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New Challenges in the Regulation of Collective Investment Schemes

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CHALLENGES IN THE REGULATION OF COLLECTIVE INVESTMENT SCHEMES

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This afternoon I would like to discuss some challenges in the regulation of Collective Investment Schemes (CIS), some problems and abuses that have recently been uncovered, and the regulatory initiatives that are proposed to address them. In particular I will highlight IOSCO's regulatory framework for CIS, and its policies with respect to fees and commissions charged by collective investment schemes, performance presentation standards, risk assessment of CIS operators, and market timing abuses.

In doing so, I invite you to consider any questions, criticisms, suggestions or points you might like to make at the conclusion of the presentation.

Background

The CIS industry has experienced tremendous growth across the globe in the last 20 years to the extent that assets held in funds – including pension funds – in many countries outweighs assets held in the banking sector. The total assets held by the world's mutual funds in the fourth quarter of 2003 was $13.96 trillion, some $2.6 trillion more than four years earlier. In Australia, between September 1996 and 2003, the amount of funds under management more than doubled from just over $300 billion to $691 billion. Developing countries have also identified the growth of the industry as critical to their future economic growth.

Regardless of short term fluctuations in the industry, it is fair to say that in the medium and long term the business of operating a CIS has been booming. Large and small investors alike have favoured the collective investment scheme as a vehicle for investment in a range of financial instruments. Many jurisdictions see the CIS as the ideal savings and investment vehicle for retirement incomes. It is undeniable that a properly managed CIS offers great advantages for retail investors in accessing professional investment management services and diversification that they may be unable to access individually.

Despite the industry's growth, we should recall the warning signs that emerged at the end of the Bull Run during the nineties, following the dot-com collapses and associated capital market slumps. More recently, the growing focus on corporate governance has also shone a light on the internal governance practices of CIS. From an investors' perspective, these concerns might be summarized as follows:

- A sense that the value of the professionally managed fund may be overstated;
- Concerns about the levels of fees charged, and in some cases overcharged;
- In some countries, a desire by investors to take more direct control of their investment; and
- Some distrust of intermediaries.

At the root of these concerns, rightly or wrongly, is a feeling that some in the CIS industry are focusing too much on generating profits for the operators and not enough on the interests of investors. It is critical for CIS operators to hold as paramount their fiduciary or contractual obligations to investors and it is important that regulators take appropriate action to ensure this. I say this for two reasons: (1) to protect consumers' investments; and (2) to protect the industry itself.

IOSCO regulatory principles for Collective Investment Schemes

In 1994, IOSCO adopted Principles for Collective Investment Schemes that related to the regulation of CIS with respect to those who operate and market CIS, the legal form and structure of CIS, the segregation and protection of CIS assets, disclosure necessary to evaluate the suitability of a CIS investment, and the proper valuation of CIS assets and the pricing of its respective shares. In 1997, IOSCO also adopted principles for Supervision of Operators of Collective Investment Schemes, which describe in detail the responsibilities of CIS operators.

These two sets of principles have since been summarized and included as Principles 17 to 20 of IOSCO's "Principles and Objectives of Securities Regulation"[1]. These principles, and various papers published by IOSCO which expand on them, are intended to encapsulate best international practice in the conduct and regulation of collective investment schemes, always bearing in mind IOSCO's overall objectives of protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk. These principles require that:

- The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme;
- The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets:
- Regulation should require disclosure …. which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme; and
- Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

Few would argue that these principles do not form a sound basis for enhancing public confidence in the CIS industry, and regulation which gives effect to these principles is widespread. But is this regulatory framework actually working to protect CIS investors and encourage good governance and investment performance within the CIS industry?

Fees and Commissions

It is fair to say that the prime interest of most CIS investors is in the return for their investment, ahead of issues such as the risk involved in the investment and the cost. However, there is growing concern about the level of fees and commissions, which obviously impact directly on the real rate of return enjoyed by investors.

The Technical Committee, through its Standing Committee on Investment Management ('SC5'), has completed a review of existing practices with respect to fees and expenses

[1] *IOSCO Objectives and Principles of Securities Regulation*, IOSCO Report (updated with references to work done by IOSCO since September 1998), International Organisation of Securities Commissions, February 2002, available at www.iosco.org.

in investment funds[2]. In February 2004, SC5 published a consultation document that acknowledged:

(1) the importance of fees and expenses to investment funds;
(2) that identifying what fees and expenses are charged to funds and how these impact performance is not straightforward; and
(3) that fees arrangements can also give rise to conflicts of interest and to breaches of the fiduciary duty of the investment fund operator.

