PUBLIC COMMENTS RECEIVED
ON THE
IOSCO TECHNICAL COMMITTEE REPORT ENTITLED

BEST PRACTICES STANDARDS ON ANTI MARKET TIMING AND ASSOCIATED ISSUES FOR CIS

INTERNATIONAL ORGANIZATION OF SECURITIES AND COMMISSIONS

October 2005

List of Organizations that have provided comments:

- Investment Funds Institute of Canada, Canada
- BNP Paribas Securities Services, France
- Investment Company's Institute, USA
- BVI, Germany
- INVESCO, France
- Hong Kong Investment Funds Association, Hong Kong
- Investment Trusts Association, Japan
- Investment Management Association, UK
- AFG, France
- Depositary and Trustee Association, UK

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May 18, 2005

Delivered via Email to mail@oicv.iosco.org

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RE: Public Comment on Best Practices Standards on Anti Market Timing and Associated Issues for CIS

We are writing to you on behalf of The Investment Funds Institute of Canada ("IFIC") and its members to comment on IOSCO's Consultation Report, Best Practices Standards on Anti Market Timing and Associated Issues for CIS (the "Report").

IFIC is the national association of the Canadian investment funds industry. IFIC's membership includes fund managers representing nearly 100% of the total mutual fund assets under management in Canada, retail distributors and affiliates from the legal, accounting and other professions.

We appreciate the opportunity to provide the following comments on the Report:

We applaud IOSCO in its endeavour to develop international best practice standards to detect and deter market timing activity in collective investment schemes. Market timing is an issue of concern in all securities markets, and the development and implementation of consistent measures around the globe will ensure that those engaging in abusive market timing activity cannot simply move from one jurisdiction to another to continue their conduct.

A. Background to Market Timing and Late Trading Issues in Canada

As a result of an industry probe that took place between October 2003 and October 2004, the Canadian regulators found no late trading activity, and only a small amount of market timing activity; activity which had ceased by the time the probe had commenced.

Regulatory action in response to this activity consisted of the entering into of settlement agreements with five mutual fund managers and four dealers, making restitution to the investors in the affected funds.

Securities regulators in Canada are now considering new regulations to deter such activity in the future. Although these considerations are still at a preliminary stage, the most favoured initiatives are all, or a combination, of (a) a requirement that all fund managers have a compliance program which includes anti market timing procedures, (b) mandatory short-term trading fees; (c) fair value pricing of portfolio securities; and (d) enhanced prospectus disclosure.

Late Trading

As mentioned, late trading in mutual funds was not found to exist in Canada. This is largely due to the existing regulations governing mutual funds as well as industry practice. Canadian regulations state that an order is considered received by a fund only when received at the "order receipt office of the mutual fund". Industry practice requires orders to be time-stamped when actually received by the fund company, or by an administrative clearinghouse known as FundServ. Only those orders time-stamped by 4:00 PM receive that day's pricing. Furthermore, on a combined basis, the six largest banks, Investors Group and the trades processed through FundServ make up over 90% of all fund trades in Canada in a given month.

This is in contrast to the United States, for example, where current rules permit an order to be deemed received by the fund company when it is received by the broker or dealer. This leaves opportunity to include orders received after the close of markets among those orders received before the close of markets, all of which would then receive that day's price. Examples of late trading were uncovered by the Attorney General for the State of New York as well as the U.S. Securities and Exchange Commission ("SEC"). A proposal has been published by the SEC requiring purchase or redemption orders to be received by a fund, its primary transfer agent, or a registered clearing agency by the time set by the fund to price its shares (usually 4 pm EST) in order to receive that day's price, however no final rule has been enacted to date.

Market Timing

Shortly after the news of the probes into late trading and market timing in the United States, IFIC established a working group to review Canadian industry practices in connection with the sale of mutual funds, initially focusing on late trading and short-term trading, and to make recommendations for changes to such practices, if warranted, to enhance protection of the interests of Canadian investors.

The Working Group's report was published in August 2004. For your reference, we have appended a copy of the report to this submission. In its report, the Working Group

presented several recommendations to ensure fair treatment of all investors in the Canadian mutual fund industry and to provide guidance for IFIC members in detecting and discouraging market timing and inappropriate short-term trading activity.

The report noted the importance of each manager member being able to implement those measures that it considers most appropriate to the needs of unitholders and its business operations, all in accordance with IFIC's overall recommendation that managers must adopt policies and institute procedures to monitor, detect and deter market timing and inappropriate short-term trading in their funds. Fund managers remain free to adopt and implement additional measures consistent with this overall recommendation as they consider appropriate or necessary based on their unique business considerations.

IFIC strongly supports measures to protect investors which will effectively deter market timing and inappropriate short-term trading practices within a viable mutual fund industry.

IFIC's report stressed that the procedures to monitor, detect and deter market timing trading and inappropriate short-term trading should include effective, consistent monitoring of trades. As part of the monitoring process, many fund managers place clients who have engaged in market timing or inappropriate short-term trading on a watch list to ensure that such activity does not re-occur.

Fund managers should then adopt a combination of the following procedures after a determination is made as to which will be most effective for their funds:

- imposition of a mandatory fee, either automatically in identified funds with stated exceptions, or, once market timing or inappropriate short-term trading is identified, to be collected and paid to the funds in question;
- utilization of fair value pricing;
- placing restrictions on client accounts, allowing only redemptions where attempts to repeat market timing or inappropriate short-term trading occur; and
- utilization of such additional measures as the fund manager deems appropriate.

B. Comments on Report

We are very pleased to see that our recommendations form a major component of the regulatory approach currently being considered by the Canadian securities regulatory authorities as well as the best practices standards published by IOSCO in the Report.

The Canadian regulatory response is still under consideration and discussion. Accordingly, although we are hopeful, we do not yet know whether, Canadian regulators will adopt the concept in paragraph 5 under Standard 2 of the Report, namely that the specific tools used by mutual fund managers should not be mandated, but that each

manager should be free to customize those tools to ensure they are appropriate for that manager's investors.

The concept that regulators should permit fund each manager to be flexible in its selection of the appropriate measures to detect and deter market timing has also been endorsed by the SEC. In its recently released final rule on mutual fund redemption fees and request for additional comment, the SEC confirmed that a flexible approach is the correct approach[1]. Initially the SEC proposed a mandatory redemption fee applicable to all managers, with certain exceptions. After much public comment, the SEC reintroduced the requirement as a voluntary measure. The rule now states that each fund's board of directors is required to assess whether the fund should charge its investors such a fee for redemptions of shares within seven days of purchase. If the board decides to do so, the fund must charge the fee uniformly among investors in all circumstances defined by the board. In other words a fund must decide whether or not the fund will charge redemption fees, and if it does, the fee must be applied uniformly and consistently.

