THE EXTENSION OF CAPITAL STANDARDS TO ASSET MANAGEMENT COMPANIES - IS THIS APPROPRIATE AND HOLISTIC FOR REGULATING THESE ENTITIES IN ZIMBABWE?

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DECLARATION

I, Esnath Mudavanhu, hereby declare that this study is my original work and that all reference materials contained therein have been duly acknowledged and that this dissertation has not previously, in its entirety or in part been submitted to any University in order to attain an academic qualification.

Student ......................................................

Supervisor ......................................................
ACKNOWLEDGEMENTS

I would like to express my sincere gratitude to all those who assisted me and contributed their valuable input to enable me to complete this dissertation. Of particular note is my supervisor, Dr. Henry Chikova of the Graduate School of Management, for his critical analysis and guidance.

In addition, I am indebted to friends, colleagues and acquaintances in the financial services sector for their assistance and support.

Heartfelt thanks are extended to my father, husband and our son Neil, who were unwavering and steadfast in their support. Their unconditional love gave me the determination to complete and submit this dissertation.
ABSTRACT

The purpose of the research was to investigate the extension of capital standards to asset management companies (AMCs) and whether capital regulation is appropriate and holistic for regulating these entities in Zimbabwe. The main objective of the study was to consider the use of capital in regulating AMCs whilst also highlighting additional regulatory measures that can be employed to buttress capital requirements, taking cognizance of the peculiarities inherent in the operations of AMCs.

In the past decade, regulatory and supervisory authorities have increasingly become more attentive to operational risk inherent in the operations of financial institutions. The most prominent regulatory stance adopted, thus far, has been to require AMCs to adhere to regulatory minimum capital requirements. The question arises if capital regulation suffices in mitigating operational and other significant risks inherent in the operations of AMCs and what additional measures, in light of evolving asset management regulation, can be employed to augment and buttress current regulatory measures in use.

Questionnaires were distributed to the target population to ascertain their perceptions on the extension of capital standards to asset management companies. The findings suggest that there are no other regulatory capital requirements, apart from regulatory minimum capital requirements, in the asset management sub-sector in Zimbabwe. In addition, there is limited knowledge by market participants on the alternatives to capital regulation.

It is recommended that the regulatory and supervisory agency responsible for the asset management sub-sector, come up with a capital regulation regime that is risk-based and well suited to the peculiarities of the sub-sector; ensures that asset managers are educated and conscientised on the non-capital regulatory mechanisms that can be employed, as well as, ensuring that these measures are prescribed at law and enforced in Zimbabwe. By so doing, establishing a comprehensive and holistic regulatory framework for the asset management sub-sector.
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<th>Definition</th>
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<tr>
<td>AFG</td>
<td>Association Française de la Gestion Financière</td>
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<tr>
<td>AIFMD</td>
<td>Alternative Investment Fund Managers Directive</td>
</tr>
<tr>
<td>AIMZ</td>
<td>Association of Investment Managers Zimbabwe</td>
</tr>
<tr>
<td>AMC(s)</td>
<td>Asset management company(ies)</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank of International Settlements</td>
</tr>
<tr>
<td>BVI</td>
<td>Bundesverband Investment und Asset Management e.V.</td>
</tr>
<tr>
<td>BLSSD</td>
<td>Bank Licensing, Supervision &amp; Surveillance Division</td>
</tr>
<tr>
<td>CBFA</td>
<td>Banking, Finance and Insurance Commission(Belgium)</td>
</tr>
<tr>
<td>CIS</td>
<td>Collective investment scheme(s)</td>
</tr>
<tr>
<td>EFAMA</td>
<td>European Fund and Asset Management Association</td>
</tr>
<tr>
<td>EMIR</td>
<td>European Markets Infrastructure Regulation</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EUR</td>
<td>Euro</td>
</tr>
<tr>
<td>FEFSI</td>
<td>Fédération Européenne des Fonds et Sociétés d'Investissement</td>
</tr>
<tr>
<td>FuM</td>
<td>Funds under management</td>
</tr>
<tr>
<td>IADI</td>
<td>International Association of Deposit Insurers</td>
</tr>
<tr>
<td>ICI</td>
<td>Investment Company Institute</td>
</tr>
<tr>
<td>Joint Forum</td>
<td>Established by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.</td>
</tr>
<tr>
<td>MiFID II</td>
<td>Markets in Financial Instruments Directive II</td>
</tr>
<tr>
<td>OCC</td>
<td>Comptroller of the Currency Administration of National Banks</td>
</tr>
<tr>
<td>OSFI</td>
<td>Office of the Superintendent of Financial Institutions</td>
</tr>
<tr>
<td>OXERA</td>
<td>Oxford Economic Research Associates</td>
</tr>
<tr>
<td>PwC</td>
<td>PriceWaterhouseCoopers</td>
</tr>
<tr>
<td>RBCA</td>
<td>Risk Based Capital framework (RBCA) Steering Committee</td>
</tr>
</tbody>
</table>
RBZ  Reserve Bank of Zimbabwe
SFBC  Swiss Federal Banking Commission
SECZ  Securities and Exchange Commission of Zimbabwe
            Taking-up and Pursuit of the Business of Insurance and Reinsurance
UCITS  Undertaking for Collective Investment in Transferable Securities
USA  United States of America
USD  United States dollar
Volcker Rule  Section 619 of the Dodd-Frank Act
1. CHAPTER ONE - INTRODUCTION

1.1. INTRODUCTION

There has been much debate, both locally and globally, on the appropriateness and effectiveness of capital as a means of regulating asset managers.

Capital regulation is the requirement that a financial institution maintains a minimum level of capital (that is, regulatory capital\(^1\)) stipulated by a regulatory entity (and in most instances, prescribed at law) (Financial Times, n.d.). In its simplest form, capital represents the free or uncommitted portion of a financial institution’s assets, available as a cushion in case the value of the institution’s assets decline or its liabilities rise.

Proponents of capital regulation rationalise on similar grounds to those considered in respect of banks and securities companies, namely, moral hazard and systemic risk (Calomiris and Herring, 2002:4). In recognition that capital is not a panacea or the ultimate remedy to institutional failure in the asset management industry and of the peculiar nature of asset management business, literature on the subject highlights seven (7) main forms of regulation appropriate to these entities\(^2\).

Given the strategic importance of the asset managers, there is need for appropriate and effective regulation of these entities which considers other factors in addition to regulatory minimum capital requirements.

The chapter outlines the background to the study, problem statement, research objectives and questions, research proposition, research justification, scope of the research as well as the limitations of the study. It concludes by outlining the structure of the dissertation.

\(^1\) Regulatory capital is distinct from balance sheet, economic or risk capital.

\(^2\) Financial resource requirements (capital requirements); conduct-of-business rules; separation of client’s assets; disclosure rules; enforcement; auditing; and investor compensation schemes; have been identified. Others note private insurance and process regulation.
1.2. BACKGROUND TO THE STUDY

1.2.1. Asset Management Companies

The Comptroller of the Currency Administration of National Banks [OCC] (2001:1) defines asset management as the business of providing financial products or services to a third party (either local or foreign) for a fee or commission. The investment is made pursuant to a trust deed (unit trusts) or written mandate (portfolio management). AMCs\(^3\) are not generally asset rich entities but are highly valued for their professionalism and expertise. Their clients comprise institutions (e.g. governments, public agencies, banks, pension and mutual funds, insurance companies, endowments and corporations) and private investors (including individuals). AMCs provide an array of services, ranging from estate, trust and corporate trust administration; investment advisory services; custody; participant record keeping; and retirement plan administration; to a third party for a fee or commission (OCC, 2011:1). Investment management services can broadly be summarised as shown in Figure 1 below.

![Figure 1.1: Overview of Asset Management Services](Source: AFG (2013:3) and OCC(2001:3))

The defining characteristic of AMCs is that investors bear the risk associated with movements in market prices and default of counterparties. Amvescap Plc. (2003:3) notes that AMCs are not involved in the settlement process, do not deal on their own account, underwrite securities, lend money and engage in other capital intensive

\(^3\)Asset managers are termed investment advisors (Franks and Mayer et al., 2001a:157); trust and asset management companies (Office of Thrift Supervision, 2001:10) in the USA or portfolio management companies in France (Association Française de la Gestion Financière [AFG], 2013:2).
activities. As a result they do not pose the same systemic risk and encounter the same level of operational risk as banking and credit institutions and other proprietary trading investments firms.

Most of the risks associated with asset management business arise from off-statement of financial position activities; hence they are not easily identified and measured using traditional financial reporting systems. In terms of the OCC’s risk assessment framework, credit, strategic, operational, reputation and compliance risks are the main risks inherent in asset management operations (OCC, 2011:3, 4).

In light of the foregoing, the question arises whether the extension of minimum capital standards to these entities is the most ideal and effective manner to regulate this sub-sector.

1.2.2. Overview of Asset Management in Other Jurisdictions

A survey conducted by Franks and Mayer et al. (2001a) and an International Funds and Funds Management Survey by KPMG published on 02 April 2012 and updated on 01 November 2012 highlights that the structure of the asset management business substantially varies across the globe. Given, the varying structure of the asset management business, would it then be appropriate and effective to extend capital standards as a way of regulating these institutions?

1.2.3. Asset Management Business in Zimbabwe

In Zimbabwe, asset management companies provide two (2) types of investment vehicles, namely, portfolio or investment management services and unit trusts (collective investment schemes). An asset manager can solely provide investment management services, or provide both portfolio management and unit trust products. As at 13 March 2014, there were seventeen (17) registered AMCs, of which, seven (7) solely provide portfolio management services and the remaining ten (10) undertake

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4 See Appendix 1: Asset Management Business in Other Jurisdictions illustrates the asset management sectors of a selected number of countries.

5 See Appendix 2: Zimbabwean AMC Sector as at 13 March 2014.
both portfolio management and unit trust activities.

The investment assets AMCs invest funds in, are money and equity market (both quoted equities and unquoted shares whose market values are determinable) instruments and immovable property, motor vehicles or other valuable property for resale within any period of twelve (12) months.

1.2.4. Historical Perspective - Asset Management in Zimbabwe

Prior to December 2003, the Ministry of Finance had sole responsibility for licensing and supervising AMCs in Zimbabwe. Asset managers engaging in collective investment schemes were directly regulated under the Collective Investment Schemes (CIS) Act [Chapter 24:19] and the supporting Collective Investment Schemes (Internal Schemes) Regulations 1998. All other asset management or investment activities on behalf of third parties were not directly regulated under a specific piece of legislation.

The asset management sector posed a significant threat to the stability, safety and soundness of the financial system. In terms of the CIS Act, registered AMCs were only required to submit monthly returns to the Registrar, which returns lacked depth and did not facilitate disclosure of pertinent information. Most AMCs were unregistered and engaging in speculative and illicit activities, and in the event that they were registered, there were no mechanisms to effectively monitor their activities (BLSSD, 2004:28). Thus, in January 2004, the Presidential Powers (Temporary Measures) (Asset Management) Regulations, Statutory Instrument 16 of 2004 was issued.

The statutory instrument brought AMCs within the ambit of the RBZ’s regulatory jurisdiction and provided for the registration (licensing) and deregistration of these entities by the Registrar of Asset Managers. Vesting of both the licensing and supervisory functions with the RBZ was intended to strengthen the regulation of the sub-sector and minimise regulatory arbitrage. Upon expiry of the Statutory Instrument, the Asset Management Act [Chapter 24:26] was passed by Parliament, giving permanence to the provisions of the temporary Presidential Powers Regulations.
Sections of the Banking Act [Chapter 24:20] were invoked to apply to AMCs through General Notice 101 of 2005, later repealed and replaced by General Notice 125 of 2008. The purpose of the invocation was to enable application of prudential supervision standards to AMCs. The BLSSD also issued several guidelines⁶, applicable to banking institutions, inclusive of AMCs so as to foster good corporate governance practices and risk management standards.

Registration of AMCs was completed by 31 August 2004 with thirty one (31) institutions having been licensed. Nine (9) applications were withdrawn and eighteen (18) applications were rejected. Reasons for the rejection of these applications included, among others, inadequate capitalisation, misrepresentation of information and improperly drawn-up project documents. A moratorium on the licensing of additional AMCs was put in place in 2004, following a determination by the RBZ that some AMCs were not conducting proper asset management business and the sector was facing viability challenges (BLSSD, 2004:36).

On-site examinations conducted by the RBZ on AMCs in 2005 revealed that some AMCs were financially unsound, failing to generate meaningful business, engaging in non-permissible activities⁷ and exhibited grave corporate governance weaknesses⁸. As a result, the RBZ revoked the licenses of thirteen (13) AMCs during the year ended 31 December 2005 and one (1) in March 2006 (BLSSD, 2005:30-33).

From 2009, the asset management sector was subject to the Securities and Exchange Act [Chapter 24:25] which was enacted into law in 2008, following Presidential assent. The preamble of the Securities & Exchange Act highlights that one of the objectives of the Act is to regulate and license persons who trade or deal in

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⁶Risk-Based Supervision Policy Framework; Minimum Internal Audit Standards in Banking Institutions Guideline; Framework on the Relationship between Bank Supervisors and Banks’ External Auditors; Risk Management Guideline; Minimum Disclosure Requirements for Financial Institutions; and the Corporate Governance Guideline.

⁷Such as lending; taking positions with clients’ funds; and non-separation of company and client reporting.

⁸Such as improperly constituted boards; poor board oversight; and inexperienced management.
or manage securities. Under the Act’s broad definition of a licensable activity asset management business has come under the purview of the Act. In addition, part xii of the Securities and Exchange Act provides for the supervision of institutions registered under the Securities & Exchange Act by the Securities and Exchange Commission of Zimbabwe (SECZ). However, section 38 of the Securities & Exchange Act excludes collective investment schemes from the requirement to hold licenses for provision of services in terms of the Act.

Publication of the Securities Amendment Act No. 2 of 2013 on 29 August 2013 brought the regulation and supervision of AMCs under SECZ. Transition of the asset managers, was provided for under section 38 of the said Act. All AMCs, which immediately before the commencement of the Amendment Act, were registered in terms of the Asset Management Act were deemed for a period of twelve (12) months to be holders of a requisite license (in terms of section 38 of the Securities & Exchange Act). The twelve (12) month period, lapses on 30 September 2014 [Notice No. 07/02/2014 - Registration of Investment Management Companies (Asset Managers) 2014:2)].

This is taking cognisance that AMCs are now licensed in terms of Section 38(1) (c) of the Securities and Exchange Act as well as paragraph D of the Third Schedule to the Securities (Registration, Licensing and Corporate Governance) Rules, 2010. The licensing procedure incorporates registration of AMCs as provided for in sections 4, 5, 6 and 7 of the Asset Management Act [Notice No. 07/02/2014 - Registration of Investment Management Companies (Asset Managers), 2014:1].

Unlike the RBZ which placed a moratorium on the licensing of AMCs and issued perpetual licenses, SECZ will issue annually renewable licenses. The list of licensed AMCs will be published in the Gazette as provided for in section 5(5) of the Asset Management Act. In addition, SECZ may also publish the list of licensed asset managers in other local media (Notice No. 07/02/2014 - Registration of Investment Management Companies (Asset Managers), 2014:2-3).
However, registration of CIS is pending amendment of the requisite legislation to factor in USD values for capital requirements, professional indemnity and guarantee. In addition, amendment of the Collective Investment Schemes (Fees) (Amendment) Regulations, 2002 remains outstanding (Circular to Trustees and Managers, 2014:1). SECZ is also working on the realignment and harmonisation of the Securities and Exchange Act, Asset Management Act, Collective Investment Schemes Act and Rules.

A common thread, however, between how the RBZ regulated AMCs and the manner in which SECZ is regulating asset managers, is the requirement that AMCs maintain regulatory minimum capital. However, is the extension of capital standards, suitable and effective in holistically regulating asset managers?

1.3. PROBLEM STATEMENT

In the past decade, regulatory and supervisory authorities, on the whole, have increasingly begun to pay more than the usual attention to operational risk inherent in the operations of financial institutions. Various regulatory responses and tools have been employed to mitigate and manage risk in financial institutions, inclusive of AMCs.

The most prominent regulatory stance adopted, thus far, has been to require investment managers to adhere to regulatory minimum capital requirements. The main reasons for implementing capital standards have been financial stability, investor protection, ensuring a level playing field among financial institutions and providing a cushion against unexpected operational risk. Capital regulation does not take cognisance of the unique risk and financial profile of AMCs, the limited role of capital, and the potential damage of enforcing capital standards on the sub-sector.

Locally, the RBZ required AMCs to hold a regulatory minimum capital requirement of USD500,000.00. SECZ also requires asset managers to hold the same amount of capital. AMCs are of the general view that USD500,000.00 is too high and have

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9 See Appendix 3: Regulation of Asset Management Institutions in Other Jurisdictions for an outline of where capital standards have been used in the regulation of AMCs.
proposed that it be replaced by a minimum capital requirement sufficient to meet three (3) months’ operating costs\textsuperscript{10}. SECZ is cognisant of the need to come up with appropriate capital standards, and recommends this capital structure for asset managers with a slight variation to the tier II capital component [Notice No. 07/02/2014 - Registration of Investment Management Companies (Asset Managers), 2014:3-4].

The proposal is similar to what investment managers in the European Union (EU) are required to maintain, that is, a minimum issued paid-up capital plus an amount equivalent to previous three (3) months expenses in addition to maintaining adequate control mechanisms (BLSSD, 2009:6). In addition, the Basel Committee on Banking Supervision [BCBS] (2006:146, 147) requires asset managers to set aside capital for operational risk equal to 12\% of average gross profit for the past three (3) years.

In light of the foregoing, SECZ is establishing a Risk Based Capital framework (RBCA) Steering Committee to spearhead the formulation of the proposed new capital framework for AMCs. The proposed framework was implemented with effect from 01 October 2014 (Notice No. 07/02/2014 - Registration of Investment Management Companies (Asset Managers), 2014:3-4).

The question arises, is the extension of capital standards to asset managers (be they stand-alone institutions or subsidiaries or divisions in a banking group or banking institution) appropriate and effective in regulating these entities. Does capital regulation suffice in mitigating other significant risks inherent in the operations of AMCs and what additional measures, in light of evolving asset management regulation, can be employed to augment and buttress current regulatory measures in use. This is particularly pertinent noting the emphasis placed on minimum capital requirements with passing reference to the other forms of regulation.

\textsuperscript{10} A capital structure akin to that applied to securities dealing firms in terms of the Sixth Schedule (Rule 53), section 4(1)(a) of S.I.100 of 2010. Alternately AMCs are proposing that the core capital requirement be pegged at USD150,000.00. SECZ, however, indicated that the minimum capital requirement of USD500,000.00 would not be changed prior to 01 October 2014 (The Source,Posted on February 12, 2014 5:37 PM, and http://source.co.zw/2014/02/asset-managers-propose-lower-capital-requirements-secz/).
International regulatory focus in the asset management sector has been on financial stability, investor protection, increased disclosure, transparency of products and markets, improved risk management and process control. To this effect, various directives have been issued in Europe and the USA. Lessons learnt from the recent global financial crisis have prompted, regulators, worldwide to rethink and enhance their regulatory and supervisory approaches (PwC, 2012a:4; PwC, 2013:1).