There were three areas of particular focus of this work:

(a) the quality and standardisation of the information disclosed to the customer;
(b) the various mechanisms of providing soft commissions; and
(c) transparency of the costs of distribution.

Regulatory approaches to fees and commissions

All jurisdictions acknowledge the importance of fees and commissions and the need to regulate this area. This is because:

- fees and commissions have a direct impact on the performance of a Collective Investment Scheme ('CIS'): and
- the level of fees and commissions is an important consideration when making an investment decision.

The various regulatory approaches derive from these two facts and are structured around the following principles:

- Firstly, an investor must have access to relevant information on fees and commissions:
    - This information should be available both to investors considering investing in a CIS and to investors who have invested in this CIS.
    - The information should enable the investor to understand the cost structure of the CIS and to make comparisons with other CISs.
- Secondly, the regulator should take steps to ensure that the above principles are implemented. In taking these steps, the regulator should consider the following issues:
    - disclosure requirements of a CIS towards the investor, taking into account the risk of overwhelming the investor with information;
    - methods of calculation of fees and commissions to ensure that these methods reflect the true cost structure of the CIS and enable comparisons between CISs;
    - homogenization of the presentation of fees and commissions between CIS to make comparisons easier.
- Finally, as a rule, the regulator should not aim to control the level of fees and commissions:
    - Rather it should aim to have a competitive and informed market, which will then ensure that the fees and commissions are commensurate with the type and quality of services provided.

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[2] *Elements Of International Regulatory Standards On Fees And Expenses Of Investment Funds*, Report of the Technical Committee of IOSCO, Consultation Document, February 2004, available at www.iosco.org.

- However, differences in the structure of the asset management industry may lead some jurisdictions to define ceilings for certain types of fees, or to require that warnings on the level of fees and commissions be inserted in documents describing CIS, or to encourage CIS to lower their fees when they consider that their level is inappropriate.
- The enforcement of best execution principles by regulators may lead them to exercise some *de facto* control on the level of fees and commissions linked to transaction costs. Best execution principles require transaction fees to be commensurate with market prices.

I will now briefly consider a number of concerns IOSCO has identified as arising from specific types of fees and commissions. They are:

1) Performance fees;
2) Funds of funds fee structures; and
3) Soft commission and fee sharing agreements.

Performance fees

Performance fees are variable management fees linked to the "performance" of a CIS. These fees aim at creating an incentive for the management company to optimize the performance of the CIS. Performance fees are allowed in many jurisdictions but are often subject to specific regulation.

From a regulatory perspective, abusive conduct may arise when CIS operators are motivated by performance fees rather than by their fiduciary duty to the CIS investor. CIS operators may have a greater incentive to take higher risks that could bring higher fees: a strategy that could be detrimental to an uninformed investor.

From an investor's perspective, the structure of the fee is also important. Many performance fees refer to a particular benchmark, such as the general performance of a particular index. During recent years where investments in the stock market performed poorly overall and suffered some net loss in value, some CIS managers were able to justify a performance fee on the basis that they had outperformed the index. For many investors who were seeing their investments dwindle in value, it hardly seemed fair that the CIS manager could take a 'performance fee' for not having lost as much of the investor's money as the benchmark might have suggested!

Regulatory initiatives have been proposed to negate abusive conduct relating to performance fees. The thrust of these proposals is to:

- Avoid performance fee structures that create incentives for fund operators to take excessive risks. For example, where the management fee is below actual management costs, operators may try to recoup profit by using performance fees;
- Disclose the calculation of performance fees in an unambiguous and verifiable manner, to ensure that investors are treated equally and adequately informed as to the existence and impact of the fee.

Funds of funds fee structures

Where funds of funds invest a significant part of their assets in other funds, an overlaying of two cost structures results: the cost structure of the original fund and the cost structure of the underlying funds. This in turn raises the question of the disclosure to the investor of fees and commissions in funds of funds and the cost structure of underlying funds. In some cases the underlying funds are affiliated with the fund of funds operator, raising the possibility of conflict of interest motivating the selection of underlying funds and the payment of fees associated with them.

Abusive conduct may arise in relation to funds of funds fee structures where the fee structure is opaque, or where fees are skewed towards affiliated underlying funds.