Further support for the proposition that managers must be allowed flexibility in their chosen approach is contained in an August 2004 study commissioned by the Investment Company Institute, prepared by Prof. Gregory Kadlec of Virginia Polytechnic Institute. The paper, entitled "On Solutions to the Mutual Fund Timing Problem", canvasses the prior commentaries and studies conducted on market timing. Prof. Kadlec concludes on page 7,

> "From the previous discussion, no single solution to the fund timing problem is both fully effective and costless.
>
> ….
>
> The opposing nature of the trade-offs across these solutions suggests that *some combination* of the approaches might be optimal.
>
> ….
>
> These examples were used for illustrative purposes and are not intended to be suggestive of the optimal combination of these solutions nor their specific parameters – that will vary on a fund-by-fund basis. The important point is that, given the practical limitations of removing predictability and the cost of imposing barriers, the most effective and efficient solution involves a balance and modest attack on each front."[2]
>
> [Emphasis added]

In this context, we are pleased to confirm our concurrence with the contents of the Report both as regards the Standards, and the particulars as to how the Standards can best be met. We are particularly pleased with the best practice that regulators should permit

mutual fund managers flexibility in the selection and adoption of measures to most effectively detect and deter market timing activity in the manager's funds.

Concerns Regarding Distribution Agreements

Despite our general endorsement of the Report, we do have concerns with respect to the applicability to managers in Canada of one of the best practices in the Report. Paragraph 17 promotes the need for "legally enforceable arrangements between a third party distributor and the fund manager" in which are set out "the distributor's role and its procedures to identify market timing" or which allow the fund manager "the right to inspect the distributor's books and records in respect of the identification and management of the risk of market timing".

We believe that this recommendation should be applicable only in those circumstances where the manager has no identifying information concerning the investor as, for example, when the investor's trades of mutual fund securities are aggregated with the trades of other investors in omnibus accounts with their dealers. In Canada the use of such omnibus accounts is not widespread. In most cases, clients trade in "client name" such that the mutual fund company is fully aware of the identity of the investor. In other cases, clients trade in "nominee name" where the dealer acts as nominee for the client. In most nominee name accounts, however, there is some unique identifier by which the manager is able to track transactions in individual accounts.

Although there are some omnibus-style accounts in place in Canada, we are not aware of any Canadian fund managers who currently have in place any agreements containing "look-through" provisions as required in the Report. We believe that managers may, perhaps only on a best efforts basis, be able to amend existing, or negotiate new, agreements with distributors pursuant to which the distributors are supposed to provide investor identifying information, however any such provisions would be subject to compliance with applicable personal information privacy laws. At any rate, we disagree that the onus of extracting this information should be imposed on managers. We submit that regulators should impose this disclosure obligation directly on distributors, with appropriate sanctions for non-compliance, rather than doing so indirectly through managers, and holding managers liable for the failure of a distributor to comply. A manager's only remedy in the event of non-compliance may be to cease business dealings with that distributor.

As noted earlier, industry practice in Canada has resulted in arrangements where the mutual fund manager generally is able to see each trade, to identify any market timing activity and to impose appropriate deterrence tools. Accordingly we submit that it would be the exceptional case in Canada where an agreement as proposed in the Report would be utilized.

* * * * *

Again we thank you for allowing us to comment on the Report. We would be pleased to discuss any of our comments with you further at your request. Please contact Ralf Hensel, Senior Counsel at (416) 363-2150, ext. 254 or rhensel@ific.ca.

Yours very truly

"Original signed by Thomas A. Hockin"

Hon. Thomas A. Hockin
President & Chief Executive Officer

Attach: IFIC Report on Market Timing

[1] SEC Release No. IC-26782, File No. S7-11-04, 17 CFR Part 270

[2] Kadlec, Gregory Bryant (2004) "On Solutions to the Mutual Fund Timing Problem". This report was commissioned by the Investment Company Institute. A copy can be located at www.ici.org/issues/timing/wht_04_mkt_time_solutions.pdf

THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

Report on Market Timing and Short-Term Trading

August 25, 2004

August 25, 2004

The Investment Funds Institute of Canada

Trading Practices Working Group

Report on Market Timing and Short-Term Trading

The Trading Practices Working Group (the "Working Group") of The Investment Funds Institute of Canada ("IFIC") was formed to study Canadian and other mutual fund markets and make recommendations with respect to detection and deterrence strategies for manager members with respect to inappropriate short-term trading and market timing activity in Canada. *The concepts of short-term trading and market timing discussed in this report are defined on page 3.*

To ensure fair treatment of all investors in the Canadian mutual fund industry and to provide guidance for IFIC members in detecting and discouraging market timing and inappropriate short-term trading activity, the Working Group recommends a set of measures. Each manager member will implement those measures that it considers most appropriate to the needs of unitholders and its business operations, in accordance with IFIC's recommendation below. Managers will be free to adopt and implement additional measures consistent with those principles as they consider appropriate or necessary based on their unique business considerations.

IFIC strongly supports measures to protect investors which will effectively deter market timing and inappropriate short-term trading practices within a viable mutual fund industry.

Overall Recommendation

Managers must adopt policies and institute procedures to monitor, detect and deter market timing and inappropriate short-term trading in their funds.

Measures

Procedures to monitor, detect and deter market timing trading and inappropriate short-term trading should include effective, consistent monitoring of trades. As part of the monitoring process, many fund managers place clients who have engaged in market timing or inappropriate short-term trading on a watch list to ensure that such activity does not re-occur.

Fund managers should then adopt a combination of the following procedures after a determination is made as to which will be most effective for their funds:

- imposition of a mandatory fee, either automatically in identified funds with stated exceptions, or, once market timing or inappropriate short-term trading is identified, to be collected and paid to the funds in question;
- utilization of fair value pricing;
- placing restrictions on client accounts, allowing only redemptions where attempts to repeat market timing or inappropriate short-term trading occur; and
- utilization of such additional measures as the manager deems appropriate.

Each of these measures will be discussed in more detail later in this report.

PART I. INTRODUCTION

(a) Background to Short-Term Trading and Market Timing Issues in Canada

Largely in response to what are being referred to as the "mutual fund scandals" which came to light in the United States in late 2003, regulators in Canada have been examining whether similar activities giving rise to those scandals may be occurring in this country. On November 5, 2003 the Ontario Securities Commission ("OSC") delivered a questionnaire to Canada's fund managers seeking information about incidents of market timing and late trading. On December 19, 2003 the Mutual Fund Dealers Association of Canada ("MFDA") issued a similar questionnaire to its members, followed on January 9, 2004 by the Investment Dealers Association of Canada ("IDA") with an almost-identical questionnaire to its members. On February 11, 2004, the OSC requested detailed trading data from 31 mutual fund managers chosen based on the responses provided to the questionnaire and on a sampling. The OSC has since May 10, 2004 been in the third phase - on-site visits to certain managers.

