firm, the compliance officer is responsible for liaising with the regulator /

supervisor. Indeed, they act as the point-person for the supervisor, overseeing the dispatch of information for reporting purposes and providing any additional information that is requested.

In smaller financial firms, the role of compliance officer is often undertaken by the director of a non-operational department who combines compliance duties with their official functions. Typical candidates for compliance officer in this case include the legal counsel, the internal auditor and the human resources director.

### **3.8.1. Compliance Officers in Colombia**

The figure of compliance officer already exists in Colombia. However, at present, this role is concerned exclusively with anti-money laundering procedures. Moreover, not all investment management companies are obliged to appoint a compliance officer. *Fondos Mutuos*, for example, are exempt from appointing such an official because their product is only offered to a limited public, that is, the employees of the company sponsoring the scheme, and the cap on contributions, whereby an adherent to the scheme may contribute no more than their salary, is thought to be a sufficient deterrent to money laundering. Furthermore, *Fondos Mutuos* fear that the mandatory appointment of such an official would increase their operating costs by at least 20-30%

### **3.8.2. Recommendations Relating to Compliance Officers**

It is recommended that the role of compliance officer be expanded to cover all aspects of legal and regulatory compliance besides just money laundering. This elevation of the profile of the compliance officer may necessitate the provision of training for existing compliance officers, and/or the hiring of more highly qualified and competent individuals into the role. Furthermore, it is recommended that all investment management entities be required to appoint a compliance officer. In smaller firms this role may be assumed by an existing senior employee in a non-operational role. The SB and SV should together decide what will be the cut-off point for the classification of a firm as "small". Preferably, this should be done on the basis of the amount of assets under management rather than number of staff.

Although there will be some resistance to the appointment of compliance officers by the *Fondos Mutuos*, the SV should nevertheless press ahead. Imposing a requirement for a compliance officer would not only relieve the SV's supervisory burden in respect of these funds (which today account for a disproportionate amount of supervisory time and effort), but should also, by raising the minimum standards for an investment management company, encourage a much needed consolidation among these numerous, tiny funds. Accordingly, the SV should also think about mechanisms to facilitate the swift merger of these funds. Ultimately, the effect of consolidation should create economies of scale that more than compensate for the extra expense of a compliance officer, so that no one is worse off.

### **3.9. Sequencing of Implementation of Recommendations**

Raising the standards of any industry necessarily involves additional costs for the participants. Where a market is incipient, it is particularly important to get the timing right in order to avoid burdening participants with so many regulatory costs that growth is stamped out altogether. Although we have made many recommendations for adjustments to

the supervisory structure, we recognise that it will not be possible to carry them all out at once. The following table therefore summarises our top three priorities and our rationale for the sequence:

Recommendation	Cost to Participants	Rationale
1. Introduction of separate and independent Custodians	Low - initial upfront costs of reorganisation of existing custodial activities into separate business lines should be modest; those that do not have a competitive advantage in offering this service will close this business line, making their overall business model more efficient; those that do have a competitive advantage will be able to profit from economies of scale; funds will continue to pay custodial fees as today, with perhaps a slight increase if additional services are provided by the custodian.	<ul style="list-style-type: none"> <li>• This is the point at which the system is most vulnerable. It is therefore absolutely essential to do something about it as soon as possible.</li> <li>• Custodians would be in a position to supply objective data to the supervisor at intervals of the supervisor's choosing.</li> <li>• There is an existing infrastructure that can be adapted.</li> <li>• The cost is not prohibitive.</li> <li>• There are recent regional initiatives in this area from which lessons can be learned (Peru).</li> <li>• Overall, the investment management industry will become more efficient as a result of this initiative.</li> <li>• International investors will have a greater level of comfort investing in Colombia, knowing that it is adopting international standards in protecting their assets.</li> </ul>
2. Appointment of Compliance Officers	Low to medium - this official already exists in most funds; it is a case of building up the role and providing extra training. (In the worst-case scenario it is conceivable that a firm would have to hire in a better-qualified individual.) The cost will be higher for smaller funds, and in particular <i>Fondos Mutuos</i> , which may be forced to merge in order to build up the critical mass necessary to be able to cover the cost of this requirement. Ultimately, consolidation will lead to economies of scale that should more than cover the additional cost of a compliance officer.	<ul style="list-style-type: none"> <li>• There is an existing infrastructure that can be adapted.</li> <li>• Since compliance officers are within supervised entities, supervisors can exercise greater control over them.</li> <li>• Compliance officers would supply data to the supervisor at intervals of the supervisor's choosing.</li> <li>• The cost is not prohibitive.</li> <li>• Overall, the investment management industry will become more efficient as a result of this initiative, as fragmentation will be reduced.</li> </ul>
3. The strengthening of the role and methodologies of external auditors and <i>revisores fiscales</i> .	Medium - the imposition of higher standards on external auditors and <i>revisores fiscales</i> by lead supervisors may lead to higher fees for investment management firms and funds	<ul style="list-style-type: none"> <li>• There is an existing infrastructure that can be adapted.</li> <li>• Since these professionals are not within supervised entities and audits are only performed once or twice per year, supervisors cannot exercise much control</li> </ul>

		over them. However, if professional standards were raised, this would free up time the supervisors presently spend duplicating the audit function (e.g. checking end-of-year accounts).
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#### 4. SUPERVISORY POWERS

In an absolute sense, the supervisory authorities of Colombia appear to have sufficient powers. In a relative sense, the SB and the SV have broadly similar powers with respect to each other, and internally with respect to different fund vehicles, as the table below demonstrates:

POWERS		Bancaria		Valores	
		Trusts (FCOs/FCEs)	Pension Funds (Voluntary)	Fondos de Valores & de Inversión	Fondos Mutuos
1	Authorising new investment management companies	√	√	√	√
2	Authorising new funds	√	√		
3	Authorise investments in new securities offered on the market				√
4	Set investment and exposure limits	(√)		√	√
5	Screening and authorising directors, managers, legal representatives, external auditors and compliance officers (before they assume their duties)	√	√	√	√
6	Broad power to issue general orders to protect sound uses and practices in the securities market			√	√
7	Issue rules to prevent and regulate conflicts of interest and insider trading in the market			√	√
8	Issue accounting and portfolio valuation rules for funds and their managing companies	√	√		
9	Review financial statements of funds and their managing companies, with full powers to order pertinent changes	√	√	√	
10	Issue technical regulations and instruct management companies about the way in which they are to implement legal provisions and regulations	√	√		
11	Instruct management companies about information disclosure to the market	√	√		
12	Authorise advertisement programmes on a general or individual basis	√	√	√	
13	Practice inspection functions, including in situ inspections on management companies and their funds, with full examination and request powers	√	√	√	√
14	Issue orders for the immediate suspension of illegal, non-authorised or insecure practices by investment management companies or their funds	√	√	√	√
15	Impose administrative penalties on management companies, their directors, managers, legal representatives or officers in respect of infractions	√	√	√	√
16	Decide in which cases a management company shall merge with another	√	√		

17	Temporarily manage or even exclude a trust company from the market by means of an administrative intervention (taking possession)	√	√	√	√
18	Hear and decide complaints from clients (from a non-judicial perspective)	√	√		

Although there appear to be some instances where the SV does not have the same powers as the SB, perhaps because it is not specifically mentioned in law or regulation, in practice it appears that the SV exercises these powers. So, for example, the SV does authorise new funds and handle client complaints. In other cases, although the SV may not have a specific power (to instruct management companies about how to implement laws and regulations, or what information to disclose to the market, for example), the broad power to "issue general orders to protect sound uses and practices in the securities market" is probably sufficient to cover these items. The few items where the SB does not have a specific power relate to the orderly running of the securities market rather than specifically to funds or management companies, and this is the unique province of the SV.

Where the powers do differ is in their quality. Powers regarding setting permitted asset classes and exposure limits vary according to fund vehicle, though for no discernible logical reason. The SB appears to have stronger powers to dictate accounting rules and procedures to be applied to funds and management companies by external auditors and *revisores fiscales*. Perhaps the most important difference is in respect of administrative penalties in respect of infractions of applicable laws, regulations and other instructions. The SB has a wider range of sanctions at its disposal than the SV, and can impose far harsher fines. This is fundamentally unsound: where the infraction is of the same nature, the degree of punishment should be the same.

As individual professionals are not licensed, the only sanction against them appears to be some sort of financial penalty. The supervisors have suggested that there is little stigma attached to sanctions and that individuals often return to work in the market when the fuss has died down, unlike in western markets where in some cases individuals may even forfeit the right to work in the financial services industry ever again. Given the problems of sales forces misleading clients by informing them that funds are substitute products for bank deposits with identical risks, which may be unintentional due to poor training or deliberately fraudulent, there is a need for a wider range of disciplinary actions here, including revocation of an individual's or operator's licence (assuming such licences are introduced, as is our recommendation).

It appears that neither party has a list of possible infractions and their potential penalties. It would be useful for the supervisory authorities of Colombia to create a combined list, classify it according to whether the infraction is light, serious or very serious and state minimum and maximum penalties for each one. In drawing up such a list, it will be necessary to distinguish between voluntary and involuntary actions. An infraction occurs voluntarily where the action or actions occurring were within the control of a regulated entity. This is true regardless of whether the action was committed knowingly or unknowingly. When a situation which is not within the control of the regulated entity arises and gives rise to a breach, usually due to external factors beyond its control, then this is an involuntary infraction. For example, if investment/exposure limits were to be exceeded, where this had occurred as a result of accidentally or intentionally buying too much of the security in question, then this would be a voluntary infraction. Where, however, the value of an asset had trebled in a very short time so that the proportion of the portfolio invested in

that asset increased as a result of revaluation and breached exposure limits, then that would constitute an involuntary infraction.

The publication of a categorised list of breaches would build awareness and create legal certainty in the market. In Spain, the list of light, serious and very serious infractions is contained in the law (*Ley del Mercado de Valores*, Título VII, Articles 99-101). However, the problem with this approach is that whenever a new type of infraction arises there may be difficulties or delays in getting it added to the list. Also, it is worth noting that, as a rule, it is best for supervisors to be able to deal with each element of the infraction separately and punish each accordingly, rather than having to impose a single penalty covering the whole situation that may involve a variety of breaches.

Another useful measure is to require the technical infraction to be corrected within a short period of time at the expense of the investment management company if there is a loss to the fund incurred in correcting it; and/or to make good any losses from its own resources to investors that have resulted from the infraction. To do this, both of the supervisors must be granted the power to order compensation to investors to be paid by a management company in these circumstances.

While the temporary exclusion of a fund from the market is obviously equivalent to the power to suspend a fund, there is no specific mention of permanent revocation of licenses. In developed markets, upon detecting irregularities in the activities of an operator or a supporting entity, a supervisor may freeze the fund and/or suspend or revoke the latter's licence. The supervisor notifies both the defaulter itself and other entities servicing the corresponding fund of this decision by a written notice, which should state the reasons for the licence suspension or withdrawal, as well as those actions that must or may not be performed as of the moment of such punishment. The SB and SV need this power in relation to investment management companies, as well as for funds and individuals.

Where the permanent revocation of a licence occurs, the fund could be taken over by another fund management company or forcibly liquidated according to normal liquidation procedures as set out in company law. In particular, this would provide a solution for those trusts who currently find themselves in a legal no-man's-land because their establishing documents did not specify a method of liquidation, so that they cannot be wound up, even though they are to all intents and purposes defunct.

## 5. SUPERVISORY PRACTICES

Compared to the banking sector, the regulation and supervision of capital markets is relatively recent: for example, although the SEC was founded in the US in 1933, and the Investment Company Act that covered mutual funds was passed in 1940 many European countries did not create an equivalent organ until the 1970s. Up until then, the securities markets had been regulated and supervised through mechanisms of self-regulation. As the table below shows, traditionally the regulation and supervision of securities markets has focused on investor protection through market transparency, information disclosure and the correct formation of prices, while that of the banking sector has paid more attention to the stability of the financial system through the solvency of financial institutions.

**Regulatory Measures and Regulatory Objectives**

Regulatory Measure	Systemic Risk	Investor Protection	Efficiency Enhancement	Broader Social Objectives
<b>A. Banks</b>				
Antitrust enforcement / competition policy		√	√	√
Asset restrictions	√			√
Capital adequacy requirements	√	√		
Conduct of business rules		√	√	√
Conflict of interest rules		√	√	
Customer stability requirements		√		
Deposit insurance	√	√		
Fit and proper entry tests	√	√	√	
Interest rate ceilings on deposits	√			√
Interest rate ceilings on loans		√		√
Investment requirements				√
Liquidity requirements	√	√		
Reporting requirements for large transactions				√
Reserve requirements	√	√		√
Restrictions on geographic reach				√
Restrictions on services and product lines	√			√
<b>B. Securities Markets</b>				
Disclosure standards		√	√	
Registration requirements		√	√	
Manipulation prohibition		√	√	
Insider trading prohibition		√	√	
Takeover rules		√	√	
Protection of minority shareholders		√		
Investment management rules		√	√	

SOURCE: Allen & Herring, 2001

The reason for the difference in focus of banking regulation and supervision compared to that of the securities markets was the supposition that securities market companies were not a major source of systemic risk. For example, as funds make investments rather than use monies deposited with them to create money through the granting of loans and credits, they were not considered to be vulnerable to "run on the bank" behaviour. In addition, as they usually did not have direct access to payment systems, the contagion of any financial shock they might suffer was less probable. This is still largely true today. Brokers may of course be a source of systemic risk, since the collapse of a major broker with many unsettled trades or enormous own book positions would cause chaos in the stock market. Asset management companies may mismanage the fund, but, since there are no guarantees, there is no liability

on the fund management company of a scale that could cause systemic shocks if it could not be met. The entire Colombian CIS industry would have to implode before it could cause the kind of systemic shock that would result from the collapse of one major bank.

These traditional differences in banking and securities market regulation and supervision are clearly visible in Colombia. Here too, banking regulation and supervision predates that of the securities market, with the former enjoying a history of some 80 years and the latter approximately 30 years. Participants in the market notice the difference and refer to the SB as "the policeman" and the SV as "the promotor". However, with the blurring of the distinctions between various kinds of financial services entities, both types of supervision are essential. IOSCO's three key objectives of securities regulation clearly demonstrate this:

*The protection of investors:* regulation of market conduct whose primary aim is to protect both market participants and investors from suffering loss or disadvantage as a result of fraud, theft or other malpractice;

*Ensuring that markets are fair, efficient and transparent:* market efficiency and transparency, which will lead to a broadening and deepening of financial markets, and

*The reduction of systemic risk:* prudential regulation, designed to protect the financial system from the systemic risks, which may result from failures in any part of it.