Soft Commissions and fee-sharing agreements

1) These agreements relate to any economic benefit, other than clearing and execution services, that an asset manager receives in connection with the CIS's payment of commissions on transactions that involve the CIS's portfolio securities. For the purposes of this work the paper concentrated on soft commissions typically obtained from, or through, the executing broker.

Abusive conduct may arise when a CIS operator chooses an intermediary on the basis of soft commissions. Regulatory initiatives should therefore promote choice that is primarily based on the search for 'best execution' services. It follows that a broker that provides soft dollar benefits should only be chosen if that broker could provide best execution that is equal to or better than other brokers.

A regulatory challenge posed by transaction costs is that transaction costs can rarely be stated with certainty, as they depend on unknown parameters such as the turnover of the portfolio and the commissions charged by the broker. Also some financial instruments (bonds, commercial paper, derivatives) are negotiated without explicitly identifying underlying transaction costs.

While only two jurisdictions directly prohibit soft commissions, other jurisdictions have defined specific rules. These rules go to limiting the potential for soft commissions to create aberrant incentives for the CIS operator, in conflict with the interests of investors.

Performance Presentation Standards

As mentioned earlier, for many investors the investment return is paramount in their selection of fund manager. It is therefore very important that performance information is presented in a way that realistically and accurately represents the investment performance of the fund.

IOSCO published a discussion paper on CIS Performance Presentation Reporting in February 2003[3], and is about to publish a best practices paper on this topic. It aims to set

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[3] *Performance Presentation Standards For Collective Investment Schemes: Best Practice Standards*, Report of the Technical Committee of IOSCO, Consultation Document, February 2003, available at www.iosco.org.

standards for the way CIS advertised scheme performance information so as to prevent abuse such as misleading and deceptive conduct. The report suggests best practice standards for the presentation of CIS performance in advertisements based upon SC5's study of performance presentation standards (PPS), the formulation of general principles for the regulation of CIS performance presentations in advertisements, and further discussion among SC5 jurisdictions.

The IOSCO report identified the following issues that may be used to address abusive conduct that relates to performance presentation standards:

- CIS advertisements should not contain any untrue statement of fact or omit to state any fact that is necessary in order to prevent the statements made from being misleading.
    - CIS advertisements that contain performance information should provide a balanced presentation, for example, a CIS advertisement should not focus on periods during which the CIS produced its best returns to the exclusion of periods in which the CIS did not perform as well). In addition, the performance information should be balanced with other relevant information, such as risk.

- CIS performance information should be calculated and presented from the viewpoint of the typical CIS investor.
    - If CIS performance information does not reflect the deduction of all fees and expenses that are indirectly and directly paid by the typical investor, it should be accompanied by prominent disclosure that the performance information does not reflect the deduction of such fees and expenses and that, as a result, the actual returns to certain (or all) investors were lower.

- CIS should calculate their advertised performance according to standardized formulas, which ideally should require the deduction of all fees and expenses that are directly and indirectly paid by each CIS investor, and assume a complete redemption of the CIS investment at the end of the performance period (which will show the effect on performance of sales loads, redemption fees or other similar expenses that are directly paid by the typical investor upon redemption).

- CIS performance information should be presented for standardized time periods: these time periods should include a short-term interval, such as one year, to show the CIS's recent performance, but should not be so short that the CIS's performance might mislead investors; and include longer-term intervals, such as five and ten years to show volatility over time.

- CIS performance information should be accompanied by a relevant performance benchmark or benchmarks to enable investors to compare CIS performance to that of the benchmark(s).

- Most importantly, there should be a prominent disclaimer that a CIS's performance changes over time and that past performance is not indicative of future results should accompany CIS performance information.

Risk Assessment of CIS operators

Correct performance reporting and transparent disclosure of fees and commissions go directly to accurately reporting the investment performance of the fund. More recently, however, there have been concerns in some funds about their own corporate governance: general non-compliance with their own internal policies and processes, either deliberate or negligent. Properly disclosing how a fund will invest its investors' money is one thing: ensuring that it does so is another.

This emphasis on internal governance of funds has brought into sharp focus how funds assess and manage risk: risk in their investment activities; risk in their marketing and selling practices; risk in their back office processing; and risk to their overall business. Regulators are also interested in better identifying and monitoring the key areas of risk from a regulatory perspective.

