# THE AGENCY DILEMMA OF INVESTMENT FUND MANAGEMENT

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**Abstract**

The currently observable flight of investors out of investment funds is counterintuitive even in a crisis situation, because they forego the benefits of the collective investment offered by the funds. In order to unveil the reasons for this development we analyze the internal governance structure of German investment funds from a principal-agent perspective. We find that investment companies face severe governance problems because they are agents to at least two groups of principals with potentially conflicting interests. One group of principals consists of the shareholders of the investment company itself, the other group of principals consists of the actual fund investors.

**Keywords:** Corporate Governance, Contractual-Type Funds, Statutory-Type Funds, Principal-Agent Theory

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## Introduction

The global financial crisis has caused severe decreases in the amount of assets under management in investment funds. The investment funds suffer from both declining market values of the assets they invest in and increased selling pressure by their investors. Consequentially, the market value of the funds decreases substantially and enormous liquidity shortages arise due to the funds obligation to redeem shares from the fund investors.

The flight out of investment funds, however, is somewhat counterintuitive since investors benefit significantly from the collective investment in mutual funds. The benefits include the diversification effect and, compared to investments in individual assets, each investor avoids individual information gathering and processing costs as well as transaction costs for buying, depositing and selling these individual assets. Furthermore, investment funds offer the opportunity to invest in assets that are not part of the investment opportunity set of the average individual investor.

On the other hand, even professional fund managers are not infallible. Empirical evidence not only shows that fund managers often cannot avoid even small crises situations, but it also documents that they are prone to suboptimal and non-rational investment behavior just like non-professionals. A prominent example is home-biased investment behavior of fund managers.[1] Still, however, much inefficiency in fund management remains unobservable to investors because of lax publication requirements. Therefore, the question is whether it is really only bounded rationality that makes managers perform poorly in many cases, or whether this view alone is too short-sighted and there are rather severe problems imminent in the corporate governance structure of the investment fund companies. While the external governance of investment funds, i.e. the influence of funds on the companies they invest in, was analyzed by several authors, e.g. Stapledon 1996 and Ingley and van der Walt 2004, the internal governance was only analyzed by very few, such as Dangl et al. 2006.

In order to shed more light on the internal governance of investment funds we analyze the governance structure of contractual-type and statutory-type funds from a principal-agent perspective. Despite the fact that besides the principal-agent model other governance models, such as the stewardship model[2], the fiduciary model[3] or the stakeholder models[4], have gained in importance in the

[1] For the home-bias effect and its impact in Germany see Oehler et al. 2006, 2008.

[2] See Donaldson 1990, Donaldson and Davis 1991, Learmount 2002, 2003, Clarke 2004b, and Davis et al. 2004.

[3] See. Kay and Silberston 1995 and Learmount 2002, 2003.

[4] See Freeman 1984, 1994, Blair 1995, Donaldson and Preston 1995, Learmount 2002, Clarke 2004b, Letza et al. 2004. However, some authors do not consider the stakeholder approaches to be complete theories because many of the stakeholder models are not testable (see, e.g., Mitchell et al. 1997).

discussion of governance issues, they appear not to be sufficiently theoretically developed to add insight to the discussion. Our study focuses on the legal situation in Germany as of December 2007 as determined by the German Investment Act (Investmentgesetz, InvG) which was enacted on January 1st, 2004 and was amended by the Investmentänderungsgesetz on December 28, 2007.[5] Most results, however, can easily be transferred to the situation in other countries.

We find that investment companies face severe governance problems that mainly arise from dual or even multiple principal-agent relations. This means that the fund manager is agent both of the investment company's shareholders and of the fund investors. This situation can be found in both German contractual-type and statutory-type investment funds. Due to the potentially conflicting interests of the two groups of principals, the fund manager must find some sort of compromise in order not to discriminate one of the groups. An aggravating factor is the fact that the German legislation focuses on the fund investors' interests, which is potentially detrimental to the shareholders of the investment company.

The paper is organized as follows. Section 2 provides a short overview of the principal-agent theory within the corporate governance debate. The types of investment funds are described in Section 3 and analyzed in Section 4. Section 5 summarizes our key findings and provides concluding remarks.