It will therefore be essential for the SB and the SV to combine their current approaches in order to cover all the aspects that regulation and supervision of the CIS industry ideally should cover.

### **5.1. Licensing and Authorisation**

One task of regulation is to keep bad-faith operators and supporting entities, as well as their financial products, which may prove detrimental to investors' interests, off the market. This is precisely why regulators put up filters in the form of licensing and registration procedures in the way of those willing to manage and service investment funds. The information about licensed firms disclosed by regulators enables investors to choose those whose services can be safely contracted: these companies have passed regulatory screening for compliance with specified parameters and will remain under regulator supervision in the course of their subsequent operations.

The word "licensing" is usually used in relation to companies: operators (fund management companies) and supporting entities like custodians, registrars, appraisers, sales agents, and corporate investment funds. Licensing is a procedure whereby a company is checked for conformity with certain requirements and issued a permission (licence) to legally undertake the particular licensed activity. No operator and no supporting entity required by legislation and other applicable regulations to obtain a licence in order to take up a specific line of business may launch, manage or service a fund before receiving an appropriate licence.

The term "authorisation" is given to the regulatory permission given to a fund to be publicly offered, following review a fund's documents (rules and/or issue prospectus), as drawn up by its operator, to verify their compliance with applicable legislative and regulatory requirements. Any advertising for a fund's shares and their marketing and distribution may only get under way following its due authorisation. The words "investment fund" may only

be included in the name of a company and/or its products upon its registration as an investment fund with an appropriate regulator/supervisor.

In most jurisdictions, applicable legislation and regulations prescribe time periods during which supervisors are required to issue a licence or carry out a registration, or to refuse to grant them for specified reasons. These time periods may vary and range, as a rule, between 30 and 90 days. Most regulators are empowered to ask for additional information to be submitted at the licensing and registration phase. It needs to be noted that even where additional data has been requested, the regulator/supervisor is still expected to observe the time limits fixed by legislation for its consideration of the appropriate documents.

Licences and registrations are granted for a fee. Such fees, whose amounts are different from country to country, are called upon to compensate regulators for their expenses incurred for document reviews and for the production and execution of licences and registration certificates. In some countries where regulators are funded out of the government budget, all collected licensing and registration fees go to the national or a local budget and are far from always returned to the regulators as their financial support. But such fees may serve, in whole or in part, as a tangible direct source for financing regulators.

It is not ruled out that the very fact that a company has a licence granted by a regulator and that its products are duly registered may come to be seen by the public as a government warranty guaranteeing the company's dependability, competence and fine performance, while in fact the licence is nothing more than an authorization issued to undertake a particular activity or to begin distributing a product, which is based on the applicant's compliance with minimum requirements. To prevent the above misconception, it is essential to ensure that the risk warnings given in offering prospectuses include a reminder that licences and registrations are not government certificates of assured quality.

### 5.1.1. Licensing CIS Operators

Companies desiring to be licensed as operators should, as a rule, meet applicable equity and/or liquid capital requirements, have sufficient and reliable human and technical resources to be able to cope with the tasks that will face them in the process of their licensed activity, be "fit and proper" and enforce appropriate internal rules and arrangements.

#### a) Capital Requirements

Capital requirements for operators are among the main licensing requirements. An operator must have enough financial resources to be able to commence and maintain its business, namely: to sustain requisite arrangements and procedures and to pay the necessary personnel, not only when filing an application for a licence, but also throughout its licensed activity. Often, capital requirements are split into initial capital and on-going or working capital requirements. Working capital requirements for licensed operators may be established in a variety of ways, each of which has its own pros and cons:

- Minimum fixed capital requirement: This is the simplest option, but it does not presuppose any differentiation between large and small companies and may, in the final analysis, lead to discrimination against the latter, thereby damaging competition
- Capital requirement pegged to the value of funds and/or the number of funds under management: Once interpreted literally, i.e. with a direct linkage between capital and fund value, this option may result in a situation where operators managing enormous

assets will find themselves altogether unable to pursue their business, since even if the ratio is minimal, the requirement on their equity capital will be unduly high. A company such as Fidelity of the US, which at one point managed a trillion dollars of assets would have required capital of \$10 billion on the basis of a 1% of funds managed requirement, which would be many times higher than the capital needed to operate the business. Therefore, it is essential to employ different equations and linkage coefficients depending on the value of funds managed by the operator. For this reason, the EU has set a minimum capital requirement of €125,000, plus an additional requirement comprising the higher of €125,000 plus 0.02% of the excess of funds under management over €250 million, subject to a maximum of €10 million, and 13/52 of the investment management firm's annual audited expenditure.

- Capital requirement tied to the operator's average weekly (monthly) costs. This relates capital to expenses, but is not so simple to apply

Capital requirements, of course, range from country to country. If they are understated, this means that financially unviable companies will troop into the CIS business. In this case, operators' risk of failing to fulfill their tasks will be higher and investors' interests will come into jeopardy. On the other hand, unduly demanding capital requirements may sift out potentially successful small companies and thus arrest healthy competition. The choice of the most acceptable approach to calculating capital, and the determination of its adequate size hinge primarily on the overall development level of business, financial services and infrastructure in general. The most important factors of relevance in this respect include the following:

- Existence of independent custodians with sizable capital and good reputations on the market
- Possibility to obtain professional risk insurance
- Existence of compensation schemes funded by the industry, whose resources can be used to reimburse investor losses

#### **b) Sufficient Human and Technical Resources**

Both after filing for and after obtaining its licence, an operator is expected to demonstrate that it has enough human and technical capabilities in order to perform its licensed activity. Such resources must relate to the business plan envisaged by the company. After licensing an operator, the supervisor will satisfy itself from time to time by way of monitoring and inspections that the licence holder continues to maintain the necessary resources.

#### **c) "Fit and Proper" Test**

In order to qualify for a licence, an operator should meet certain standards known as "fit and proper" requirements. These requirements are different in different countries, but are, as a rule, stringent enough for regulators to satisfy themselves that the particular company maintains or is able to maintain high operating standards so as to do business in an honest and fair fashion, guided, most notably, by investor interests. In order to pass the relevant test, the would-be operator should demonstrate a perfect record that is unmarred by - for example:

- Any past bankruptcy,
- Major regulatory breaches
- Charges of fraud or other economic crime

In many countries, special requirements are made on operators' directors and some of their employees (typically, anyone who deals with clients, all personnel with palpable influence on funds' performances and the compliance officer), as well as significant shareholders (i.e., those holding 10%+). These "fit and proper" requirements mostly concern the latter's integrity, good reputation and competence. By requiring such individuals to undergo a "fit and proper" test, regulators want to make sure that the person in question:

- Does not have a record of convictions, in particular, those for economic crime;
- Did not work for a company whose licence has been subsequently withdrawn;
- Was not the subject of any serious complaints from any of the regulators in the past;
- Does not have any personal assets under interdiction or attachment, and
- Has a proven track record in the given or a related line of trade

In some jurisdictions, such persons are also required to have specified qualifications that can only be verified by taking a special examination. Since business practices and regulatory requirements tend to change with time, professionals with adequate qualifications, who have not worked in their field for a certain time, are obliged in many countries to confirm their competence by undergoing a repeat examination or by undertaking ongoing training. Furthermore, each company is responsible for maintaining the competence levels of those with appropriate qualifications and unbroken records of service in their area of specialization through appropriate training.

The passing of a "fit and proper" test and registration in a regulator's register are effectively tantamount to individual licensing. In most countries, regulators keep registers of persons who have taken and passed these tests. Such records include not only current information about those professionals' jobs and qualifications, but also about all of their career moves and all of their transgressions, related reprimands and other regulatory penalties. The role of these registers is significant, as they enable regulators to bar those with tarnished reputations from going into, or continuing in, the business.

#### **d) Internal Rules and Arrangements**

The operator is required to prove at the licensing phase that it has the requisite arrangements and procedures in place in order to ensure a full separation of its own assets and the assets of funds under its management. Its internal rules and procedures should regulate the work to be done by its staff who should, for their part, know and understand these regulations and be ready to observe them. Liability for the conduct of their personnel and their performance should be borne by competent managers.

### **5.1.2. Authorising CIS Funds**

#### **a) Contractual Fund**

The registration of a contractual fund consists of checking sponsoring firm's eligibility to launch or manage such a fund, then checking the fund's rules and/or issue prospectus. If information found in these documents attests to the particular investment vehicle's compliance with applicable laws and regulatory requirements and the documents contain all the information necessary for investors to make informed decisions to invest in the fund, the regulator registers the rules and issue prospectus and assigns them a separate registration number. When subsequently advertising the fund or publishing any reports on its activities, the operator is required to refer to the fund's registration data. The principal documents necessary for the registration of a fund are:

- Its rules
- Offering prospectus
- Contracts between the operator, on the one hand, and the custodian, registrar, appraiser and external auditor, on the other

A fund's prospectus is a lynchpin document as it represents the operator's invitation to an investor to buy a participation or unit. Therefore, the operator is duty-bound to make sure that before making such a purchase, each investor is provided with the prospectus. Key data to be included in the prospectus includes:

- Fund's name
- Data regarding the fund's management company, including its name, address, telephone number and other contact information
- Names of the other funds managed by the same management company
- Data regarding the fund's supporting entities (custodian, registrar, external auditor and appraiser)
- Type of fund (open-type, interval or closed-ended)
- Characteristics of the fund's units or certificates (for example, whether a share is a security)
- Purpose of investment (income, growth or balanced)
- Information about the duration of the primary placement of the fund's shares and distinctive features of their pricing during that period
- Minimum (and maximum) value of the fund (if applicable)
- Procedure for making refunds to investors in the event that the fund fails to raise sufficient cash
- Operator's rights and obligations
- Investor's rights and obligations, including the right to take part in and vote at meetings (if granted)
- Investment declaration, including details about the types of assets to absorb investments, the proportions of investments to be made in different types of assets, borrowing policy and the policy of making loans out of the fund's assets (if at all permitted by the regulator)
- Amount of minimum investment
- Description of risks of investing in the fund and a set of related warnings
- Policy on dividend and other profit distributions
- Procedures for the acquisition and repurchase of units or certificates (if provided for in accordance with the type of fund)
- Share, unit or certificate valuation and pricing procedures, including the regularity of net asset value determinations, methods for making NAV determinations, NAV per share, and conditions for the collection of the initial mark-up upon an investor's purchase of a share and of the mark-down upon the repurchase of the investor's share
- Explanations regarding the media outlet/s publishing information about the fund, including its share prices, and the regularity of such disclosures
- Data regarding compensation payable to the operator and other supporting entities of the fund
- Data regarding the list and amounts of expenses which may be incurred at the expense of the fund's assets
- Conditions for suspending the repurchase and placement of the fund's units or certificates (if provided for in accordance with its type)

- Conditions under which the fund may be restructured or wound up, and related procedures

A fund's rules set forth the same data, though frequently in greater detail.

Most prospectuses are long documents. Quite frequently, they use terminology that is clear only to regulators, professionals and lawyers, but is not understandable or meaningful to most ordinary people. Experience demonstrates that despite warnings about the need to read the prospectus and even to sign a confirmation of being familiar with this document during the actual purchase, many investors fail to do so and enter into the proposed deal without having properly considered the contents of the prospectus. As a result, all too often they suffer unexpected and unwelcome consequences of investing in the particular fund. In order to limit the incidence of such disappointments, regulators have lately enabled operators to offer 'short form' prospectuses with concise and readily understandable wordings. A regulator may set requirements for the minimum of information to be contained in a short prospectus. During registration, the regulator will scan its contents to satisfy itself that this kind of synopsis meets applicable requirements and is consistent with the data to be found in the principal, long prospectus.

#### **b) Trusts**

Just like contractual funds, trust funds are not companies and they do not have staff, offices, etc as a company usually does; though trusts are arrangements recognized by law under which one person, the trustee, holds property for the benefit of another. A trust is based on a trust deed - an agreement between the operator and the trust. Just as the trustee plays the role of directors (who are non-existent in a trust), the trust deed replaces all of the foundation documents for this kind of fund. In the UK, during the registration (authorisation) of a trust fund, the FSA checks the documents.

#### **c) Corporate Funds**

Unlike contract funds and trust funds, corporate funds are independent companies. Just like contract funds and trusts, they can exist without any personnel or office, but they do have their own foundation documents, by-laws and directors, bear legal liability and pay corporate taxes (though possibly under special taxation arrangements established specially for funds). A corporate fund has a dual nature: on the one hand, it is a joint stock company subject to the Joint Stock Company Law generally and to the Securities Market Law when it comes to share offerings; on the other, it is a fund which is distinct from regular corporations and is governed by legislation that regulates investment funds.

The by-laws of a company intended as a fund should include the following provisions:

- Statement to the effect that the subject matter of the fund's activities will consist in investments and that any activities other than investments are prohibited
- Investment declaration specifying the types of assets to be purchased with investors' cash and the proportions of investments to go into different types of assets, as well as the fund's borrowing policy and its policy of providing loans out of its assets
- Data regarding the classes of shares existing in the fund or a ban on the issuance of shares of different classes that give unequal rights to investors
- If the fund is an open-type corporate fund, information to advise investors of the possibility of acquiring its assets, as well as requiring that the fund repurchase its assets, subject to no limitation

- If the fund is a closed-ended corporate fund, information about the number of shares issued, the possibility of acquiring them and the prohibition of the fund's repurchase of such shares or those circumstances under which such repurchases become possible
- Data concerning investor rights
- Data concerning annual meetings and decision-making procedures at such meetings
- Specifics regarding the fund's dividend policy or other income distributions
- Data concerning directors and their role
- Data regarding the fund's management company or, if the fund is managed by an individual manager, data regarding such individual
- Information about affiliates of the fund, of its directors and of its management company
- Information about the fund's supporting entities (custodian and/or trust, registrar, external auditor and appraiser)
- Information about the regularity and form of the fund's reporting
- Data concerning accounting procedures at the fund and calculations of its net asset value and NAV per share
- Specifics regarding the fund's restructuring and winding-up

In those jurisdictions where funds need to undergo licensing, the documents to be submitted for the purpose include the following:

- Foundation documents of the joint stock company
- Certificate of state registration
- Offering prospectus
- Contracts with the operator, custodian and other supporting entities
- Data confirming payment of the licence fee

The securities offerings and prospectuses of corporate funds must be registered with the supervisor. This is, of course, logical, as corporate funds are share issuers and place their shares by public subscription. Since these shares are distributed among an unlimited range of investors, the regulator tailors its requirements on the contents of documents under regulation so as to enable investors to have full information in order to make a balanced decision whether to buy offered shares. If a fund is an open-type one and issues an unlimited number of shares, their issuance is registered only once; if a fund is a closed ended fund, each new offering of securities should be accompanied by the registration of a relevant issue prospectus.