The issue of late trading which occurred in the United States does not appear to be an issue in Canada because of differences in structure of the industry and order placement systems.

Short-term trading and market timing are not issues unique to mutual funds. The Working Group understands that the Financial Services Commission of Ontario ("FSCO"), which regulates Ontario's insurance companies and the distribution of insurance products in Ontario, released a similar questionnaire on May 20, 2004 to the insurance companies whose products it regulates, in connection with the trading practices in their asset portfolios, including their segregated funds.

The Financial Services Authority ("FSA") in the United Kingdom conducted a fund survey similar to that conducted in Canada. The FSA recently announced that although there was some evidence of limited market timing in U.K. funds, there is "no sign either that market timing is widespread or that it has been a major source of detriment to long-term investors"[1]. The Luxembourg Commission de Surveillance du Secteur Financier ("CSSF") also conducted a survey, the results of which indicated that there does not appear to be a significant problem in that country.[2] Appendix A provides a summary of the survey results of the FSA and the CSSF. In addition, it includes a summary of the recent activities that occurred in the U.S. with respect to market timing practices, including the legislative measures which have been proposed and adopted by the Securities and Exchange Commission.

The regulatory review process in Canada has not yet concluded. However, IFIC and its members strongly support the adoption of measures to protect investors which will effectively deter market timing and short-term trading practices.

[1] Financial Services Authority, Press Release, www.fsa.gov.uk/pubs/press/2004/024.html (March 18, 2004)
[2] Commission de Surveillance du Secteur Financier, Press Release, http://www.cssf.lu/docs/press_release_late_trading.pdf (February 17, 2004)

(b) Information about the Working Group

At its December 11, 2003 meeting, IFIC's Manager Issues Committee agreed to form the Working Group to study the issues around various trading practices, including market timing and short-term trading, and to articulate the industry's position and recommendations in relation to enhanced detection and deterrence measures.

(i) The Working Group's Mandate

To review industry practices in connection with the sale of mutual funds, with an initial focus on late trading and short-term trading, and make recommendations for changes to such practices, if warranted, to enhance protection of the interests of Canadian investors.

To act as liaison between the industry and appropriate securities regulators to promote discussion and the flow of information about industry trading practices.

(ii) The Working Group's Process

This report discusses only the short-term trading portion of the Working Group's mandate.

The Working Group has reviewed current Canadian regulatory requirements, prospectus disclosure and operational practices. It has also reviewed the issues and concerns presented by the U.S., the U.K and the Luxembourg investigations, as well as the proposed and adopted detection and deterrence measures, and is monitoring current developments in these jurisdictions.

For the purposes of this report, the Working Group developed definitions for the trading practices at issue. The Working Group considered a number of measures that could be adopted by the industry. It also considered the difficulty and costs of implementation of these measures and agreed that industry members should come to their own conclusions as to which measures or combination of measures are most appropriate for them and which meet the principles set out in this document.

The Working Group presented its report to IFIC's Board of Directors. Senior IFIC staff and industry members will be liaising with the OSC to ensure the recommendations are consistent with, and appropriate to address, any findings resulting from the OSC, MFDA and IDA surveys.

(iii) The Working Group's Definitions

For purposes of this report, the following definitions were used:

"Short-Term Trading" means trading that involves a combination of a purchase and a redemption or switch (a redemption and purchase of another fund in the same fund family) of mutual fund securities occurring within a short period of time, generally up to 90 days. Short-term trading may involve market timing.

"Market Timing" means trading in mutual fund securities with the intent to exploit short-term discrepancies between the stale price of a mutual fund's securities used in determining the fund's

net asset value and the fair value of those securities. This practice is also known as **"stale price arbitrage"**.

"Fair Value Pricing" means a procedure to determine the appropriate or fair price for a mutual fund portfolio's securities in circumstances where market prices for such securities are unavailable, unreliable or not considered reflective of the securities' current market value.

PART II. DISCUSSION

Short-term trading and market timing by themselves are not illegal. This fact has been expressly affirmed by the regulators in Canada, the U.S. and U.K.

An important feature of mutual funds is that they are liquid investments, able to be redeemed fairly easily and quickly at the request of the investor. On the other hand, many mutual funds are intended to be long-term investments and, as such, the investors in those funds may be harmed by short-term trading activity, whether or not such activity is motivated by market timing. While it is generally accepted that a reasonable amount of purchase and redemption activity should not have a significant effect on a fund, short-term trading activity, if too frequent, may disrupt efficient portfolio management as it may necessitate ill-timed portfolio transactions, or require the portfolio manager to maintain higher cash floats than would otherwise be appropriate in order to meet increased redemption requests. Such activity may also increase the fund's transaction costs. Typically, managers have the discretion to apply short-term trading fees if the short-term trading activity is considered to be inappropriate.

Market timing, which involves short-term trading intended to capitalize on pricing inefficiencies in a mutual fund, makes profits out of gains that would otherwise accrue to a fund's long-term investors. Market timing should be discouraged and is inappropriate in a mutual fund. Short-term trading may also be inappropriate in a mutual fund, depending on the circumstances.

Although all market timing involves short-term trading, not all short-term trading constitutes market timing. Short-term trading can occur for a number of reasons other than market timing, not all of which reasons are inappropriate. For example, short-term trading may be appropriate and/or short-term trading deterrence measures may not be applied, where:

- (i) the funds are described in their offering documentation as being designed to accommodate some short-term trading;
- (ii) the funds are included within fund-on-fund or cloned fund product structures or within structured notes;
- (iii) the transactions occur in systematic pre-authorized purchase and withdrawal plans, or they are internal account rebalancing transactions;
- (iv) the investor produces evidence of undue hardship or unusual circumstances that justify short-term trading; or
- (v) the amount of the transaction is *de minimis*.

The Working Group believes that it is important that fund managers distinguish market timing, which is always unacceptable, from other types of short-term trading that may be appropriate in some circumstances. Consequently, the Working Group recommends that fund managers maintain documentation of short-term trading deemed to be acceptable and that such documentation be maintained.