## 2 The Principal-Agent Conflict

The problem of corporate governance is based on the division of labor and the separation of management and finance of a company. Some authors attribute the starting point of the corporate governance debate to Adam Smith, while most authors, such as Fama and Jensen 1983, Shleifer and Vishny 1997, Zingales 1998, and Clarke 2004a, state that Berle and Means 1932/1968 were the first who extensively discussed corporate governance issues. Since then, and in particular since the 1970s, an immense discussion of these issues has emerged. By and large, we follow the broad definition of the Cadbury Committee (Committee on the Financial Aspects of Corporate Governance): „Corporate governance is the system by which companies are directed and controlled".[6] According to this definition a corporate governance analysis has to consider involved persons, measures (incl. their implementation) and rules (incl. their enforcement) as well as entire control systems.

The most prominent approach to analyze corporate governance issues is the principal-agent model. It is applicable to contractual relations which are characterized by asymmetrically distributed information between the parties to the contract. In general, the principal assigns a task to the agent without having the same amount and/or quality of information as the agent does. Typically, the relation between shareholders and managers constitutes a principal-agent relation. The shareholder (principal) transfers the property rights of a certain amount of money (wealth) to the manager (agent), in order that the latter maximizes the shareholder's wealth. This is what Fama (1980) refers to as separation of management and finance. The shareholder position in the company, however, guarantees only residual claims, which means that the shareholder is the residual risk taker of the business and of the manager's decisions.[7] Figure 1 shows a simplified model of a principal-agent relation.

**Please insert Figure 1 about here**

The asymmetrical distribution of information between the parties to the contract is caused by transaction costs as described by Coase 1937 and/or by limitation of the parties to gather and process information.[8] The latter idea is known as bounded rationality as developed by Simon 1956, 1957.[9] As described by Alchian and Demsetz 1972, Jensen and Meckling 1976, and Fama and Jensen 1983, transaction costs hinder the parties to enter into a complete contract and to fully enforce all provisions of the contract. In all situations that are not provided for in the contract, the manager's decision making power is not restricted. If individuals are assumed to act such that they maximize their utility (see, e.g., Alchian and Demsetz 1972 and Jensen and Meckling 1976) or even to act opportunistically (see, e.g., Williamson 1975 and

[5] In April 2005 the Corporate Governance Code for Asset Management Companies (Corporate Governance-Kodex für Asset Management-Gesellschaften) has been published. It repeats the most important issues provided by law, complemented by a number of comply-or-explain recommendations. We will refer to the Code where necessary.

[6] Committee on the Financial Aspects of Corporate Governance 1992, 15. An example for a much narrower definition is provided by Shleifer and Vishny 1997, 737: „Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."

[7] Not only is the shareholder's position as residual risk taker the result of the separation of management and finance, but it is also efficient from an economic point of view, because compared to managers and employees the shareholder is less bound to the company and has better opportunities to diversify the risk from the investment in the company; see Fama and Jensen 1983.

[8] See Williamson 1984, Clarke 2004b. Not only are individuals limited in their ability to gather and to process information, but also in their ability to learn; see Oehler 2004, 2006, Oehler et al. 2006; van Nieuwerburgh / Veldkamp 2006a, b.

[9] Furubotn and Richter 2005 refer to this as imperfect individual rationality. It is partly resulting from incomplete and time-varying preferences and limited problem-solving capacity. See also Williamson 1975, 1989 and Oehler 2002

Davis et al. 2004) [10], the decisions of the manager will not necessarily be in the best interest of the principal, i.e. there will be a conflict of interests.[11] Jensen and Meckling 1976 describe the wealth reduction that is caused by the conclusion of such a contract and its enforcement compared to the optimal result from a situation without transaction costs and with fully informed individuals as agency costs. They consist of (1) the principal's costs to monitor the agent (monitoring costs), (2) the manager's costs to act in certain situation in the principal's best interest and to show his efforts (bonding costs), and (3) the residual loss which arises despite the monitoring and bonding efforts.

From the corporate-governance point of view it is necessary to determine how to align the manager's interests with the principal's interests by incurring minimal agency costs. As described by authors such as Williamson 1975, Blair 1995, Keasey et al. 1997, Learmount 2002, Clarke 2004b, and Letza et al. 2004 both external (market) and internal (hierarchical) mechanisms and structures may be appropriate to achieve the alignment. In cases in which market mechanisms are supposed to worsen rather than to reduce the agency conflict, which might be the case in bubble or crisis situations, it would even be reasonable to limit the market influence.