In contrast, local regulatory guidance applicable to asset managers has slowly been updated to reflect the evolving approach to the regulation and supervision of AMCs. The main regulatory tool has been capital regulation, which, albeit important, is not sufficient to ensure the continued safety and stability of the sector given its role in the overall financial sector. In addition, the regulatory landscape in Zimbabwe remains fragmented, whilst, the emphasis internationally has been on coming-up with a systemic regulator. This is key if financial sector safety is to be maintained. Hence, the rate of regulatory innovation has been outpaced by industry innovation.

If this scenario is not remedied, it may lead to inappropriate and ineffective regulation of asset managers, which as seen from the historical perspective above, can derail financial sector stability and impair the publics’ perception and confidence in the financial sector as a whole.

In light of the foregoing, the research highlights the use of capital in regulating AMCs whilst also highlighting additional regulatory measures that can be employed to buttress capital or financial resource requirements, taking cognisance of the peculiarities inherent in the operations of AMCs.

1.4. RESEARCH OBJECTIVES

The objectives of the research include:

a) establishing the rationale and the relevance of requiring AMCs to hold regulatory minimum capital;

b) investigating the appropriateness and effectiveness of extending regulatory
minimum capital requirements to AMCs, that is, the extent to which regulatory minimum capital requirements mitigate risk in AMCs; and
c) identifying and assessing the usefulness of alternative measures for regulating investment management firms.

1.5. RESEARCH QUESTIONS
Research questions allied with the research objectives are:
a) why do regulators employ capital standards to regulate AMCs;
b) is the use of capital standards effective in holistically supervising AMCs and ensuring the absence of regulatory fissures;
c) which additional forms of regulation can be fostered and employed by the local regulator in line with evolving asset management regulation; and
d) what are the pros and cons of these other forms of regulation.

1.6. PROPOSITION
Capital Standards alone are not an appropriate vehicle for the regulation of AMCs.

1.7. JUSTIFICATION
Asset managers occupy a central position in the market economy. They significantly contribute to employment creation; finance an economy and support economic growth; provide a link between investors, corporations, banks and government agencies that have funding needs; provide liquidity needed for the good functioning of financial markets, thereby contributing to lower cost of capital and higher levels of investment. In effect, they are the lynchpin of managed investments.

In Zimbabwe, total FuM controlled by AMCs amounted to USD2.17 billion as at 30 September 2013 an increase from USD1.59 billion as at 31 December 2011. Internationally, AMCs managed total FuM as shown in table 1.1 below.
Table 1.1: Total Global FuM (EUR trillion) 2008-2011

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<tbody>
<tr>
<td>Japan</td>
<td>2.4</td>
<td>3.1</td>
<td>3.2</td>
<td>3.4</td>
</tr>
<tr>
<td>Australia</td>
<td>0.7</td>
<td>1.3</td>
<td>1.3</td>
<td>1.1</td>
</tr>
<tr>
<td>United States</td>
<td>15.8</td>
<td>17.8</td>
<td>19.4</td>
<td>19.9</td>
</tr>
<tr>
<td>Asia, ex-Japan and Australia</td>
<td>1.4</td>
<td>1.8</td>
<td>2.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Europe</td>
<td>10.8</td>
<td>12.4</td>
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</tr>
<tr>
<td>Latin America</td>
<td>0.5 (Brazil)</td>
<td>0.8</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Middle East, South Africa &amp; rest of world</td>
<td>0.4</td>
<td>0.7</td>
<td>0.7</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>32.0</strong></td>
<td><strong>37.9</strong></td>
<td><strong>41.8</strong></td>
<td><strong>45.0</strong></td>
</tr>
</tbody>
</table>

Source: EFAMA (2013:8); EFAMA (2012:6); and EFAMA (2010:7), with modification by the author.

The foregoing explains why the regulation and supervision of the asset management sector has now taken centre stage at the international level. Financial institutions and their supervisors have paid heightened attention on operational risk, given recent high-profile operational loss events attributed to operational errors; insider trading; rogue trading; allegations of fraud and improper use of information; and the desire to increase shareholder value (EFAMA, 2012:2, 11; EFAMA, 2011:5; AFG, 2013:2, 13). International best practice dictates that regulators institute measures to strengthen regulatory systems with respect to AMCs by employing both financial resource requirements, chief of which are capital standards, mainly, for operational risk as well as ancillary means to regulate risks attendant to the operations of the sub-sector (The Joint Forum, 2003:1 and PwC, 2012a:4).

The global financial crisis prompted deep reflection on the effectiveness of existing risk management frameworks. AMCs, worldwide, have had to contend with an evolving regulatory landscape coupled with growing complex investor expectations. These enhancements are meant to reduce systemic risk, increase investor protection and transparency, bring a more rigorous and wide-ranging approach to conduct rules, extend regulation to previously unregulated activities, and provide regulators with new powers (PwC, 2012b:2; PwC, 2012c:1; 2012a:4; 2013:1; and PwC, 2012a:4).

Unlike banks, investment management companies, in most instances, are not covered by government insurance nor do they fall under the government safety net (Calomiris
and Herring, 2002:22), thus, there is need to ensure that they are supervised appropriately.

The trend, internationally, has been to augment capital regulation of asset managers with measures aimed at enhancing disclosure, transparency, consumer protection and the role of depositories (Joint Forum, 2001:38). These measures have been prescribed at law and regulatory guidance published. Thus, for local regulatory bodies to fully subscribe to international best practices, supervision of asset managers needs to be holistic and encompass all forms of regulation of risks allied with such entities.

Very little scholarly work on the regulation of AMC s has been done, particularly; in developing countries despite the fact that these institutions are an integral part of these countries financial sectors. It is anticipated that the research will assist fellow students; future scholars and policy makers to augment their knowledge base on the subject matter. In addition, it is hoped that the research will prompt policy makers and regulatory authorities to adopt a more holistic approach to the regulation of asset managers and consider updating the regulatory framework already in place. Further, the researcher intends to use the research as a catalyst to prompt further research on the topic.

1.8. SCOPE OF THE RESEARCH
The research will focus on the asset management sub-sector which comprised 17 registered institutions as at 13 March 2014 and the Association of Investment Managers of Zimbabwe (AIMZ). The research will also focus on the regulatory body responsible for AMCs, namely, SECZ, as well as the RBZ (former AMC regulator). Particular emphasis will be placed on the rationale for requiring and allocating a capital charge for AMCs, shortcomings of this approach, as well as explore other techniques to augment capital requirements.

The research will not delve into the technical realm of computing capital for operational risk as per the Basel II Framework nor the challenges attendant to
allocating capital in investment companies.

1.9. LIMITATIONS TO THE STUDY
Since little scholarly work on the regulation of AMCs has been done, challenges in accessing empirical research on capital regulation of AMCs, published within the last five (5) years were encountered. Much of the research on the subject matter was published by Franks and Mayer et al. and Calomiris and Herring in 2001a and 2002, respectively. The overcome this limitation, the most recent information on the regulation of asset managers, in the form of survey reports and articles by audit firms such as KPMG and PwC, was used in conjunction with the available empirical research.

The number of operational AMCs was another hindrance, particularly, in terms of sample size required to undertake some statistical computations that aid in data analysis. Asset management may be considered a specialised area, hence, the limited scope in terms of target respondents as enumerated in section 1.8 above. To circumvent this limitation, two (2) respondents per AMC were targeted.

The researcher, being a full time employee, was impacted by time constraints. Time constraints were minimised by working after hours, public holidays, weekends and obtaining short periods of leave of absence from work to focus on the research.

1.10. DISSERTATION STRUCTURE
The rest of this paper is organised as follows:
a) Chapter 2 discusses theoretical and empirical literature on the regulation of asset managers.
b) Chapter 3 discusses the methodology applied in carrying out the study, as well as the limitations of the methodology and problems encountered.
c) Chapter 4 provides analysis of data gathered using various research instruments and discusses interpretation of results.
d) Chapter 5 outlines conclusions and recommendations based on research findings.
e) References, appendices and concluding remarks are given at the end of the research.

1.11. CHAPTER SUMMARY
Chapter 1, the introduction to the research, provided a synopsis of the research problem at hand, rationale for the research, an indication of the research questions to be addressed and an outline of the overall dissertation structure.
2. CHAPTER TWO - LITERATURE REVIEW

2.1. INTRODUCTION

The ensuing account outlines both theoretical and empirical literature on the regulation of AMCs. Focus of the discussion will be on areas of divergence and consensus on the adoption of capital regulation, originally meant for banking institutions, for the asset management sector. The discussion will highlight how best the asset management sector may be regulated as well as evolving trends in asset management regulation. The chapter discusses the theoretical and empirical literature on the capital regulation of AMCs. It concludes with a summary highlighting the salient points arising from the literature reviewed.

2.2. THEORETICAL LITERATURE REVIEW

2.2.1. Importance of Regulatory Capital in Financial Institutions

Capital adequacy regulation has been described as one of the more important developments in twentieth-century central banking. Indeed, much of the case for modern central banking heavily rests on the justification (or otherwise) for capital adequacy regulation (Dowd, 1999:1).

Elliott (2010:1) concurs with these sentiments, describing capital as one of the most important concepts in banking, particularly, in light of the financial crisis which underscored the critical importance of capital for financial institutions. As a result, virtually all proposals to reform regulation of financial institutions aim to increase the amount and quality of capital held.

In its simplest form, capital represents the free or uncommitted portion of a financial institution’s assets. It is, therefore, available as a cushion in case the value of the institution’s assets decline or its liabilities rise (Elliott, 2010:1).

Economic literature abounds with research on the role of capital regulation in fostering financial sector stability, with emphasis on banking institutions (Dowd, 1999:1). This is
in sharp contrast to the study of capital regulation for non-bank financial institutions (NBFIs), particularly, AMCs, which is often limited. To understand the rationale that regulators advance for requiring asset managers to hold regulatory capital, it is critical to examine the reasons put forth to compel banks to hold capital, in context.

Calomiris and Herring (2002:4) state that the economic justification for prudential capital regulation is underpinned on arguments regarding unwillingness of intermediaries to voluntarily select appropriate amounts of risk and capital in the absence of regulation. They put forth three (3) economic arguments for prudential capital regulation, namely, incentive problems associated with government protection, systemic risk, and consumer protection.

**Systemic Risk**

Regulatory capital requirements are key in minimising risks to customers and counterparties arising from the financial failure of an investment firm or credit institution (Amvescap Plc., 2003:6). Markets cannot be relied upon to ensure that financial institutions make appropriate risk management and capital budgeting choices, thus, the need for regulatory intervention, in the form of capital regulation (Calomiris and Herring, 2002:4).

Prudential regulation of financial institutions ensures the stability of the financial system, which would otherwise be undermined by widespread failure of institutions. The failure of a large number of banks or a small number of significant banks could trigger a domino effect that may undermine the stability of the financial system (Berger et al, 1995:19).

While not all researchers concur that systemic risk is an important issue, widespread financial institution failures can inflict heavy social costs, which include but are not limited to, a reduction in credit extended, bottlenecks in the payment system, undermining of the effectiveness of monetary policy and a general collapse of confidence in the macro-economy (Berger et al, 1995:20).
Although several remedies to the risk of bank runs have been put forward in theoretical literature, they have their inherent shortcomings. Thus, when faced with the trade-off between the shortcomings of bank run remedies and the opportunity cost of holding capital by banks, regulators opt for imposition of capital standards. Increased capital requirements constitute an enhanced safety net for banks thereby reducing the inevitable social costs allied with a systemic crisis. Used in conjunction with compensation schemes (investor insurance), capital requirements have the auxiliary role of protecting regulators and the society (taxpayers) against the cost of bank failures, agency problems, and the reduction in market discipline caused by the safety net (Franks and Mayer et al., 2001a:113-114). Thus, to keep risks of default below a given threshold, deemed tolerable by a regulator, banks are required to hold capital.

KPMG (2013a) notes the heightened global focus on increased capital requirements for AMCs. There are many proponents who think that it is unnecessary to impose capital requirements on asset managers, arguing that AMCs do not pose systemic risk to the global financial system. Nonetheless, regulators seem to require ample evidence to support this viewpoint.

Incentive Problem of Government Action

From the research papers surveyed, it appears that the incentive problem of financial system safety nets or government protection is the most common argument for capital regulation. In its simplest form, government protection usually takes the form of deposit insurance; lender of last resort loans to assist troubled banks; or anticipated compensation of bank depositors.

Calomiris and Herring (2002:4) agree, noting that since taxpayers and in some instances, other financial institutions; bear the bulk of the costs associated with the failure of another institution to set aside adequate capital, an institution may face incentives to take on higher default risks. To quote Calomiris and Herring:

“Protected institutions can raise funds at default-free rates, then boost asset risk and leverage, and thereby enhance their expected profitability to stockholders”.

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Prudential capital regulation, thus, provides a tool for aligning incentives to ensure individual institutions do not abuse such protection.

A research by the BCBS (2010a:1), notes that the long-term impact of the committee’s capital reforms is a sturdier financial system which is less vulnerable to financial crisis and their allied losses. The BCBS contended that there was leeway to further tighten capital requirements whilst still yielding positive net benefits.

**Consumer Protection**

Consumer protection is another argument used to advance the use of minimum capital in prudential regulation.

Unsophisticated consumers find it challenging to appropriately analyse the quality of financial information and services provided to them. Consumers are thus vulnerable to asymmetric information, adverse selection and moral hazard. Adverse selection is the possibility that a customer will choose an incompetent or dishonest firm for investment or agent for execution of a transaction. In turn, moral hazard is the possibility that firms or agents will put their own interests or those of another customer above those of the customer or even engage in fraud. Unsophisticated consumers are, hence, vulnerable to incompetence, negligence, and fraud (Calomiris and Herring, 2002:4) and need to be protected.

**Capital Regulation to Promote a Level Playing Field**

Apart from the three (3) economic arguments for prudential capital regulation discussed in the foregoing, Calomiris and Herring (2002:4) add a political-economic dimension, that is, the need to maintain a “level playing field” among potential competitors. By enforcing uniform minimum capital standards through the Basel Accords, internationally active institutions headquartered in different countries are required to compete on an equal footing. Establishing competition on an equal footing reduces the chance of a “race to the bottom”, the alleged tendency for regulators to promote risk-taking so that their financial institutions might gain or retain international
market share.

**Determination of Financial Institution Ranking**

Another angle to the importance of regulatory minimum capital standards is described by Estrella (2000). Estrella (2000:6-7) states that minimum capital requirements provide a means to determine large first-order exposures in an informative but approximate way, since minimum capital is:

a) objective and verifiable - the basic information and formulas used to compute regulatory capital standards are well defined;
b) comparable across institutions and across time, and bears a stable relationship to the underlying positions;
c) a guidepost, representing the minimum required level; and
d) an early warning indicator that an institution’s net worth has deteriorated to socially costly and negative level.

This ranking is essential in determining the regulatory cycle for a certain sector, that is, the degree and frequency of monitoring of institutions.

**2.2.2. Operational Risk in Asset Management**

Operational risk has been advanced as the major risk inherent in asset management business (Franks and Mayers et al., 2001a:80-81, 89). The question arises, what is operational risk and in what form does it manifest itself in AMCs.

Doerig (2001:20) provides an array of operational risk definitions adapted from the work of several researchers. He lists the following operational risk definitions:

a) the risk of everything other than credit and market risk;
b) risk associated with the Operations Department;
c) risk that deficiencies in information systems or internal controls will result in unexpected loss. Thus, the risk associated with human error, systems failure, and inadequate procedures or controls; and
d) risk of direct or indirect losses resulting from inadequate or failed processes,
people, and systems or from external events.

The BCBS (2011:3) defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic, reputational and systemic risk. The BCBS (2003:2-3) goes further to highlight seven (7) operational risk event types, that is, internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; damage to physical assets; business disruption and system failures; execution, delivery and process management.

Much reliance in terms of the documentation of the most common operational risks in AMCs is placed on the studies by Franks and Mayers et al. (2001a) and Blais et al (2003). Oxera Consulting Limited (2006:126-129) makes reference to these studies and note the same top four (4) operational risks, in terms of frequency and magnitude of loss, as those identified by Franks and Mayer et al. (2001a).

Table 2.1: Top Four Operational Risks in Terms of Magnitude & Frequency

<table>
<thead>
<tr>
<th>Largest Losses (in descending order)</th>
<th>Highest Frequency (in descending order)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Breach of client guidelines</td>
<td>Breach of client guidelines</td>
</tr>
<tr>
<td>Misdealing</td>
<td>Mischealing</td>
</tr>
<tr>
<td>Unit trust mispricing</td>
<td>Settlement problems</td>
</tr>
<tr>
<td>Risk from new business</td>
<td>Unit trust mispricing</td>
</tr>
</tbody>
</table>

*Source: Authors' own table derived from Franks and Mayers et al (2001a:80-81, 89)*

The least significant operational risks in terms of magnitude of loss and frequency of occurrence were stock lending failure and financial insolvency, respectively.

2.2.3. The Extension of Minimum Capital Requirements to Asset Managers

Reasons put forward by regulators, worldwide, for the extension of capital regulations to asset managers are more or less similar.


¹¹ Annexure to correspondence to the BCBS dated 29 July 2003.
‘that in light of the results of the Toulouse Study\textsuperscript{12} evidence or confirmation abounds to support the view that neither systemic risk nor the incentive problem are sufficient justification for capital regulation of investment advisory companies. They cite only investor protection as being relevant to the regulation of risk in AMCs.

The above opinion is cited as being the main conclusions of the report by Franks and Mayer et al. (2001a)\textsuperscript{13} as well as the study published in the United States of America by the Investment Company Institute\textsuperscript{14}. Similar sentiments are expressed in Annex 1 of correspondence by the Fédération Européenne des Fonds et Sociétés d’Investissement (FEFSI) to the BCBS dated 30 July 2003, highlighting, investor protection, tempered with the need to avoid adverse effects on competition and attainment of a level playing field, as the main reason for imposing capital regulation on asset managers.

In contrast, other research works are of the opinion that capital provides clients with a cushion against losses sustained from operating failures of the business. Losses are said to be “covered up to the value of the reserves of the business” (Franks and Mayer et al, 2001b:7).

In light of the foregoing, the most widely advanced reasons for requiring minimum capital requirements for asset managers are:

a) investor protection;

b) attainment of a level playing field among financial institutions;

c) provision of cushion against unexpected operational risk; and

d) financial sector stability -which involves:

i) ensuring that only sound and competitive institutions engage in asset

\textsuperscript{12} “Operational Risk and Capital Requirements in the European Investment Fund Industry”, A Report by Bruno Blais, Catherine Casamatta and Jean-Charles Rochet, January 2003, IDEI - Université de Toulouse, an independent research project commissioned by FEFSI.