It is perfectly obvious that the prospectus of a corporate investment fund should meet such requirements on offering prospectuses as are made by regulators for all open-type joint stock companies. But it should also offer additional information to reflect the special nature or purposes of an investment fund. Just as in the case with contractual funds, regulators, as a rule, make specific requirements on the contents of corporate funds' prospectuses. The following can be deemed to be the main differences in which the prospectus of a corporate fund differs from that of a trust.

- Inclusion of data regarding the fund's state or company registration
- If the fund is a closed-ended one, information about the quantity and nominal value of shares issued, about the impossibility of acquiring or requiring that the fund repurchase an unlimited number of such shares, and about how the fund's shares can be purchased the initial offer or subsequently bought or sold on the secondary market
- Data about the listing of the fund's shares by exchanges and trading systems
- Detailed information about the fund's directors and their role

- Data concerning the procedure for holding investors' meetings, since most corporate funds arrange such meetings
- Description of investment risks and a set of related warnings

### 5.1.3. Licensing and Authorisation in Colombia and Recommendations

The market perceives each supervisor to have a different approach to licensing and authorisation. This difference is accounted for by the fact that the SV is a promotor of the market while the SB is its policeman. Unfortunately, due to time constraints, both the SB and the SV were unable to complete the analytical template on licensing and authorisation, so it has not been possible for us to conduct a detailed evaluation of the differences and similarities in their approach to this important process. Anecdotal evidence from market participants suggests that this is an area where both supervisors could improve: the worst case scenario for licensing/authorisation by the SB is up to 2 years, and up to 1 year by the SV. Both supervisors counter that delays are the result of incomplete dossiers and failure to supply additional information that may be requested in a timely manner. In the absence of solid data on the process, we can only recommend that there be a time limit of six months for licensing and authorisations, as is the case in the UK. The clock would only start to run once the required documentation was complete. If on expiry of the 6-month period approval had not been granted, then the application would be deemed to have failed.

With respect to requirements for licensing fund operators, since none of the three supporting elements of independent, highly capitalised custodians, investment management insurance products and investor compensation schemes are present in the Colombian market at this time, we would expect capital requirements for CIS operators to be quite strict. The imposition of an examination for those wishing to work in the CIS industry would help to raise professional standards and provide supervisors with a useful tool for establishing suitability to work in the profession. Internal controls have been dealt with in some detail in paragraph 3.6 above.

Recent problems have shown that supervisors in Colombia need to set some minimum specifications for IT systems appropriate for the CIS industry. It appears that some applications are far too easily manipulated, or give spurious answers to simple queries such as the number of investors in a fund. Ideally, IT systems for CIS operators should demonstrate the following characteristics:

- Capacity - the system has the capacity to handle existing and projected volumes without the danger of breakdown, which could put investors to inconvenience or risk
- Integrity -there are no weak spots within the architecture of the system, particularly, if, as is common, the system is an amalgamation of old and new elements
- Security -the system is secure from internal or external tampering - "cracking" or "hacking". This is increasingly relevant as internal systems are interfaced with thousands of external points of access through the Internet
- Robustness - the system has the ability to stand up to unexpected shocks, which may result from either system misuse or software or hardware failure
- Interfaces - the interfaces between an operator's system and those of outside systems, typically those at the custodian, third party administrator, registrar, broker/dealers, exchanges' price feeds, information providers and others, must be secure. Ideally, there should be firewalls to prevent contamination or the leakage of confidential information.

- Backup – there should be arrangements for thorough back up and off site safe keeping of key data on a regular basis
- Compliance –the system is conducive to good compliance and lends itself to audit or compliance trails

## 5.2. Off-site Inspection

Regulatory investment fund monitoring is a procedure which enables the supervisor to make sure that a fund and its service providers are complying with the legal and regulatory requirements applicable at the time of licensing, as well as with the other operational requirements, internal rules and procedures; and to detect violations or signs that may constitute the grounds for suspecting their occurrence. As a rule, monitoring entails in-house desk-based analysis of fund operations performed by the supervisor on the basis of such documents as may be provided by the relevant entity. There are usually three components to reporting to supervisors:

- Reports and accounts: these are similar to the financial reporting required of publicly traded companies. In the case of funds, these are usually required to be a half yearly unaudited report and a full year audited report. In developed markets, funds and their service providers set their own financial years which usually relate to the date of foundation of the entity but in some countries there is a mandatory financial year (eg to 31 December each year)
- Compliance reports: these are other reports which are specifically required by the regulator in relation to funds or their service providers: eg daily statements of portfolios and their net asset value and units in issue or quarterly compliance statements
- Notifications: this is the provision to the regulator of information concerning events, either prior to, or following, their occurrence – the categories of events which have to be notified are defined by the regulator but in general are events which change the basis on which the regulated entity was licenced

### International Example of Reporting: the UK

	INVESTMENT MANAGEMENT FIRM	CUSTODIAN	FUND
Daily net asset values and prices			Published
Annual audited accounts	Yes	Yes	Yes
Half-yearly unaudited accounts	No	No	Yes
Quarterly report on compliance as licensed entity	Yes	Yes	No
Clearance of events prior to occurrence	Yes	Yes	No
Notification of events upon occurrence	Yes	Yes	No

Compliance monitoring is performed on the basis of several types of information that are required to be submitted to the Regulator, such as:

- A fund’s registration documents, rules and prospectus
- A fund’s reports and accounts
- Licensing of fund operators and service providers
- Reports and accounts of the fund’s operator (or sponsor or investment manager) and other service providers (such as custodians)
- Information provided by the fund or its operators or service providers demonstrating their ongoing compliance with the conditions of their licence
- Information provided by the fund and its operators concerning such changes as may require the Regulator’s prior approval (known as ‘advance notification’)
- Information provided by the fund and its operators concerning such events as may require the Regulator’s notification after said events have occurred (known as ‘notification’)
- Advertising materials
- Additional information to be provided on the Regulator’s demand

Monitoring will also extend to reviewing other sources of information such as:

- the media (both ‘trade’ or industry specialist media and retail media) and their coverage of funds, operators and service providers;
- comments from competitors, who are a frequently a source of information and views on other operators, though it has to be accepted that their view is potentially biased in their own favour, and
- complaints which may alert the supervisor to analyse reports more carefully, or identify the need for an inspection.

Basing monitoring solely on submitted reports means that the supervisor does not see the reports in context: for instance, if there is a boom in ‘high tech’ stocks and funds investing in them are also performing well, this will prompt the supervisor who is aware of this to enquire why one particular fund is not doing so well. It may be that it has simply made a bad selection of stocks (which could imply lack of competence); or there may be very high charges levied, or there may be poor accounting, or manipulated valuations. If the supervisor is unaware of market developments, it will not be alert to indications of malpractice; which is its job.

Reporting requirements represent a cost to participants who must put in place the systems necessary to produce and submit the reports, as well as to the supervisor who must allocate resources to the administration and analysis of such reports. Consequently, in setting reporting requirements and the frequency of such reports, the supervisor should strive for a balance between the significance of the reports and the reporting costs borne by the regulated entities, and ultimately by investors. The following factors should be taken into consideration:

<b>Factor</b>	<b>Requires greater frequency of reporting</b>	<b>Requires lower frequency of reporting</b>
Status of Entity:	Newly licensed	Old, established operator
Type of Fund:	open-ended funds where units in fund can be bought daily	closed-end funds where shares are not bought and sold on a daily basis
Type of Report:	reports on items affecting investor protection, such as NAV,	reports on items where changes are infrequent, such as the managing

	movements in the fund's assets and exposure limits, as well as reports on items specifically related to the terms of the license, such as capital adequacy, the minimum number of investors and liquidity	company's personnel chart
Market Situation:	Market in crisis (frequency of reporting at supervisor's discretion)	Market not in crisis (normal reporting frequency)
Market maturity:	Fund operators are not used to the regulatory requirements and do not have sufficient experience in ensuring compliance therewith	Mature market operators working in a mature market
Supervisory Structure:	Other elements in the supervisory structure do not fulfil a supervisory role, or do not do so well	Other elements in the supervisory structure fulfil a supervisory role, e.g. the custodian and the external auditor
Supervisor's Resources and Practices	Excellent IT and sufficient human and financial resources	Poor IT and scarce human and financial resources (it is unsound to request reports that the supervisor does not have time to review)

A machine can make calculations, a checklist will guide staff through the established procedure, but only a knowledgeable and trained person can make conclusions. In order to draw conclusions, the links between various indices must be understood, and the correlation between various statements, also causes and effects. To achieve that, one has to be familiar with fund and management company operations, as well as the legal and regulatory framework governing its activities. To make successful conclusions, the entire picture of the fund's operations has to be kept in mind and not only individual elements or aspects. If this type of analysis is not performed, the result is a misallocation of the supervisor's resources, time and effort: the regulated entity wastes time and effort on the clarification and elimination of minor procedural violations, while serious offenses may remain undetected. There is no doubt that the supervisor should impose sanctions for carelessness, but this is not what monitoring is aimed at or limited to.

The principle of relevance or "materiality" should be the Regulator's guiding star – serious problems should take up more time and resources, and, respectively, minor problems should require less time and resources. To save time and effort without diminishing its efficiency, the Regulator can use sample monitoring and risk assessment techniques. Sample monitoring envisages a thorough analysis of reports presented by a limited number of companies and funds for every reporting period, rather than an intensive monitoring of all returns. Within an established period of time, for instance, within a year, each company or fund should be subjected to sample monitoring. The risk assessment technique is based on ascribing a certain risk ratio to a company or fund. This is a function of size of the fund and the number of investors, as well as the regular incidence of the following factors:

- Non-compliance with regulatory norms in the past
- Any past reporting problems
- Any significant changes in the fund's operation specified in the fund's rules or prospectus
- Change of management

- Significant fluctuations in the market where the fund's assets are invested
- Changes or lack of stability in the fund's parent or affiliated companies, operator and custodian
- Investors' complaints
- Warnings from other regulators
- Deviations of the analyzed data from the average sectoral indices

The higher the risk ratio, the more frequent and thorough monitoring procedures should be. Risk factors must be justified and specified in the Regulator's internal documents. It is inadmissible to determine risks exclusively on the basis of the Regulator's "gut feeling" or when knowledge of risks is stored in the mind of the most experienced specialist but remains a complete mystery for the rest of the staff. In this case all the monitoring and relating procedures would remain nontransparent, costly and inefficient.

### 5.2.1. Off-site Inspection in Colombia

Both the SB and the SV conduct off-site monitoring. Report formats are consistent within the supervisors, but not across them. The types of reports received and their frequency are described in the chart below:

REPORT	BANCARIA		VALORES	
	Frequency	Format	Frequency	Format
Financial Statements	Daily	Electronic	Monthly	Excel
Fund Valuation (NAV)	Daily	Electronic	Daily	Excel
NAV per unit	-	-	Daily	Excel
Number of investors	-	-	Daily	Excel
Movements in the Portfolio	Weekly	Diskette	Weekly	Excel
Portfolio Composition	Monthly	Diskette	Weekly	Excel
Reconciliation	Monthly	Paper	-	-
"repo" transactions	Monthly	Paper	-	-
Yield	Monthly	Paper	-	-
End of Year Accounts	Annually	Electronic	Annually	Excel

It is not clear whether the differences revealed in the table above are the result of the use of different terminology or if the two supervisors are really receiving different information. It is also uncertain whether the "electronic" format of the reports received by the SB is more advanced than that of the SV and so permits more sophisticated analysis through exception reporting. What is clear is that most of the information is submitted in a way that does not facilitate the easy manipulation of the data, rendering it virtually impossible for analysts to carry out such value-added analysis as peer-group comparisons or the use of indices. Such databases as exist will be incomplete unless someone is assigned to collate and input all the information received on paper, diskettes and Excel spreadsheets.

Furthermore, it has been drawn to our attention that there is a high error rate in the information submitted, although this is largely due to incomplete rather than inaccurate information. For example, 95% of reports submitted to the SV show some form of deficiency. This indicates that either the intermediaries do not understand the reporting requirements and need clearer explanations, or that they do not take them seriously. It is essential to solve

this problem, otherwise analysts will spend too much time filling in gaps and checking that figures add up, rather than analysing the data.

The first problem can be taken care of by reviewing and clarifying instructions, then presenting them at a workshop/seminar. The second problem is more difficult to solve. However, when faced with a similar problem with the submission of end-of-year financial results, the SB published a "list of shame" on its web-site, and this prompted a rapid correction of the problem! The use of compliance lists and ratings is becoming quite popular in emerging markets and is a useful, inexpensive tool for encouraging market participants to fulfill their obligations. Since the cost of non-compliance, which is higher than that of compliance, is ultimately borne by the investors, they should have the right to know how well investment management companies perform in this respect. Another solution is to fine offenders, but this will only work if the sanction process is agile and swift. The proposed hiring of a lawyer into the SV's CIS department should help to speed the sanction process up for this type of offence.

Another area of concern is the amount of work that is performed on the financial statements of the supervised entities. Both supervisors seem to be working as *de facto* auditors. While it is understandable that where auditing standards are weak there is a need for some sort of control to be exerted, it must be recognised that this is a major source of inefficiency for the lead supervisory entities. Although participants appreciate having the supervisor's stamp of approval on their accounts, they complain about the delays this can occasion. The problem seems to be particularly acute in respect of *Fondos Mutuos* who claim that their end-of-year reports are rarely approved before their annual meeting in March and that it can take up to five months to have quarterly accounts approved, thereby delaying distributions to investors. The fulfillment of these auditing tasks is diverting the lead supervisors from the supervisory tasks that only they are competent to perform.

It is worth remembering that intentional and habitual offenders do their best to submit immaculate regular reports; as a rule, they ensure that all the reports are presented on time, that they contain complete and seemingly authentic information. Swindlers generally have a very good idea of what the reports of an exemplary institution should look like, so they appropriately compile facts and figures. Serious and thoroughly planned offenses may only be detected during on-site inspections by demanding detailed additional information and making use of such evidence as may be provided by third parties.

### **5.2.2. Recommendations Relating to Off-site Inspection**

In interviews with market participants it was specifically mentioned that some operators are using repurchase (repo) transactions to hide problems in their portfolios, since through such operations fund managers can temporarily remove poor performing or devalued assets from their portfolios. It is therefore highly recommended that the SV, like the SB, require operators to report their repo transactions. The SB itself should ensure that it is making good use of the information it receives to identify sharp practices.