## 3 Fundamentals of investment funds and legal provisions

### 3.1 Purpose and fundamental structure of investment funds

Investment funds, regardless of legal provisions and restrictions, are a form of collective capital investment. Amongst other things they allow investors, even those with only relatively small amounts of money, to make use of professional investment management and to broadly diversify[12] their assets to significantly lower costs as if they would manage them themselves (see Wang 1994 and Roggatz 2003). Investment funds consequentially offer a significant intermediation and transformation benefit. This, however, is not restricted to the benefits of the transformation of lot size and the risk transformation. Rather, it also covers the transformation of investment horizons resulting from the fact that the horizon of the investment decisions of the fund is almost completely independent from the investment horizon of the individual investors. Finally, there is also the benefit of information transformation which is necessary due to different information needs of investment funds and individual investors and manifests itself in the differences in the information gathered and the information published by the mutual funds.

The core element of an investment fund is the bilateral contractual relationship between the individual investors – mostly a variety of more or less heterogeneous economic agents[13] – and the investment company that develops and manages the fund[14] on behalf of the investors. Due to the fact that the coordination of the investment policy of the fund's management with every singly individual investor is impossible because of the sheer number of investors, the relationship between the investment management company and each investor is different to the one between an asset manager or financial advisor and his individual client.

In order to benefit from the collective capital investment in the form of diversification effects and of economies of scale, investors transfer the property rights over the amount of money they invest in the fund to the investment company for a typically previously undetermined period of time. The bilateral relationship sets out the key terms of the investment fund. This includes in particular the investment policy of the fund presented in the sales prospectus and other sales documents. On the one hand, the investment policy serves as the fund management's guideline for future investments; on the other hand, it helps investors to select a fund that that fits their investment objectives. The investment policy contains amongst other things information about the risk-return profile of the fund and about certain investment restrictions (e.g. on a specific sector or industry group). It also determines the fees charged by the investment management company for the management of the assets and as a compensation for the investment company's risks.[15]

[10] As described by Furubotn and Richter 2005, the combination of opportunism, incomplete information, and transaction costs also hinders one party to the contract in determining whether or not the opposite party does indeed act opportunistically.

[11] There are specific asymmetries in the contract negotiation period, the actual duration of the contract and during the contract settlement. The negotiation is characterized by information asymmetries in the form of hidden information. After conclusion of the contract there are additional asymmetries resulting from the agent's discretion and the consequential problems of moral hazard and holdup. After the end of the contractual relationship there are still asymmetries with regard to the bearing of the consequences of the relationship; See Furubotn and Richter 2005, Oehler 2006, Oehler and Kohlert 2008.

[12] The advantages of diversification are described extensively in the literature based mostly on the findings of Markowitz 1952.

[13] The heterogeneity of investors with regard to their preferences is probably limited, largely due to the fact that only investors with the same or at least similar preferences (particularly regarding the investment policy) will invest in a particular fund (see Wang 1994). With regard to individual wealth and investment horizon, however, investors will be much more heterogeneous.

[14] The terms "investment fund" or "fund" are not clearly defined. It can either represent the organizational unit or the sum of the actual funds or assets.

[15] See Wang 1994. Possible risks taken by the investment company include, for example, situations in which the fund

The practical implementation of the investment fund concept has led to two main forms of investment funds, statutory-type fund and contractual-type funds, which do not necessarily always occur in the below described ideal forms.

### 3.2 Contractual-type funds

In case of contractual funds, the task of managing the fund and the task of custody over the invested amounts are transferred to different contractual parties (see Roggatz 2003). This means, that the actual fund's assets are kept separate from the assets of the investment management company. The investors who invest in a contractual-type fund are consequently neither financiers nor shareholders of the investment company but instead they only transfer the property rights over their funds to be managed. Their funds, however, are deposited with a third institution. Contractual funds dominate the market in Europe and Japan but can also be found in many other countries (see Wang 1994).

The German legal system categorizes contractual funds as Kapitalanlagegesellschaften (KAG, see §2 InvG), which were the only legally allowed form of investment company until the InvG came into effect on January 1st 2004. A KAG is a financial institution which has the main purpose of managing investment funds and has to operate as a corporation, either a stock corporation or a limited liability corporation (§§ 2 and 6 InvG). An investment fund whose assets are managed by a KAG is called separate fund asset portfolio (Sondervermögen). A KAG, however, is not limited to manage only one such portfolio (§ 30 InvG).