\textsuperscript{14} “The Regulation of Operational Risk in Investment Management Companies” by Professor Charles W. Calomiris and Professor Richard J. Herring, in Perspective, September 2002.
management business by imposing minimum capital requirements at entry (as part of the licensing criteria) to deter weak institutions; and
ii) countering regulatory arbitrage by ensuring that all financial institutions are effectively regulated and required to maintain minimum capital.

2.2.4. Applicability of Capital Regulation to Asset Management Companies

The Unique Risk and Financial Profile of Asset Managers

Proponents of capital regulation for AMCs assume that the asset management industry bears seeming resemblance to the banking industry, and has much in common with it in terms of operational risk (Calomiris and Herring, 2002:4).

The European Asset Management Association (correspondence to the European Commission dated 23 February 2001:3) acknowledge that prudential capital requirements for banking institutions are justified on grounds of mitigation of systemic risk and investor protection. However, they note that the asset management industry is distinct from the banking industry due to several reasons, cited below.

Asset managers present a vastly different risk profile from credit institutions and other investment firms, for which regulatory capital regimes are designed, due mainly to segregation of client assets from proprietary assets; absence of involvement in the settlement process; absence of principal trading positions or a trading book; absence of securities underwriting business; absence of money lending business; and availability of appropriate insurance cover (Amvescap Plc., 2003:6).

These differences mean that AMCs are not exposed to credit and market risk, or operational risk to the same extent that credit institutions and position taking investment firms are, and accordingly, do not pose a material systemic risk. In addition to, and partly as a result of, their different risk profile, asset managers generally have a different financial profile to most other financial services firms. Thus, they generally have a low value of assets on their balance sheets and are frequently transacted at a premium to net book value (Amvescap Plc., 2003:7).
Limited Role of Capital Requirements in the Asset Management Industry

Capital regulation of the asset management industry has largely been premised on the need to mitigate the risks arising from the factors discussed hereunder. The ensuing discussion will examine if there really is a rationale for imposing minimum capital requirements on AMCs.

Systemic Risk - there is no systemic risk rationale for imposing regulatory capital requirements since operational risk is highly idiosyncratic. Correlation of risk events across financial institutions is low, whilst, the spillover effect of financial distress from one institution to another, extremely unlikely. The likelihood of systemic ramifications from losses in investment advisory companies is considered negligible. Operational losses with the potential to result in the collapse of an institution are mostly attributed to internal control failures, not inadequate capital. Thus, no rational amount of capital is sufficient to cover extreme operational risk events (Calomiris and Herring, 2002:2 and Herring, 2009:5-7).

It has been observed by research studies conducted in other jurisdictions that market failures that occur in asset management are different from those that occur in banks. Market failures in the asset management sector are mainly motivated by information asymmetries and fraud, and not in general systemic risk.

Franks and Mayer et al. (2001a:115) quote Llewellyn (1999) to substantiate the foregoing, noting that systemic risk is less evident or non-existent for NBFIs, which include asset managers. Financial sector contagion risk is unlikely to occur:

a) due to the nature of the contracts involved in asset management business - asset managers merely act as agents for investors;
b) in the event that an investment manager fails, client funds are held separately from the firm’s own assets and are easily transferred at minimal costs to another asset manager (Franks and Mayer et al., 1989); and
c) provided AMCs do not take positions on their own account, inter-linkages between
institutions are limited. Thus, the collapse of one asset manager will not have repercussions elsewhere in the financial system.

The Financius Jurist (2011, para. 2-4 and para. 9) disputes the assertion that minimum capital requirements are premised on the notion that an AMC’s capital base is interconnected with its FUM. They contend that asset managers are simply agents and that regulatory capital does not afford protection in times of distress nor does it provide required liquidity in the event that asset managers need to fund redemptions by investors. Regulatory capital is unlikely to suffice since AMCs manage funds that are many times larger than their net capital base. Thus, use of minimum capital requirements, as a means of dealing with illiquid investments, negates asset managers as simply being pass-through vehicles.

**Investor Protection** - Calomiris and Herring (2002:2) argue that out of the various justifications put forth for minimum capital requirements, it appears that only consumer protection is applicable to the regulation of operational risk in investment management companies.

The scale of any liabilities to clients arising from operational failures is small and the resultant impact of any operational failure is mitigated by keeping client assets legally separate from the asset manager’s own assets and ensuring that these assets are held by external or non-group custodian. The foregoing reasoning weakens the argument for the use of minimum capital requirements to safeguard investors.

Calomiris and Herring (2002:5) liken capital regulation to a blunt and ineffectual instrument with regard to consumer protection. Although they concede that capital does provide a measure of protection against default risk, its usefulness in terms of customer protection is best served in the context of banking institutions where consumers hold claims on the regulated institution.

**Moral Hazard** - Calomiris and Herring (2002:2) contend that the use of capital
requirements to control risk in investment management companies cannot be rationalised on the basis of protection against abuse of the bank safety net (moral hazard) and systemic risk, as in the case of banks. By their very nature, asset managers do not issue depository claims or depository claims guaranteed by the government.

In addition, as opposed to banking institutions, investment management companies are not catered for by government insurance and safety net. Consequently, there is no moral-hazard justification for capital regulation of investment companies (Calomiris and Herring, 2002:3-4).

**Level Playing Field** - Trying to level the playing field between financial institutions of varying size and risk profile, that is, banks and asset managers seems inapt since the rationale for imposing the capital charge on banks does not apply to investment management companies. Banks and asset managers pose different systemic threats to the financial system and should be treated differently (Annex 1 of correspondence by FEFSI to the BCBS dated 30 July 2003:6).

Trying to equalise capital requirements may be an unsuitable instrument to level the playing field. Financial institutions differ across a number of dimensions, not just capital requirements. True leveling of the playing field would make capital requirements commensurate with risk, or more generally, provide a regulatory framework that equates the marginal cost with the marginal benefit associated with taking greater risk (Annex 1 of correspondence by FEFSI to the BCBS dated 30 July 2003:6).

Frank and Mayer et al. (2001:116) quote Schaefer (1992) as well as Dimson and Marsh (1996) who point out that there is no case for a level playing field between banks and asset managers. This is particularly so if the socially optimum capital requirement for a certain type of institution depends on the systemic costs imposed on society by its failure. These costs differ across institutions. This explains why
theoretical literature considers capital requirements mainly in the context of banks and not NBFIs, in this case asset managers.

**Operational Risk** - The size of operational losses in the asset management sector is low (Biais et al., 2003:18). The European Asset Management Association (2001:4) state that the typical size of operational loss sustained within the European asset management industry is lower than the amount of capital required. The only type of operational loss likely to exceed the required capital is loss occasioned by fraud.

The level of capital that would be required to counteract the effect of possible fraud would seriously limit the competitiveness of the asset management industry.

**Potential Damage to the Asset Management Sector**  
There are potential negative unintended effects of relying on minimum capital requirements to regulate asset managers.

The main consequence of imposing inappropriate capital regulations on investment advisory companies is raising barriers to entry and making the structure of the asset management industry less competitive. Limiting the number of asset managers leads to inefficient price discovery (provision of services not done in an innovative low cost manner).

The European Asset Management Association (2001:4-5), with reference to European asset managers highlight potential damage due to high capital requirements as follows:

a) damage to competition within European asset management industry. The asset management sector is highly competitive in terms of level of fees and quality of service provided. One of the reasons for the high degree of competition is the low entry barriers into the industry. Imposition of capital requirements would constitute an entry barrier;

b) damage to competitive position of European asset management industry - high
capital requirements increase the cost base of carrying on business and this higher cost needs be reflected in fees charged to customers, rendering AMCs subject to minimum capital requirements less competitive;

c) damage to small business - small business are adversely affected by the imposition of capital requirements. Firstly institutions wishing to set up a small niche asset management business would be inhibited from doing so. Secondly, many small AMCs specialise in investing in smaller quoted companies the market capitalisation of which may be too low to be considered by a larger AMC. To the extent that small AMCs are discouraged from operating, there will be fewer institutions in operation, hence, expertise available.

Herring (2009:5-8) is of the opinion that setting aside an operational risk capital charge is misguided. Herring queries the very definition of operational risk noting that the internationally accepted definition of operational risk ignores business risk and excludes indirect costs and reputational risk. Business risk is a critical component in asset management companies, considering that the largest component of operational risk economic capital is set aside for business risk.

2.2.5. Alternatives to Capital Regulation for the Asset Management Sector

According to Biais et al. (2003:4), since it is not socially efficient to impose large capital requirements to ensure customer protection regulators can rely on other tools. They add that imposing a regulatory regiment requiring the facets listed hereunder is critical in mitigating operational risk in an investment management setting:

a) mandatory holding of investors’ assets with a third-party supervised institution;
b) compulsory risk spreading and management process;
c) governance regulation;
d) multi-level controls that range from internal audit, compliance procedures, external depositaries/trustees to independent auditors; and
e) active involvement of regulators in establishing and monitoring regulations.

The report compiled by the European Asset Management Association (2001:6) adds
an additional dimension indicating that market failures that occur in the asset management sector are best corrected by a combination of disclosure, auditing, enforcement, insurance, custody and trustees, rather than indirectly through capital requirements.

Franks and Mayer et al. (2001a:16) as commented on by Calomiris and Herring (2002:16) agree demonstrating that market failures that occur in AMCs are different from those that occur in banks. In the former instance, market failures arise from information asymmetries and fraud, and generally not from systemic risk. The most ideal means to rectify these deficiencies is directly, through a balanced regime of disclosure, auditing, enforcement, insurance, custody, and trustees, rather than indirectly through capital requirements.

The Joint Forum (2001:38) assert similar views noting that investment company regulation is premised on (i) inspections and reporting - coupled with an annual audit by an independent auditor, to authenticate periodic reports submitted to the Regulator; (ii) quality of books and records processes - critical in providing assurance that an entity is complying with requisite anti-manipulation and anti-fraud regulations; (iii) operational controls - as enshrined in sound internal policies detailing limits, confirmation of all deals booked, and segregation between of front and back office functions; (iv) safe custody of client assets; and (v) capital - the primary cushion against potential loss.

Herring (2009:7-11) notes that pillar II is most effective in mitigating operational risk. Sound procedures, policies and practices are most effective in mitigating operational losses arising from internal events, and insurance for external events. Thus, the supervisory review process is more adept at managing operational risk as opposed to arbitrary extension of capital regulation. Further, operational risk capital regulation may result in further distorting competition.

Financius Jurist (2011, para. 2-3) indicate that instead of imposing a uniform capital
requirement for all AMCs, regulatory capital requirements need to be proportionate to the level of funds under management. Risk management systems, investor education and investor protection are considered more critical aspects in the asset management sub-sector.

Thus, the most direct means to mitigate or prevent the failure of AMCs is through implementation of safe custody arrangement, rigorous information disclosure requirements, enforcement, auditing, use of compensation schemes, insurance and conduct-of-business rules, as opposed to capital.

To effectively provide for investor protection, the most compelling reason for regulating asset managers, a combination of institutional arrangements and/or formal systems of regulation is required (Franks and Mayer et al., 2001a:14).

The account hereunder further elaborates the alternatives to capital regulation, highlighting their superiority to minimum capital requirements as well as their shortcomings.

**Operational Risk Transfer**

Various instruments may be employed to transfer operational risk. Insurance coverage seems to be most widely used and preferred operational risk transfer methodology (Joint Forum, 2003:1).

**Insurance**

Institutions have several options to mitigate identified operational risk. Internal control measures may be implemented to manage low-severity, high-frequency operational risk. Residual risk not mitigated by internal controls, may be absorbed by earnings, provided they are within the AMCs Board determined risk tolerance threshold. High-severity, low-frequency losses (tail risk) not mitigated by the above measures are best dealt with through operational risk transfer (Joint Forum, 2003:9-10). Frank and Mayer et al (January 2001b:13) concur indicating that firms regard insurance as particularly
relevant to areas where substantial losses occur as a consequence, for example, of
fraud and failures in information technology systems.

Calomiris and Herring (2002:12) describe insurance as a particularly beneficial
approach to risk management. Large insurance companies, which pool and reinsure
the losses of many firms, would be in a better position to absorb small-probability,
large losses associated with operational risk. Thus, laying-off the risk via insurance
would be superior to internally absorbing the risk via capital.

Conventional protection from insurance markets takes the form of fidelity cover,
professional indemnity insurance, employee fidelity and fraud insurance, and other
insurance, including civil responsibility, real estate & property, business interruption
insurance, electronic/computer crime, general liability, employment practices liability,
and directors’ and officers’ liability insurance (BCBS, 2010b:10).

Biais et al.(2003:4) note that, the use of insurance cover as a risk mitigation tool
create an incentive for institutions to develop sound monitoring and management
systems for operational risk. The resultant effect would be a reduction in capital
requirements for institutions contracting operational risk insurance. The drawback with
the use of insurance highlighted by Biais et al.(2003:4) is the need to further develop a
more effective operational risk insurance market, in particular to cover low frequency,
high impact risks. Moral hazard, regulatory capital arbitrage, risk concentrations, intra-
group risk transfer, transparency are additional issues of concern attendant with
insurance noted by The Joint Forum (2003:19-21).

However, studies conducted on the usefulness of insurance for asset managers have
noted that there are doubts about the promptness and reliability with which claims are
met by insurers. In addition, a study by the Joint forum (2003:3) points out that
operational risk transfer through insurance is a growing trend, but, there is need to
ensure that the process is well managed and regulated to ensure that the risks
attendant with risk transfer are aptly catered for.
Further, gaps and overlaps have been identified in terms of mapping institutions’ operational risk profiles to the traditional insurance policies. Strides towards the creation of new operational risk insurance products are at hand according to the BCBS (2010b:12). The proposed ‘basket’ operational risk policy addresses identified gaps in conventional insurance cover, allowing insurance companies to supply supplementary types of cover, thus providing benefits from diversification.

**Outsourcing**

Outsourcing is another dimension to risk transfer as it enables an entity to focus on its core business. However, outsourcing may not always result in risk transfer given that it exposes an institution to strategic, reputational, compliance, operational, exit strategy, counterparty, country, contractual, concentration and systemic and access risks (The Joint Forum, 2005:9-11). If managed effectively allow the asset manager to yield the intended benefits of outsourcing.

The Joint Forum developed and published high-level principles on outsourcing in financial services, in 2005. These principles provide guidance on best practices with respect to outsourcing. In addition, in other jurisdictions specific regulatory guidance on how outsourcing activities are to be undertaken has been issued as shown below.

**Table 2.2: Outsourcing Approaches in Other Jurisdictions**

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulatory Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Common guidance circular for banking and investment services sector issued in June 2004 by the CBFA.</td>
</tr>
<tr>
<td>Canada</td>
<td>Guideline B-10 which outlines regulatory expectations on outsourcing published by OSFI in May 2001 (revision issued in December 2003). Guideline applies to all federally regulated entities.</td>
</tr>
<tr>
<td>France</td>
<td>New provisions introduced in 2005 in the form of regulation 97-02 relating to internal control in credit institutions and investment firms. Provisions cover both material and non-material outsourcing.</td>
</tr>
<tr>
<td>Germany</td>
<td>In December 2001, regulatory authorities issued guidelines on outsourcing covering all credit institutions and financial services institutions.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Swiss Federal Banking Commission (SFBC) introduced “Outsourcing Guidelines”</td>
</tr>
</tbody>
</table>
### Compensation Schemes

In the absence of well-functioning insurance markets, more emphasis should be laid on compensation funds.

The Financial Stability Forum on Enhancing Market and Institutional Resilience (2008) as quoted by the BCBS (2009:1) support the above noting that the recent financial crisis emphasised the significance of effective compensation schemes.

Strong and robust safety net mechanisms protect investors and foster financial system stability. To quote the BCBS (2009:1):

> “Explicit investor insurance has become the preferred choice compared to reliance on implicit protection. Investor protection schemes promote public confidence, help contain the costs of resolving failed institutions, provide countries with an orderly process for dealing with institutional failures; and a mechanism for institutions to fund the cost of failures.”

Further, preconditions of a robust investor compensation scheme create an enabling environment conducive to effective and holistic AMC regulation. These include, among others, ongoing assessment of the financial system and the economy as a whole; strong prudential supervision and regulation; and a well-developed legal, disclosure and accounting framework (BCBS and IADI, 2009:2).

Thus, compensation schemes encourage (discourage) entry and compensation where

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulatory Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America</td>
<td>Rules 342, 346 and 382 of the New York Stock Exchange (of which most large firms are members) have certain restrictions on outsourcing with respect to securities firms. The Securities Exchange Act of 1934 requires certain registering with the U.S. Securities and Exchange Commission before outsourcing may be done.</td>
</tr>
</tbody>
</table>

they are large (small) in relation to the regulatory burdens imposed on firms; subsidise high-risk firms at the expense of low risk firms or the taxpayer; and therefore, at least in part, make entry easier by mitigating the consequences of other forms of regulation, in particular, capital requirements.

However, like government assistance or intervention, compensation schemes misrepresent the operational landscape of AMCs, thus, the competitive setting of the sector between countries. Since compensation schemes shield the asset manager’s clients from bearing all the costs of the firms’ failure, they may create externalities.

While this shortcoming of compensation schemes might be thought to justify the imposition of capital requirements, regulators cannot readily establish the extent to which compensation schemes influence firms’ capital structure decisions (Calomiris and Herring, 2002:13).

**Process Regulation**

As operational losses result from inadequate or failed internal processes, people and systems or from external events, the most direct approach to limit operational risk is to implement carefully monitored internal controls and risk management systems.

Reliance on process regulation to regulate operational risk, used in conjunction with private insurance, ensures the investor protection whilst preserving competition. Thus, rewarding lower risk with lower costs of compliance ensures free entry of efficient investment management companies, and ultimately a level playing field.

Calomiris and Herring (2002:17) add that in light of various problems associated with defining and measuring the “additionality” to overall risk coming from operational risk and with quantifying the amount of capital needed to absorb losses, process regulation and mandatory private insurance are the best approaches to dealing with this risk.
Biais et al. (2003:14) explain that process regulation reduces moral hazard and consequently the need for capital requirements. It can to some extent substitute (and prove less costly than) capital requirements. In exchange for less demanding capital requirements, the regulator would require asset managers to provide clear evidence of rigorous and effective control and compliance systems. Hence, it might be efficient in this context to offer a menu of regulatory regimes to fund management companies.

Process management in operational risk can be summed up by referencing the work of the BCBS (2003:4-5) which outlines principles of sound practices for managing operational risk premised on an appropriate risk management environment, risk management, regulatory supervision and disclosure. The updated guidance (BCBS, 2011) incorporates progression of sound industry practices noting that comprehensive operational risk management is premised on the risk management environment, governance and disclosure. A new mindset comes to the fore, sound operational risk governance premised on three lines of defence: risk owners - business line management; an autonomous operational risk management unit; and independent review.

Process regulation can be augmented by self-regulatory organisation rules. These rules provide an additional layer of regulations to buttress both process and supervisory regulation. The focus of self-regulatory organisation rules is to institute certain internal controls in asset managers, the aim being to mitigate inherent risk, primarily, operational risk (The Joint Forum, 2003:36).