Since the number of resources are low in relation to the amount of information received, particularly in the SV where there is only one analyst to analyse the data received from 60 funds, much of which requires some form of manual manipulation or calculation, it is

strongly recommended to introduce sample reporting as described in paragraph 5.2. above. Another useful mechanism, which the Colombian supervisors should consider adopting, is the 'representation' report in which the regulated entity is required to state whether it has been in compliance throughout the reporting period by answering a series of questions 'yes' or 'no', with explanations required where the answer is negative. This would include statements that the entity has not undertaken activities that lie outside the terms of its licence, and ongoing capital adequacy, presence of qualified personnel, etc. Such representations must state the nature of any breaches that have occurred and action taken to rectify such breaches. These statements are "signed" (possibly electronically) as being accurate by a senior authorized signatory and must be approved by the board of the fund operator. This 'representation' formula can save regulatory time and effort and, as the basis of inspections, can identify whether the regulated entity has been honest and efficient in its representation statement, or not.

The SV is currently in the process of implementing a new IT system for off-site monitoring, which will greatly enhance efficiency. It may be too late for the SB to participate in the specification of the design of this system, but in order to ensure consistency of approach to supervision, it would be recommendable for the SB to implement the same system.

### **5.3. On-site Inspection**

The purpose of an inspection is to conduct a thorough examination of the business of a regulated entity to detect breaches and violations in order to ensure compliance and adequate investor protection. Inspections should be differentiated from investigations, which are not routine, but which are only undertaken when either routine monitoring or complaints or, more likely, an inspection or referral has uncovered matters which indicate problems of either a more serious or fundamental nature than mere technical breaches of regulations.

Inspection is designed to check that:

- Activities are consistent with regulation
- Activities are consistent with disclosure
- Internal systems of controls and compliance are effective

Inspections may be general or thematic. General inspections are a comprehensive and all embracing review that covers all aspects of the operator's business and its relationships with organisations to whom it delegates or sub-contracts certain tasks. Such an inspection will most likely be a result of the elapse of time since the last inspection, a time period during which rapid growth and dynamic change has created an environment that has put severe pressure on operators' systems and may have eroded the ability of the procedures and systems to ensure compliance. General inspections usually tie up a large team for a relatively long period of time. Thematic inspections are more targeted at a particular issue. Such an inspection may either use a current issue against which to measure industry compliance, such as E-commerce for example, or perhaps aim to test the response of a sample of operators to recent substantial regulatory changes - changes in valuation and pricing methodology for instance. Alternatively it may single out parts of one operator's system - where there have been continual late filings or persistent pricing errors for example. Another reason for a snap inspection may be a change of ownership of the CIS operator, which may have been bought by an organisation that has not previously had a track record in managing

CISs. A specifically targeted inspection should require a smaller team and can be completed much more quickly.

There is no standard answer to the question about how often inspections should be conducted. Plainly an unexpected and serious problem identified within a particular operator will give rise to an immediate inspection, regardless of when the last visit occurred. The programming of the routine inspection cycle depends on the amount of information filed with the regulator on a routine basis on the one hand, and the reliability of other parts of the supervisory structure and the efficiency of disclosure mechanisms on the other. In countries whose CIS industry is older and more established, the supervisor will require less voluminous and less frequent reporting and rely to a greater extent on inspections rather than by desk monitoring, since off-site inspection is unlikely to detect major misdemeanours.

The Netherlands, whose supervisory model is the closest to that of Colombia, conducts inspections annually. The SEC, which oversees in excess of 18,650 investment management companies, only conducts visits every 5 years. The UK uses a risk classification system (see Appendix 1) to determine which of its 1,160 investment management companies to visit, but the minimum is one visit every three years. Visits may be either scheduled or "surprise". The US's SEC will make both surprise and scheduled visits; so will the UK's FSA, though it will tend to give reasonable notice and is usually prepared to schedule a visit at a time which is suitable for the operator – for instance ensuring that key personnel, particularly compliance staff, are available. Clearly too much advance notice risks giving the operator time to dress up the business and to attempt to bury any skeletons, as is the case if the frequency of inspections is too regular and predictable.

Inspection teams should be made up of both staff whose regular jobs are desk monitoring and of those who perhaps specialise in inspections. Each will complement the others' skills, the desk monitoring specialists bringing deep and up to date knowledge of the business of a particular operator, and the inspection specialists their aptitude for on-site work. Apart from this, it provides variety and experience for those whose primary role is desk monitoring, a task which may become tediously repetitive over time. Since an assessment of the capability of an operator's system itself will form an important part of any inspection, nowadays most inspection teams will contain, or have access to the specialist services of, an IT expert.

The conduct of the inspection can usefully be divided into four phases:

1. Planning – time spent in gathering data, allocating staff resources and determining the purpose and structure of the work (for a list of information to consult, see Appendix 2)
2. The visit – time spent at the offices of the operator (for a sample workplan of an inspection visit, see Appendix 3)
3. Post visit review – further review of documents, analysis, discussion, writing the report and the inspection letter to be sent to the operator
4. Dealing with problems – response of the operator to the matters raised in the inspection letter, discussion of issues which have arisen with the operator, setting timetable for resolution of any problems

It is usual for the inspection to start with a meeting with senior management. It is desirable that the chief executive is present together with the head of compliance, and that the finance and personnel directors, and the heads of administration, sales and marketing and

investment, are all present or at least available. Plainly administrative matters need to be dealt with at the outset such as:

- Introductions to the inspection team and their respective functions and tasks
- Arrangements for providing office accommodation and services
- The likely duration of the visit
- The departments to be visited, the work to be carried out in each

From this, both sides can create an outline schedule and appropriate staff can be asked to arrange their agendas so as to be available at certain times and to have available appropriate and relevant records and files. There will then be a general discussion of the operator's business including:

- Organisation and business relationships - clear responsibilities at senior level for different aspects of the business; documented organisation chart
- Personnel policies and remuneration strategy
- Current sales climate
- New products
- Investment management and market topics
- Administration and accounting arrangements
- Internal procedures and controls
- Specific compliance arrangements such as procedural manuals and staff training

This meeting should enable at least the senior members of the inspection team to obtain a general impression of the attitudes of management to compliance and perhaps also to identify any areas of work which may help to pinpoint risks and problems. Further interviews will be conducted with more junior managers as the inspection progresses and the outcomes of these will provide a useful comparison between what actual day-to-day practice is and what senior management have described. The synthesis of these interviews with a detailed inspection and analysis of books and records will enable the inspection team to form a judgement on the present compliance, likely future compliance and risk of non-compliance of the operator. (For a list of records a supervisor would expect an investment management fund to keep, see Appendix 4.)

### **5.3.1. On-site Inspection in Colombia**

A detailed comparison between the on-site supervision procedures of the two inspection departments at the SB and that of the SV is presented in Appendix 5. There are several extremely positive comments to make about the way on-site inspections are conducted in Colombia:

- Visits may be planned or by surprise, although the SB prefers planned visits so that all the documentation they need will be ready for them to inspect when they arrive;
- Both general and thematic inspections are undertaken;
- A rudimentary regulatory risk assessment mechanism is in place to determine the priority for visits;
- The visits are organised according to the four phases of planning, visit, report submission and follow-up described above;
- A vast array of information from various sources is consulted during the planning phase;

- Work plans for the inspections are drawn up;
- Visits are conducted in teams, so that the "four eyes" principle is respected;
- Each team will have at least one portable computer between them, so that the confidentiality of their work is safeguarded;
- The SB at least has access to IT specialists;
- The SB inspections teams for trust companies normally include off-site analysts as well as full-time off-site inspectors;
- SB inspectors of trust companies hold a kick-off meeting similar to the one described in paragraph 5.3. above, and
- Both supervisors have the basis for a good methodology for examining internal controls, risk measurement mechanisms and money laundering.

The following aspects of on-site inspection could be improved:

- The risk system should be formalised and harmonised across the three inspection groups. As well as a participant's financial indicators and past compliance record, it should be weighted towards larger funds and/or those with a large number of investors, as the impact of problems in such funds is likely to be greater.
- Due to the shortage of resources, follow-up visits to ensure problems detected have been put right are rare. Usually, this has to wait until the firm comes due for its next routine inspection in two years' time.
- Standards for the inspection of IT systems need to be developed and implemented.
- Best practices need to be shared between the three inspection teams, including the composition of inspection teams (i.e., including an IT expert and off-site analysts on the team) and the holding of an informative kick-off meeting with senior management of the entity under review.
- A uniform approach to the examination of internal controls and risk mechanisms needs to be developed, combining the best features of the SB's and the SV's respective methodologies.
- All inspection teams need to enhance their understanding of the sources and measurement of operational risk. (The most common examples of operational risk are listed in Appendix 6.)
- Portfolios should be subjected to much more thorough analysis to detect the types of trading abuses listed in Appendix 7 and manipulation practices listed in Appendix 8.

### 5.3.2. Recommendations Relating to On-site Inspection

The most important recommendation is for the SB and SV to unify their inspection techniques. This they may either do by selecting the best practices from their current methodologies to achieve a middle or common ground, or alternatively by adopting the methodology of another country. To achieve the former and to harmonise inspection styles further, joint-inspections with teams consisting of members of staff from both the SB and the SV, are recommended. Although a previous attempt to conduct a joint-inspection failed (because the host inspectors did not inform the guest inspectors of the identity of the entity to be inspected ahead of time, or provide them with the relevant documentation), the SB and SV are strongly encouraged to make another attempt at this initiative. Lessons should be learned from the previous exercise, and this time the "guest" inspectors should be given sufficient time and material to prepare.

Should the SB and SV choose the second alternative and seek to adopt the practices of

another country, they could emulate the Comisión Nacional Bancaria y de Valores (CNBV) of Mexico, which in our judgement is one of the principal sources of best practices for emerging markets in Latin America. Specifically, their "MACRO" methodology could be of interest to supervisors in Colombia. "MACRO" evaluates the:

- "*Manejo de fondos*" (the management of funds);
- "*Adecuación de capital*" (capital adequacy);
- "*Calidad de activos*" (quality of assets);
- "*Rentabilidad*" (profitability), and
- "*Organización*" (organisation).

The methodology attempts to integrate these elements in on-site visits as well as in routine off-site inspection of financial intermediaries. As it is based on the risks that intermediaries face, rather than in the functions they undertake, MACRO places an emphasis on the prevention of problems.

Given the major gaps in the supervisory structure and the poor quality of information provided for off-site inspection, the SB and SV should aim for an inspection cycle of one year. This could be relaxed in the medium-term once other aspects of the supervisory structure had been established or upgraded. This would entail the hiring of more inspectors for both the SV and the trust inspection department of the SB, or alternatively the reduction of staff in areas such as legal control and "trámites" in favour of the inspection team. For the SV it is particularly important to include an IT specialist in the inspection team.

Furthermore, where staff of the monitoring and inspections departments are assigned responsibility for a group of operators, or even, in the case of a major operator, one operator alone, it is recommended that these responsibilities are regularly rotated. Extreme familiarity can not only breed blindness to repetitive errors and breaches but can also create an excessively symbiotic relationship, even without any suggestion of corruption, between the regulator's staff member and the operator's equivalent staff, usually the compliance department. Rotation too can offer staff fresh interests and new challenges, and the opportunity for promotion. All of these are important considerations in the constant struggle to attract and retain high quality staff in a regulator, whose pay scales are likely to be lower than those of the commercial financial services sector.

## 6. TRAINING

A well-established training programme is necessary if the supervisor is to be able to carry out its regulatory responsibilities effectively. Training is particularly important if the CIS industry is growing rapidly. This will require regulators to expand their staff rapidly, and train new entrants quickly, to keep up with the extra workloads. Training is particularly important in the development of effective inspection teams. Not only do the team members require detailed knowledge of the rules and regulations that govern the operation of CIS, but also of the practical operations of the financial sector and the CIS business in particular. Mere knowledge of the letter of the rules is likely to be insufficient to make a good inspector. While routine desk monitoring is largely a mechanical operation involving the analysis of objective data and the calculation of ratios, much of which can now be done automatically, an inspection will require not only the wider knowledge referred to above but an ability to get on with and understand people and to 'read between the lines'. Thus while training for desk monitoring may be carried out in the classroom, much of the training that will make a good inspector will need to be in the field, under the guidance of an experienced campaigner. Training should be as broad as possible, so that staff can understand the wider context within which CIS operate, as one part of a financial market. Otherwise there is a danger that staff will become mere box-ticking bureaucrats.

### 6.1. Training Needs Analysis

The SB has its own internal training department, but training is oriented to the supervision of credit institutions and has not yet been adapted to take into account the supervision of the CIS industry. Most internal training therefore takes the form of seminars given by a member of staff who is expert in a particular subject. This is also the principal source of training at the SV. High potential staff may be sent on training courses abroad, such as to the SEC for example, but this is rare.

From discussions with the supervisors and participants, it became clear that there is a need for general training, as well as for specific training related to the regulatory changes proposed as a result of this project. To assess these needs, a needs assessment matrix was created and distributed to the Ministry of Finance, the SB and the SV. Unfortunately, only the Ministry of Finance and the SV were able to complete the matrix, so the assessment only reflects their needs. Their designation of priorities is almost identical, but where it differs this has been signalled with an "SV" or an "MF" (for Ministry of Finance). The first part of the table refers to general needs, and the second part to specific topics which have arisen in the course of discussion.

N°	I. GENERAL TOPICS	Number of People	Priority?		
			High	Medium	Low
<b>1. The Development of the Collective Investment Industry</b>					
1.1.	An overview of the current international situation and future trends	16	*		
1.2.	Legal and operational structures	16	*		
1.3.	Roles and Responsibilities	14	*		
1.4.	Corporate Governance and Conflicts of Interest	16	*		



<b>7. Self-regulation</b>					
	The role of self-regulation in the regulation and supervision of the CIS industry, and models which could be emulated in Colombia	14		*	
<b>8. The Supervision of Financial Conglomerates</b>					
	The identification and supervision of connected transactions vinculadas through the cooperation between the various supervisory entities	16	*MF	*SV	
<b>9. Liquidation</b>					
	The process of liquidation of a CIS and the role fo the supervisor	14		*	
<b>10. Public Relations</b>					
	The instigation of a publicity campaign to promote a more sophisticated financial press, build investor awareness and elevate the reputation of the supervisors	14		*	

The SV would like the training to cover as many themes as possible, and where it is not possible to give training in the time available, then for Cadogan Financial to develop and leave behind material that permits them to continue to study the topics internally. Clearly, this is not going to be possible given the scope of the project and the time remaining. The second visit is scheduled to last only one week and most of the intervening time will be consumed with drafting regulations and the development of new procedures. Besides, training related to the topics listed in part two of the table is highly specific to Colombia and cannot really be developed until the new regulations are accepted. Furthermore, given the absence of a response from the SB, at this point it is not possible for us to state exactly what the training will consist of or how many people will attend. That task will have to be held over to the second phase of the project.