The separate fund asset portfolios may be classified either as sole property of the KAG or as co-property of the investors (§ 30 InvG). These two types are also called fiduciary type and joint-ownership type. In the prior case, the separate fund asset portfolio remains property of the KAG, which therefore also serves as creditor of the assets. It manages the portfolio as trustee on behalf of the investors. In the latter case, investors have co-ownership over the assets to the extent of their share in the portfolio. Factually, although in each case assets are managed by the management company, investors do not only economically but also legally own the fund's assets in the joint-ownership case, but they only have economic ownership in the fiduciary case (see Cox 1971).

Under normal circumstances, KAG investors can reclaim their share of the separate fund asset portfolio and consequently their property rights over it at any time. However, if a suspension of the redemption serves the interests of the entity of the investors or if the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) mandates such a suspension (§ 37 InvG), the KAG shall suspend redemptions. On the other hand, the investment management company is allowed to withdraw from their management contract at 13 months prior notice to the investors. In case insolvency proceedings are initiated against the assets of the KAG, or the initiation of insolvency proceedings is declined due to the lack of insolvency assets, the KAG looses its right to manage the separate fund asset portfolio (§ 38 InvG).

### 3.3 Statutory-type funds

A statutory type investment fund is an investment company, mostly in the legal form of an stock company, whose shareholders' invested capital represent the assets under management and the collective capital investment, respectively. Therefore, the actual fund's assets and the assets of the investment management company are not separated. Typically, investors are shareholders of the management company with all corresponding rights and liabilities (e.g. voting rights). The investment management company has not only the property rights to manage the invested assets but also over the assets themselves (see Cox 1971, Baur 1997, Stotz 1998, and Roggatz 2003). The most prominent examples of the statutory-type fund are mutual funds in the US.

According to the InvG, statutory-type investment funds can only be issued in the legal form of an investment stock corporation (Investmentaktiengesellschaft, InvAG) with variable nominal capital.[16] However, according to §96 InvG, an InvAG has to be established in a first step by so-called *company shareholders* with registered shares that guarantee voting rights. At later stages new company shareholders may be accepted to replace old company shareholders or as additional company shareholders. Every change in the composition of the company shareholders has to be announced to the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin). After official registration of the InvAG the actual fund investors enter as so-called *investment shareholders*. If not specified otherwise in the statutes of the InvAG, the investment shareholders do not have any voting rights.

The InvAG is allowed to issue, buy-back or resale own shares as long as certain minimum and maximum capital limits are maintained and as long as the nominal capital is covered by the value of company's assets. As long as a minimum capitalization of €1.25 million is maintained and no other reasons for a suspension exist, the shareholders have the right to claim back the net asset value corresponding to their shares and in return give their shares back to the InvAG (§§ 104-105 InvG).

cannot be fully established or in which operational costs exceed revenues.

[16] The formerly included possibility to found an InvAG with fixed nominal capital, i.e. in form of a closed-end investment company, was deleted from the InvG in December 2007, in particular, because of a lack of acceptance in the market (see Dornseifer 2008).

Furthermore, an InvAG may be created in form of an umbrella construction for separate funds (§100 InvG). In this case, the investment shareholders participate only in the assets that form the respective fund and that are strictly separated from the other funds under the umbrella.

### 3.4 Officially required supervision

#### 3.4.1 Custodian

Contractual as well as statutory funds are obliged to enter into a contractual relationship with another financial institution that serves as custodian. The custodian is independent from the investment management company and primarily acts as a support and monitoring institution while processing the ongoing transactions (§§ 9, 20, and 97 InvG). Table 1 summarizes the corresponding functions.

**Please insert Table 1 about here**

The custodian principally has to perform its tasks exclusively in the interest of the investors and therefore independent from the investment management company. Simultaneously, however, it has to follow the latter's instructions. Only in case the instructions are illegal or violate contractual agreements the custodian has to refuse to follow them. Executives of the investment company may not simultaneously be employees of the custodian and vice versa (§§ 22 and 99 InvG). Claims of the investors against the custodian can either be made indirectly by the investment management company or directly by the custodian. The custodian can take its remuneration for its services directly from the assets under management, if the investment management company agrees (§§ 28, 29, and 99 InvG).