**Depositaries**

Both the BVI and FEFSI highlight depositaries as playing a key role of being asset safe keepers and monitors of certain obligations faced by the fund managers. They complement the monitoring role of the fund management company, and thus contribute to reducing operational risk.

The role of the custodian in addressing operational risks is extremely broad. The most
significant or probable operational risks to which AMCs are exposed to can be limited or hedged by the custodian, with the notable exception of misleading the investor, which can be subject to consistency control or warning procedures (The European Commission, 2005:24).

Disclosure and Transparency Requirements
These help investors to clearly understand the services and activities of investment fund management companies. This is particularly so if the regulator can directly observe the efficiency and reliability of the control systems implemented by the fund management company, helping reduce the need for capital requirements.

2.3. EMPIRICAL LITERATURE REVIEW & EXPERIENCES OF OTHER COUNTRIES

2.3.1. Operational Risk in Asset Management
Biais et al. (2003:18-22) as noted above, report misdealing, breaches of fund rules and errors in the computation of net asset values as the main sources of operational risk in asset management. Franks and Mayers et al. (2001a:80) collaborate these findings as shown in the diagrammatical representation below.

The distribution of operational loss is skewed, with frequent small losses and rare large losses (Biais et al., 2003:35).
2.3.2. Capital Regulation and Alternate Forms of Investor Protection

Minimum capital requirements in other jurisdictions studied by Franks and Mayer et al. (2001b) are generally low. The survey results highlight that the maximum capital requirement is €730,000 (USD988,493 using the exchange rate as at 11 June 2014).

Appendix 3: Regulation of Asset Management Institutions in other Jurisdictions outlines that capital regulation buttressed by other forms of protection, is used to regulate the asset management sector. The most compelling observation is that these other forms of protection are provided for at law and, thus, legally enforceable. In instances, that alternative to capital regulations are not enshrined at law, they are part of the constitution of asset management or investment management association conduct-of-business rules or charters.

The Financius Jurist (2011, para.9) note that a high capital requirement will not provide an adequate buffer to investment management firms in bad times, as evidenced by what transpired in October 2008, where the industry sharply declined by over 18% and the larger investment management companies had to approach the apex bank for redress.

Implications of the various forms of regulation on investor protection and the level of competition in the asset management industry is as summarised by Franks and Mayer et al. (2001b) below.

<table>
<thead>
<tr>
<th>Table 2.3: Impact of Different Responses on Investor Protection and Competition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investor Protection</strong></td>
</tr>
<tr>
<td>Capital Requirements</td>
</tr>
<tr>
<td>Custody/Trustees</td>
</tr>
<tr>
<td>Disclosure/Auditing</td>
</tr>
<tr>
<td>Insurance</td>
</tr>
<tr>
<td>Compensation Schemes</td>
</tr>
</tbody>
</table>

Source: Franks and Mayer et al. (2001b:14)
Most investor protection schemes are intended for deposit taking institutions, with two (2) “loose” exceptions. In Canada the deposit protection scheme covered all banks, trust and loan companies, whilst, in Sweden all banks and investment firms authorised to receive deposits were covered by the scheme (BCBS, 1998).

**Evolving Asset Management Regulation**

The global financial crisis revealed that regulatory structures in place were inadequate to regulate progressive financial markets. It, however, afforded regulatory bodies with a learning curve and an opportunity to strengthen and enhance their regulatory oversight systems.

The ICI put forth a number of proposals to modernise the regulation of investment managers to reflect the current financial landscape, with particular reference to the USA. The salient features of the recommendations were as follows: the need for:

a) a systemic risk regulator, which could either be a new agency or designation of an existing body;

b) capital markets regulator, who among others, would be the regulatory best practice “trend setter” for registered AMCs; empowered to regulate areas wherein regulatory shortcomings exist as well as harmonise legislative standards applicable to asset managers; and maintain emphasis on investor protection;

c) enhanced collaboration, coordination and information sharing among various regulatory agencies;

d) periodic reviews of the existing regulatory structure to ensure that it was not outmoded by developments in the financial markets; and

e) enhanced investor education and disclosure. Although, the SEC has an Office of Investor Education and Advocacy that provides investor education on its website, the need for further investor outreach was noted.

The principal epicenters of regulatory change are the USA and the EU, although, regulatory reforms are also being implemented in other jurisdictions. The table below highlights the key regulatory reforms in the USA and the EU.
Table 2.4: Key European and USA Regulation

<table>
<thead>
<tr>
<th>European Regulation</th>
<th>US Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solvency II - minimum capital requirements, supervisor review and disclosure.</td>
<td>Commodity Exchange Act - CPO and CTA Registration and Reporting Requirements.</td>
</tr>
<tr>
<td>Markets in Financial Instruments Directive II (MiFID II)</td>
<td>Section 619 of the Dodd-Frank Act, also known as the “Volcker Rule”</td>
</tr>
<tr>
<td>European Markets Infrastructure Regulation (EMIR).</td>
<td>Dodd-Frank Act - Designation of Systemically Important Financial Institutions (SIFIs); measures to tackle consumer protection and systemic risk reporting; and more rigorous and wide-ranging approach to conduct rules.</td>
</tr>
<tr>
<td>UCITS IV, V &amp; Potential VI Directives.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Allen & Overy (2012:3)

Although pre-crisis regulation of AMCs focused on market efficiency, the new regulatory measures are aimed at increased capital requirements; enhancing investor protection; risk management practices; governance, accountability and fiduciary requirements for senior management, executives and directors; financial stability; disclosure (transparency of products and markets) and due diligence; which issues are fast becoming industry best practice. This is on the back of increased demands by discerning institutional investors, coupled with, regulatory change (KPMG, 2012b:2; KPMG, 2013a:8; and PWC, 2012c:2).

The regulatory reforms have compelled AMCs to review some of the fundamental ways in which they operate, the emphasis being on organisational structures, product development, cultures, investment strategies, distribution and marketing. Thus, asset managers have become more institutionalised in a short period of time.

Appendix 4: Salient Features of Key European Regulation provides a description of the salient features of some of the new regulatory reforms.

2.4. CHAPTER SUMMARY

Literature on the capital regulation of AMCs is in agreement in that the rationale for the imposition of minimum capital requirements on banking institutions cannot be in its
entirety applied to AMCs. It has been noted that neither systemic risk nor moral hazard problems provide sufficient justification for capital regulation of AMCs.

By virtue of the unique risk profile and operational characteristics of AMCs, the most probable justification of capital regulations of asset managers is investor protection and mitigation of unexpected risk. However, imposition of capital requirements on AMCs has been noted to have negative effects on the competitiveness of the sector, if capital regulation is not tempered with moderation.

International best practice is swayed towards the application of minimal capital requirements (capital regulation) used in conjunction with strong process regulation, enforcement, disclosure/audit, compensation, depositaries and operational risk transfer through insurance, all of which are enshrined at law.
3. CHAPTER THREE - RESEARCH METHODOLOGY

3.1. INTRODUCTION
This chapter presents the methodology used to conduct the research as well as a brief justification of the methods used to collect and evaluate data. The focus of the research is to ascertain if the extension of capital standards to asset management companies is appropriate and holistic in regulating these entities. The chapter outlines the research design; strategy; population and sampling technique; data collection; research procedure; and the research limitations.

3.2. RESEARCH DESIGN
A research design is a grand plan of the approach to a research question (Greener, 2008:38). Research design runs across the spectrum of the research process from the conceptualisation of a research idea to the compilation and presentation of research findings. The basis underlying the research design adopted by the researcher was the problem statement, the reason for being, for the research.

The study was qualitative in nature. Shank (2002:5) as quoted by Ospina (2004:2), define qualitative research as “a form of systematic empirical inquiry into meaning”. Thus, qualitative research only uses non-mathematical procedures when interpreting and explaining research (Greener, 2008:81).

A qualitative method was used in this research so the data collected would be correct and relevant (Greener, 2008:81). In terms of this approach, a questionnaire was designed and a sample of the employees was requested to complete them in order to assist in ascertaining their perceptions on the extension of capital standards to asset management companies is appropriate and holistic in regulating these entities. In addition, open-ended interviewing was employed to explore and understand attitudes, opinions, feelings, and behaviours of individuals or a group of individuals.
3.3. RESEARCH STRATEGY

A sample of employees from the Risk Management and Finance Departments of Zimbabwean AMCs, requisite regulatory bodies (RBZ and SECZ) and AIMZ were selected to participate in the study. In instances where an asset manager is part of a financial services group, employees from the Group Risk Department were co-opted into the sample. It was envisaged that individuals in the Risk Management and Finance Departments would have knowledge and information on the regulation of AMCs.

In a bid to achieve the aims and objectives of the research, the researcher elected to use the survey approach. A survey entails sampling a population, identifying a target sample, and studying that sample to make inferences about the larger population. A questionnaire was administered on identified respondents.

Ordinarily, surveys are used when large volumes of data are involved (with quantitative methods of analysis). In this study a sample of a forty-five (45) questionnaires which were considered to be a sizeable amount of data, were used.

3.4. POPULATION AND SAMPLING TECHNIQUES

3.4.1. Population

The Abey Francis (2010) defines a population as the entire aggregation of items, people, or objects or events, which have at least one characteristic in common, and from which a sample can be drawn. In this research, the population is confined to the asset management sector (and the Group Risk Departments of financial services group companies that encompass asset managers), regulatory bodies (RBZ and SECZ) and the AIMZ.

As at 31 March 2014, there were seventeen (17) registered AMCs in the asset management sub-sector. Of the seventeen (17) licensed asset managers, ten (10) were part of a financial services group company. SECZ through its Supervision and Surveillance Division regulates and supervises asset management companies.
Previously, the RBZ through its Bank Licensing, Supervision and Surveillance Division, regulated and supervised AMCs.

The research was concentrated in Harare considering that the target population has their head offices situated in Harare. In an asset management company as well as a financial services group, the Risk Management and Finance Departments are largely responsible for capital management and regulatory compliance. The Risk Management and Finance Departments are housed at the entities head office. The Supervision and Surveillance Division of SECZ and Bank Licensing, Supervision and Surveillance Division of the RBZ are also located in Harare. The SECZ and RBZ Examiners, Risk Management and Finance Department staff, and AIMZ employees, comprise the target population. This group of people was selected because it is considered to be in a better position to have knowledge about capital regulation and regulatory compliance in asset management companies.

3.4.2. Sampling Strategy

Sampling is the act, process, or technique of selecting a representative of a population in order to determine the characteristics of the larger population (Abey Francis, 2010). The researcher opted to employ simple random sampling in a bid to avoid bias. Saunders et al (2009:222-224) note that random sampling allows every member in the population to have an equal opportunity of being selected to participate in a study. The object of the sample size was to ensure an appropriate number of respondents participated in the research.

3.4.3. Sample Size

The table below highlights the sample size and how it was determined.
Table 3.1: Number of Organisations in the Population and Sample

<table>
<thead>
<tr>
<th>Type of Organisation</th>
<th>Total Number (N)</th>
<th>Number in the Sample (n)</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMCs (licensed AMCs as at 13 March 2014)</td>
<td>17</td>
<td>17</td>
<td>100</td>
</tr>
<tr>
<td>Group Risk Departments of financial services institutions which have an AMC (see Appendix 2: Licensed Zimbabwean AMCs as at 13 March 2014)</td>
<td>10</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>Industry Bodies (AIMZ)</td>
<td>1</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Regulatory bodies (RBZ and SECZ)</td>
<td>2</td>
<td>2</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
<td>30</td>
<td>100</td>
</tr>
</tbody>
</table>

The researcher distributed two (2) questionnaires to each of the licensed; one (1) questionnaire to each of the Group Risk Departments of financial services institutions which encompass an asset management company; one (1) questionnaire to the AIMZ; and two (2) questionnaires to both the RBZ and SECZ.

3.5. DATA COLLECTION METHODS

The section below discusses the primary and secondary data sources.

3.5.1. Primary Data Collection Instruments

Questionnaire

Questionnaires were used to collect primary data. Questionnaires enable the researcher to pose questions to subjects in their research to obtain answers to the research questions. Questionnaire eliminates interviewer bias and guarantees anonymity of respondents as most respondents in the research preferred to remain anonymous. The questionnaires covered a broad array of issues concerning capital regulation of AMCs (Saunders et al., 2009:364-365).

Questions were specifically designed to obtain relevant information from the sampling unit pertaining to the:

a) rationale and the relevance of requiring AMCs to hold regulatory minimum capital;

b) appropriateness and effectiveness of extending regulatory minimum capital requirements to AMCs; and

c) usefulness of alternative measures for regulating investment management firms.
The design of a questionnaire is critical to ensure that the correct research questions are addressed and that accurate and appropriate data for statistical analysis is collected. The questionnaire was designed in three sections, the administrative, classification and the information sought sections. The administrative section was used to record the identity of the researcher and the respondent. The classification section describes the respondent by a number of demographic characteristics.

Questionnaires have a number of advantages. They enable a researcher to gather facts, figures, amounts, statistics, dates, attitudes, opinions, experiences, events, assessments, and judgments during a single contact. In this regard, questionnaires were very effective in soliciting descriptive responses. In addition, they do not require trained interviewers. This was particularly important to a student who had not studied a human psychology course. Respondents were not required to state their names on the questionnaires, affording them anonymity and the ability to indicate their responses freely. Respondents were given the opportunity to answer the questions while the researcher was not present (except in instances where they willingly undertook to complete the questionnaire in the researcher’s presence).

Questionnaires were considered as a relatively inexpensive means to conduct the research, in comparison to other instruments. This was ideal considering the researcher’s budgetary constraints. In addition, given the standardised nature of the research instrument (i.e. the same questions were posed to different respondents) (Saunders et al., 2009:364-365); it was anticipated that responses would be gathered in a standardised way and therefore more objective, than other data collection methods.

Despite their advantages, questionnaires had a number of shortfalls. Regulation of asset management companies is a technical topic. Thus, the researcher faced the challenge of constructing simple and concise questions that could easily be understood by the respondents. Questionnaires also do not afford respondents an opportunity to seek clarification on issues they may be having difficulties in
interpreting.

**Questionnaire Distribution Strategy**

There are three major means of distributing questionnaires, namely, e-mail, personal distribution and direct mail. E-mailing involves sending questions using e-mail, with the responses also expected to be received using the same technique. Direct mail involves sending questionnaires to the respondents by mail. Personal distribution entails delivering the questionnaires by hand to the respondents and leaving them to go through the questionnaires and provide feedback.

Considering that the target population was based in Harare where the researcher was also based, the researcher made use of the personal distribution and e-mail techniques. Direct mail and e-mail distribution techniques were avoided because the questionnaires take time to be delivered to the recipients.

3.5.2. **Secondary Data Collection Methods**

Blumberg, Cooper and Schindler (2011:501) define secondary data as historical data collected and recorded by someone else for a purpose other than the current research project.

Secondary data is primarily used to accumulate further information which could have been unobserved during primary research. The use of secondary data is less time consuming as well as less expensive since databases and library research will be applicable to locate the information.

The researcher reviewed various documents, in the evaluation of secondary data. Documentary evidence used was in the form of published reports and other documents and information in the public domain. Throughout, qualitative methods were applied in collecting and processing data for the research.

The researcher benefited from the use of documentary review as information was
readily available. Various sources of information were used to give researcher wider scope. It was a cost effective method of data gathering in terms of time and finance. However, locating suitable documents was a challenge as some libraries did not file the records in a user friendly manner. In addition issues to do access block and reporting bias arose. Some information was deemed highly confidential therefore the researcher was denied access to the documents. Further, most documents have an in-built proneness to subjectivity because humans tend to report more favorably about themselves.

Research was also carried out from various websites on the internet. The Internet was considered of immense help as information was readily available on the Internet, various sources could be accessed in a short space of time, it was time and cost effective, and enabled the researcher easier and fast access to documents by experts on the subject matter at hand. However, use of the internet posed some disadvantages. Searching through various links was time consuming, whilst, the credibility of some data sources may be questionable since they may not have been easily verified. The researcher made every endeavor to substantiate the findings of one research work with other similar works on the subject matter at hand.

3.6. RESEARCH PROCEDURE

The completed questionnaires, in respect of those that were hand delivered to the respondents, were personally collected by the researcher. In instances where the respondents had ample time to complete the questionnaire in the presence of the researcher, informal discussions, which were particularly insightful, were held. In total, forty (40) questionnaires were distributed. Upon collection, the questionnaires were coded and cleaned. The data was then entered using Epi-info. Thereafter, it was exported to the statistical package, EPI-info.

3.7. ETHICAL ISSUES

Ethical issues allied and applicable to the research relate to damage of professional relationships, which, Gillespie (n.d.) contends occurs when principles of professional
conduct are violated. The violations take the form of plagiarism, failure to abide by laid-down regulations, data falsification (including but not limited to selective reporting), failure to ensure informed consent and abuse of confidentiality. For a researcher to effectively add to the body of knowledge, concise and accurate collection of data, detailed analysis and impartial reporting are critical. The researcher endeavoured to institute these baseline ethical considerations throughout the research (para. 14).

3.8. RESEARCH LIMITATIONS
The researcher encountered challenges in accessing requisite and up-to-date information for the research. The main challenge related to accessing recent empirical research on the regulation of AMCs. Further, ensuring that the targeted respondents timeously completed and returned the questionnaire proved challenging. The researcher made extensive follow-ups with the respondents to ensure that the questionnaire was completed and returned.

3.9. CHAPTER SUMMARY
Chapter three discussed the methodology used to collect and evaluate data. The chapter outlined the research design, research method, the population under study, the sampling procedure and the method used to collect data. The advantages and disadvantages of research instruments employed as well as ethical considerations relating to the research were covered in the chapter.
4. CHAPTER FOUR - RESEARCH FINDINGS AND DISCUSSION

4.1. INTRODUCTION
This chapter discusses the findings of the study, following an analysis of the primary data, through the use of a statistical package, EPI-info. The chapter provides insights into the use of capital regulation for AMCs and whether this is an appropriate and effective means to supervise the sub-sector, whilst highlighting alternative methodologies which may be used to reinforce capital resource requirements, taking cognisance of the peculiarities inherent in the operations of AMCs. In addition, the chapter outlines why regulators employ capital standards to regulate AMCs. The findings are accompanied by a discussion citing of the relevant literature on the subject.

4.2. RESPONSE RATE
Of the forty five (45) questionnaires administered to the target population, thirty seven (37) questionnaires were successfully completed. This represents 82.22% response rate.

Johnson and Owens (n.d.:132) indicate that a comparatively high survey response rate, alone, may not be adequate to assure that a paper is acceptable for publication; a relatively low rate could be enough to guarantee the rejection of research findings. To quote the results of a study conducted by Johnson and Owens (n.d.: 32):

“none of the journals contacted for the study reported formal policies, regarding minimally acceptable response rates, one did indicate that only in “rare” instances did a study with a response rate of less than 60% get accepted for publication”.