Measures Considered

The Working Group considered and studied a number of measures to enhance detection and deterrence of market timing and short-term trading activity. The effectiveness of each measure was assessed on its own and in combination with other options. As well, the difficulty and cost of implementation of each measure was considered in light of the potential benefits. Below are the measures which the Working Group considers to be the most effective. They include:

- effective monitoring of trades, including placing clients on watch lists;
- imposition of a mandatory fee, either automatically imposed, or imposed once market timing or inappropriate short-term trading is identified;
- fair value pricing; and
- preventing future purchases in client accounts.

All fund managers should put in place effective procedures to monitor trades. In addition, fund managers must determine which combination of the other measures listed above they believe will most effectively deter market timing and short-term trading in their funds. This determination must take into account their own operations, structure, internal controls, compliance systems and costs. In most circumstances it is believed that the adoption of a combination of the measures considered should virtually eliminate trading issues while providing a cost effective solution for the unitholder.

(1) <u>Effective Trade Monitoring</u>

In order to detect market timing and inappropriate short-term trading activity in their funds, managers require effective trade monitoring systems that enable identification of the investors transacting such trades and review of trades over various time periods, trading patterns and other indicia of such activity.

Most fund managers already have processes and systems in place to perform trade monitoring. Managers use various review systems to generate and assess trading data from their funds, and to take appropriate action.

Managers may consider placing clients who engage in market timing or inappropriate short-term trading on a watch list to ensure that further market timing or inappropriate short-term trading activity does not occur. Watch lists may include names of clients or dealers and financial advisors who have previously engaged in these activities one or more times.

Unlike in the United States, Canadian fund managers can monitor and detect trading activity at an account level and generally know the client name, financial advisor and dealer name. The Working Group believes that trade monitoring and the use of watch lists may be an effective way to eliminate repeat market timing and inappropriate short term trading.

(2) Short-Term Trading Fees

Managers may impose a mandatory fee, either automatically in identified funds with stated exceptions, or once market timing or inappropriate short-term trading is identified, to be collected and paid to the funds in question.

Most Canadian mutual fund prospectuses currently include disclosure permitting the funds to impose, at the manager's discretion, a short-term trading fee on redemptions of fund securities that take place within a specified time period after purchase of the securities. Generally these fees are 1% or 2% of the net asset value of the securities redeemed and the fees are generally imposed, in the manager's discretion, on redemptions of securities that occur within periods ranging from 30 to 90 days of purchase. Several large fund managers already impose automatic, mandatory short-term trading fees on certain of their funds.

The Working Group discussed the advantages and disadvantages of such fees and the nature of various types of fees that could be charged. The Working Group also discussed whether the fees should be applied only to funds that are vulnerable to market timing activities.

A majority of Working Group members believe that mandatory fees should be implemented on at least those funds vulnerable to market timing – for instance, a fee of up to 2% on redemptions or switches of securities occurring within a certain number of business days (as few as 5, as many as 30) of purchase, to deter market timing. Many Working Group members believe that mandatory fees should be implemented on all funds (other than money market funds), on redemptions or switches of securities occurring within a certain number of days (as few as 5, as many as 90) of purchase, to reduce the incentive to engage in, and compensate the funds for any additional costs generated by, short-term trading.

Managers should consider allowing a *de minimis* level of redemptions below which mandatory fees should not apply and allowing an exemption from the application of the mandatory fees where the investor is able to produce evidence of undue hardship or unusual circumstances that justify the investor's short-term trading. As well, managers must assess the appropriate implementation of short-term trading fees to transactions such as rescissions and withdrawals, systematic pre-authorized purchase and withdrawal plans, internal automatic account rebalancing transactions, or to transactions relating to investments by, among others, fund-on-fund, segregated fund, clone fund and structured note products.

Managers should also have the ability to levy discretionary fees for periods or for events beyond mandatory fees, on all funds if they so desire, to provide an additional tool to allow the funds to combat market timing and inappropriate short-term trading.

The Working Group members who already have experience in levying short-term trading fees agree that they are an effective tool to reduce market timing and short-term trading activity.

However, there remain concerns among some fund managers that the costs to fund investors of implementation and ongoing administration of a short-term trading fee program may be significant, particularly for fund managers who choose other measures which may be effective to address these issues and which may be less costly.

(3) <u>Fair Value Pricing</u>

Manager members may consider using fair value pricing for their funds. Certain fund managers currently apply fair value pricing to eliminate stale prices within mutual fund portfolios, thereby reducing the pricing discrepancies which market timers seek to exploit. The Working Group recognizes that fair value pricing may be an effective tool to deter market timing trading.

In accordance with the general nature of the information required to be disclosed in mutual fund prospectuses, fund managers currently provide general disclosure of their asset valuation procedures, including fair value pricing where applicable. In accordance with the provisions of NI 81-101F2, such disclosure is generally set out in a fund's annual information form, rather than in its prospectus. It may be necessary for fund managers to amend their funds' constating and disclosure documents, if they wish to be able to introduce fair value pricing.

Fair value pricing is a necessarily subjective process. Different funds that use fair value pricing could apply the same principles and procedures reasonably and appropriately and still arrive at different values.[3] In March 2002, for guidance to its members, IFIC issued a Bulletin entitled "Fair Valuing Portfolio Securities" ("IFIC Fair Valuing Bulletin")[4], which focuses upon unusual events involving securities trading, such as illiquid securities, trading halts in securities, closure of markets as well as foreign securities. The IFIC Fair Valuing Bulletin itemizes general principles to be observed by a fund when it fair values a security, and provides illustrations of implementation of fair value pricing in certain situations.

It is generally agreed that fair value pricing can reduce pricing discrepancies and thereby reduce the opportunity for stale price arbitrage. The effectiveness of fair value pricing as a deterrent to market timing activity has also been highlighted in the United States and the United Kingdom, and is among the best practice recommendations of the Association of the Luxembourg Fund Industry with respect to funds domiciled in Luxembourg, as set out in the discussion in Appendix A.

However, there remain concerns among some fund managers that the costs to fund investors of implementation and ongoing administration of a fair value pricing program may be significant, particularly for fund managers who choose other measures which are effective to address these issues and which may be less costly.

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[3] *Report of the Fair Valuing Working Group of the Investment Funds Institute of Canada*, December 2001, page 6, http://www.ific.ca/pdf/IFICFairValuingReport_December2001.pdf.

[4] The Investment Funds Institute of Canada, Bulletin Number 23, *Fair Valuing Portfolio Securities*, March 2002, http://www.ific.ca/pdf/IFICBull23_FairValuing_English_March2002revised.pdf.

(4) Restricting Client Accounts

Where attempts to repeat market timing or inappropriate short-term trading occur, fund managers should restrict client accounts, permitting no further purchases so that the client is only permitted to redeem current holdings. Further, monitoring should continue to ensure that new accounts are not opened by the same clients.