#### 3.4.2 Government Supervision

In addition to the supervision by the custodian, investment companies are also subject to government supervision that is executed by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin). The BaFin is entitled to make all necessary arrangements to safeguard the legality of all activities associated with investment management and depositary services [17]

## 4 The investment management companies from the principal-agent perspective

### 4.1 The KAG

The application of the principal-agent approach to contractual type investment companies in the form of a KAG appears at first glance incompatible with the focus on investor interests demanded by law. Actual principals of the KAG's management are its shareholders, who are not identical with its investors. Instead, they hold claims that are residual to those of the investors. According to this view, investors themselves only represent clients of the KAG who use the collective investment service in return for a management fee. Consequently, the legal provisions are not only contradictory to the principal agent theory but also to the economic interests of the KAG's shareholders in respect of both the fund's management as well as the supervisory bodies.

On closer examination, however, the relationship between investors and a fund's management can also be interpreted as principal-agent relationship. This is due to the fact that transfer of property rights on financial resources is based on an incomplete contract that is characterized by the asymmetries between the two parties and the resulting risks. The investors are therefore principals with regard to the separate fund asset portfolio and not to the KAG itself. The transfer of property rights through incomplete contracts along with information asymmetries leads to potential conflicts between investors and fund management. The self-interest maximizing or even opportunistic behavior of the fund managers may adversely impact investors' wealth through lower returns and/or higher risk. The conflict potential is further amplified by the fact that the quality of the services offered by the investment company can not at all or only be partly assessed. In particular, investors cannot adequately assess the risk of the investment in the fund by past (or existing) information because the risk mainly depends on the skills and the integrity of those who will manage the fund in the future.[18]

The management of the KAG and thus a fund's management is therefore an agent of (at least) two different groups of principals (shareholders and investors) with potentially different interests. While investors are interested in a fund management that maximizes their wealth by reducing transaction costs and making sensible investment decisions, shareholders are interested in maximizing their residual claims which typically depends on the management fees as well as the volume of the assets under management.

Despite of this dualism of the principal-agent relationship, the legal framework focuses on the investor-management relationship by determining that the management has to act exclusively in the interest of the investors, which, in turn, means that the interests of the shareholders shall not be the focus of the management.[19] The most important measures that

[17] The relevant legal framework particularly encompasses the InvG, German Banking Act (KWG) and Securities Trading Act (WpHG); see §§ 5 and 141 InvG.

[18] The actual quality (the risk) of the fund's management and therefore of the fund might be judged too low (too high). This will cause the investors to demand a comparatively too high risk compensation and therefore lead to adverse selection effects as described by Akerlof 1970. See also Wang 1994.

[19] The investment management company is obliged by law to focus all of its activities on the investors' interests as well as to safeguard market integrity. Conflicts of interest are to

were implemented in the InvG in order to achieve this are:

- Restrictions and other guidelines concerning the management of specific types of assets (§§ 46-65 InvG)[20]
- Publication and information duties (§§ 10, 41-45 InvG)
- Internal and external supervisory bodies[21]

Furthermore, the investors' possibility of returning their shares to the investment company has a disciplinary effect on the fund's management (§37 InvG). Not only does this lead to a smaller market share of the investment management company but also will the income of the KAG sink due to lower management fees.

With regard to the supervision of the fund management, greater independence from the latter can be assumed for the custodian than for the supervisory board although there has to be at least one independent officer on the supervisory board. The problems of the collective (supervision) function of the investors should therefore be less important. However, the relationship between fund investors and the custodian is also characterized by potential principal-agent conflicts. The fact that the remuneration of the custodian is taken out of the fund's assets creates incentives for the custodian to maximize its own benefit at the expense of the investors.[22] In addition, the custodian, by carrying out functions on behalf of the KAG, is simultaneously an agent of the latter. Therefore, principal-agent considerations are also necessary in this case.

It is obvious that the shareholder-management relationship is largely ignored by legislation. This is contradictory to the fundamental idea of the principal-agent theory that every action taken by management has to serve the interest of the shareholders. Consequentially, shareholders potentially have to bear higher agency costs. The apparent contradiction between corporate governance ideas and legal regulation does not appear compatible with either investor or shareholder interests as long as the application of the principal-agent approach is considered to be reasonable in an investment fund context. If the shareholders of a KAG demand a higher compensation for their invested capital, in particular when they feel that their interests are insufficiently considered in management decisions, this will likely happen at the expense of investors because of increased management fees.

Additionally, the costs of the simultaneously operating supervisory institutions (supervisory board, custodian, BaFin) reduce the benefits of the investors. Consequently, the investment in mutual funds becomes less attractive compared to other investment opportunities and investors therefore abstain from investing in the funds. This, in turn, reduces the investment company's shareholders' wealth.