In light of the foregoing, an 82.22% response rate warrants reliability and validity of research findings.
4.3. BACKGROUND INFORMATION

4.3.1. Respondents’ Profiles

The research participants were drawn from asset management companies, Group Risk Departments of diversified financial services companies, regulatory and professional bodies.

The positions of the respondents varied, as did their qualifications and work experience. The respondents encompassed Fund Managers, Risk Managers (including Market Risk Managers), Compliance Officers, Auditors, Accounting Officers (and Managers), RBZ Bank Examiners, SECZ Examiners, as well as individuals with experience in AMCs.

The respondents had the requisite experience in their various disciplines and were involved in the compliance with the regulatory minimum capital requirements in their respective organisations; therefore, one could conclude that their responses were well informed and up-to-date.

4.3.2. AMC Regulatory Minimum Capital Requirement

The research sought to ascertain the regulatory minimum capital requirement for AMCs in Zimbabwe. The views of the various respondents are shown in the figure below.

![Figure 4.1: AMC Regulatory Minimum Capital Requirement](image)

Figure 4.1: AMC Regulatory Minimum Capital Requirement
Figure 4.1 shows that 71.4% of the respondents stated that the regulatory minimum capital requirement for asset managers was USD0.50 million (USD500,000.00), whilst, 28.6% argued that the regulatory minimum capital requirement for asset managers was USD10 million. This implies that the majority of the respondents were conversant with the regulatory minimum capital requirement for the asset management sub-sector.

4.4. CAPITAL REGULATION OF ASSET MANAGEMENT COMPANIES

4.4.1. Existence of Other Regulatory Capital Charges

The questionnaire sought to establish if there were any other regulatory capital charges, apart from the minimum capital requirement.

All the respondents that participated in the research were of the view that there were no other regulatory capital charges. This shows that there are no other regulatory capital charges levied to the asset management sub-sector in Zimbabwe. This is in line with literature on the capital regulation of AMCs, as expounded in the literature review, which makes reference to regulatory minimum capital requirements and no other capital charges.

4.4.2. Importance of Capital

An investigation was carried out to determine the importance of capital to asset managers. Some respondents indicated that capital was important as it allowed for the absorption of losses and was a vehicle for the growth of business. Others stated that capital was important as it served as a cushion against unexpected losses (particularly, operational risk losses) and enabled timely planning with less limitation on investments.

Moreover, the research established that capital was important to asset management companies as it safeguarded investors’ funds. Other respondents argued that capital was important to the sub-sector as it enabled indigenous AMCs to fulfill contractual and fiduciary responsibilities. In its simplest form, capital represents the free or
uncommitted portion of a financial institution’s assets. It is, therefore, available as a cushion in case the value of the institution’s assets decline or its liabilities rise (Elliott, 2010:1).

In support of the study findings, above, Franks and Mayer et al. (2001a:113-114) indicate that adequate capital requirements constitute an enhanced safety net for investment companies, thereby, reducing the inevitable social costs allied with a systemic crisis. Used in conjunction with compensation schemes (investor insurance), capital requirements have the auxiliary role of protecting regulators and the society against the cost of institutional failures.

Elliott (2010:1) concurs with these sentiments, by describing capital as one of the most important concepts in finance and banking, particularly, in light of the recent financial crisis which underscored the critical importance of capital for financial institutions. Also Franks and Mayer et al. (2001a:113-114) further add that, in the presence of deposit insurance, capital requirements have the additional role of protecting regulators and taxpayers against the cost of bank failures. Thus, to keep risks of default below a given threshold, deemed tolerable by a regulator, financial institutions are required to hold capital.

4.4.3. Internal Capital Standards

The survey sought to find out if AMCs had their own internal capital standards, the views of the respondents on the subject matter are presented below.

![Figure 4.2: Internal Capital Standards](image-url)
Findings in the figure above reveal that 42.90% survey participants agreed that their respective institutions had their own internal capital standards. Based on the responses from the majority of the respondents, one can imply that most AMCs do not have their own internal capital standards, over and above the regulatory minimum capital requirement. The Joint Forum (2003:9-10) concur that internal capital standards may be implemented to manage low-severity, high-frequency operational risk. Residual risk not mitigated by internal capital controls, may be absorbed by earnings, provided they are within the AMCs Board determined risk tolerance threshold, hence it is not very popular to asset management companies. Frank and Mayer et al. (2001b:13) corroborate indicating that firms regard internal capital standards as particularly relevant to areas where substantial losses occur as a consequence, for example, of fraud and failures in information technology systems.

4.4.4. Appropriateness of Current Capital Requirements for Regulating AMCs

The researcher asked the respondents whether the current capital requirement was appropriate for regulating asset managers. The responses are summarised below.

As shown above, 93% of the respondents were of the view that the current regulatory minimum capital requirements were appropriate for regulating asset managers. However, a minority (7%) of the respondents disagreed, noting that the regulatory capital requirement was not appropriate to holistically regulate AMCs. Respondents
added that the minimum capital requirement (of USD500,000) was appropriate given that the risk of loss arising from the asset management sector was lower than for other financial institutions. In addition, client assets were managed under specific mandates and the asset manager indemnified in the event that the client incurs any losses.

Explanations put forward by regulators, worldwide, for the extension of capital regulations to asset managers are more or less similar. The research literature in light of the foregoing, states that the most widely advanced reasons for requiring minimum capital requirements for asset managers are:

a) investor protection; and
b) provision of cushion against unexpected operational risk.

Other research work agrees that the basis for capital regulation of investment managers is investor protection, tempered with the need to avoid adverse effects on competition and attainment of a level playing field (Financius Jurist, 2011, para. 2-3).

In contrast, there is an opinion that capital provides clients with a cushion against losses sustained from operating failures of the business. Losses are said to be “covered up to the value of the reserves of the business” (Franks and Mayer et al., 2001b:7).

4.4.5. Effectiveness of Minimum Capital Requirements in Regulating Asset Managers
Survey investigated whether minimum capital requirements are effective in regulating asset managers.

All the respondents that participated in the survey agreed that minimum capital requirements are effective in regulating asset managers. The research therefore implies that minimum capital requirements are effective in regulating asset managers. Respondents were further probed on their reasons of the response given and stated that minimum capital requirements are effective in regulating asset managers as it minimizes the risk of abusing client money and to some extent they deter fraudulent
firms from obtaining a license. The effectiveness of minimum capital requirements in the regulation of asset managers is important as it enhances valuation of market players and detection of fraud.

In addition to the study findings, the research literature adds that asset managers present a vastly different risk profile from credit institutions and other investment firms, for which regulatory capital regimes are designed, mainly due to segregation of client assets from proprietary assets; absence of involvement in the settlement process; absence of principal trading positions or a trading book; absence of securities underwriting business; absence of money lending business; and availability of appropriate insurance cover according to (Amvescap Plc., 2003:6). On the other hand, as indicated by Biais et al. (2003), since it is not socially efficient to impose large capital requirements to ensure customer protection, regulators can rely on other tools.

According to Calomiris and Herring (2002:18) capital regulation comes at a cost, especially when regulatory requirements do not capture underlying variances in risk. Use of capital regulation may fail to reward lower risks and better managerial practices with lower costs. This is the case, since capital regulation is in most instances, not risk-sensitive (imposes a uniform cost irrespective of risk profile), thus, working at cross-purposes to efficient market competition.

4.5. OPERATIONAL RISK IN ASSET MANAGEMENT

4.5.1. Operational Risk in Asset Management Companies

The study sought to determine the form in which operational risk occurs in AMCs. The opinions of the respondents are tabulated below.

<table>
<thead>
<tr>
<th>Form of Operational Risk</th>
<th>% Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal fraud</td>
<td>93</td>
</tr>
<tr>
<td>External fraud</td>
<td>84</td>
</tr>
<tr>
<td>Employment practices and workplace safety</td>
<td>85</td>
</tr>
<tr>
<td>Clients, products and business practices</td>
<td>77</td>
</tr>
<tr>
<td>Damage to physical assets</td>
<td>65</td>
</tr>
<tr>
<td>Business disruption and system failures</td>
<td>92</td>
</tr>
</tbody>
</table>
Table 4.1 above, shows that 93% and 92% of the respondents, stated internal fraud, business disruption, and system failures, respectively, as the main forms in which operational risk was manifest in asset managers. On the contrary, 85% and 84% of the respondents indicated employment practices and workplace safety; and external fraud as the main form in which operational risk occurs. According to 77% of the survey participants, the form in which operational risk was manifest in asset managers was clients, products and business practices, whilst, 65% of the respondents argued that damage to physical assets was a significant form of operational risk occurrence in asset managers.

In light of the foregoing, internal fraud; and business disruption and system failures are the main sources of operational risk in asset managers. Other significant sources of operational risk in asset management companies are external fraud; clients, products and business practices; and employment practices and workplace safety.

In support to the research findings, the BCBS (2011:3) defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (the definition includes legal risk but excludes strategic, reputational and systemic risk). The BCBS (2003:2-3) goes further to highlight seven (7) operational risk event types, similar, to the main sources of operational risk indicated by the research findings.

4.5.2. Impact of Operational Risk Forms

Table 4.2 provides a ranking of the impact of the various sources of operational risk, as put forward by the respondents. The rankings were averaged by the researcher [on a scale of 1-7, lowest (1) to Highest (7)].

<table>
<thead>
<tr>
<th>Operational Risk Forms</th>
<th>Impact (Average Rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal fraud</td>
<td>5</td>
</tr>
<tr>
<td>External fraud</td>
<td>4</td>
</tr>
<tr>
<td>Employment practices and workplace safety</td>
<td>4</td>
</tr>
<tr>
<td>Clients, products and business practices</td>
<td>6</td>
</tr>
</tbody>
</table>
Operational Risk Forms

<table>
<thead>
<tr>
<th>Operational Risk Forms</th>
<th>Impact (Average Rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Damage to physical assets</td>
<td>4</td>
</tr>
<tr>
<td>Business disruption and system failures</td>
<td>3</td>
</tr>
</tbody>
</table>

The respondent’s highlighted clients, products and workplace safety as having the highest rank (ranked sixth) in terms of impact, whilst, internal fraud was ranked fifth. All the other operational risk forms with the exception of business disruption and system failures were ranked fourth, in terms of impact, by the survey participants. Based on the findings, the researcher can infer that clients, products and business practices; and internal fraud have the highest impact, while, external fraud; damage to physical assets; and employment practices and workplace safety, have a moderate impact.

The most obvious risks encountered by AMCs are created as a result of failure to fulfill contractual and fiduciary responsibilities, lost business, litigation and failed strategic business initiatives (OCC, 2011:3). Other risks, which are more subtle but as potentially damaging arise from the manner in which an institution markets itself, the quality and integrity of the individuals it employs and the type of leadership and strategic direction provided by its board of directors and senior management.

4.5.3. Frequency of Occurrence - Sources of Operational Risk

The table below presents the average rankings, as indicated by the survey participants, on the frequency of occurrence of the various sources of operational risk.

<table>
<thead>
<tr>
<th>Sources of Operational Risk</th>
<th>Average Rank [Scale of 1-14, from Lowest (1) to Highest (14)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock lending failures</td>
<td>3</td>
</tr>
<tr>
<td>Financial insolvency</td>
<td>6</td>
</tr>
<tr>
<td>Failure to collect income</td>
<td>4</td>
</tr>
<tr>
<td>Settlement problems</td>
<td>5</td>
</tr>
<tr>
<td>Failure to best execute</td>
<td>6</td>
</tr>
<tr>
<td>Failure to reconcile assets</td>
<td>5</td>
</tr>
<tr>
<td>I. T. systems failure</td>
<td>5</td>
</tr>
<tr>
<td>Failure to meet guarantees</td>
<td>3</td>
</tr>
<tr>
<td>Fraud</td>
<td>4</td>
</tr>
<tr>
<td>Risks from new business</td>
<td>4</td>
</tr>
</tbody>
</table>
Survey participants ranked financial insolvency and failure to best execute as the most frequently occurring forms of operational risk. Breach of client guidelines, settlement problems, failure to reconcile assets and I.T. systems failures were ranked fifth. Failure to collect income, fraud, risks from new business and unit trust mispricing were ranked fourth in terms of frequency of occurrence.

One can conclude, that the major sources of operational risk in terms of frequency of occurrence are financial insolvency and failure to best execute, based on the results tabulated in Table 4.3. In addition, other sources of operational risk with a high frequency of occurrence were settlement problems, failure to reconcile assets, I.T. systems failure and breach of client guidelines.

Franks and Mayer et al. (2001a:89) highlight that the most frequently occurring (in descending order) sources of operational risk in AMCs as breach of client guidelines; misdealing; settlement problems and unit trust mispricing. According to Biais et al. (2003:16-17) misdealing; settlement process; mispricing; and breaches of investment rules are the common sources of operational risk in asset management. Operational risk often results in high frequency low impact losses, which are easily mitigated through robust internal controls. Residual risk not mitigated by internal controls, may be absorbed by earnings. High-severity, low-frequency losses (tail risk) not mitigated by the above measures are best dealt with through insurance (Joint Forum, 2003:9-10). The drawback with the use of insurance highlighted by Biais et al. (January 2003:4) is the need to further develop a more effective operational risk insurance market, in particular to cover low frequency, high impact risks. Hence, the use of regulatory minimum capital requirements to mitigate against these risks.

Internal control measures may be implemented to manage low-severity, high-
frequency operational risk.

4.6. EXISTENCE OF ALTERNATIVES TO CAPITAL REGULATION

4.6.1. Alternatives to Capital Regulation

The research also carried out an investigation on whether there were alternatives to capital regulation. The figure below analyses the views of the respondents on the subject matter.

![Figure 4.4: Alternatives to Capital Regulation](image)

Figure 4.4 reveals that 39% of the respondents agreed that there were alternatives to capital regulation. They enumerated close regulatory supervision of AMC; enhanced market discipline and enhanced disclosure standards in the market; upgrading of risk management and internal control systems; as the most apt alternatives of capital regulation. On the contrary, the majority of the respondents (61%) disagreed that there were alternatives to capital regulation.

In support to the study findings, Financius Jurist (2011, para. 2-3) indicates that instead of imposing a uniform capital requirement for all AMCs, regulatory capital requirements need to be proportionate to the level of funds under management. Risk management systems, investor education and investor protection are considered more critical aspects in the asset management sub-sector.

4.6.2. Measures that Help Mitigate Risk in Asset Management

The study sought to determine the measures that help mitigate risk in asset management. The study findings indicate that close regulatory supervision of AMC; enhanced market discipline and enhanced disclosure standards in the market; upgrading of risk management and internal control systems; are considered the most apt alternatives of capital regulation. On the contrary, the majority of the respondents (61%) disagreed that there were alternatives to capital regulation.

In support to the study findings, Financius Jurist (2011, para. 2-3) indicates that instead of imposing a uniform capital requirement for all AMCs, regulatory capital requirements need to be proportionate to the level of funds under management. Risk management systems, investor education and investor protection are considered more critical aspects in the asset management sub-sector.
management companies. Table 4.3 below gives a summary of the views of the respondents on the subject area to be investigated.

Table 4.4: Measures That Help Mitigate Risk in Asset Management

<table>
<thead>
<tr>
<th>Measure</th>
<th>% Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure</td>
<td>84</td>
</tr>
<tr>
<td>Auditing</td>
<td>72</td>
</tr>
<tr>
<td>Enforcement</td>
<td>71</td>
</tr>
<tr>
<td>Insurance</td>
<td>64</td>
</tr>
<tr>
<td>Use of depositories/ custodians</td>
<td>53</td>
</tr>
<tr>
<td>Compensation schemes</td>
<td>28.6</td>
</tr>
<tr>
<td>Conduct-of-business rules</td>
<td>69</td>
</tr>
<tr>
<td>Process regulation</td>
<td>31.6</td>
</tr>
<tr>
<td>Self-regulatory Organisations</td>
<td>42.9</td>
</tr>
<tr>
<td>Investor Protection</td>
<td>59</td>
</tr>
</tbody>
</table>

Table 4.4 above indicates that the majority of the respondents, that is, 84%, 72% and 71%, in that order, indicated disclosure, auditing and enforcement as measures that help mitigate risk in asset managers. Conduct of business rules, insurance and use of depositories and custodians were also highlighted by the respondents as measures that mitigate risk.

The above imply that there are many measures that help mitigate risk in asset management companies with the most prominent measures being disclosure, auditing, enforcement, conduct-of-business rules and insurance. Other measures that assist to alleviate risk in AMCs are investor protection, self-regulatory organisations, process regulation, compensation schemes and use of depositories/ custodians.

Thus, the most direct means to mitigate or prevent the failure of AMCs is through implementation of safe custody arrangement, rigorous information disclosure requirements, enforcement, auditing, use of compensation schemes, insurance and conduct-of-business rules, as opposed to capital. Moreover to effectively provide for investor protection, the most compelling reason for regulating asset managers, a combination of institutional arrangements and/or formal systems of regulation is required (Franks and Mayer et al., 2001b:14).
Institutions have several options to mitigate identified operational risk. Internal control measures may be implemented to manage low-severity, high-frequency operational risk. Residual risk not mitigated by internal controls, may be absorbed by earnings, provided they are within the AMCs Board determined risk tolerance threshold. High-severity, low-frequency losses (tail risk) not mitigated by the above measures are best dealt with through operational risk transfer (Joint Forum, 2003:9-10). Frank and Mayer et al (January 2001b:13) concur indicating that firms regard insurance as particularly relevant to areas where substantial losses occur as a consequence, for example, of fraud and failures in information technology systems.

4.6.3. Asset Management Code of Business Conduct (or Standard) for Zimbabwe

An investigation was carried out to determine if there was an asset management code of business conduct or standard for Zimbabwe. The views of the study respondents on the subject matter are illustrated in the figure below.

![Pie Chart: Asset Management Code of Business Conduct for Zimbabwe]

The findings illustrated in figure 4.5 above indicate that 81.70% of the respondents agreed that there was an asset management code of business conduct or standard for Zimbabwe. On the other hand 18.30%, a minority of the respondents disagreed and stated that for Zimbabwe there was no asset management code of business conduct or standard. The views of the survey participants lead to the conclusion that there is an asset management code of business conduct for Zimbabwe. The researcher was availed of a copy of the said document.
4.6.4. Forms of Insurance Cover Held by Most Asset Management Companies

The research qualitatively studied the forms of insurance cover held by most AMCs. The respondents indicated employees and director’s liability insurance, physical property insurance and professional indemnity as the main forms of insurance held by asset managers. Calomiris and Herring (2002:12) describe insurance as a particularly beneficial approach to risk management because of the possibility of small-probability, large losses associated with operational risk. Large insurance companies, which pool and reinsure the losses of many firms, would be in a better position to absorb such operational losses, thus, laying-off the risk via insurance would be superior to internally absorbing the risk via capital.

To further explain the research findings above the research literature adds that conventional protection from insurance markets takes the form of fidelity cover; professional indemnity insurance; employee fidelity and fraud insurance; and other insurance, including civil responsibility, real estate and property, business interruption insurance, electronic/computer crime, general liability, employment practices liability, and directors’ and officers’ liability insurance (BCBS, 2010b:10).