## Appendix 1

### Regulatory Risk Assessment in the UK

The UK's Financial Services Authority assesses regulatory risk by using two sets of factors:

#### 1. Impact factors

These factors aim to quantify the effect that serious problems at or the collapse of a particular firm might have:

- The impact on the financial industry as a whole – the ripple effect of a collapse
- Perceived importance of the firm – effect on public confidence of the collapse of a well-known name
- Retail customer base – number and nature of customers
- Availability of compensation or redress for consumer loss

#### 2. Probability factors

These factors fall into three categories:

*Business risk* - The risk arising from the underlying nature of the industry, the external context, the firm's decisions and strategy:

- Capital adequacy – the ability to absorb volatility or losses
- Volatility of assets – risk to portfolio of assets
- Volatility of earnings – cyclical nature of profits
- Strategy – changes in business and sustainability of earnings

*Control risk* - The risk that a firm cannot or will not assess, understand and respond to the risks it faces:

- Internal systems and controls – information flow, decision making, risk management
- Board management and staff – skill, competence and fitness
- Compliance culture – adherence to internal procedures and compliance record

*Customer relationship risk* - The risk that a firm will cause damage to consumers by failing to provide suitable products and services:

- Nature of customers and products – mismatch between nature of product and customer sophistication
- Marketing, selling and advice practices – sales force incentives and controls

The overall risk factor results from an amalgamation of the two:

Priority for inspection = impact of potential problems x probability of occurrence

Appendix 2

Information to be Gathered Prior to an Inspection

<i>Area</i>	<i>Data required</i>
Size of operator's business	<p>Ownership structure of the operator</p> <p>Latest balance sheet and profit and loss accounts</p> <p>Capital adequacy calculation</p> <p>Family tree of all group companies and their associates outlining the principle activities of the companies</p> <p>Number, names and values of all CISs managed</p> <p>Details of CISs launched or acquired since last inspection</p> <p>Known problems regarding launches or acquisitions</p> <p>CISs merged, liquidated or disposed of since last inspection</p> <p>Known problems regarding mergers or disposals</p> <p>Any CIS changed names or investment objectives since last review</p> <p>Significant holders &gt; 10% of fund value</p>
Custodian/trustee	<p>Custodian for each fund</p> <p>Any changes in custodian and reasons</p> <p>Details of results of last inspection visit to custodian (if the custodian, as part of a bank, is supervised by the banking regulator, it would be useful to have a report from that regulator)</p> <p>Any criticism or qualifications of the operator's conduct by custodian received by regulator (the extent of this will depend on the degree of supervisory responsibility that the custodian is required to undertake)</p> <p>Results of any monitoring activity of the operator undertaken by the custodian</p>
Auditor	<p>Auditor for each CIS</p> <p>Changes in auditor and why</p> <p>Latest quarterly, half yearly and annual reports for each CIS</p> <p>Changes in accounting year ends and reasons (extensions to an accounting period may be to delay the acknowledgement/identification of problems)</p> <p>Is the auditor independent</p> <p>Is the auditor of the CISs the same as the auditor of the operator</p> <p>Auditor's report qualifications of either the CISs, the operator or the custodian</p>
Investment	<p>Does the operator undertake its own investment management?</p> <p>Structure of investment management department, names of individual managers and responsibilities</p> <p>Investment decision making process, responsibilities, procedures and controls</p> <p>Dealing process, and arrangements for dealing by staff</p> <p>Names of any third parties to whom investment advice or discretionary management for all or part of the CIS portfolios is</p>

	<p>delegated</p> <p>Agreements with delegated advisers</p> <p>Availability of and access to information held by any third parties or sub-advisers</p> <p>Operator's monitoring of delegated activities</p> <p>Rules and prospectus of all CISs</p>
Delegated administration	<p>Delegated functions</p> <p>Taking sales and redemption orders and dealing in CIS shares</p> <p>Registration of CIS shares</p> <p>Portfolio and investment accounting</p> <p>Settlement of portfolio transactions</p> <p>Pricing</p> <p>Distributions of dividends to investors</p> <p>Other record keeping functions</p> <p>Operation of delegated functions</p> <p>Schematic or flow chart outlining various functions by entity</p> <p>Written contracts in place between manager and delegates</p> <p>Monitoring undertaken by the manager of delegated functions</p>
Investment results and performance	<p>Obtain performance statistics from operator or from specialist supplier</p> <p>To what is performance attributable according to the operator</p> <p>How does performance compare to the performance of CISs with similar objectives</p> <p>Review latest trust reports critically and compare with operator's comments on performance</p> <p>Consider whether good or bad performance is spread equally across all CISs managed or whether there are notable exceptions</p>
Disclosure to investors	<p>Are reports made available to all investors in a correct and timely way?</p> <p>Is all the required information made available?</p> <p>Where are prices of CIS shares normally published?</p> <p>Are prices published regularly and in timely fashion?</p>
Marketing and sales	<p>Distribution and sales</p> <p>Direct advertising or internet</p> <p>Sales force</p> <p>Independent advisers</p> <p>Current list of sales agents Figures for sales and redemptions for each CIS</p> <p>Significant changes in pattern</p> <p>Copies of recent advertising and promotional literature</p> <p>Customer complaints</p>
Internal controls	<p>Name of compliance officer and time in job</p> <p>Size and responsibilities of compliance department</p> <p>Internal procedural manuals</p>

	Any unresolved problems on file Past enforcement and disciplinary action
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## Appendix 3

### Sample Workplan for an Inspection Visit

The plan divides the activities up logically into operational areas, shown in column 1. The potential problems to be found are shown in column 2. The work undertaken in order to find out whether problems exist is shown in column 3. The source of the information is shown in column 4.

<i>1 Operational area</i>	<i>2 Risks and problems</i>	<i>3 Action/verification</i>	<i>4 Source</i>
Advertising and marketing	Incomplete or misleading information in prospectus  Prospectus out of date  Advertisements and marketing material do not contain statutory information and disclaimers  Incomplete records of all advertisements and marketing material	Sample recent prospectuses  Check sample of advertisements and marketing material	Prospectus  Brochures  Advertisements  Website
Investment portfolio and valuation	Portfolio is in line with the stated objectives of the CIS  Only permitted assets are included Investment limits are not exceeded Outstanding transactions recorded Cash reconciliation Accruals of income and expenses Borrowing limits not exceeded  Correct prices used  Market rates of interest being achieved	Check portfolio against prospectus  Sample portfolios over a previous period  Check price used against market price  Check market rates	Prospectus  Valuation and investment records  Valuation records and exchange archives Income records and market data
Investment transactions	Churning  Other types of misuse of the portfolio	Calculate portfolio turnover ratios  Check transactions by affiliates and staff	Investment records  Dealing records

	<p>Not best execution</p> <p>Concentration of business through few brokers</p> <p>Soft commissions</p>	<p>Sample contract notes, market prices, and commission charges</p> <p>Analysis of dealing</p> <p>Hard to detect</p>	<p>Contract records and exchange archives</p> <p>Dealing records</p> <p>Operator's own accounts</p>
Pricing	<p>Ensure that valuations and pricing are carried out with the appropriate frequency</p> <p>Ensure that the operator is only dealing on the right basis - historic or forward</p> <p>Is price correctly calculated and mathematically correct?</p>	<p>Check fund rules or prospectus</p> <p>Sample prices</p>	<p>Prospectus</p> <p>Published prices</p>
Dealing	<p>Deals entered by agents were only by authorised agents</p> <p>Was advice given to the customer? Is it permitted to give such advice?</p> <p>There is evidence that a customer received a prospectus</p> <p>Specific investor rights have been observed (right to cool off for example)</p> <p>Ensure that all deals received prior to the valuation point have been processed.</p>	<p>Check name of agent</p> <p>Regulations</p> <p>Check customer records for application forms</p> <p>Check dealers records against shares created</p>	<p>Register of accredited agents</p> <p>Voice records</p> <p>Speak to sample of customers</p> <p>Dealing records against creations and liquidations</p>
Issue	<p>Is a contract or advice sent out promptly?</p> <p>Are details for registration required and when are they received?</p> <p>Is prepayment required and has it been received?</p> <p>Are shares of the CIS sold on credit?</p> <p>Are there long outstanding</p>	<p>Check sample of transactions</p>	<p>Dealing records</p> <p>Cash book/Bank records</p>

	examples of non-payment? Procedure for cancelling a transaction if payment is not received.		
Redemption	Establish what proof of title the operator requires prior to making payment for units redeemed. Has proof of title been received in correct for on every occasion? Is contract or advice sent out promptly? Ensure that proceeds of redemption are remitted on a timely basis.	Check sample of transactions	Dealing records/Bank records
Affiliated transactions	Ensure that no deals are back dated i.e. made after a valuation point; particularly look at purchases by associated or intra group entities Are there any "special" prices used - i.e. not the regular price of the day	Check all transactions with affiliated persons  Check prices of all deals on a sample of days	Records of owners and affiliates Dealing records
Registration	Establish time lapse between completion of transaction and entering or deleting the name of the investor on or from the register. If certificates are required, are these sent out on time? If non-certificated or dematerialise register, what notification is there of ownership? Reconciliation of total number of shares outstanding according to the register with the figure used to calculate the CIS share price	Check samples of transactions from order to completion	Register Valuation Schedules
Charges and expenses	Are total charges within the limits set out in the fund rules and the prospectus? Are charges being accrued correctly? Is there any attempt to use	Check CIS rules/ trust deed and prospectus	Prospectus CIS accounts Reports

	<p>delayed or temporarily reduced charges to improve performance?</p> <p>Is the initial charge correctly applied? Are there any special discounts or concessions?</p> <p>Are commissions paid to sales agents in line with stated policy?</p> <p>Are there any additional commissions or other inducements paid?</p>		
Reports and dividends	<p>Do reports to shareholders contain all relevant information?</p> <p>Is the information contained in them accurate?</p> <p>Are reports sent out within the time allowed after the end of an accounting period?</p> <p>If, dividends are paid, are they paid equally to all shareholders and in a timely fashion?</p>	<p>Check a sample of CIS reports</p> <p>Check timing of despatch</p> <p>Check dividend amount and despatch</p>	<p>Reports</p> <p>Postal records</p> <p>Sample shareholders</p> <p>Bank records</p>

## Appendix 4

### Records to be Kept

The following tables show the specific records that a regulator will usually require an operator (or his sub contractors or the organisations to whom he has delegated certain duties) to keep. The inspection team will need to check the availability, integrity and accuracy of these records.

<i>Item</i>	<i>Record to be kept</i>
Employees	<p>If the employee needs to be registered with the regulator, then records showing that such notification was made must be kept</p> <p>The employment details of all senior managers and employees (defined as those who are required to take the qualification examination of the regulator at any level) must be kept up to date</p> <p>The record must show relevant examination qualifications and the date passed or any previous qualification that is accepted as a substitute.</p> <p>The record of any employee in the above category who leaves or is dismissed must contain the reason for the departure or dismissal</p>
Sales agents or distributors	<p>A full list of accredited sales agents or distributors must be maintained together with copies of the contracts made with each</p> <p>Any correspondence with that sales agent or distributor which relates to his performance under the contract must be kept</p> <p>Any sales agent or distributor who ceases to be an accredited sales agent or distributor for any reason and reasons for the cessation must be noted</p> <p>Full details of all transactions with each sales agent or distributor must be capable of being available separately, including:</p> <ul style="list-style-type: none"> <li>• The names of the share holders for whom he has acted</li> <li>• The designation of the CIS(s) he has bought or sold for each</li> <li>• The total amount of transactions he has done for each</li> <li>• The commissions that he has received</li> </ul>
Personal dealings	<p>All personal dealings by any director, manager or member of staff must be recorded according to the same rules as deals done for the CIS and kept in a special file or record</p>
Internal audit and compliance	<p>The internal audit department will be responsible for keeping full records of:</p> <ul style="list-style-type: none"> <li>• All personnel who need to be qualified - including:</li> <li>• Employment record</li> <li>• Any misdemeanours</li> <li>• All internal investigations and audits and their findings</li> <li>• Records of all cases where compliance with the legislation and regulations of the regulator was not observed</li> <li>• Action taken to ensure compliance</li> <li>• Records of all communications with the regulator, including:</li> <li>• All regular reports which are required by the regulations</li> </ul>

	<ul style="list-style-type: none"> <li>• Whether those reports were submitted on time</li> <li>• Whether any comments were received from the regulator</li> <li>• What action was taken as a result</li> <li>• Reporting to regulator and inspections</li> <li>• Responsibility to ensure that all records are available to the regulator</li> <li>• All records to be sent to regulator on request</li> <li>• Complaints</li> <li>• Maintenance of records [see later]</li> </ul>
Prospectus, Advertising, Marketing, Reports	<p>Copies of all the following must be kept:</p> <ul style="list-style-type: none"> <li>• All prospectus and associated documents</li> <li>• Advertisements in written, broadcast or electronic form</li> <li>• Brochures, handouts, posters</li> <li>• Direct mail letters</li> <li>• All reports and other statutory communications with share holders</li> </ul> <p>Records must be kept of all the media in which the above appeared, where relevant, with dates; for posted or otherwise disseminated papers a record of the date sent out must be kept.</p>
Shares or certificates of the CIS	<ul style="list-style-type: none"> <li>• Records of all new issues of shares or certificates</li> <li>• Details of the issue</li> <li>• Name and address of subscriber</li> <li>• Date</li> <li>• Number of shares or certificates</li> <li>• Prices</li> <li>• Charges</li> <li>• Name of sales agent or distributor (if any)</li> <li>• Commissions paid</li> <li>• Total consideration</li> <li>• Date of conclusion of deal</li> </ul> <p>Records of payments received and made related to each contract</p> <ul style="list-style-type: none"> <li>• Date received and from whom</li> <li>• Date paid into CIS account</li> <li>• Date paid and to whom</li> <li>• Date deducted from CIS account</li> </ul>
Purchase and sales of assets for the portfolio of the CIS	<p>All movements of money into and out of the CIS, related to the specific transaction to which the payments and receipts refer</p> <ul style="list-style-type: none"> <li>• In respect of money received from new issues of shares</li> <li>• In respect of money paid out for redemptions of shares (if relevant)</li> <li>• In respect of money paid to the market or to brokers for purchases of assets</li> <li>• In respect of money received from the market or brokers from sales of assets for the CIS</li> <li>• All transactions for the purchase or sale of assets should be recorded the time the order is placed with the management company's dealer with a record of any special authorisation if required or special instructions to the broker; the record should show: <ul style="list-style-type: none"> <li>• The name of the CIS or other client for whom the order is being</li> </ul> </li> </ul>