## 4.2 The InvAG

By transferring the property rights of a certain amount of money to the InvAG the investment shareholders (as principals) entrust the InvAG and its management with the management of their funds. However, despite the fact that the investors are shareholders of the InvAG, their role as principal is different compared to shareholders of non-financial companies in respect of several aspects.

First, the introduction of dual class shares of InvAGs has left two groups of shareholders with possibly different interests. The aim of the investment shareholders is to benefit from the investment in a fund, while the company shareholder wishes to invest in a business. This has created a dual principal-agent relationship that is comparable to the situation in the KAG. Specifically, if investors pursue the goal of participation in cost-effective diversification opportunities as described above and thus invest relatively large proportions of their assets in a single fund, this indirect diversification, namely the transfer of diversification activities to the InvAG, will be paid for by giving up own diversification opportunities. Due to the legally implemented similar structure of KAG-type and InvAG-type investment companies, most of the governance issues described above are also relevant for the InvAG.

Second, investment shareholders of an InvAG are primarily non-residual risk takers of the investment company, but instead they are characterized by fluctuating demands on the investment company and thus insured against negative developments to some extent as they will get back at least the net asset value less a fee for transaction costs when they decide to give their shares back to the InvAG (see also Wang 1994).

Third, the disciplining effect of the exit option by selling the shares to other investors is extended through the additional possibility of returning the shares to the InvAG. The latter way does not only have an indirect effect on the investment company by changing the fund share price, but also a direct one, since it reduces the InvAG's nominal capital.

be avoided or, in the case that they cannot be avoided, to be solved in the investors' interest. See § 9 InvG. Engert 2004 notes in this context that investor protection and the functioning of the capital market are not contradictory but parallel goals considered from different perspectives.

[20] In addition to those general rules, there are specific duties for specific types of separate fund asset portfolios (e.g. real estate, mixed funds, old-age provision) which are listed in §§ 66-95 InvG.

[21] I.e. the supervisory board, the custodian and the BaFin.

[22] Successively arranging monitoring bodies leads to a shift of the actual principal-agent problem to the "last" supervision instance. At this point, however, it can not be clarified whether this shift is economically justified from the investors' point of view or whether the multitude of principal-agent relationships (investors - fund management, investors - supervisory board, investors – custodian, (investors - state supervision)) has detrimental effects for the wealth of the investors' due to increased monitoring costs.

However, the exit strategy is the investment shareholders' only means to align the interests of the fund managers and with their own interests. If we assume that the investment shareholders are not able to fully assess the manager's quality, this disciplining mechanism will not be particularly effective. This is why, legal provisions and sanctions have been implemented to reduce information asymmetries and to align management decisions with the investment shareholders' interests:

- Business bans on the Board and the Supervisory Board[23]
- Restrictions on investment opportunities[24]
- Publication- and information-duties[25]
- Internal and external supervisory bodies[26]

Due to the similarity in the construction of an InvAG and a KAG most governance problems discussed above are also relevant for the InvAG and shall not be repeated.

Figure 2 exemplifies the dual principal-agent relationship for both KAG- and InvAG-type investment companies.

**Please insert Figure 2 about here**

## 5 Conclusion

The aim of this paper was to analyze corporate-governance situation of investment management companies from a principal-agent perspective. We could show that both German contractual-type investment funds and statutory-type investment funds face severe governance problems. The cause for these problems is a dual or even multiple principal-agent relationship. Both investment company shareholders and actual fund investors are principals of the same management. The legal provisions however are very much in favor of the fund investors. It is important to have in mind that it was not purpose of this paper to discuss investor protection issues. Rather, any study that focuses on investment management companies must primarily clarify, whether the latter, being financial intermediaries, should be analyzed on the basis of corporate-governance or investor-protection considerations.

In both types of funds, the apparent contradiction between principal-agent considerations and legal regulations does not seem compatible with either investor or shareholder interests. If the company shareholders demand more influence or a higher return as compensation for the risk they face, for example when they feel that their interests are insufficiently considered in business decisions, this is likely to happen at the expense of investors, because they have to bear the cost of the resulting higher administrative costs of the assets as well as the cost of the simultaneously operating supervisory institutions. If the investment in mutual funds become less attractive compared to other investment opportunities and investors therefore abstain from buying, this will again hurt shareholders.