4.7. PROPOSITION TESTING

The proposition that capital standards alone are not an appropriate vehicle for the regulation of AMCs has been accepted in this study. The research revealed that alternatives to capital regulation that can be used for the regulation of AMCs, are close supervision by regulators on asset management companies; enhanced market discipline; enhanced disclosure standards; robust risk management and internal control systems.

4.8. CHAPTER SUMMARY

This chapter analysed information which was collected through a questionnaire. Major concepts under discussion were why regulators employ capital standards to regulate AMCs; the use of capital standards effectiveness in holistically supervising the asset management sub-sector and ensuring the absence of regulatory fissures. The chapter
also went on to analyse which additional forms of regulation of AMCs can be fostered and employed by the local regulator in line with evolving asset management regulation. The next chapter contains conclusions and recommendations of the study.
5. CHAPTER FIVE - CONCLUSIONS AND RECOMMENDATIONS

5.1. INTRODUCTION
This chapter outlines the major conclusions and recommendations on the appropriateness and effectiveness of extending capital standards to asset management companies. It ends with suggestions for future research.

5.2. CONCLUSIONS
The research presents the conclusions indicated hereunder.

5.2.1. Capital Regulation of Asset Management Companies
The following conclusions in respect of capital regulation of asset managers were drawn from this research:

a) there are no other regulatory capital charges, apart from regulatory minimum capital requirements, in the asset management sub-sector in Zimbabwe;
b) the majority of AMCs do not have their own internal capital standards;
c) capital regulation (i) allows for the absorption of losses; (ii) is a vehicle for the growth of business; (iii) serves as a buffer against unexpected losses; (iv) ensures investor protection; and (v) enables indigenous asset managers to fulfill their contractual and fiduciary responsibilities;
d) the current regulatory minimum capital requirements are appropriate for regulating the asset management sub-sector given that the risk inherent in asset management business is significantly lower than that emanating from other financial institutions; client assets are managed under specific mandates; and an asset manager is indemnified in the event that the client incurs losses; and
e) regulatory minimum capital requirements are effective in regulating asset managers. Capital regulation minimises the risk of abusing investor funds; deter the entry of fraudulent firms into the sub-sector; and provide a measure of assurance to the investors on the safety and soundness of the asset management sub-sector.
5.2.2. Operational Risk in AMCs

The research made the following conclusions with regard to operational risk in the asset management sub-sector:

a) the major forms of operational risk in AMCs are internal fraud and business disruption and system failures. Other forms of operational risk in AMCs, include external fraud; clients, products and business practices; and employment practices and workplace safety;

b) clients, products and business practices as well as internal fraud are the forms of operational risk which have the highest impact, whilst, external fraud; damage to physical assets; and employment practices and workplace safety, have a moderate impact; and

c) in terms of the frequency of occurrence, financial insolvency and failure to best execute are the most common forms of operational risk. Breach of client guidelines, settlement problems, failure to reconcile assets and I. T. systems failures are other commonly occurring forms of operational risk.

5.2.3. Alternatives to Capital Regulation

The survey concluded that there:

a) is limited knowledge by market participants on the alternatives to capital regulation. Alternatives to capital regulation, cited by a few of the respondents as being key, include enhanced supervision and regulation of the asset manager sub-sector; market discipline, disclosure standards and robust risk management and internal control systems;

b) are many measures that help mitigate risk in AMCs, with the most prominent measures being disclosure; auditing; enforcement; conduct-of-business rules; and insurance. Other measures that assist alleviate risk in asset management are investor protection; self-regulatory organisations; process regulation; compensation schemes; and use of depositories/ custodians; and

c) is a code of business conduct or standard for Zimbabwean AMCs.
5.3. RECOMMENDATIONS

5.3.1. The study recommends that the SECZ (the regulator of AMCs):

a) come-up with a capital regulation regime that is risk-based and not arbitrarily
determined, and well suited to the peculiarities of the asset management sub-
sector;

b) ensure that asset managers are educated and conscientised on the non-capital
regulatory mechanisms that can be employed, as well as, ensure that these
measures are prescribed at law and enforced in Zimbabwe; and

c) consolidate and document the regulatory framework for the asset management
sub-sector in Zimbabwe.

5.3.2. In addition, the study recommends that AMCs:

a) prioritise the improvement and enhancement of their internal processes and risk
management systems so as best to mitigate operational risk inherent in their
operations;

b) foster good corporate governance practices in their operations which are in tandem
with international best practices; and

c) discern the rationale underlying the imposition of regulatory capital requirements,
and come-up with their own internal capital standards (economic capital)
commensurate with the nature of their activities and respective risk profiles.

5.4. AREAS OF FURTHER STUDY

The study was a preliminary attempt to establish the appropriateness and
effectiveness of capital regulation of AMCs. Assuming that the above
recommendations are put in place, future research on this topic could investigate how
the regulatory bodies can best determine risk-based minimum capital requirements for
AMCs; and how to compute regulatory capital for operational risk as per the Basel II
Framework for AMCs and workaround the challenges attendant with allocating capital
in investment companies. Further, a research on the implementation of the
alternatives to capital regulation, in Zimbabwe, particularly, to ascertain the sub-
sector’s maturity profile in terms of non-capital regulation could be undertaken.
It was apparent from this research that there is need to carry out a research on AMCs performance and prospects in relation to their level of compliance to regulatory and supervisory requirements. This could be done by rating AMCs using the following eight (8) attributes of investment sustenance, namely, (i) quality of management; (ii) quality of products and services; (iii) long term investment value and innovativeness; (iv) financial soundness; (v) ability to attract, develop and retain talented staff; (vi) use of corporate assets; (vii) community and environment responsibility; and (viii) regulatory minimum capital requirements.
REFERENCES


8. **Basel Committee on Banking Supervision** (2010a), *An Assessment of the Long-


45. **PriceWaterhouseCoopers LLP [PwC]** (2012c), *Alternative Investment Fund


# APPENDICES

## Appendix 1: Asset Management Business in Other Jurisdictions

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Ownership of AMCs</th>
<th>Investment Forms</th>
</tr>
</thead>
</table>
| **France**   | • Part of banking groups - 69.20%  
• Owned by insurance companies - 23.10%  
• Stand-alone investment managers - 7.70%  
• Owned by pension funds - 0.00% | • Portfolio management companies (sociétés de gestion de portefeuille) - manage financial assets on behalf of third parties, including all types of discretionary asset management and the management of undertaking for collective investment in transferable securities (UCITS).  
• UCITS management firms (sociétés de gestion d’organismes de placement collectif en valeurs mobilières):  
  ➢ OPCVMs) exclusively managed UCITS which include:  
    (i) sociétés d’investissement a capital variable (SICAVs), open-ended investment companies - legal entities set-up under the form of a Société Anonyme (SA) or Société par Actions Simplifiée (SAS); and  
    (ii) fonds communs de placement (FCP), which have a contractual form and represent ‘co-ownerships’ of transferable assets.  
  ➢ Two (2) principal categorisations of OPCVMs:  
    (i) general OPCVMs (OPCVM généraux); and  
    (ii) specific OPCVMs (OPCVM spécifiques).  
• Specific Fund:  
  (i) Fonds Commun de Titrisation (FCT) - invests in securitisation products; and  
  (ii) Real-estate collective investment scheme (OPCI) - real-estate investment trust (FPI) or limited liability real estate company with variable capital (SPPICAV). |
| **Germany**  | • Part of banking groups - 25.00%  
• Owned by insurance companies - 53.60%  
• Stand-alone investment managers - 17.90%  
• Owned by pension funds - 3.60% | • UCITS - funds compliant with the UCITS Directive as implemented into German law - open-ended funds (Richtlinienkonformes Sondervermögen); and  
• Non-UCITS funds - other types of funds:  
  ➢ institutional funds (Spezialfonds);  
  ➢ stock corporation (Aktiengesellschaft, AG);  
  ➢ real estate funds (Immobilienfonds);  
  ➢ hedge funds - single hedge fund (Sondervermögen mit zusätzlichen Risiken) or fund of hedge funds (Dach-Sondervermögen mit zusätzlichen Risiken);  
  ➢ infrastructure funds - investments in public-private-partnerships (PPPs); and  
  ➢ miscellaneous funds (Sonstige Sondervermögen). |
| **Ireland**  | • Part of banking groups - 66.70%  
• Owned by insurance companies - 33.30%  
• Stand-alone investment managers - 10.00%  
• Owned by pension funds - 0.00% | • UCITS funds established under common EU framework and benefit from EU passport.  
• Non-UCITS funds for more sophisticated investors:  
  ➢ segregated funds - which refer to funds that are managed for a single client and not pooled;  
  ➢ endowment funds - pension products sold by insurance companies; and  
  ➢ unit-linked funds that are sold by insurance companies whose value relates to that of the underlying fund. |
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Ownership of AMCs</th>
<th>Investment Forms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>Part of banking groups - 60.00%</td>
<td>UCITS: (i) open-end mutual investment funds which comply with the UCITS Directive (Fondi Comuni Mobiliari Aperti armonizzati); (ii) open-end mutual investment funds not in compliance with the EU Directive (Fondi Comuni Mobiliari Aperti non armonizzati); (iii) closed-end mutual investment funds (Fondi Comuni Mobiliari Chiusi); (iv) funds for collective investment in real estate property (Fondi Comuni Immobiliari Chiusi); (v) funds reserved for special categories of investors (fondi riservati); speculative (fondi speculativi); (vi) variable capital investment (SICAVS); (vii) guaranteed; protected; and index funds.</td>
</tr>
<tr>
<td></td>
<td>Owned by insurance companies - 30.00%</td>
<td>Asset management companies - manage assets of funds and contain assets of “managed accounts” (accounts set up in banks or with securities houses on behalf of private clients). Most asset management companies have become società di gestione del risparmio permitted to manage assets on behalf of mutual funds, life insurance companies and pension funds.</td>
</tr>
<tr>
<td></td>
<td>Stand-alone investment managers - 10.00%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Owned by pension funds - 0.00%</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>Part of banking groups - 85.70%</td>
<td>Financial Collective Investment Institutions (CIIs):</td>
</tr>
<tr>
<td></td>
<td>Owned by insurance companies - 0.00%</td>
<td>- open-ended securities investment companies (sociedades de inversión de capital variable; SICAV), with variable share capital; and</td>
</tr>
<tr>
<td></td>
<td>Stand-alone investment managers - 14.30%</td>
<td>- investment funds (fondos de inversión; FI), set-up as separated assets that belong to several investors.</td>
</tr>
<tr>
<td></td>
<td>Owned by pension funds - 0.00%</td>
<td>Non-financial CIIs - investment and management of real estate assets in the following legal forms:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- real estate investment companies (sociedades de inversión inmobiliaria; SII) with fixed share capital (closed-ended); and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- real estate investment funds (fondos de inversión inmobiliaria; FII).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Insurance companies.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Entidades Gestaros de Fondos de Pensiones, which primarily manage pension funds.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Part of banking groups - 11.40%</td>
<td>Insurance companies</td>
</tr>
<tr>
<td></td>
<td>Owned by insurance companies - 34.30%</td>
<td>Pension funds</td>
</tr>
<tr>
<td></td>
<td>Stand-alone investment managers - 31.40%</td>
<td>CIS:</td>
</tr>
<tr>
<td></td>
<td>Owned by pension funds - 22.90%</td>
<td>- regulated schemes which comprise: authorised unit trust schemes (AUTs), open-ended investment companies (OEICs), recognized schemes and authorised Contractual Schemes (ACSs);</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- unregulated schemes: unit trusts, overseas open-ended investment companies or any other form of arrangements (such as limited partnership); or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- closed-ended funds - investment trust or venture capital companies, investment trust companies listed on the London Stock Exchange.</td>
</tr>
<tr>
<td>United States of America</td>
<td></td>
<td>Insurance companies - life insurance and other insurance companies.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Pension funds - private pension and state and local government employee retirement funds.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mutual funds - money market, mutual and close-end funds.</td>
</tr>
</tbody>
</table>

Source: Authors’ own table derived from Franks and Mayer et al. (2001:22-40, 43) and the KPMG International Funds and Funds Management Survey Report (2012a).
## Appendix 2: Licensed Zimbabwean Asset Management Companies as at 13 March 2014

<table>
<thead>
<tr>
<th>Entity</th>
<th>Ownership</th>
<th>Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ABC Asset Management Company (Private) Limited</strong></td>
<td>Subsidiary of a banking group - 100% owned by African Banking Corporation Holdings Limited.</td>
<td>Portfolio management - Equities, Bonds, Treasuries, Real Estate and Alternative Investments. Custodial Services are also a significant part of portfolio management. Unit Trusts - ABC Gross Income Fund; ABC Managed Growth Fund; ABC Net Income Fund; and Property Unit Trust Fund. Clients: individuals, companies, pension funds, trusts, insurers, and non-governmental organisations (NGO) retirement funds.</td>
</tr>
<tr>
<td><strong>CBZ Asset Management (Private) Limited t/a Datvest</strong></td>
<td>Subsidiary of a banking group - 100% owned by CBZ Holdings (Private) Limited.</td>
<td>Portfolio management - Private Equity Portfolio, Custodial of Shares, Investments, Pension Funds and Money Markets. Unit Trusts: General Equity Fund; Specialist Equity Fund; and High Income Fund. Clients: individuals, corporates, pension funds etc.</td>
</tr>
<tr>
<td><strong>Fidelity Life Asset Management (Private) Limited</strong></td>
<td>Subsidiary in a holding company, predominantly involved in the insurance sector and to a lesser extent banking activities - 87% owned by Fidelity Life Assurance, 10% by ZIMRE Holdings Limited and balance by other small investors.</td>
<td>Portfolio management - Managed Funds; Special Funds - Weaver and Momentum Funds; and Short-term Portfolio Management. Investment Advisory Services - advice in cash-flow management, corporate restructuring, rights issues, initial public offers, mergers, takeovers and management buyouts. Unit Trusts: (i) Money Market Funds - ZIMRE Money Market Fund and Fidelity Money Market Fund. Money market investments in bankers acceptances (BA’s), treasury bills (TB’s), negotiable certificates of deposits (NCD’s) and bonds. (ii) Equity Funds - ZIMRE Blue Chip Fund, Fidelity Growth Fund. (iii) Balanced or Blended Funds - FLAM Hybrid Fund, FLAM Executive Fund.</td>
</tr>
<tr>
<td><strong>Imara Asset Management (Private) Limited</strong></td>
<td>41.79% owned by CF Africa Limited, 19.30% by Tristeele Investments and 11.14% by Anglo African Investment Management Zimbabwe, 9.85% by Imara Capital Zimbabwe and the balance by other small investors.</td>
<td>Portfolio and fund management - Segregated Investment Management Services for institutional clients; and Private Wealth Management Services for high net worth and mass affluent market.</td>
</tr>
<tr>
<td><strong>AfriAsia Capital Management (Private) Limited [formerly Kingdom Asset Management Company (Private) Limited]</strong></td>
<td>Subsidiary of a banking group - 100% owned by AfriAsia Zimbabwe Holdings Limited.</td>
<td>Fund management - Private Portfolio Management; Pension Fund Management; and Institutional Investments. Manages AfriAsia Unit Trusts: Wealth Fund; Growth and Stability Fund; Special Situation Fund; and AfriAsia Gross Income Fund. Clients: individuals, partnerships, companies, schools and pensions and provident funds.</td>
</tr>
<tr>
<td><strong>Old Mutual Investment Group Zimbabwe (Private) Limited</strong></td>
<td>Subsidiary of a diversified group - 100% owned by Old Mutual Zimbabwe Limited,</td>
<td>Portfolio management to wholesale and retirement funds - Core Equity Investments Boutique; Select Equity Investments Boutique; Interest Bearing</td>
</tr>
<tr>
<td>Entity</td>
<td>Ownership</td>
<td>Activities</td>
</tr>
<tr>
<td>--------</td>
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</tr>
</tbody>
</table>
| **Zimbabwe** | which is 100% owned by Old Mutual Plc. | Investments - TBs, Certificates of Deposit, BAs, Commercial Paper (CP), Corporate Bonds, Government Bonds and Quasi-Government Bonds, Variable Coupon Bonds, Inflation Linked Bonds; Alternative Investments Boutique - Public Infrastructure, Quantitative Products, Derivatives and Hedge Funds; and Property Investments Boutique - invests in land, buildings and developments covering all sectors of the property market.  
  - Unit Trusts: Equity Fund; Gross (Tax free) Fund Money Market Fund; Money Market Fund; Balanced Fund; Old Mutual Large Cap Equity Fund; Old Mutual Small Cap Equity fund; and Old Mutual Long Term Income Money Market Fund. |
| **Ecobank Asset Management Company (Private) Limited** | Subsidiary of a banking group - 100% owned by Ecobank Zimbabwe Group Limited | Portfolio and fund management.  
  - Collective investment schemes.  
  - Clients: individuals, high net worth investors and institutions. |
| **TFS Management Company (Private) Limited [under corrective order - undercapitalised]** | Subsidiary of a diversified group - 100% by Tetrad Holdings Limited. | Portfolio management.  
  - Economic research.  
  - Advisory services.  
  - Management of Unit Trusts: Equity Fund (Jupiter and Venus Managed Funds); Balanced Fund (Capricorn); and Money Market Fund (Net Income Market Fund Gross Income Fund); and Gold Fund.  
  - Clients: pension funds, corporate and institutional investors, high net worth individuals and retail investors. |
| **TN Asset Management Company (Private) Limited** | Subsidiary of a banking group - 100% owned by Lifestyle Holdings (Private) Limited. | Portfolio and fund management - Equity and Money Market Investments; Special Funds - Savings and Investments Fund, Wedding Investment Fund, Property Investment Fund, World Youth Day 2013 Investment Fund, Today’s Woman Israel Pilgrimage Fund; Pension and Insurance Funds Management; Custodial Services; Wealth Management; and Estate Planning. |
| **ZB Asset Management (Private) Limited** | Subsidiary of a banking group - 100% owned by ZB Financial Holdings (Private) Limited.  
  - ZB Asset Management Company falls under Investment Banking Division. | Portfolio management - Growing Gold Fund, Balanced Portfolios (designed for pension funds, other institutional investors); and Money Market Managed Fund.  
  - Unit Trusts: General Equity Fund; and Specialist Equity Fund. |
| **Zimnat Asset Management (Private) Limited** | Subsidiary of a diversified group - 100% by Zimnat Life Assurance Company Limited, which in turn is 100% by TA Holdings Limited. | Portfolio management, Treasury and Investment Advisory.  
  - Unit Trusts - Zimnat Stable Income Fund; Zimnat Total Income Fund; Zimnat Financial Focus Fund; Zimnat Exporters Growth Fund; Zimnat Prudent Fund; and Zimnat Top Ten Fund.  
  - Clients: pension funds, insurance companies and brokers, medical aid funds, small and large corporates, and private individuals. |
<p>| <strong>Alpha Asset Management (Private) Limited</strong> | Stand-alone (not part of a banking/ financial group) | Portfolio and fund management - Equity Portfolio Management (Quoted Shares), Money Market Portfolio Management, Pension Fund Management; and Custodial Services. |</p>
<table>
<thead>
<tr>
<th>Entity</th>
<th>Ownership</th>
<th>Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equivest Asset Management (Private) Limited</td>
<td>Stand-alone (not part of a banking/financial group)</td>
<td>Portfolio and fund management - Equity Investments on the ZSE; Portfolio Management and Islamic Finance.</td>
</tr>
<tr>
<td>Infinity Asset Management (Private) Limited</td>
<td>Stand-alone (not part of a banking/financial group)</td>
<td>Portfolio and fund management.</td>
</tr>
<tr>
<td>F. M. I. Asset Management (Private) Limited</td>
<td>100% owned by FMI Holdings (Private) Limited [FMI Holdings (Private) Limited is wholly owned by Masawara Plc.]. In turn Masawara Plc. is a company controlled by Shingi Mutasa through the Shingai Mutasa Family Trust.</td>
<td>Portfolio management.</td>
</tr>
</tbody>
</table>