PART III. RECOMMENDATIONS

In Canada, as in the United States, the United Kingdom and Luxembourg, there is no one solution to deter market timing and inappropriate short-term trading activity.

The overall recommendation noted at the beginning of this report permits each manager member to adopt such measures it considers most suitable for its business operations.

All fund managers should put in place effective procedures to monitor trades. The Working Group agrees that, in addition, the appropriate adoption of a combination of some, or all, of the other measures outlined above will be effective, and will produce a more uniform response, in deterring and preventing market timing and inappropriate short-term trading activity in Canadian mutual funds.

IFIC should continue to work to create guidelines for fund managers for determining products or product structures for which the deterrence measures recommended in this report should not be applied.

Appendix A

The following is a brief summary of the current status of investigations and regulatory actions taken in the United States, the United Kingdom and Luxembourg on the issues of short-term trading and market timing.

United States

United States regulators have alleged that certain U.S. mutual fund managers permitted certain investors to engage in inappropriate short-term trading and market timing activity in their mutual funds to the detriment of the other investors in those funds. In those cases that have led to the filing of administrative or civil complaints, fund managers are alleged to have inconsistently applied the funds' explicit short-term trading rules and procedures that are intended to be uniformly applicable to all investors in the funds; or permitted market timing arrangements to be established which directly contravened unequivocal prohibitions or restrictions on market timing activity disclosed in the funds' prospectuses.

To deal with these issues the U.S. Securities & Exchange Commission ("SEC") has proposed and enacted a number of new rules which will be detailed below. Further, in addition to supporting the SEC's proposals, the Investment Company Institute ("ICI") has submitted a number of recommendations, notably a mandatory short-term trading fee to be imposed on any investor who sells units purchased within the previous 5 business days, which the SEC has adopted and circulated as a proposal.

The SEC has already enacted new rules requiring mutual funds to adopt and implement procedures "reasonably designed to ensure compliance with their disclosed compliance programs" regarding, among other items, market timing.[5] These rules became effective on February 5, 2004, and have a compliance date of October 5, 2004.

In addition, the SEC has enacted rules to enhance prospectus disclosure of funds' policies, procedures and restrictions for deterring market timers (the "Disclosure Rule"). In its request for comments on the Disclosure Rule, the SEC stated that although many funds state in their prospectuses that they discourage market timing, "many do not identify with specificity the frequency or type of trading that they consider to be problematic, or the specific steps that they will take to ensure that market timing trades are detected and prevented".[6] The SEC suggested "it may be useful to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions and the circumstances and arrangements under which the restrictions are not imposed. These additional disclosure requirements would enable investors to better assess a mutual fund's risks, policies, and procedures in this area, and to determine if a fund's policies and procedures are in line with their expectations".[7]

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[5] U.S. Securities and Exchange Commission. *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Release No. 26299 (December 17, 2003), 64 Fed. Reg. 74714 (December 24, 2003).

[6] U.S. Securities and Exchange Commission. Proposed Rule, *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, Investment Company Act Release No. 26287 (December 11, 2003), 68 Fed. Reg. 70404 (December 17, 2003).

[7] *Ibid.*

The Disclosure Rule requires:

- a mutual fund to describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders of the fund;
- a mutual fund to state in its prospectus whether or not the fund's board has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares, and if not, it must state the specific basis for the board's view that it is not appropriate to have such policies and procedures;
- a mutual fund to describe with specificity in its prospectus any policies and procedures for deterring frequent purchases and redemptions of fund shares;
- a mutual fund to describe in its Statement of Annual Information any arrangements that exist to permit frequent purchases and redemptions of fund shares;
- all of these disclosures from insurance companies with respect to their variable annuity products; and
- mutual funds (other than money market funds) and insurance companies (with respect to variable annuities) to explain in their offering documents the circumstances under which they will use fair value pricing and the effects of using fair value pricing

These new disclosures are required to be included within all initial registration statements, and all post-effective amendments to effective registration statements, filed on or after December 5, 2004.

On February 25, 2004, the SEC issued for public comment a proposal to require mutual fund managers to impose a mandatory 2% short-term trading fee on all redemptions that occur within 5 business days of purchase of the shares being redeemed, applicable to all funds except money market funds, exchange-traded funds and mutual funds that encourage active trading and that have provided disclosure to investors that such trading will likely impose costs on the fund (the "Fee Proposal"). The fee is intended to be a "user fee" to reimburse the fund for the cost of accommodating frequent traders, regardless of their motivation. The Fee Proposal includes the following features designed to prevent the fee from affecting most ordinary redemptions by smaller investors:

- the fee would apply on a first-in, first-out basis, with the fee first being calculated on shares held the longest period of time;
- there would be a *de minimis* threshold - the fund would not be required to impose a redemption fee of $50 or less. This means that a mutual fund could waive redemption fees on mutual fund redemptions of $2,500 or less; and
- there would also be provision for the waiver of this fee for redemptions of up to $10,000 if the investor can demonstrate an unanticipated financial emergency. This means that some funds would be available to a shareholder in a financial emergency without imposition of the redemption fee.

The Fee Proposal is still under consideration. It is not intended to be a stand-alone response to the inappropriate short-term trading problem in the U.S., nor is it designed solely to address large traders; rather it supplements the other measures the SEC has recently taken and that it proposes to take to address inappropriate trading activity. The SEC stated that a short-term trading fee together with fair value pricing can reduce, if not eliminate, the profits that market timers seek to extract from the funds.[8]

As the SEC noted in its Fee Proposal a significant proportion of market timing transactions are meant to exploit price discrepancies between the value assigned to a fund's portfolio securities for purposes of the fund's net asset value calculation and the current market value of those securities. Accordingly, the SEC reiterated that the principal solution to deterring such market timing transactions is accurate calculation of a fund's net asset value each day, using current and not stale prices. The *Investment Company Act* requires U.S. mutual funds to calculate a "fair value" for a portfolio security, as determined in good faith by the fund's board of directors, when market quotations for the security are unavailable or unreliable[9].

We understand that the SEC may issue further guidance with respect to fair value pricing in 2004.

United Kingdom

In the United Kingdom, the Financial Services Authority ("FSA") conducted an investigation of trading activity in collective investment schemes (mutual funds) which it regulates, concentrating on stale price market timing. As part of its investigation, the FSA examined 9,620 transactions in funds managed by 31 firms. Only 118 transactions required follow-up during on-site visits to 25 firms. In a press release dated March 18, 2004, the FSA noted that there was some evidence of market timing in funds, however, most occurrences were short-lived with fund managers taking swift action to terminate relationships where clients attempted to time funds.[10] Total amounts involved are expected to be less than £5 million.