The Technical Committee at its meeting in October 2002 approved publication of the paper entitled "Investment Management: Areas of Regulatory Concern and Risk Assessment Methods"[4], designed to help develop a common view of the risks that CIS operators pose to the achievement of regulatory objectives and of the relative importance of those risks.

This paper is designed to describe the nature of risk factors associated with managing and operating a CIS, and to describe some mechanisms or models which regulators might use to come up with relative risk assessments of operators in their jurisdictions. These risk models might be used to target particular regulatory activity, such as inspections or surveillances, on particular areas of the CIS's business.

The Technical Committee has since published three further papers that analyse particular types of risk and describe some of the regulatory mechanisms available to deal with those risks. These papers focus on managerial culture and effectiveness, operational processes and procedures; and marketing and selling practices.

To take the last as an example, the marketing risk, as viewed by the regulator, is a risk either by mismanagement or by misconduct in the marketing and selling processes that the CIS operator will cause consumer losses, which may lead to a loss of confidence in the financial system or to liabilities for damages. This may cause solvency problems for the CIS operator. For regulators, there is a further concern that inadequate understanding by consumers of a CIS will lead to an inappropriate or ill-informed investment decision by the investor thereby causing investor loss.

Risk assessment: Sales Practices of Market Intermediaries

For example, abusive conduct may occur where CIS products are offered through intermediaries and the intermediaries wrongly sell CIS products to investors and mismanage the relationship between the CIS and investors.

Risk Indicators include:

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[4] *Investment Management: Areas of Regulatory Concern and Risk Assessment Methods*, Statement of the Technical Committee of IOSCO, November 2002, available at www.iosco.org.

- Inadequate training and assessment of competency of sales force
- Salesmen rewarded by commission and set aggressive sales targets
- Aggressive selling techniques adopted
- High level of customer complaints
- High level of sales force turnover
- Rapid growth of sales, which might lead to strains on systems, rapid take-on of inexperienced salesmen
- Sales targets start being missed might lead to desperate attempts to boost sales
- Unusual sales force incentive structures, e.g. transfer payments of certain excessive amounts of the management fees to the intermediaries biased by the mediated volume of units on a currently repeated basis (reward heavily biased towards volume of products sold); and
- Inadequate control over the salesmen and their practices

Controlling marketing and selling risk

The regulator has several tools at its disposal, which can assist in controlling marketing and selling risk. The regulator has power to make specific rules – and using this power could prescribe the content of an advert, codify past performance presentation and set a precedent format. This may mitigate against misleading adverts. Such rules could include training and competence standards of sales forces. The regulator could also require all adverts to obtain its approval before being issued. This would provide a quality and consistency check.

Also, the regulator could exercise its powers to fine CIS operators or to withdraw adverts**.** The regulator could issue public statements condemning poor practice or recommending higher standards from the CIS industry. Finally, the CIS might encourage an active trade body to issue codes of conduct for the industry**.**

Market timing and associated issues

Issues relating to "Late Trading" and "Market Timing" have recently been uncovered in the US mutual fund industry, triggering reviews in Australia and other IOSCO member jurisdictions to assess whether abusive practices were evident in their domestic CIS industry.

Late trading is where a fund manager accepts late applications into a fund after the days' close, giving them the benefit of that day's price. This advantages the applicant if markets have moved after the price was struck. In Australia, late trading is illegal, because fund managers must treat all investors equally and not confer an individual any particular advantage.

Market timing occurs where arbitrageurs take advantage of out-of-date or stale prices within a CIS's net asset value. Investors enter in and out of a fund, quickly and frequently, to arbitrage movements in markets where the unit price has not caught up with market prices. Market timing is not illegal**,** but good practice suggests a fund should mitigate against it so as not to cause detriment to long-term investors.

So, for example, a UK CIS invested in North America pricing at 12:00 GMT would be using prices from the previous US market close (i.e. 21:30 the previous day). This is called time zone arbitrage. Time zone arbitrageurs are able to exploit stale prices by

(i) purchasing CIS units at inappropriately low prices, and

(ii) redeeming CIS units at inappropriately high prices, both of which dilute the interests of the remaining unitholders.

Market timing potentially acts to the detriment of continuing investors, causes a CIS to incur additional investment costs and presents a conflict of interest between investors.

Regulatory Actions

Market timing seems to be most prevalent in the United States mutual funds industry, at least for now. Costs associated with market timing are substantial. Academic research in 2002 suggested that the activity of time zone arbitrage costs the US mutual funds industry up to $5 billion each year. Time zone arbitrageurs are not constrained by geographical borders. On the contrary different time zones enable time zone arbitrage.