Source: Authors Own Table derived from information on requisite AMCs websites; Notice No LD13/03/2014 - Licensing for the year ending 31st December 2014 (dated 13th March 2014); The Zimbabwe Situation, 2010 (http://www.zimbabwesituation.org/?p=20154, accessed 30 May 2014); and Securities and Exchange Commission of Zimbabwe, 2014 (http://www.seczim.co.zw/regulated-entities/investment-managers, accessed 02 June 2014).
### Appendix 3: Regulation of Asset Management Institutions in Other Jurisdictions

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1) FRANCE</strong></td>
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</table>
| Regulatory Authority | • French Securities and Exchange Commission [Commission de Opérations de Bourse (COB)] - authorisation and supervision of the activity of individual and collective portfolio management; and investor protection in France and law enforcement.  
• Financial Activities Modernisation Act 1996 - allows management companies the freedom of choice of their purpose either as UCITs or portfolio management companies.  
• Consultative Council of Asset Managers - allows asset managers to play a role in the regulatory and supervision process.  
• Disciplinary Council of Asset Management - disciplinary body to sanction any breach of French legislation applicable to funds and offer of portfolio management services. |
| Capital Requirements | • FF350,000 or 25% of overheads in the anticipated or previous year’s statement of comprehensive income. |
| Separation of Clients’ Assets | • Client assets to be held separately from those of AMC - compulsory in case of mandated asset management.  
• Assets of OPCVMs are held by depositaries (custodians) - this requirement set out in legislation.  
• Mandated Individualised Portfolio Management Professional Ethics - outlines rules of conduct, particularly, on contractual obligations between an asset manager and a custodian. |
| Disclosure | • Required to provide clients with periodic reports detailing value and composition of portfolio. |
| Enforcement | • Law of August 2 1989 - empowers COB to impose administrative sanctions concerning practices contrary to its regulations. Fines imposed by COB capped at FF10 million or when profit has been realised up to ten times the profit amount. Sanction procedure is made public. Appeal mechanism is in place - decision subject to appeal at Cour d’Appeal in Paris.  
• COB has right to revoke authorisation if company does not meet requirements under which it was licensed, following, a formal investigation and sanction procedure. |
| Audit | • It is a requirement that audited accounts be prepared and submitted to COB.  
• COB and senior management at AMC to be informed of any irregularity noted by auditors during their audit. |
| Compensation | • No specific scheme for AMC clients. However, scheme available where deposits, bonds and cash are guaranteed - clients’ investments also covered here. |
| Complaints | • Complaints received by COB. Courses action available: levying of a fine; referral to Public Prosecutor (if case of criminal fraud established); referral to civil courts if compensation appears justified; or amicable resolution.  
• However, very few of complaints received relate to AMCs. |
| Authorisation | • COB licenses portfolio management companies and UCIT management firms. Laid down licensing criteria which incorporates adequate initial minimum capital requirement. |
| Supervision | • COB - prudential control and supervising rules of conduct allied to this; ensuring controls and procedures submitted during licensing are put in place and adhered to; requirement for a Compliance Officer and appointment of an individual responsible for internal controls.  
• COB Chairman has the authority to order an investigation into the operations of an AMC at any time - unfettered access to all premises, files and documents etc. |
<p>| Professional Ethics &amp; Rules of Conduct | • Mandated Individualised Portfolio Management Professional Ethics (published by the AFG-ASFFI in April 1997) which contains 60 rules of conduct covering; the management and prevention of conflicts of interest; the obligation of means; the contractual relationship between manager and principals; the relations with principals; the relations with intermediaries; the marketing of individualised management under mandate; and the behavior of the portfolio manager employed by the |</p>
<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
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<tbody>
<tr>
<td><strong>2) IRELAND</strong></td>
<td>Department of Finance is responsible for the development of all legislation on regulation of financial services.</td>
</tr>
<tr>
<td>Regulatory Authority</td>
<td>The Central Bank of Ireland (Bank) is the principal regulatory authority for AMCs. The Bank receives its statutory powers under the provision of a number of Acts and legislation governing CIS.</td>
</tr>
<tr>
<td></td>
<td>The Department of Enterprise, Trade and Employment devises legislation on the regulation of CIS which are directly authorised and regulated by the Bank.</td>
</tr>
<tr>
<td></td>
<td>Where asset management business is under an insurance company, it is authorised, supervised and regulated by the Department of Enterprise, Trade and Employment.</td>
</tr>
<tr>
<td></td>
<td>Investments Intermediaries Act provides the legislation for the authorisation and supervision of investment firms by the Bank.</td>
</tr>
<tr>
<td>Capital Requirements</td>
<td><strong>€50,000</strong> - firms that only receive and transmit orders from investors and not authorised to hold client’s funds or financial instruments or deal for own account or underwrite issues on a firm commitment basis.</td>
</tr>
<tr>
<td></td>
<td><strong>€125,000</strong> - firms that hold client’s money or financial instruments.</td>
</tr>
<tr>
<td></td>
<td><strong>€730,000</strong> - all other firms.</td>
</tr>
<tr>
<td></td>
<td>The Bank reserves the right to impose additional capital requirements on firms that are exposed to higher levels of operational risk.</td>
</tr>
<tr>
<td>Separation of Clients’ Assets</td>
<td>Section 52 of the Investments Intermediaries Act places requirements on authorised investment firms regarding the safe-keeping of clients’ funds and instruments.</td>
</tr>
<tr>
<td></td>
<td>Clients funds should be kept separate from own funds.</td>
</tr>
<tr>
<td></td>
<td>Where money is held on behalf of a client, authorised firm to ensure money is held in a client account with a credit institution that is continually assessed.</td>
</tr>
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<td></td>
<td>In the event that authorised client holds client’s funds with an institution that is part of the same group, client should be informed in writing, name of institution disclosed to client and ongoing rigorous assessment undertaken.</td>
</tr>
<tr>
<td>Disclosure</td>
<td>It is a requirement that each client be furnished with a copy of the AMCs investment agreement which provides the basis upon which the AMCs’ services are provided. Minimum disclosures for the investment agreement are stipulated.</td>
</tr>
<tr>
<td></td>
<td>Clients are to be provided with a statement at least once every six (6) months detailing value of the portfolio at the start and end of the period, composition at the end of the period, and for a discretionary client changes in its composition between the given dates.</td>
</tr>
<tr>
<td></td>
<td>There is provision for periodic information, unless stated otherwise in the investment agreement.</td>
</tr>
<tr>
<td></td>
<td>If portfolio contains open positions in derivatives, there are additional disclosures.</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Investments Intermediaries Act empowers the Bank to enforce compliance with regulations. Several options are at the disposal of the Central Bank of Ireland, such imposition of fines, revocation of license, removal of officers or employees etc.</td>
</tr>
<tr>
<td>Audit</td>
<td>Legislation stipulates that at times external auditors may be required to provide the Bank with information on an AMC. For instance, if during an audit they discover issues that may impact the solvency of the institution, material deficiencies in the financial systems of control and significant omissions and inaccuracies in returns of the AMC.</td>
</tr>
<tr>
<td>Compensation</td>
<td>Investor Compensation Company established under the Investor Compensation Act to provide compensation to private clients of a failed investment firm. It is funded by contributions of member firms.</td>
</tr>
<tr>
<td></td>
<td>Investment firms regulated by the Central Bank are among the firms covered, whilst, units in CIS are some of the investments covered.</td>
</tr>
</tbody>
</table>
| | Compensation is only payable when a firm is unable due to its financial condition to return clients funds or investments as
<table>
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<tr>
<th>JURISDICTION</th>
<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
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<tr>
<td></td>
<td>determined by the Central Bank or the courts.</td>
</tr>
<tr>
<td></td>
<td>• Maximum level of compensation is 90% of the net loss subject to a maximum payment of €20,000. Investors have up to five (5) months to make a claim.</td>
</tr>
<tr>
<td>Complaints</td>
<td>• AMCs required to keep a written record of all complaints received against them from clients, including a record of their response and any action taken as a result of the complaint. If client is not satisfied with AMCs resolution of complaint, the AMC should inform the client of their right to seek, recourse from the Central Bank.</td>
</tr>
<tr>
<td></td>
<td>• Adequate procedure to handle complaints should be in place.</td>
</tr>
<tr>
<td>Authorisation</td>
<td>• Prior to authorisation, the Bank must ascertain that the AMC has sufficient capital, directors and managers are persons of probity and competence, requirements set out by the bank are likely to be met.</td>
</tr>
<tr>
<td></td>
<td>• There are several steps preceding authorisation. At time of authorisation Bank may impose further detailed requirements on the entity in accordance with the requisite legislation, which for NBFIs includes following broad headings; general reporting requirements, capital requirements, requirements in relation to the safe-keeping of client’s assets, advertising requirements, conduct-of-business requirements and anti-money laundering guidelines.</td>
</tr>
<tr>
<td></td>
<td>• Investment is required to ensure that the transactions it executes on behalf of clients or advice given is appropriate for that client.</td>
</tr>
<tr>
<td>Supervision</td>
<td>• Ongoing supervision after licensing. Both on-site (examination of the books and records of the supervised entity, and assessment of compliance with Bank supervisory requirements and relevant legislative provisions) and off-site (regular collection and analysis of data, regular review meetings with management and addressing issues as they arise) surveillance.</td>
</tr>
<tr>
<td>Professional Ethics &amp; Rules of Conduct</td>
<td>• The Bank has issued a code of conduct for AMCs.</td>
</tr>
<tr>
<td>3) ITALY</td>
<td>• Supervision of financial intermediaries is divided between the Bank of Italy and Consob as per the Consolidated Law on Financial Markets (Legislative Decree 58/1998).</td>
</tr>
<tr>
<td></td>
<td>• Bank of Italy - prudential supervision, information monitoring, and conducting on-site controls with the aim of limiting risk and ensuring financial stability of intermediaries.</td>
</tr>
<tr>
<td></td>
<td>• Consob - ensuring transparency and proper conduct.</td>
</tr>
<tr>
<td></td>
<td>• Difficult to distinguish between the role of Consob and the Bank of Italy in the regulation of AMCs - an AMC managing a fund will be supervised by the Bank of Italy, while one managing assets on behalf of a private client or managed account by Consob.</td>
</tr>
<tr>
<td></td>
<td>• Consolidated Law allows AMCs to engage jointly in the activities of management on a client-by-client as well as collective basis.</td>
</tr>
<tr>
<td>Capital Requirements</td>
<td>• Determined by the Bank of Italy.</td>
</tr>
<tr>
<td></td>
<td>• Capital requirements applicable to AMCs consist both of a fixed and variable component.</td>
</tr>
<tr>
<td></td>
<td>• Fixed component is a single level of share capital of €1.03 million.</td>
</tr>
<tr>
<td></td>
<td>• Variable component is a function of the value of assets under management:</td>
</tr>
<tr>
<td></td>
<td>• 0.5% of the value of assets in open-ended funds, SICAVs and pension funds</td>
</tr>
<tr>
<td></td>
<td>• 2.00% for close-ended funds; and</td>
</tr>
<tr>
<td></td>
<td>• an additional capital charge for pension funds that guarantee repayment of principal.</td>
</tr>
<tr>
<td></td>
<td>• Nonetheless, total capital charge, must be at least equal to 25% of total fixed operating costs in the previous financial year. However, this percentage may vary (either lower or higher) per institution depending on the Bank of Italy's evaluation of the</td>
</tr>
<tr>
<td>JURISDICTION</td>
<td>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</td>
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<td>--------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>company’s business plan and activities.</td>
</tr>
</tbody>
</table>
| Separation of Clients’ Assets | ▪ The Bank of Italy has issued rules on the separation of clients’ assets in order to ensure that there is separation between the assets of individual customers, and between customers’ assets and those of the intermediary.  
▪ Regulations include; separation of clients’ assets from those of other clients and from those of the company (i.e. clients’ assets must be held outside the AMC, but may be held within the group to which the AMC belongs); separate reporting of the assets of each customer; prompt deposit of money received from clients with a bank; and prohibition of the use of clients’ assets by intermediaries, unless authorised to do by the client, in writing. |
| Disclosure | ▪ Bank of Italy or Consob may require information on the names of shareholders of the AMC; directors of companies and entities that hold equity in the AMC to enumerate names of their controllers; and trust companies that hold an equity stake in an AMC to provide the names and details of beneficiaries. |
| Enforcement | ▪ In instances of serious administrative irregularities or violations of regulations - administrative body of AMC may be replaced by a provisional administrator appointed by the Chairman of the Consob for a period not to exceed sixty (60) days.  
▪ Minister of Treasury may issue a decree on the withdrawal authorisation to continue business and ordering compulsory liquidation of the AMC.  
▪ Provision of investment services without a valid license or requisite authorisation or breach of regulations is punishable with a fine and imprisonment. |
| Audit | ▪ Licensed AMCs or their auditors may be required to furnish the Bank of Italy or the Consob with requested data and information.  
▪ The auditors are required to promptly notify or report any irregularities uncovered during the audit of an AMC to the Bank of Italy or Consob.  
▪ External auditors of AMCs are required to provide an opinion on the state of the investment advisory’s statement of operations.  
▪ Auditors are prohibited from conducting an examination of an AMC with prior notification. |
| Compensation | ▪ Provision of investment services dependent on an AMC being a member of a compensation scheme aimed at protecting investors. Organisation and operational modalities of the compensation scheme is determined by the Minister of the Treasury in liaison with the Bank of Italy and Consob.  
▪ There are two (2) separate compensation schemes in Italy (i) for banks and (ii) another joint scheme for AMCs and security houses which has been in operations since 1991. Debate on whether to have separate compensation schemes for AMCs and security houses, following failure of a number of the latter. |
| Complaints | ▪ No specific ombudsman for complaints against AMCs regulated by the Bank of Italy and Consob. Clients may individually complain to Consob with the potential to take up the matter further in the courts. |
| Authorisation | ▪ Licensing of an AMC that provides collective asset management services or on a client-by-client basis is done by the Bank of Italy after consultation with Consob. Nine key conditions, among others, need to be met prior to licensing. |
| Supervision | ▪ The Bank of Italy or Consob may conduct inspections of AMCs. Consob may assign rankings to AMCs which ranking criterion is not publicized. This ranking is what is used to determine the frequency of visits to companies perceived to be higher risk by the Consob.  
▪ Findings of inspections by the Bank of Italy or Consob are not publicised. |
| 4) NETHERLANDS | Regulatory Authority | ▪ Stichting Toezicht Effectenverkeer (STE) established in 1988 as an independent entity to supervise the securities trade. Provided for the separation of the regulation of the securities industry from the Government and the trade itself. |
### JURISDICTION

<table>
<thead>
<tr>
<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
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</thead>
<tbody>
<tr>
<td>• Mandate of STE is to ensure the proper functioning of the securities market; investor protection; and increasing disclosure and transparency of securities markets.</td>
</tr>
<tr>
<td>• Portfolio managers are among the institutions regulated by the STE. Portfolio managers are not permitted to hold clients’ funds.</td>
</tr>
<tr>
<td>• CIS are regulated by the Dutch Central Bank.</td>
</tr>
<tr>
<td>• Decree on the Supervision of Securities Trade (Bte) and the Further Regulation on the Supervision of the Securities Trade (drafted by STE) contain the full regulations governing these institutions.</td>
</tr>
<tr>
<td>• There is a Supervision of Securities Trade Act of 1995 which incorporates Investor Services and Capital Adequacy Directives into Domestic Legislation.</td>
</tr>
</tbody>
</table>

### Capital Requirements

<table>
<thead>
<tr>
<th>Further Regulation on the Supervision of the Securities Trade 1999 (the Regulations) - amount of capital held by a portfolio manager is comprised of equity capital and actual own funds. The Regulations clearly outline eligible forms of equity capital.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The level of equity capital should be equal to the following as per the characteristics of the portfolio manager:</td>
</tr>
<tr>
<td>- €35,000 - receives orders from a client and transmits these orders to another company;</td>
</tr>
<tr>
<td>- €50,000 - receives and transmits orders on behalf of clients in another state subject to EU economic area agreement; receives and executes orders on behalf of clients; offers to obtain receivables by opening accounts; operates as a local enterprise; carries out portfolio management (which is defined as management of clients’ financial instrument or monies, including transmission or execution of orders).</td>
</tr>
<tr>
<td>- €730,000 - trades on own account, underwrites issues of securities; and executes transactions in order to maintain a market in financial instruments.</td>
</tr>
<tr>
<td>- Levels similar to the Capital Adequacy Directive, with exception of omitting middle capital level of €125,000 since securities institutions are not permitted to hold clients’ funds unless they are a credit institution (as per the custody rules enshrined in the legislation).</td>
</tr>
<tr>
<td>- Level of own funds is equal to a maximum of 25% of the fixed costs of an institution in a preceding year or the minimum of the sum of capital adequate requirement to cover position risk; settlement, delivery and counterparty risk; large exposures; foreign-exchange; and other risks.</td>
</tr>
<tr>
<td>- Fixed costs are as defined by the regulator.</td>
</tr>
</tbody>
</table>