The FSA noted that its Principles and Rules provide sufficient tools to manage the conflicts posed by market timers. The ability of funds to price underlying assets at a fair value and the ability to suspend market timers, as well as measures to reduce dilution and otherwise increase the cost (and decrease the attractiveness) of market timing, appear to have been proven effective.

[8] U.S. Securities and Exchange Commission. *SEC Proposes Mandatory Redemption Fees for Mutual Fund Securities,* Press Release 2004-23, http://www.sec.gov/news/press/2004-23.htm (February 25, 2004)

[9] Investment Company Act of 1940, section 2(a)(41)(B). This subsection defines "value" as: "(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors." This definition also is used in Rule 2a-4 under the 1940 Act as the required basis for computing a fund's current NAV.

[10] Financial Services Authority, *FSA Statement on market timing*, Press Release FSA/PN/024/2004, http://www.fsa.gov.uk/pubs/press/2004/024.html (March 18, 2004)

Among regulatory measures, the FSA is pushing ahead with reforms to fund regulation (CP 185) that include clarification of the measures available to deter market timing, including fair value pricing and clarification of the scope for a fund manager to decline a transaction (usually referred to in the U.K. as a "deal"). In a January 2004 meeting with the FSA, the industry proposed the use of fair value pricing in preference to mandatory shifts in funds' valuation points (a valuation point being the time each day at which a fund's net asset value is calculated).

Notably, with respect to the problem caused by order aggregators, who place combined deals for several customers, potentially hiding the activities of market timers, the FSA noted that if fund managers are unable to satisfy themselves that potentially suspicious deals are not on behalf of market timers, they need to use the range of tools at their disposal to not allow any unduly preferential dealing arrangements.

Luxembourg[11]

In November 2003, the Luxembourg Commission de Surveillance du Secteur Financier ("CSSF") sent a questionnaire to 407 service providers with respect to late trading and market timing. Although it has not finalized its findings, the CSSF has stated that based on the responses received, the situation is overall under control, even though some supplementary information will be required in certain isolated instances, and the CSSF may carry out some on-site inspections to verify the information provided.

The CSSF stated that it is satisfied "that the entities surveyed have taken or are taking the necessary additional measures of protection" on these issues.[12] The CSSF proposes to issue guidelines to the industry to serve as a reference for future decisions and choices, taking into account the specifics of the Luxembourg fund industry.

In June 2003, the Association of the Luxembourg Fund Industry ("ALFI") created a working group to investigate fair-value pricing and arbitrage protection for funds. As a result of the fund industry scandals in the U.S., the working group focussed on formulating guidance and recommendations on the late trading and market timing issues, bearing in mind that Luxembourg-domiciled funds are invested throughout the world's time zones and the sale of their securities is generally undertaken by intermediaries domiciled outside Luxembourg and supervised by other nations' regulators.

ALFI stated in its recommendations that it is the responsibility of the fund's board of directors to take all reasonable steps to prevent late trading, market timing and fund arbitrage from taking place. It is also recognized that some fund investors operate a short-term trading strategy, known as "excessive or market trading", without any intention of taking advantage of pricing inefficiencies. This is still detrimental to other investors, and ALFI recommends funds' boards

[11] Recent figures released by the CSSF indicate that the Luxembourg fund industry comprises 7,820 funds and sub-funds, just over €1 trillion of net assets under management and has an 80% market share in European cross-border UCITS distribution.
[12] Commission de Surveillance du Secteur Financier, Press Release, http://www.cssf.lu/docs/press_release_late_trading.pdf (February 17, 2004)

of directors take the appropriate measures to protect investors from disadvantages cause by such strategies. [13]

As best practices for the Luxembourg fund industry, ALFI recommends:

1. Strict application of order cut-off time to prevent late trading;
2. Valuation point after order cut-off time (forward pricing) to prevent late trading;
3. If the board of directors of a fund determines that investors in that fund could be exposed to market timing, it should employ measures to minimize such risk, such as:
    a. Fair value pricing;
    b. Trading fees to discourage short-term and frequent trading. Such fees can be transaction fees, dilution levies or bid/offer spreads; and
    c. Monitoring to identify whether market timing is taking place.
4. Information on Portfolio Holdings - to be disclosed so as not to facilitate market timing; and
5. Disclosure – the fund's prospectus should include the fund's policy with respect to prevention of market timing.

[13] Association of the Luxembourg Fund Industry, *Protecting Investors from Late Trading and Market Timing*.

Paris, 18/05/2005

BNP Paribas Securities Services
Response to IOSCO Consultation Report

BEST PRACTICES STANDARDS ON ANTI MARKET TIMING AND ASSOCIATED ISSUES FOR CIS

BNP Paribas Securities Services is a wholly owned subsidiary of BNP Paribas, dedicated to providing securities services to clients, both within and outside BNP Paribas Group.

BNP Paribas Securities Services does not engage in trading or investment activities, and operates exclusively as a custodian bank. BNP Paribas Securities Services is strategically focussed on Europe, where it has established offices in 12 European countries.[1]

We cover the whole range of financial instruments – listed and unlisted securities, bonds, UCITS, derivatives and provide four main streams of services:

- **Global Fund Services:** Fund administration and accounting, performance measurement, transfer agency**, compliance and trustee services**, retail product, administration, middle- and back-office outsourcing for institutional investors ;
- **Custody services**: Local and global custody, general clearing member services, cash services, middle- and back-office outsourcing for broker-dealers ;
- **Global Corporate Trust:** Shareholder services, AGM management, employee share and stock option plans, paying agency, securitisation and issuer advisory services ;
- **Global Liquidity Services:** Securities and cash financing, foreign exchange, collateral management

We are pleased to have the opportunity of contributing views to the IOSCO consultation. We believe this consultation provides a comprehensive overview of the main worldwide practices.

We would like to submit the following comments, which are based on our market experience as Compliance and Depositary Bank, an activity which we perform in 8 European countries.

- In order to prevent the risks linked with Market Timing practises, the CIS, especially the CIS invested into stocks and bonds, ought to be built and managed in a way which ensures that the Subscription / Redemption processes are always executed on unknown prices: unknown price of Net Asset Valuation and also unknown prices for the underlying Financial Instruments of the CIS. In few cases, the best practice should dictate Subscription / Redemption on the D+2 Net Asset Valuation (« Super Unknown » NAV).

- The Accountancy rules of the CIS should plan to book every transaction on Trading Date T (and not on Trading Date + x or on Settlement Date).

- The CIS portfolio should not be brought to shareholder notice in real time. Rather, the manager ought to keep this information confidential and all shareholders of the CIS should receive the same level of information in all circumstances.