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[24] InvAG are not allowed to invest in real estate and property companies (§ 2 InvG).
[25] See above.
[26] These include the supervisory board, the custodian and BaFin. The latter, however, is rather seen as an enforcement organ of the legislature and less as part of the corporate governance structures, especially because of the lacking direct payment of the BaFin by the investors. The duty to have a supervisory board is not stated by the InvG but by the AktG. See § 30 AktG as well as in this context §§ 95-116 AktG.

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**Table 1**. Administrative and supervisory functions of the custodian according to §§ 23-29, 36 and 99 InvG

| **Order-processing** | **Supervision** |
|---|---|
| (1) Issuance and redemption of fund shares<br>(2) Allocation of the issue price (less load) to a blocked account specifically established for the fund<br>(3) Payment of the redemption price (less discount) to the investor from the blocked account<br>(4) Custody the investment fund's assets<br>(5) Monitoring assets that cannot be deposited<br>(6) Ascription of the price realized in an asset sale and of other relevant monetary funds (e.g. returns, option premium) to the blocked account<br>(7) Payment of the purchase price for assets to be acquired by fund management (securities, real estate)<br>(8) Providing collateral for derivatives, credit and pension transactions from the blocked account<br>(9) Payment of fees (e.g. transaction fees) and fulfillment of other obligations resulting from the management of fund assets<br>(10) Delivery of assets, securities etc. in case of sale and transfer<br>(11) Distribution of the capital gains to the investors | (1) Approval of certain transactions of the investment company, e.g. raising of credit for joint account of the investors and investing fund assets in an account at other banks, if legal requirements are fulfilled<br>(2) Supervision of, e.g.,<br>- the legality and the compliance with the contractual agreements concerning the issuance and redemption of fund shares,<br>- the calculation of the value of issued or redeemed fund shares,<br>- the asset transfer into the bank deposit,<br>- the legality and the compliance with the contractual agreements concerning the usage of the fund's returns,<br>- the granting and/or existence of collateral for security lending, and<br>- transactions and the compliance with regulations in case of real estate investments. |
| | **Other functions** |
| | (1) Asserting investor claims (arising, e.g., from the violation of the InvG by the investment company)<br>(2) Compensation of the investment company for managing the fund's assets<br>(3) Determining the value of the fund asset on each trading day (if not done by the investment company) |

**Figure 1**. A simplified principal-agent relation (based on Oehler / Voit 1999)

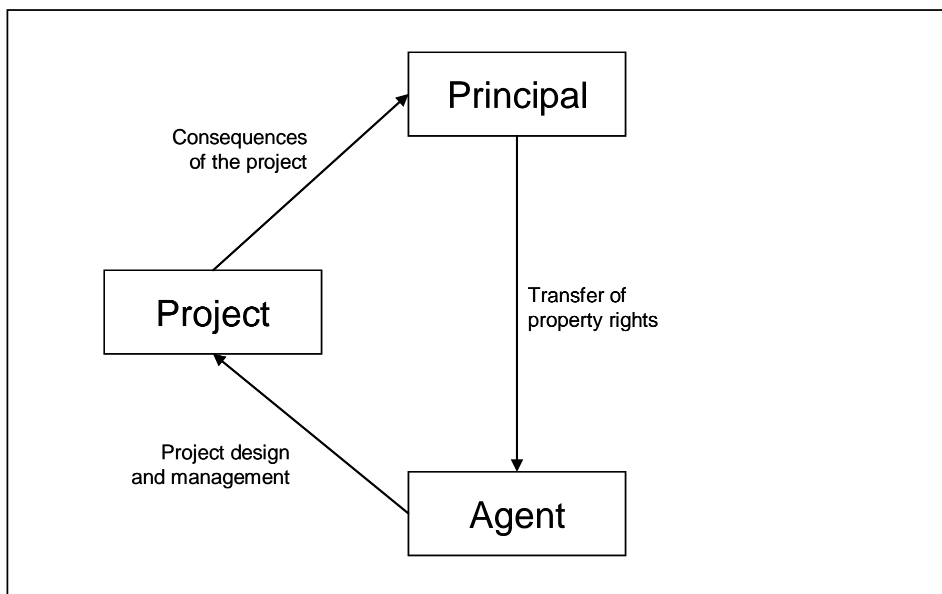

**Figure 2**. The dual principal-agent relationship in German investment fund management