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	<p>placed</p> <ul style="list-style-type: none"> <li>• The number of securities in question</li> <li>• The time that the order was placed</li> </ul> <p>At the time the broker reports the transaction is done; the record should show:</p> <ul style="list-style-type: none"> <li>• The name of the CIS or other client for whom the order has been transacted</li> <li>• The number of securities in question - with a note if the order is partially completed</li> <li>• The time of receipt of notification</li> </ul> <p>By keeping the contract with the broker on file</p> <ul style="list-style-type: none"> <li>• At the time that the record of ownership is received or released by the depositary bank</li> <li>• Any errors or subsequent changes or modifications to transactions should be recorded</li> </ul>
Investments - capital account	<p>All investments must be accounted for in a way which shows:</p> <ul style="list-style-type: none"> <li>• The amount and price of each asset purchased and sold</li> <li>• The total cost including commissions and charges added to or deducted from the market price</li> <li>• Subsequent sales and purchases of the same asset</li> <li>• The price(s) at which these subsequent transactions were done</li> <li>• Capital actions</li> </ul> <p>Any action by the issuer which changes the nature, number or value of the asset (rights and scrip issues, capital reductions, changes in nominal value, change of name, take-overs or mergers, bankruptcy or liquidation) must be recorded showing:</p> <ul style="list-style-type: none"> <li>• The type of action</li> <li>• The date it became effective</li> <li>• The result in terms of the change in value or amount</li> </ul>
Investments - income account	<p>Income and interest should show</p> <ul style="list-style-type: none"> <li>• The type</li> <li>• The name of the payer</li> <li>• The source</li> <li>• The date of receipt</li> <li>• The rate (coupon or dividend)</li> <li>• The amount</li> <li>• Tax deducted and rate</li> </ul>
Borrowing	<p>Borrowing (if permitted at all)</p> <ul style="list-style-type: none"> <li>• The amount of the borrowing</li> <li>• Details of the permission received from the regulator</li> <li>• The purpose</li> <li>• Any security given - details</li> <li>• The name of the lender</li> <li>• The date of repayment</li> <li>• The rate of interest</li> <li>• Any special conditions</li> </ul>
Calculation of net asset value	<p>All records relating to the calculation of net asset value should be kept including:</p> <ul style="list-style-type: none"> <li>• The number of shares or bonds or other asset, or in the case of</li> </ul>

	<p>real estate the precise name and location of each property on which the calculation is based</p> <ul style="list-style-type: none"> <li>• The prices for each asset and the source of the price</li> <li>• The form showing the calculation which is submitted to the regulator</li> <li>• Any verification of the calculation received from the custodian</li> <li>• Any comments made by the verifier</li> <li>• Any notification of errors identified by the verifier or the regulator must be recorded and kept</li> </ul>
Calculation of CIS share price for issue and redemption	<ul style="list-style-type: none"> <li>• The net asset value calculation and date on which it was done</li> <li>• Whether used as a historic or forward price</li> <li>• The number of shares in issue which was used for the purposes of the calculation</li> <li>• The charges - initial or redemption - which were added or subtracted from the price</li> <li>• The form showing the calculation which was submitted for verification and submission to the regulator</li> <li>• The evidence of publication and dissemination of the price</li> </ul>
Registration of CIS shareholders	<p>The register of share holders must be kept up to date and available for inspection in paper or electronic form; each record should show:</p> <ul style="list-style-type: none"> <li>• The name and current (if known) address of the share holder, customer number, social security or other identifying number</li> <li>• The number of shares held</li> <li>• When the shares were purchased</li> <li>• The name of the sales agent or distributor (if any)</li> <li>• Any special instructions or prohibitions on the account (units pledged, subject to bankruptcy proceedings, subject to criminal investigation, pending transfer on death of holder)</li> <li>• The record of each individual transaction across the register must be kept which will show: <ul style="list-style-type: none"> <li>• The nature of each transaction (purchase, sale, other transfer)</li> <li>• The name of each purchaser or seller</li> <li>• The date on which the transaction was completed</li> <li>• The number of shares in question</li> <li>• The name of the sales agent or distributor (if any)</li> </ul> </li> </ul>
Custodian	<p>A complete list of all the assets held including:</p> <ul style="list-style-type: none"> <li>• The name in which they are held</li> <li>• The CIS or other client for whom they are held</li> <li>• Details of any sub custodian agreement in respect of each asset</li> <li>• The number or amount of the asset in question</li> <li>• The date purchased</li> <li>• The price(s) at which the assets were purchased</li> <li>• The location of the physical proof of ownership (bearer or registered certificate, advice, account, register entry, title deed etc.)</li> <li>• Any special characteristics (pledged, subject to bankruptcy proceedings, subject to criminal investigation, pending transfer on death of holder)</li> </ul> <p>The list must be capable of being analysed</p>

	<ul style="list-style-type: none"> <li>• By asset</li> <li>• By CIS or other client</li> <li>• A record of all transactions including: <ul style="list-style-type: none"> <li>• The name of the asset or</li> <li>• The amount of money</li> <li>• The nature of the transaction</li> <li>• The authorisation and date of authorisation for carrying out the transaction</li> </ul> </li> <li>• Evidence of completion of the transaction (receipt, acknowledgement, bank statement)</li> <li>• Deletion or addition of the asset to the list</li> <li>• Net asset value and price calculation</li> <li>• If the custodian is responsible the list is as ] above</li> <li>• If the operator is responsible the evidence of checking and verification, and copies of any notifications sent to the operator confirming correctness or errors</li> </ul>
Safe keeping	<ul style="list-style-type: none"> <li>• The location of all assets must be recorded</li> <li>• The authority by which these assets may be moved or transferred must be noted</li> <li>• Evidence and records of periodic checks and verification of the existence of the assets, either by the specialised depositary or the statutory auditor, must be retained</li> </ul>
Customer complaints	<p>A complete record of all complaints received must be kept as follows:</p> <ul style="list-style-type: none"> <li>• Nature of complaint</li> <li>• Identity of complainant</li> <li>• Date received</li> <li>• Action taken</li> <li>• Reported to regulator</li> </ul> <p>This record must be made available for periodic inspection by the regulator and the auditor.</p>

Comment [MSG2]: [Show reference](#)

Appendix 5

COMPARISON OF INSPECTIONS CONDUCTED BY  
SUPERINTENDENCIA BANCARIA AND THE SUPERINTENDENCIA DE VALORES

INSTITUTIONAL SUPPORTS	BANCARIA "Individual Savings" Yes, Partial or No?	BANCARIA "Trusts" Yes, Partial or No?	VALORES Yes, Partial or No?
Is there a risk ranking to determine who to visit (more often)?	Yes, informal	Yes, formal. It consists of an inventory of indicators which are subjected to a calculation that results in a ranking. The indicators include the chart of accounts, compliance with valuation standards, compliance with limits and the trend of profitability.	Partial - there is an incipient system based on investor protection. It consists of a table of the degree of non-compliance.
Is there an annual visit programme?	Yes	Yes	Yes
Is there a guide to the conduct and logistics of a visit, and the report to be produced?	Yes	Partial - it exists, but not in written form	Yes
Are there detailed procedures for the conduct of a visit?	Yes	Yes, they are written in the work programme	Yes
Is there an inspection manual?	Partial	Partial: it dates from 1996 and is focused on credit institutions. They are updating and adapting it to CIS institutions.	Partial: as yet it does not cover all the processes in detail
Is there a list of document to request and consult in the planning and execution of an inspection visit?	Yes	Yes	Yes
Do the inspectors have their own portable computers?	They share 2 portable computers among the; they request access to the Internet, a printer, etc. from the client	Half of them have portable computers; they request access to the Internet, a printer, etc. from the client	There is one personal computer per team. (Each team consists of 3 professionals.)
What evidence of credentials do	Identity card + a letter from the	Identity card + a letter from the	A letter from the Superintendente

they give to the subject inspection?	Delegada	Delegada (the letter gets the visit underway)	
<b>VISIT PLANNING</b>	<b>BANCARIA "Individual Savings" Yes, Partial or No?</b>	<b>BANCARIA "Trusts" Yes, Partial or No?</b>	<b>VALORES Yes, Partial or No?</b>
Review standing information	Yes	Yes	Yes
Review historical performance – latest accounts, personnel and responsibility, etc.	Yes	Yes	Yes
Review previous visit reports	Yes	Yes	Yes
Define the reason for the visit – routine or specific	Yes	Yes	Yes
Define the objective of the visit	Yes, general or specific	Yes, they decide what aspects they are going to examine: assets / liabilities / patrimony / operations, etc.	Yes, general or specific
Draw up an action plan for the visit	Yes	Yes, including the submission of preliminary reports – internal qualitative and quantitative reports at the end of each week during the visit, and an external report about areas of non-compliance one week after the visit.	Yes
<b>ITEMS ASSESSED</b>	<b>BANCARIA "Individual Savings" Yes, Partial or No?</b>	<b>BANCARIA "Trusts" Yes, Partial or No?</b>	<b>VALORES Yes, Partial or No?</b>
<i>Capital Requirements and Investors</i>			
Check calculation	off-site	off-site – every month they verify minimum capital, solvency margin and requirements to administer assets of the social security system	on-site and off-site (to check that the information submitted for off-site inspection purposes is a true reflection of the real situation)
Verify securities and bank accounts	on and off-site: compare with bank accounts and with DECEVAL	On and off-site: compare with bank accounts and with DECEVAL. The majority of trust	on-site, because they do not have an on-line connection with DECEVAL and the reports are

		companies hold their accounts at their parent bank and the SB checks that the bank does not give them more favourable treatment than other clients. They would be worried if there was a concentration of the liquidity of the trust funds in the parent bank. They receive a banking reconciliation every month which they look at off-site, while on-site they conduct a detailed reconciliation.	paper-based (until March 2004)
Verify the size of the fund	off-site: daily, they check operations with accounting	off-site and on-site: the check if the real situation squares with the information sent by electronic means.	off-site (daily) and on-site
Verify minimum capital / solvency margin	off-site (but only for pension funds because they are open-ended)	off-site (but only for FCOs because they are open-ended)	off-site and on-site for open-ended funds. The SV's "own capital : assets under management" ratio is stricter than that of the SB.
Verify minimum number of investors	Not applicable	on-site (minimum = 20) The funds have the obligation to send this information to the SB	off-site and on-site (for open-ended funds there is a minimum of 10 investors, and for the rest, 5.)
<b><i>Dealing, Issue and Redemption</i></b>			
Timely execution	on-site	on-site	on-site
Correct price	on-site	off-site (daily, by automatic calculation) and on-site (although the fact that participations in trusts cannot be transferred in the secondary market should be taken into account; participants have to deal directly with the trust)	on-site (off-site too once the SV's new system is in place)
Contract	on-site	on-site	on-site
Payment/certificate	on-site	on-site	on-site

Cashflow movements and accounts payable / receivable	on-site, particularly in relation to operations with affiliates	on-site	on-site
Dividends and interest payable and receivable	off-site, part of daily valuation	on-site	on-site
Commissions	on-site	on-site	off-site (monthly) y on-site
Distribution channels and sales force effectiveness	on-site, but this aspect needs much more attention than is presently given	on-site (NB: the law needs modifying because trust companies can use other distribution channels)	on-site they conduct very general interviews with commercial staff
Registration	on-site	on-site	on-site
Other concepts	<ul style="list-style-type: none"> <li>• They review operational manuals (to compare the real with the ideal) and the IT applications in use</li> <li>• They investigate the methods of valuation of financial instruments, as well as risk measurement mechanisms</li> <li>• They look at correspondence, meeting minutes, risk reports, etc.</li> <li>• They examine transactions, asking questions such as, what was the investment strategy? why did you do this transaction? why did you hold these securities in the portfolio up until this date? why did you sell them at this particular point in time? etc.</li> </ul>	<ul style="list-style-type: none"> <li>• They review operational manuals (to compare the real with the ideal) and the IT applications in use</li> <li>• They investigate the methods of valuation of financial instruments, as well as risk measurement mechanisms</li> <li>• They look at correspondence, meeting minutes, risk reports, etc.</li> <li>• They examine transactions, asking questions such as, what was the investment strategy? why did you do this transaction? why did you hold these securities in the portfolio up until this date? why did you sell them at this particular point in time? etc.</li> </ul>	<ul style="list-style-type: none"> <li>• They review the investment policy, particularly risk management; the buy / hold/ sell strategy; the functions of the investment committee, and the follow-up functions of the Board</li> <li>• They perform an analysis of the portfolio in its entirety. They examine transactions, asking questions such as, what was the investment strategy? why did you do this transaction? why did you hold these securities in the portfolio up until this date? why did you sell them at this particular point in time? etc.</li> <li>• They compare the proprietary portfolio with those of the funds and search for abuses such as operations between funds and triangulation</li> <li>• They also look at: accounting and evaluation processes; maximum limits per subscriber; administrative independence;</li> </ul>

			the cashing up of securities, and the reports of the <i>revisor fiscal</i> .
<b>Agents</b>			
Accredited or not	Yes, they verify that they are accredited with the SV	Yes, they verify that they are accredited with the SV	Only in the case of <i>fondos de inversión</i>
Timely execution	Yes, they have to trade via an official market	Yes, they have to trade via an official market	Only in the case of <i>fondos de inversión</i>
<b>Valuation/Prices</b>			
Check prices used in valuation	off-site	off-site	off-site and on-site
Check calculation	off-site	off-site	off-site and on-site
Fees and charges	off-site	off-site	on-site
Check pricing	off-site	off-site	off-site and on-site
<b>Investment</b>			
Portafolio reconciliation	off-site (between DECEVAL and the fund; they have a direct connection with DECEVAL)	off-site (between DECEVAL and the fund; they have a direct connection with DECEVAL)	on-site (with paper-based reports from DECEVAL)
Investment limits	off-site	off-site	off-site (daily) and on-site
Income	off-site (depends on the valuation)	off-site (depends on the valuation)	off-site and on-site by different concepts
Turnover of the portfolio	No, the Colombian market is too small to permit such luxuries as churning	No	on-site (they verify if the degree of turnover accords with the investment policy)
Principal and affiliated dealing	off-site	off-site	on-site (they check it against the contract and the regulations)
Concentration by broker / comission paid	No	No	on-site
<b>TECHNICAL BASIS</b>	<b>BANCARIA "Individual Savings"</b>	<b>BANCARIA "Trusts"</b>	<b>VALORES</b>
	Based on the <i>Circulo 88/2000</i> on the treasury activities of credit institutions, which will eventually be adapted to funds.	Based on the <i>Circulo 88/2000</i> on the treasury activities of credit institutions, which will eventually be adapted to funds.	Based on the SV's manuals 1. <u>Internal Control, Administration, Management and</u>