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[1] Belgium, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Switzerland as well as the United Kingdom

INVESTMENT COMPANY INSTITUTE

May 18, 2005

VIA E-MAIL

Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Re: Public Comment on Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes

Dear Mr. Richard:

The Investment Company Institute[1] appreciates the opportunity to comment on IOSCO's Consultation Report on Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes.[2] We believe it is appropriate and timely for IOSCO to set out the obligations of funds and their operators with respect to market timing and late trading and the standards that regulators will apply in assessing whether these obligations have been met.

The report sets forth three broad best practice standards with which we agree. The first best practice standard provides that a fund operator should demonstrate that it treats all investors fairly and that it manages any conflicts of interest between itself and investors. It also should disclose to investors its policies to deal with conflicts. The second best practice standard requires that a fund operator have a compliance program in place to assure that it is treating all investors fairly and disclose its policies and procedures relating to market timing and late trading, fair valuation and disclosure of portfolio holdings. Compliance programs should include written policies and procedures designed to monitor, deter and detect market timing and late trading and fund operators should conduct regular reviews to assess the adequacy and effectiveness of their compliance programs. The third best practice standard provides that the regulatory regime should allow funds flexibility in addressing the risk of detriment to investors arising from market timing.

[1] The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is attached to this letter.

[2] Best Practices Standards On Anti Market Timing And Associated Issues For CIS, Report of the Technical Committee of IOSCO (Feb. 2005).

The report discusses the three standards in some detail and explains how they might be applied. While we agree in principle with the standards described above, we have concerns about some of the statements made in the report. This comment letter outlines our concerns.

Conflicts of Interest

The report states that fund operators may face a conflict of interest in connection with market timing when the fund operator is compensated based on the net assets of the fund. We believe this proposition is stated too broadly. A fund operator has a conflict of interest if the operator agrees to permit market timing in exchange for a market timer's placement of other assets under the operator's management. Absent this kind of "arrangement" with market timers, however, we do not believe that a conflict exists. In fact, we believe the interests of fund operators and fund shareholders to eliminate market timing are aligned. Short-term flows from market timers make it difficult to manage a fund portfolio and increase fund transaction costs. This directly affects fund performance and the manager's reputation and standing, all of which impairs the ability of a fund to attract investor dollars in the competitive fund markets that exist today.

NAV Accuracy

The report states that fund operators should monitor valuation methodologies to ensure that the net asset value of a CIS is accurate. We agree that the valuation of portfolio securities is a core function for a fund that should be monitored closely. We have concerns, however, about the application of this "accuracy" standard with respect to fair valuation methodologies.

As the report states, some jurisdictions do not permit the use of fair valuation methodologies if closing market prices for a security are available. In jurisdictions where regulators have made a policy decision to require the use of closing prices, the closing market price always will be "accurate." The task for fund operators in these jurisdictions is to take care that the fund accurately transcribes closing prices in computing its NAV.

By definition, fair valuation is used only where closing market prices are not available or reliable. It is important to recognize that fair valuation represents a good faith estimate of the value of the security at a time when no actual or reliable trading in the security exists. There is no "right" or "accurate" price for a fair valued security. Thus, the report should not place an obligation on fund operators to monitor valuation methodologies to "ensure" that the net asset value of a CIS is "accurate." In our view, the best practice standards in this area should require funds and their operators to develop appropriate processes for making informed valuation decisions, to follow those processes consistently and in good faith, and to review their valuation methodologies over time for appropriateness and accuracy so that they can be adjusted going forward, as needed.

The process used by independent accountants in auditing funds underscores the reasonableness of this approach. Auditors of U.S. funds seek to independently verify securities values for a fund's portfolio as of certain dates. (Auditors are required to verify values at the fiscal year-end but may verify values at other dates, particularly if the client

requests it.) Auditors do not "verify" prices for securities that were fair value priced, as there are no observable market prices that would enable this type of independent verification. For securities whose price was established by fair valuation, auditors consider whether the fund's valuation methodology was appropriate in the circumstances and applied consistently.[3]

Agreements with Distributors

The report recognizes that funds and their operators face difficulties in policing market timing when transactions come through distributors that aggregate orders in omnibus accounts. Nevertheless, the report states that operators have an obligation "to ensure that market timing transactions are identified." We think this standard places unrealistic obligations on the fund industry. While funds and their operators can seek to address market timing in contracts with distributors, they cannot impose, as the report would demand, legally enforceable duties on all intermediaries maintaining omnibus accounts to comply with fund restrictions on trades or collect fund-imposed redemption fees. For example, where omnibus accounts are held for pension plan participants or holders of unit-linked insurance products, the plan document or underlying insurance contract may govern the frequency with which shares can be traded and whether redemption fees can be imposed. The fund and its operator cannot unilaterally impose policies that conflict with the terms of the plan document or insurance contract.

Even where funds are able to obtain a contractual promise from a distributor, they cannot *guarantee* that all market timing transactions will be identified by the distributor. We believe that IOSCO should expect funds and their operators to use their best efforts to incorporate into existing contracts with intermediaries legally enforceable duties requiring intermediaries to comply with fund policies with regard to market timing and late trading. Funds and their operators also should be expected to take appropriate steps to monitor intermediary compliance with these duties. It is unreasonable, however, to expect them to "satisfy themselves that potentially suspicious transactions are not effected on behalf of market timers." If regulators would like greater certainty that a fund's policies to limit transactions and impose redemption fees on short term trading will be respected when accounts are held through intermediaries, the regulators themselves should impose duties on intermediaries in this regard.

External Auditors

The report states that external auditors should review as part of their regular audit the systems and controls established by the operator and comment on their effectiveness. We are concerned that this statement may impose new, and unrealistic obligations on auditors. As part of the annual financial statement audit, external auditors to U.S. funds examine internal controls in order to determine the nature and extent of audit procedures to be performed. Internal controls considered by the external auditor relate to financial statements and related disclosures. They would not necessarily include controls relating to compliance with securities law requirements, such as obligations with respect to late trading and market timing.

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[3] A paper recently published by the Institute, "An Introduction to Fair Valuation," explains some of these points in greater detail. The paper will be available on the Institute's web site (www.ici.org) shortly.

External auditors typically do not have the expertise necessary to review and test compliance controls relating to securities laws. Furthermore, it would be cost-prohibitive to require the external auditor (or other independent third party) to test all securities laws related compliance controls. As a policy matter, this approach also would be unnecessary in the U.S. in light of the new fund compliance rule which requires written policies and procedures designed to prevent violations of the securities laws, and requires annual review and testing of the procedures.