### Separation of Clients’ Assets

<table>
<thead>
<tr>
<th>Onus is on the portfolio manager to ensure that clients’ assets are protected.</th>
</tr>
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<tbody>
<tr>
<td>• Legislation details custody rules for institutions including portfolio managers the range of activities they are engaged in. clients’ assets must be kept separate from those of the asset manager but not necessarily held in safe custody by a third party with the exception of beleggersgiro which are required that safe-custody is done by a separate legal entity from themselves.</td>
</tr>
<tr>
<td>• AMCs that:</td>
</tr>
<tr>
<td>- only act as a financial intermediary are required to ensure that securities and funds of clients are held in one (1) or more bank accounts, in the name of the client;</td>
</tr>
<tr>
<td>- execute transactions, clients need to hold their assets and funds in one (1) or more accounts in their name with a financial institution that is involved in the settlement of transactions in accordance with the tripartite agreement in place with the asset manager, the client and the institution itself; and</td>
</tr>
<tr>
<td>- are beleggersgiro should strictly keep clients’ assets separate from their own by placing accounts into a legally separate entity.</td>
</tr>
<tr>
<td>• Alternative custody rules are in force in the case of cross-border transactions and custody arrangements.</td>
</tr>
<tr>
<td>• Custodians are mandated to ensure that records are available to the client whose assets are held in safe custody.</td>
</tr>
<tr>
<td>JURISDICTION</td>
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</tbody>
</table>
| Disclosure  | ▪ Portfolio managers to submit quarterly returns to the STE and provide clients with statements of their accounts on an annual basis.  
▪ Minimum information disclosures both to the STE and the client are stipulated. |
| Enforcement | ▪ STE is empowered to impose a fine for breaches to the Bte and the Regulations as well as penalise institutions for continually failing to comply with the regulations. Both measures are enforced by order.  
▪ Some of the measures taken by the STE to sanction institutions are issues of reprimands, reports, appointments of secret receivers, public earnings, refusals of license applications and withdrawal of licenses.  
▪ Institutions have the right to appeal and object to any fines charged. Objections are lodged with the STE. A decision on the objection may be appealed against in court in Rotterdam, after which is allowance of appeal to the Industrial Appeals Court.  
▪ Institutions are required to maintain a record of all breaches of regulations and provide the STE with a consolidated report on these breaches on a regular basis. |
| Audit       | ▪ External audit is done annually. External auditors are appointed by AMC or portfolio manager. Annual audited accounts to be submitted to STE. |
| Compensation| ▪ Investor Compensation Scheme Directive in force under whose auspices there are two (2) compensation schemes. The applicable compensation scheme is the Investor Compensation Scheme administered by the STE.  
▪ Maximum pay-out under this scheme is €20,000 in the event that asset manager is unable to pay clients their funds. Compensation can only be paid to non-professional investors. |
| Complaints  | ▪ All institutions supervised by the STE to comply with further regulations on complaints handling. They outline that complaints are to be resolved within a reasonable period of time. Management at the institution deems what they consider a reasonable period of time.  
▪ The complaint and the manner in which it is resolved are to be recorded in order to track the complaints process for internal and external audit review.  
▪ If a proposed resolution by an AMC fails to satisfy a client, the former are required to inform the latter of their right to notify the STE. The STE may also be notified in the preliminary stages.  
▪ Although the STE does not have the mandate to compensate investors it can ensure that the problem which gave rise to the complaint does not recur.  
▪ Dutch Securities Institute has put in place a Complaints Committee to deal with complaints from private investors of institutions regulated by the STE. Committee acts as an arbitrator in cases where client fails to receive satisfactory remediation from an AMC for a complaint lodged. |
| Authorisation| ▪ Certain legal requirements are to be met for an institution is licensed to provide portfolio management services. STE monitors compliance with these regulations. |
| Supervision | ▪ Institutions are subject to continual assessment and monitoring by the STE. In particular, adequacy of financial resources is investigated. Violation of regulations is punishable with a fine or penalties. |
| 5) UNITED KINGDOM | |
| Regulatory Authority | ▪ Regulation of financial institutions done by the Financial Services Authority (FSA). FSA supervises banks under the Banking Act of 1987 and investment services under the Financial Services and Market Act of 2000.  
▪ There are a number of front-line regulatory bodies or Self-regulatory Organisations (SROs) which authorised, recognised and supervised by the FSA. The Investment Management Regulatory Organisation is the SRO for AMCs. IMRO used to regulate fund managers, unit trust managers and trustees, banks, life offices and friendly societies, local authorities, trustees and in-house managers of pension funds, venture capital managers and institutional investment advisors. |
### JURISDICTION

**DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK**

- These entities are regulated by the FSA.
- There is a three-tiered approach to the regulation of investment managers:
  - principles - to ensure particular standards for persons authorised to provide investment services;
  - core rules – relate to the conduct of business and financial resources; and
  - third tier rules - guidance from SROs.
- Principles - 10 Broad Principles contained in IMRO Handbook. Internal systems and controls need to be place to ensure compliance with IMRO rules; financial condition of institution to be reported periodically to regulator; Institution to provide any requested information and cooperate with any investigation; and agree to be subject to disciplinary procedures to regulator and pay its contribution fees to IMRO.

### Capital Requirements

- Regulatory financial requirements are dependent on the range of financial services offered by an institution.
- Consist both of own-fund and a liquid capital requirement. Liquid capital requirement is equivalent to the total capital requirement.
- Institutions compute their own-fund and liquid capital requirement using the template or guidance from the regulator.
- Investment Services Directive Own-Fund Requirements:
  - €50,000 - institution that does not hold clients’ assets and funds, deal for own account or underwrite issues;
  - €125,000 - if institution holds clients’ assets and funds but does not deal for own account or underwrite issues; and
  - €730,000 - if company deals for own account and/or underwrites issues.
- Liquid capital requirement - total capital requirement is the sum of: expenditure-based requirement; position risk requirement; counterparty risk requirement; foreign exchange requirement; and other assets requirement.
- There are certain thresholds and stipulations to the expenditure-based approach as per the characteristics of the institution.
- In addition to the risk requirements computed as part of the capital requirements, AMC to monitor its large exposures and ensure that counterparties do not exceed limits set by regulator or SRO.

### Separation of Clients’ Assets

- IMRO come up with rules for AMCs which are themselves the custodians of clients’ assets or which have outsourced safe-custody services.
- The thrust behind the rules is to ensure that client assets are kept separate from those of the institution.

### Disclosure

- Authorised investment firm to furnish its private clients with details on their address, identity and status with the firm of employees and other relevant agents with whom client has contact and the identity of the firm’s regulator.
- Details of transactions must be reported to regulator. Transactions Reporting Handbook provides the format of these reports.
- Clients to be advised of any sale or purchase on their account - Contract Note.
- Periodic reporting to clients in the form of a statement stating among others, value of portfolio at start and end of reporting period, portfolio composition, etc.

### Enforcement

- Varied actions may be taken to enforce regulations:
  - a warning, levying of a fine which may take into account prior unheeded warnings when determining its magnitude and disciplinary proceedings in event of continued breach;
  - powers of intervention - include placing of restrictions or impositions of requirements by regulator e.g. prohibiting an AMC from conducting business;
  - summary fine for failure to submit financial returns or a statement of representation; and
  - an investigations, particularly, if AMC is deemed no longer fit and proper to continue operations. Investigation team reports to Enforcement Committee, depending on outcome case may be escalated to the Disciplinary Tribunal which may reprimand AMC, impose a fine, remedy situation or suspend or terminate membership with IMRO. Appeal Tribunal caters
### JURISDICTION

#### UNITED STATES OF AMERICA

**Regulatory Authority**
- Three (3) criterions for classification as an investment advisor.
- Investment Advisors Act governs the supervision of investment advisors.
- AMCs can be regulated at a state or federal level, which is by the states or the SEC, respectively.
- Advisors with USD25.00 million or more of assets under management or which provide advice to investment company clients are permitted to register with SEC. Smaller advisors register under state law with state securities authorities. There is a measure of overlap with this scenario.

**Capital Requirements**
- SEC does not require minimum capital charge for investment advisors it regulates.
- However, some state securities authorities do impose capital requirements e.g. California - minimum net tangible capital of USD25,000; USD5,000 (if AMC has power of attorney over clients’ funds but does have custody of clients’ funds or securities); and USD1,000 (if AMC does have this power of attorney, but receives fees for investment publications, bulletins or analysis done).

**Separation of Clients’ Assets**
- Under Investment Advisors Act investment advisors are permitted to hold clients’ funds and securities. Such advisors are subject to additional requirements.
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| Disclosure  | • Investment Advisors Act requires each AMC to send prospective clients a written disclosure statement. Existing clients receive a copy of this brochure annually. The information in the written disclosure statement is the same as that contained in Part II of Form ADV.  
• However, in instances where AMCs only provide impersonal services of less than USD200.00 in value then they are not required to deliver the brochure to clients.  
• Division of Investment Management requires asset managers to disclose to clients all material information regarding its compensation such as if the advisory fee charged is higher than that charged by other AMCs. In addition, all potential conflicts of interest are to be disclosed.  
• A SEC registered AMC that has custody of clients’ assets and funds to promptly disclose to clients and prospective clients on any financial condition of institution which may impair its ability to meet its contractual obligations. This also extends to disclosure on any legal and disciplinary events. |
| Enforcement | • Division of Enforcement is responsible for enforcing Federal Securities Laws.  
• It may conduct investigations.  
• SEC civil suits prosecuted by the Division in the federal courts as well as its administrative proceedings.  
  ➢ Civil suits - SEC seeks injunction to prohibit future violations; and  
  ➢ Administrative proceedings - to among others, revoke or suspend registration etc. |
| Audit       | • Office of Compliance and Examinations is responsible for the examination program at the SEC.  
• Inspections and examinations authorised under the Securities Exchange Act, Investment Company Act and Investment Advisors Act. |
| Authorisation| • Registration is done by the SEC. AMCs to file Form ADV and keep it updated by filing periodic amendments including an annual amendment to Schedule I to Form ADV.  
• Registration also requires firms to comply with the Brochure rule. |
| Best Execution| • As a fiduciary investment manager to always ensure best execution on behalf of the client. |
| 7) Germany  | • No single regulatory authority. Asset managers and investment companies are regulated by the Federal Banking Supervisory Authority (Bundesaufsichtsamt für das Creditwesen, BAKred).  
• Regulation of investment management skewed towards BAKred as opposed to BAV (Federal Insurance Supervisory Authority).  
• To the extent asset managers trade in securities, they are also supervised by the Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel), responsible for market supervision (market supervision serves to ensure the protection of depositors, the transparency of the securities markets and the integrity of the capital market).  
• Legal basis for all financial services institutions, including those that provide portfolio management services is provided by the Banking Supervisory Act (Kreditwesengesetz, KWG).  
• The Investment Companies Act (Gesetz über Kapitalanlagegesellschaften, KAGG) regulates operations of domestic investment companies.  
• Ancillary legislation: Securities Trading Act (Wertpapierhandelsgesetz) implements the prudential and conduct-of-business rules for trading with securities; Safe Custody Act (Depotgesetz) which governs deposits of securities and applies to all safe custody activities; and the Deposit Guarantee and investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz) which provides for basic investor compensation in the event of losses. |
| Capital Requirements | • Capital adequacy rules applicable to all financial institutions including those that provide portfolio management to a third party |
**JURISDICTION**

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<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
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<td>is laid down in the Banking Supervisory Act (KWG).</td>
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<td>- Capital requirements for investment companies are legislated in the Investment Companies Act (KAGG).</td>
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<td>- Separate solvency regulation applicable to insurance companies, including the asset management part of these companies, if it has not been outsourced to a separate business, is contained in the Insurance Supervisory Act.</td>
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<td>- Banking Act (KWG)</td>
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<td>- Anyone desirous of providing financial services including portfolio management requires a written license from the Federal Banking Supervisory Authority. As per the Investment Companies Act (KAGG), the Authority may only grant a license if minimum capital is met:</td>
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<td>- €50,000 if applicant company does not have power of attorney and trade on own account</td>
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<tr>
<td>- €125,000 if applicant company has power of attorney</td>
</tr>
<tr>
<td>- €730,000 if applicant company engages in own account trading for others</td>
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<td>- €5.00 million if applicant company engages in deposit taking activities</td>
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<td>- Federal Banking Supervisory Authority reserves the right to change minimum capital requirements on an individual basis.</td>
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<td>- Ongoing capital requirement, Banking Supervisory Act (KWG) legislates that portfolio managers or other financial services institutions must have own funds amounting to at least a quarter of their own costs as shown in the statement of comprehensive income as per the previous set of annual accounts under general administrative expenses, depreciation of tangible and intangible fixed assets and value adjustments. If accounts are not yet available, estimates as per the business plan may be used.</td>
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<td>- Financial services institutions are also subject to own-funds requirements that take into account market risk positions. This additional requirement applies to institutions which conduct trading for their own account, or which are authorised to obtain ownership or possession of funds or securities of customers.</td>
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<tr>
<td>- Investment Companies Act (KAGG)</td>
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<td>- This is the decisive law for German investment companies in addition to KWG.</td>
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<td>- Provides that Banking Supervisory Authority may grant a financial institution a license to carry out investment fund activities if the paid-up nominal capital is at least €2.60 million. There is no variable component in capital requirement for investment companies.</td>
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<tr>
<td>- Insurance Supervisory Act</td>
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<tr>
<td>- Only applicable to asset managers that are insurance companies that continue to manage their own funds in-house. Solvency requirements for insurance business capture the capital requirements for the asset management part of insurance as per The Decree on Capital Requirements of insurance Companies (has provisions on the calculation of solvency margins).</td>
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**Separation of Clients’ Assets**

<p>| Basic safe custody rules are laid down in the Safe Custody Act (Depotgesetz) and apply to all non-private persons performing safe custody activities. The Safe Custody Act (i) specifies legal responsibility of the custodian, ensuring safe keeping; and (ii) provides for punishment in the cases of breaches. |
| Custodian services are classified as a banking activity (Banking Act, KWG) that correspondingly requires a license from the Banking Supervisory Authority. Custodian is not a credit institution in very rare instances. |
| Financial services institutions that manage assets on a discretionary basis (portfolio managers) are required to keep security in a safe custody account, otherwise, the institution needs a license to conduct safe custody business (Banking Act, KWG). |
| There are strict safe custody rules according to the Investment Companies Act (KAGG). |</p>
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<th>DETAILS ON EACH COMPONENT OF THE REGULATORY FRAMEWORK</th>
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<tr>
<td>Disclosure</td>
<td>▪ Investment Companies Act (KAGG) - firms to submit reports on funds on a regular basis to regulatory authority.</td>
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<td>Enforcement</td>
<td>▪ Under the auspices of the Banking Act (KWG) Banking Supervisory Authority allows to impose sanctions and fines in accordance with the provisions of the Administration Enforcement Act (Verwaltungsvollstreckungsgesetz) to punish breaches with administrative regulations and enforce compliance.</td>
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</table>
▪ All registered providers of financial services legally obliged to join and financially contribute to the Compensation Fund of Securities Trading Companies (EdW). Investment companies only required to join if they engage in third party portfolio management.  
▪ Fund provides minimum protection only. Compensation granted limited to 90% of the value of deposits taken up to a maximum of €20,000 and up to a maximum of 90% of liabilities from security transactions up to a maximum of €20,000 per investor and financial institution.  
▪ Institutions are required to inform non-institutional customers about the guarantee provisions including the scope and amount of the guarantee in a written and easy to understand manner. |
| Complaints  | ▪ Conduct-of-business rules require firms (which are part of banking groups) to implement internal procedures to deal with complaints. |
| Authorisation| ▪ Banking Act and Investment Companies Act  
➢ Any institution that intends to pursue financial services, including asset management activities, needs a written license from the Federal Banking Supervisory Authority.  
➢ Minimum capital requirements, governance structures, fitness and propriety of directors and senior management, comprehensive business as the stated specifications, among others, form the licensing criteria.  
▪ Insurance Supervision Act  
➢ Detailed operating plan (per regulatory dictates) and minimum capital requirements key to consideration of application. |
| Supervision | ▪ Banking Act  
➢ Grants the Banking Supervisory Authority several supervisory rights; conduct of audits and inspections; monthly regulatory checks on asset allocation (at times every three [3] months); submission of monthly returns on a quarterly basis; submission of annual accounts with the BAKred within three (3) months after year end; and inform regulator about important events such as significant losses or changes in management.  
▪ Insurance Supervision Act  
➢ Similar provisions. Notable difference is that the BAV might just inspect an institution every seven (7) or eight (8) years and send its representatives to meetings of the institution. |

Source: Authors’ own table derived from Franks and Mayer et al. (January 2001:119-161)
## Appendix 4: Salient Features of Key European Regulation

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<th>Regulation</th>
<th>Entities Affected &amp; Salient Features</th>
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| **Alternative Investment Fund Managers Directive (AIFMD)** | All non-UCITS fund managers.  
  - The key compliance issues are: regulatory capital requirements; marketing of funds to professional investors, with local exceptions; transparency - reporting and disclosure requirements; requirement to use depositories and custodians; liabilities for depositories and custodians; and changes to remuneration structures.  
  - Other issues: authorisation; delegation; organisational and business conduct; risk, liquidity and valuations; distribution; and prime brokers. |
| **Capital Requirements Directive I, II and III** | Investment firms, subject to local implementation & proportionality depending on size and influence of particular firms.  
  - The directive establishes the regulatory framework for financial services firm’s capital requirements.  
  - Directive incorporates the Basel II provisions, including a three pillar approach to capital adequacy, controls and reporting and also remuneration of key staff. |
| **Central Securities Depositories (CSD)** | Potentially all market participants.  
  - This establishes a common regulatory framework for CSDs.  
  - It harmonises certain aspects of securities settlement in the European Union. |
| **European Market Infrastructures Regulation (EMIR)** | All market participants including users of OTC derivatives.  
  - EMIR provides for the regulation for central counterparty clearing, reporting and risk mitigation of OTC derivatives. |
| **Investor Compensation Directive (ICSD)** | All providers and users of MiFID covered services and activities.  
  - ICSD extends the existing investor compensation measures to include UCITS and all investing services and activities covered by MiFID. |
| **Markets in Financial Instruments Directive (MiFID II)** | Large parts of the financial services sector, including providers and consumers of retail investment products.  
  - MiFID II addresses issues raised by the financial crisis - thrust being a commitment to enhance transparency and regulation of opaque markets.  
  - MiFID II revisits MiFID with a view to providing consumers with greater clarity, more thorough reporting and increased ethical standards.  
  - MiFID deals with inducements, investment advice, non-complex products, best execution, product intervention, transparency and transaction reporting, derivatives trading, third country access and custodians. |
| **Packaged Retail Investment Products (PRIPs)** | Products including all structured products, such as investment funds.  
  - PRIP’s is aimed at better informing consumers and improving consumer protection.  
  - The Key Information Documents (KID) proposal is a key feature of PRIPs - KID provides clear and comparable information about products to aid consumers in decision making and prevent mis-selling. |
| **Retail Distribution Review** | Anyone involved with retail investments, including investment advisors.  
  - Improves clarity about financial advice for consumers.  
  - Regulates payment for advisory services.  
  - Increases ethical standards among financial advisors. |
| **UCITS IV** | All fund managers and investors in UCITS funds.  
  - UCITS allows for among others, management company, supervision, notification procedure (simplified regulator-to-regulator communication) and key investor information |
| **UCITS V** | All firms covered by previous UCITS. |
Focus on investor protection. It has three key aims: (i) harmonise UCITS depositary regime clarifying duties and liability; (ii) harmonise remuneration rules with other sectors; and (iii) harmonise sanctions regime for UCITS breaches. Its key elements are: depository, remuneration and sanctions.

**Source:** Deloitte (2013:9-22) and State Street (2011:11-13)