	<p><u>1. Responsibilities of the Board and Senior Management of the Managing Company</u></p> <ul style="list-style-type: none"> <li>• Guarantee the adequate organisation, monitoring and follow-up of treasury activities, including fixing limits for risk-taking and the adoption of measures necessary to limit risk</li> <li>• Approve the policies, strategies and rules of business that the company should follow, including: (i) a code of ethics that includes provisions on the confidentiality of information, the use of privileged information and conflicts of interest; (ii) the definition of functions and the respective levels of responsibility of directors or managers and of each employee; (iii) the definition of the nature, scope and legal basis of each of the activities undertaken; (iv) the definition of the businesses and markets in which it is admissible to participate; (v) the definition of procedures to measure, analyse, monitor, control and administer risks; (vi) the definition of investment limits per product, maturity and issuer; (vii) the definition of procedures to follow in the case</li> </ul>	<p><u>1. Responsibilities of the Board and Senior Management of the Managing Company</u></p> <ul style="list-style-type: none"> <li>• Guarantee the adequate organisation, monitoring and follow-up of treasury activities, including fixing limits for risk-taking and the adoption of measures necessary to limit risk</li> <li>• Approve the policies, strategies and rules of business that the company should follow, including: (i) a code of ethics that includes provisions on the confidentiality of information, the use of privileged information and conflicts of interest; (ii) the definition of functions and the respective levels of responsibility of directors or managers and of each employee; (iii) the definition of the nature, scope and legal basis of each of the activities undertaken; (iv) the definition of the businesses and markets in which it is admissible to participate; (v) the definition of procedures to measure, analyse, monitor, control and administer risks; (vi) the definition of investment limits per product, maturity and issuer; (vii) the definition of procedures to follow in the case</li> </ul>	<p><u>Control of Risks</u></p> <p>There is a table to complete with 68 questions about the following matters:</p> <ul style="list-style-type: none"> <li>• Verify if the funds have an adequate organisational structure, properly supported by functional manuals and procedures necessary for the fulfilment of the different functions of administration, management and control of risks</li> <li>• Determine if there is an adequate delegation of functions for each one of the areas and employees of the firm</li> <li>• Examine whether there are appropriate levels of command and whether for each activity employees have an appropriate level of authority relative to their functions</li> <li>• Verify if the funds have an appropriate system of internal control which include mechanisms for the identification, measurement, evaluation and management of risks derived from the performance of its activities</li> <li>• Determine if the policies and measures adopted by directors and/or administrators are properly applied and that the managing entity subjects them to proper controls</li> </ul>
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	<p>of over-stepping the limits or in the face of significant and unexpected movements in the market; (viii) the definition of internal systems of control and monitoring of risks; (ix) the IT platform and equipment; (x) the types of internal and external management and financial reports, and (xi) remuneration scales.</p> <ul style="list-style-type: none"> <li>• Designate a member of the Board to be responsible for risk management.</li> </ul> <p><u>2. Requirements &amp; Characteristics of Risk Management</u></p> <ul style="list-style-type: none"> <li>• The existence of an area charged with risk management, separate from the trading area</li> <li>• The existence of strategies, policies and mechanisms of measurement and control for credit, counterparty, market, liquidity, operational and legal risks.</li> <li>• The measurement of risk by financial instrument and by product, at both individual and aggregate level</li> <li>• The fixing of maximum limits of exposure to the different risks</li> <li>• The existence of sufficient knowledge of all aspects of a new product or market and its associated risks before launch</li> </ul>	<p>of over-stepping the limits or in the face of significant and unexpected movements in the market; (viii) the definition of internal systems of control and monitoring of risks; (ix) the IT platform and equipment; (x) the types of internal and external management and financial reports, and (xi) remuneration scales.</p> <ul style="list-style-type: none"> <li>• Designate a member of the Board to be responsible for risk management.</li> </ul> <p><u>2. Requirements &amp; Characteristics of Risk Management</u></p> <ul style="list-style-type: none"> <li>• The existence of an area charged with risk management, separate from the trading area</li> <li>• The existence of strategies, policies and mechanisms of measurement and control for credit, counterparty, market, liquidity, operational and legal risks.</li> <li>• The measurement of risk by financial instrument and by product, at both individual and aggregate level</li> <li>• The fixing of maximum limits of exposure to the different risks</li> <li>• The existence of sufficient knowledge of all aspects of a new product or market and its associated risks before launch</li> </ul>	<ul style="list-style-type: none"> <li>• Identify the policies and the strategies adopted by the managing entities for the administration, control and management of risk</li> <li>• Assess if the funds keep the book of minutes, diaries, orders, and account supports for orders, operations, and subscriptions, amongst others, in correct, timely and ordered fashion that accords with technical norms</li> <li>• Determine if the funds have total administrative and financial independence in the performance of all of its activities</li> <li>• Verify if the funds have an appropriate contingency plan</li> <li>• Assess the efficacy of the <i>Revisor Fiscal</i>, including: (i) that he assesses whether the management complies with legal provisions, statutes and internal controls in place; (ii) that he undertakes a control to assure himself that the fund is adequately protected, conserved and utilised, and that the operations are executed efficiently; (iii) that he effects an inspection of the way the books of accounts, the book of minutes, accounting documents and other general supports are kept; (iv) that he assesses the the</li> </ul>
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	<ul style="list-style-type: none"> <li>• Fulfilment of the minimum level of analysis for each type of risk</li> </ul> <p>3. <u>Organisational Characteristics</u></p> <ul style="list-style-type: none"> <li>• The clear organisational and functional separation of the functions of trading, monitoring, control and administration of risks, and processing and accounting</li> <li>• Appropriate personnel policies, including: (i) training which provides employees with a deep understanding of the products dealt in and the associated operational and administrative procedures; (ii) remuneration packages that do not incentivise an excessive appetite for risk; (iii) clear rules about the acceptance of gifts and favours from clients and intermediaries, and (iv) rules which assure the certainty in the close of and accounting for operations, such as the registration of operations in a way that records the terms and conditions of the trade; the recording of calls; the prohibition on use of cell phones in the trading area; the definition of the conditions under which a trade negotiated outside of the trading room</li> </ul>	<ul style="list-style-type: none"> <li>• Fulfilment of the minimum level of analysis for each type of risk</li> </ul> <p>3. <u>Organisational Characteristics</u></p> <ul style="list-style-type: none"> <li>• The clear organisational and functional separation of the functions of trading, monitoring, control and administration of risks, and processing and accounting</li> <li>• Appropriate personnel policies, including: (i) training which provides employees with a deep understanding of the products dealt in and the associated operational and administrative procedures; (ii) remuneration packages that do not incentivise an excessive appetite for risk; (iii) clear rules about the acceptance of gifts and favours from clients and intermediaries, and (iv) rules which assure the certainty in the close of and accounting for operations, such as the registration of operations in a way that records the terms and conditions of the trade; the recording of calls; the prohibition on use of cell phones in the trading area; the definition of the conditions under which a trade negotiated outside of the trading room</li> </ul>	<p>adequacy of the system of internal control; (v) that he determines if in his judgement the financial statements of the fund are presented according to general accounting standards, as well as those of the Superintendencia de Valores, and (vii) that he maintains in written form the supporting data, reports, recommendations, observations, working papers and other documents that evidence his work on the audit.</p> <p>2. <u>Money Laundering</u>  <i>There is a table to complete with 89 questions about the following matters:</i></p> <ul style="list-style-type: none"> <li>• Find out about the faculties, functions and performance of the compliance officer</li> <li>• Examine the manual specific to money laundering procedures</li> <li>• Analyse the procedures for single and multiple operations in the securities market</li> <li>• Assess the efficiency of the <i>Revisor Fiscal</i>, including: (i) that the revision method has controls that facilitate the detection of the deficiencies in the mechanisms adopted by the firm to prevent illicit activities as well as any incompliance with applicable norms; (ii) that he applies said</li> </ul>
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	<p>would be accepted, and the immediate recording of any positions taken</p> <p><u>4. Internal and External Audit</u></p> <ul style="list-style-type: none"> <li>The concepts to be reviewed include: (i) the limits system; (ii) the reconciliation and close of operations; (iii) the timeliness, relevance and reliability of internal reports; (iv) the quality of the documentation of operations; (v) the segregation of functions; (vi) the relation between market conditions and the terms of the operations performed, and (vii) the operations with connected companies or individuals</li> </ul> <p><u>5. Information Disclosure</u></p> <ul style="list-style-type: none"> <li>The obligation of the risk management department to inform top management about the risk position on a dialy basis</li> <li>The obligation of the entity to submit quantitative and qualitative information to the Superintendencia Bancaria</li> <li>The obligation of the entity to present a true and fair view of its activities to the public through the disclosure of quantitative information</li> </ul>	<p>would be accepted, and the immediate recording of any positions taken</p> <p><u>4. Internal and External Audit</u></p> <ul style="list-style-type: none"> <li>The concepts to be reviewed include: (i) the limits system; (ii) the reconciliation and close of operations; (iii) the timeliness, relevance and reliability of internal reports; (iv) the quality of the documentation of operations; (v) the segregation of functions; (vi) the relation between market conditions and the terms of the operations performed, and (vii) the operations with connected companies or individuals</li> </ul> <p><u>5. Information Disclosure</u></p> <ul style="list-style-type: none"> <li>The obligation of the risk management department to inform top management about the risk position on a dialy basis</li> <li>The obligation of the entity to submit quantitative and qualitative information to the Superintendencia Bancaria</li> <li>The obligation of the entity to present a true and fair view of its activities to the public through the disclosure of quantitative information</li> </ul>	<p>controls at acceptable intervals; (iii) that they are documented in a manual; (iv) that he updates, modifies or increments them whenever appropriate, and (v) that he informs the appropriate people when he detects deficiencies in the mechanisms which the firm has adopted for the prevention of money laundering</p> <ul style="list-style-type: none"> <li>Look at forms to open an account to ensure that they include adequate controls</li> </ul>
<b>TIMING OF EACH STEP IN THE</b>	<b>BANCARIA "Individual Savings"</b>	<b>BANCARIA "Trusts"</b>	<b>VALORES</b>

VISIT PROCESS	(time)	(time)	(time)
Visit planning	3 days	3 days	2-3 weeks (documents they have to analyse during the visit)
Conducting the visit on-site	3-4 weeks	4 weeks  During the first week, the supervised entity makes a detailed presentation about its organisation, which helps to orientate the inspectors	2-4 weeks
Writing the final report	1 week	1 week	0-2 weeks (depending on the complexity)
Follow-up of the implementation of the recommendations and/or sanctions	It depends: step 1 – send the report to the supervised entity; step – wait for the response of the supervised entity; step 3 – evaluate the response of the supervised entity, and step 4 - decide if it is necessary to impose sanctions  Sometimes they conduct a follow-up visit to see if their recommendations have been implemented, otherwise this is done during the next (programmed) visit	It depends: step 1 – send the report to the supervised entity; step – wait for the response of the supervised entity; step 3 – evaluate the response of the supervised entity, and step 4 - decide if it is necessary to impose sanctions  Sometimes they conduct a follow-up visit to see if their recommendations have been implemented, otherwise this is done during the next (programmed) visit	2 years  In practice, they do not have the resources to conduct follow-up visits to check if their recommendations have been implemented – this is done during the next (programmed) visit
Duration of a complete cycle of inspections (i.e. the time necessary to inspect all the institutions / funds)	1 year	2 years – the inspection cycle for "trusts" is longer than that of "individual savings" because trust companies run other types of businesses more complex than funds, which they also have to inspect.	2 years

## Appendix 6

### Sources of Operational Risk

Operational risk comes in many guises. Most problems arise as a result of inadvertent rather than deliberate actions. A recent study by professors Julian Franks, Colin Mayer and Luis Correia de Silva found that the most common forms of operational risk in investment management companies in developed markets to be as follows, listed in order of importance:

OPERATIONAL RISK	EXAMPLE
Breach of client guidelines	This refers to a violation of the guidelines as set out by the client in their contract with the asset management company. For example, a client may specifically request that their portfolio does not contain any tobacco companies' stocks. Inadvertently purchasing tobacco stocks for this client would therefore contravene the clients' guidelines. In order to reverse the transaction, the investment management company must sell the shares. In the meantime, the price of the share could have fallen, which could result in a loss for the investment management company.
Misdealing	This refers to generally unintentional errors, for example in issuing orders to brokers – selling instead of buying a security, or doing a foreign exchange transaction the wrong way round, for example.
Unit trust mispricing	The wrong price is published, perhaps due to faulty valuations. Investors who redeemed their units at an artificially lower price will be entitled to compensation, as will those who bought at an artificially higher price. In practice, it will be difficult to claim back money from investors who sold at an artificially higher price if they did so in good faith, just as it would be to charge the excess to those investors who bought at an artificially lower price. The investment management company would have to make up the difference out of its own funds.
Risks from new business	Operational failures may occur when a client mandate has been acquired from another asset management company. The previous asset manager may not have maintained current records, which implies that there may be discrepancies between what is reported and what is actually held in the client's account. This is a particular problem for businesses that are growing and are therefore taking on a relatively high proportion of new clients.
Fraud	This occurs as a result of the dishonest behaviour conducted by employees or managers. This is the only deliberate act in this list. Segregation of duties reduces the level of control that any one individual may have over a single transaction, and therefore reduces the probability of fraud.
Failure to meet guarantees	This arises when an asset manager is unable to provide the client with the return that was guaranteed on a particular

	product. This problem has a potentially large impact if there is a downturn in the stock market and the risks are unhedged or imperfectly hedged.
IT systems failure	This occurs as a result of a breakdown in the computer system. Installing back-ups to take over from the primary system may reduce any subsequent loss from a failure of the IT system.
Failure to reconcile assets	This may arise when an investment management company is unable to reconcile the assets according to its own internal records with those according to the reports from the custodian. In order to minimise the probability of such a failure occurring, investment management companies may conduct daily reconciliations of client accounts.
Failure to "best execute"	This refers to the failure to obtain a best price for a client.
Counterparty failure	This arises when a third-party to an investment management company, such as a broker, becomes insolvent. The risk of counterparty failure is particularly high in dealing with financial intermediaries in emerging markets.
Settlement problems	These may occur, for example, when the investment management company has already paid the costs of purchasing stocks, but the broker, for some reason, is unable to deliver the stocks. This problem can be limited to some extent by implementation of a delivery-versus-payment system, which means that an investment management company will only pay the cost of the transaction upon receipt of the stocks.
Failure to collect all income	An example of this type of risk occurs in the event of a corporate action failure. For example, a client may hold stock in company A, which is being taken over by company B. Failure to complete the relevant documentation before a specified deadline may result in failure to transfer stock in company A into stock in company B. This could lead to losses, for example, in cases of the depreciation of stock value.
Stock lending failures	This arises when the party that borrowed the stock is unable to repay the amount and collateral is insufficient to cover the total value of the stock lent.