High profile legal and regulatory cases in the US in 2003 raised the spectre of market timing. This has prompted a number of regulators to examine the practices of their domestic CIS industries with respect to late trading and market timing. In Australia, the Australian Securities and Investments Commission ("ASIC") recently conducted enquiries into unfair business practices in the Australian CIS industry. ASIC sought to ascertain whether issues such as late trading, market timing and indeed the provision of fund information on a preferential basis were present in the Australian market. ASIC made direct enquiries of fund managers covering more than 90% of the market (by value), to enquire about these practices. We have received responses from those fund managers and work continues in analysing them.

This work is not yet complete and so I can only offer some general comments today. It appears that features of the Australian marketplace such as forward pricing, and buy / sell spreads have mitigated against the worst excesses. However as I said earlier, our analysis of the responses received continues, and I am not in a position to flag what the final outcome will be.

In terms of process, there are some entities to which we will go back for further information. Also, in our usual compliance program, these issues will feature in our visits to fund managers. We will look at the practices in place and whether there is any evidence of misconduct.

I therefore believe the issue of market timing would not only benefit from, but requires coordinated international activity through IOSCO. The Technical Committee this week agreed to undertake some work in this area. The proposed work to be completed by SC5 includes producing a questionnaire to be completed by IOSCO members, a report consolidating results from the survey, a discussion paper setting out the detrimental effects from market timing, and possibly publishing a set of best practice standards.

General Observations for the Future

When one looks at the history of the CIS industry, one sees an industry, which has been innovative, has grown fast, and now plays a very substantial role not just in the securities markets, but in the management of a vast number of individual consumers savings and investments. The question going forward is whether the CIS industry can maintain and build on that position. History would suggest that it can, but I believe that there are a few challenges that need to be addressed, if it is to continue its rate of development.

First, the market setbacks in the late nineties reminded many investors (or perhaps more accurately brought home to them for the first time) that markets can go down as well as up. But it also caused many investors to question the value of retaining professional fund managers, as they saw their CIS investments dwindling in value as fast as (and sometimes faster than) their direct holdings of securities.

Logic suggests that there must be efficiencies in costs of transactions by pooling assets, and that retaining a professional fund manager with experience and research resources should produce a better result in the long term than taking one's own, less professional advice. But I think there are many who really question whether they are getting value for money from their fund manager.

Perhaps this is because investors don't really understand the complexities and costs of investing wisely. Part of this stems from some distrust, especially in cases where either:

- the fee structure is opaque and hidden from the investor; or
- there are payments to or from affiliates that raise the spectre of conflicts of interest.

Hence my emphasis today on proper and accurate disclosure of fees and costs.

Secondly, in Australia and I suspect in many other countries, an increasing number of investors want to take more control of their investments. In my country this is most evident in the growth of self-managed retirement funds. This might be because there is so much interest in the financial markets now. I am not suggesting that reading the Financial Times or even the business pages is a mainstream activity for investors, but the fact that the performance of the market is the sole subject of several television channels and is a topic on every evening's news bulletin is an obvious indication of public interest. It may be also fuelled by their disenchantment with the cost or value of taking professional investment advice, as mentioned above.

Thirdly, in this environment, bad examples of overcharging, or negligent funds management, or non-disclosure of soft dollar benefits, or other abusive conduct at the expense of investors, have a severe effect on investor confidence. While History suggests it is impossible to prevent fraud, when cases involving fraud arise they need to be dealt with quickly and effectively. This means that:

- The problem must be identified and disclosed clearly,
- Investors' rights need to be protected and, if appropriate, compensation paid, and
- Those responsible are brought to book.

Both the industry and the regulatory community bear a responsibility to act very quickly on abuses.

At its heart, it may be that we need to focus more clearly on the core values of collective investment activity, and those are enshrined in the fiduciary or contractual duties owed by the manager or operator to the investor. The investor places trust in the manager to act appropriately and professionally with his or her investment, and expects the manager to act in the investors' interests, rather than the commercial interests of the industry or the operator. If operators are able to convince investors that they are and continue to act in the investors' best interests, investors will be willing to pay a fair price for that service and the industry will continue its development. If not, we may see more investors managing their own investments or using other more personally tailored investment vehicles, potentially at much greater cost.