SOURCE: Franks et al, 2003

Most of these risks can be minimised through good business processes and adequate training. Any losses can be covered by (a) insurance, (b) compulsory liquidity reserves constituted for this purpose and (c) investor compensation schemes.

### Portfolio abuses

1. Exploiting acting as a principal in transactions with a CIF

This is where an entity or individual which has influence on CIF portfolio transactions takes advantage of its position in relation to the CIF while either buying assets from the CIF or selling assets to it. This may involve:

Acquiring assets from the fund at below market price and selling them on at the market price for a profit

Buying assets at the market price and reselling them to the fund at a price higher than the market price

In both cases the entity or individual acting as a principal in the purchase or sale benefits at the expense of the CIF and can only do so because of their position, in relation to the CIF. This can occur in relation to assets or in relation to deposits, where banks may pay lower than market interest rates to affiliated CIFs on their deposits.

This is why regulation often bans CIF transactions with affiliates or sets requirements – such as arm’s length terms – with which they must comply.

2. Financing ‘friends’

Operating CIFs in some markets is simply seen as a way of financing affiliates of the CIF operator; this can be a particular tendency where regulation is weak and when CIF operators are parts of large groups that include banks and brokerage firms. Thus money is raised from the public that will not be invested in the best investments available within the mandate of the CIF; but will be used to buy the bonds and equity of CIF operator affiliates, regardless of their quality or profitability. It can be argued that where the CIF operator is affiliated with strong companies, this can benefit CIF investors. This may be true in some cases but CIF investors are being deceived if they have invested upon the basis of the independence, professionalism and quality of CIF management services being offered; and at least some of the assets being bought are likely to underperform those chosen upon purely investment criteria.

3. "Front running"

Profits can be made by buying some shares and subsequently placing an order for a large number of the same shares for the CIF, in order to move the market price up. The earlier purchaser can then sell at a profit. This may be done by fund managers or their relatives or by affiliated entities such as brokers. Here the CIF does not necessarily suffer loss or damage, but it is being used to advantage outsiders rather than its own investors.

This is usually controlled either by a flat ban on managers owning the same shares as the CIFs on whose behalf they act; or by requiring that managers may only deal through an approved broker who discloses all deals to their employer - ie, management company, or by management companies only permitting managers to invest in the funds that they manage.

4. "Scalping"

Here a CIF operator's employees derive benefits for themselves at the expense of the CIF: an example is placing CIF money on deposit with an institution at a lower than market rate of interest in return for the operator or operator's employees receiving preferential mortgage or other loan terms for themselves. The concept is similar to front running in that CIF money is being used to benefit its operator or the operator's personnel.

Requirements to act in the best interests of fund investors make such transactions a breach of regulation. Regulated entities requirement that employees' financial transactions are disclosed to a central personnel office may also assist in identifying such problems.

5. "Rat trading"

This is a practice whereby a manager of a CIF purchases or sells CIF assets without designating the name of the buyer or seller, telling the broker to hold over the name until later. If the shares go up they are booked to the CIF's manager personally or CIF operator corporately and if they go down the shares are booked to the CIF.

Here the CIF loses out on a gain that it might have made, to the benefit of others.

6. Inside knowledge

A CIF may have a holding of shares in a company, which an affiliate of the CIF knows to be more valuable than the market realizes because the affiliate has knowledge of some news that will, when it is made public, enhance the market value. In this case the CIF sells the shares at market value to the affiliated entity. When the true value emerges the shares are sold on again at a profit to the affiliated entity and the CIF loses out.

7. "Rarity value"

This can occur where a CIF holds a block of shares, which, put together with another block already owned by - or available for purchase by - an affiliate of the CIF, would form a block whose larger size would enable it to be sold at a higher price. The block owned by the CIF then is sold to the affiliate, which then sells the larger block at a profit to itself, so the CIF does not benefit from higher price and loses out.

8. "Dustbin"

This is the reverse of rarity value, when affiliates of the CIF manager (in this case likely to be an investment bank or broker) have a block of shares or bonds which cannot be sold, and which has been on the books for some time and which costs money to finance.

The temptation is to sell them to the CIF ("the dustbin"), which is of course a "long term" investor so can be argued to be likely to benefit in due course. The CIF therefore suffers from the acquisition of a poor investment.

9. Tail end underwriting

The same "dustbin" principle applies to affiliates of a CIF that are attempting to underwrite a new issue of shares for a company for which they are acting. If it is proving hard to find underwriters to complete the list, it may be convenient to use an affiliated CIF to take up

some of the unplaced underwriting. Although the terms on which the CIF takes the underwriting are the same as those for any other underwriter, it may be that the shares open at a discount to the underwriting price when trade starts in them and the CIF would thus have done better to have waited until that time to buy.

10. “Churning”

The temptation to ‘churn’ CIF portfolios arises when the CIF operator has an affiliated (or friendly) brokerage in need of revenue or seeking higher profitability. For the broker turnover equals commission equals profit, which can be split with the CIF operator. The CIF operator then undertakes large numbers of transactions through the broker that generates commissions for that broker (the expression churning derives from making butter where milk is turned over and over again: here CIF portfolio assets are bought and sold – turned over – repeatedly). The CIF may, as a result, have incurred high expenses for trading without any corresponding benefit in terms of increased net assets; indeed the reverse may be the case.

11. Assisting in takeover

In the overheated atmosphere of a contested takeover battle, where more than one bidder is trying to win control of the company being bid for, the final outcome can often rest on a few percent of that company. If an affiliated fund happens to hold a vital percentage, it will be tempting to extract from the CIF operator an irrevocable acceptance of his client's bid, even though the bidding may go higher. The CIF loses out on the higher price due to its operators' affiliations.

12. “Warehousing”

Also often associated with takeover activity, a CIF or CIFs can be used to accumulate a significant holding of a particular company that is a takeover target for one of the affiliate's clients. Immediately prior to the bid being made public, the client buys all the shares from the CIFs and then bids a higher price for the shares he does not already own. The CIF investors lose out on the increase in price.

13. Using CIF assets to support a price

Here the affiliate or one of its clients may hold shares whose price is likely to decline, and where there are more sellers than buyers; it is tempting to use CIFs' assets to support the price by buying shares. This may also occur in relation to takeover battles where the client of an affiliate, the predator company, wants to arrange for buyers to stand ready to support its price (an illegal practice under many regulatory frameworks): affiliated CIFs may be used for this purpose.

14. Manipulated valuation

Given the reliance placed on broker's quotations or bid and asked prices for the purposes of valuing funds, the temptation for a CIF operator to use an affiliated or friendly broker to help manipulate the prices used for valuing CIFs is obvious.

15. Investing in illegal assets

It has not been unknown ("the Young technique" at Morgan Grenfell in the UK in the late 1980s) for a CIF operator or its personnel to create a "shell company" which can get a technical listing with the help of an affiliated or friendly broker, which is an eligible asset for a CIF to invest in, but which in turn invests in unquoted shares or other non permitted assets, and whose prices can be manipulated; this is almost a valuation point.

16. Reciprocal and soft agreements

This may involve any CIF and any broker. The arrangement is - if the broker buys shares in the CIF for its clients, the CIF will buy its portfolio through the broker. This does not necessarily result in best prices being obtained for the CIF. The same applies to the practice called "soft" commission. This arises when a broker pays for certain services installed at the CIF operator's office - for instance Reuters or Bloomberg - and is repaid plus a percentage profit in commission. This can lead to churning in order to fulfill the obligation to pay a certain sum of commission to the broker.

### Performance Manipulation

Part of the relative attractiveness of any CIF is its performance by comparison with its competitors. CIF operators and their affiliates can 'massage' improvements in CIF performance by:

- As banks, paying affiliated CIFs above market rates of interest either occasionally or continuously on their deposits (what the bank loses on the interest 'swing' the CIF operator will gain on the fee 'roundabout')
- As investment banks or brokers, ensuring that affiliated CIFs get access to the 'best' new issues and that non affiliated CIFs do not; particularly in cases where supply of assets - high yielding bonds, for instance - is limited (allocation of highly attractive new issues to a selected new CIF is a common way for CIF operators to boost their performance, thus enhancing their attractiveness)
- As brokers, charging lower than market rates of commissions on affiliated CIF transactions on an occasional or continuing basis
- As operators, choosing not to levy management charges for a period - this can have quite a strong impact on apparent performance money market or bond funds - recovering these charges later
- 'Portfolio pumping' - this entails an agreement between funds to 'ramp up' prices (by purchases) of assets in which they are invested in order to improve performance

A common practice in most markets is the legal 'end of period performance fix': most CIF performance measurement is focused on end of quarter or end of year performance. Depending on the nature of the market, it can be worthwhile for CIF operators to enter lots of orders on the last day of the performance period, which will boost market prices and hence fund valuations.

While none of the above practices damage the interests of existing investors in affected CIFs - in fact, they benefit from them, albeit perhaps temporarily, except in the penultimate case where they will pay higher management cost later if they are still invested - potential investors are likely to be misled into thinking that the apparent superior performance is due to superior investment management. If they invest on this basis they have been deceived.

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## VISIT PROGRAMME

- 27-10-2003 **Reunión Inicial:** Mauricio Rosillo Rojas (Hacienda), Juan Pablo Buitrago (Hacienda), Ligia Helena Borrero (Bancaria), Álvaro Montero (Bancaria), Maria José Ramírez (Valores), Luisa Fernanda Vargas (Valores)
- 27-10-2003 **Superintendencia de Valores:** Ruth Jeanette Zambrano García (Directora de Supervisión de las Carteras Colectivas supervisadas por la SV)
- 30-10-2003 **Superintendencia de Valores:** Maria José Ramírez (Delegada de Supervisión de Carteras Colectivas) y Ruth Jeanette Zambrano García (Directora de Grupo de Supervisión de Carteras Colectivas)
- 28-10-2003 **Superintendencia Bancaria:** Ligia Helena Borrero (Jefa de Delegatura de Inversión Colectiva), Juan Carlos Bonilla (Director de Supervisión de Fiduciarios) y Eduardo Orejuela (Director de Supervisión de Ahorro Individual)
- 28-10-2003 **Corredores Asociados S.A.:** Alfonso Duran Villegas (Director General)
- 28-10-2003 **Superintendencia de Valores:** Maria José Ramírez y Ruth Jeanette Zambrano (Delegatura de Fondos)
- 29-10-2003 **Consultoría y Capacitación Financiera:** Gustavo A. Madrid-Malo de Andreis (Gerente General), Luis Hernán Mantilla Mantilla (Consultor Externo), Felipe A. Flórez Millán (Asesor Despacho del Superintendente de Valores)
- 29-10-2003 **Correval S.A.:** José M. Santamaría Uribe (Gerente, Fondos de Valores), Roberto Paez Muzzulini
- 29-10-2003 **Asociación de Fiduciarias:** Federico Renjifo Vélez (Presidente), Helena Hernández Córdoba (Secretaria General)
- 30-10-2003 **Superintendencia Bancaria:** Ligia Helena Borrero (Jefa de Delegatura de Inversión Colectiva), Juan Carlos Bonilla (Director de Supervisión de Fiduciarios) y Eduardo ??? (Director de Supervisión de Ahorro Individual)
- 30-10-2003 **Superintendencia de Valores:** Clemente del Valle (Superintendente)
- 30-10-2003 **Nación (Sociedad Administradora de Inversión):** Juan Manuel Velasco Barrera (Gerente General)
- 30-10-2003 **SuValor:** Juan Luis Franco
- 31-10-2003 **Banco de la República (FIMBRA):** Joaquín Bernal (Chief Operations Officer), Alvaro E. Cuestas Bernal (Gerente, Fondo Mutuo de Inversiones FIMBRA)
- 31-10-2003 **FonSocial:** Aydee Arbelaez Monzon (Gerente)
- 31-10-2003 **FiduColombia:** Jaime Eduardo Garzón Ávila (Vicepresidente Financiero)
- 31-10-2003 **FiduAlianza:** Juan Carlos Garzón Leal (Vicepresidente Financiero)
- 04-11-2003 **Skandia:** Angela María Fina (Gerente de Gestión de Fondos)
- 04-11-2003 **Helm Trust:** Edgar Alberto Mora Hernández (Presidente)

- 04-11-2003 **Banco Santander:** Guillermo Espinosa Salazar (Gerente, Unidad de Gestión de Activos Grupo Santander Colombia)
- 05-11-2003 **DECEVAL:** Jorge Hernán Jaramillo Ossa (Presidente)
- 06-11-2003 **Reunión de cierre 1:** Clemente del Valle (Superintendente de Valores); María José Ramírez (Delegada de Carteras Colectivas, SV); Ruth Jeanette Zambrano García (Jefa de División de Inspección, SV); Luisa Fernanda Vargas (Jefa de División de Normativa y Trámites, SV); Juan Pablo Buitrago (Hacienda); Mónica Andrade (Hacienda); Ligia Helena Borrero (Delegada de Pensiones, SB); Juan Carlos Bonilla (Jefe de División de Inspección de Fiduciarios, SB); Eduardo Orejuela (Jefe de División de Inspección de Ahorro Individual, SB)
- 07-11-2003 **Reunión de cierre 2:** María José Ramírez (Delegada de Carteras Colectivas, SV); Ruth Jeanette Zambrano García (Jefa de División de Inspección, SV); Luisa Fernanda Vargas (Jefa de División de Normativa y Trámites, SV); Mauricio Rosillo Rojas (Hacienda); Mónica Andrade (Hacienda); Ligia Helena Borrero (Delegada de Pensiones, SB); Juan Carlos Bonilla (Jefe de División de Inspección de Fiduciarios, SB)
- 07-11-2003 **Comité de Cooperación:** María José Ramírez (Delegada de Carteras Colectivas, SV); Ruth Jeanette Zambrano García (Jefa de División de Inspección, SV); Luisa Fernanda Vargas (Jefa de División de Normativa y Trámites, SV); Ligia Helena Borrero (Delegada de Pensiones, SB); Juan Carlos Bonilla (Jefe de División de Inspección de Fiduciarios, SB)