The statement in the report that auditors should comment on the controls' effectiveness appears to contemplate an opinion expressing positive assurance that the controls have been implemented and are functioning as intended. We note that the internal controls report currently prepared by external auditors to U.S. funds is a "negative assurance" type report (*i.e.*, it states that the external auditor's consideration of internal control would not necessarily disclose all matters in the internal control system that might be material weaknesses).

Dilution

The report would hold a fund operator responsible where market timing causes investors to suffer loss or the fund suffers dilution. We have several concerns with this standard. It seems patently unfair to hold an operator to this standard in a jurisdiction that does not permit fair valuation. Where fair valuation is permitted and is used in combination with other tools available to address market timing (*e.g.* redemption fees and limitations on short-term trading) it is possible to significantly reduce arbitrage opportunities and profits for short-term traders.[4] The use of these tools involves costs, however, and may be subject to regulatory requirements limiting, for example, the size of the redemption fee that can be imposed.

Accordingly, it is not possible to assure that market timing in a fund will *never* occur. Funds and their operators must use their business judgment in devising the most appropriate means for each fund to address market timing. If a fund and its operator use a reasonable process to analyze the potential for market timing in the fund, devise an appropriate response that is implemented conscientiously, and periodically review these determinations, the operator should not be held responsible should market timing in the fund nevertheless occur.

Backward Pricing

While the report states that forward pricing can reduce the attractiveness of a fund to market timing, it recognizes that not all jurisdictions permit forward pricing. We believe that any set of best practice standards for dealing with market timing and late trading must be based on forward pricing. There is no place in a best practices paper in this area for backward pricing.

* * * *

[4] *See*, *e.g.*, Gregory Kadlec, "On Solutions to the Mutual Fund Timing Problem" (August 30, 2004). The paper is available at http://www.ici.org/issues/timing/wht_04_mkt_time_solutions.pdf.

The Institute appreciates the opportunity to support IOSCO's work on this topic and to share our concerns. If you have any questions concerning our views or would like additional information, please contact me at (202) 326-5826 or Bob Grohowski at (202) 371-5430.

Sincerely,

Mary S. Podesta
Senior Counsel

Attachment

About the Investment Company Institute

The Investment Company Institute is the national association of the U.S. investment company industry. Its membership includes 8,512 open-end investment companies (mutual funds), 650 closed-end investment companies, 143 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $7.959 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

BVI · Eschenheimer Anlage 28 · D-60318 Frankfurt am Main

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May 18th, 2005

Public Comment on Best Practices Standard on Anti Market Timing and Associated Issues for CIS

Dear Mr. Richard,

BVI[1] gladly takes the opportunity to comment on IOSCO Consultation Report in regard of anti market timing and associated issues for collective investment schemes.

General Remarks

We appreciate the flexible approach taken by IOSCO by determining broad best practice standards in order to address the issues of late trading and market timing. However, given the different susceptibility of national jurisdictions to these practices, the specification of general standards should take into account the different levels of action required in the respective member states. For the German fund market, a survey conducted by the Federal Financial Supervisory Authority in 2003 has produced no evidence of fraudulent practices in the field of late trading and market timing. Nevertheless, as a precautionary measure, the German industry introduced in 2004 specific provisions to prevent late trading, market timing and short term trading in the industry's code of ethics. These provisions comprise the responsibility to lay down an appropriate "hard" closing time for each fund, to ensure proper valuation of assets and to implement measures against short term trading.

[1] BVI Bundesverband Investment und Asset Management e.V. represents the interest of the German investment fund and asset management industry. Its 75 members currently manage more than 7,200 investment funds with assets under management in excess of € 1,000 bn. The units of these funds are held by some 15 million unit holders.

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Therefore, we perceive no need to take rigorous steps in this area and strongly oppose to any measures imposing disproportionate burden of implementation on the fund industry. In this respect, we fully support IOSCO's view that CIS operators should be given the flexibility to select anti market timing and anti short time trading tools which are most appropriate to their investors.

Specific Comments

Although the IOSCO proposals may allow for some flexibility in terms of interpretation, we are of the opinion that the following areas of concern require further improvement or clarification:

Agreements with Distributors (p. 9, marginals 17 and 18)

The proposal to hold CIS operators "responsible to ensure that market timing transactions are identified" does not sufficiently take their position under the distribution agreement into consideration. Fund managers cannot unilaterally change the terms of distribution contracts. Even where funds are able to obtain a legally enforceable consent from the distributor to conform to anti market timing standards, they cannot actually ensure that all market timing transactions will be properly identified. Therefore, we suggest that IOSCO should rather expect funds and their operators to use their best efforts to incorporate into contracts with intermediaries duties to adhere to fund policies in respect of late trading and market timing and to monitor their observance on a regular basis.

Disclosure (marginals 23 and 24)

IOSCO campaigns for a comprehensive disclosure of market timing policies and procedures. While recognising the general need to inform investors of the risks associated with market timing and late trading, we are of the opinion that a too detailed description of provisions in place could have a rather detrimental effect on the overall efforts to prevent those practices. The explicit disclosure of policies and procedures adopted to prevent market timing might, at the end of the day, provide undesirable guidance for circumventing those measures. Moreover, one must fear that the increasingly broad range of information provided to retail clients by reason of legal requirements will eventually impair the clients' ability to select information essential to their investment decisions. We therefore suggest restricting the information duties to a rather general description of the safety measures taken.

Loss or dilution suffered by CIS (marginal 27)

The Consultation Report suggests that the CIS operator should be held responsible for any loss or dilution caused to the fund or its investors by market timing activities. We have strong concerns with this approach. First of all, a general liability of fund operators appears inadequate especially in jurisdictions that do not generally permit the use of fair valuation. Furthermore, although the application of fair value in combination with other tools might considerably reduce the opportunities for market timing and short term trading, it is virtually impossible to fully eliminate those risks.

We believe that CIS operators must remain in a position to rely on their business judgement in order to identify and address the potential for objectionable practices in a fund. If they meet these requirements in an appropriate manner and on the basis of a comprehensive analysis of the respective fund risk profile, they should be exempted from any liability for loss or dilution.

Hoping that you deem our comments helpful, we remain at your disposal for further information.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

Signed: Rudolf Siebel, LL.M Signed: Marcus Mecklenburg

Technical Committee of the International Organisation of Securities Commissions

Consultation Report - Best Practice Standards on Anti Market Timing and Associated Issues for CIS

Comments from: *INVESCO Asset Management SA*, Paris.
Dated: 18 May 2005

No.	Extract from Consultation Report	INVESCO Comments
	Introduction	
	Definitions of market timing (paragraph 5), late trading (paragraph 10) and short term trading (paragraph 13)	The distinction made in the Consultation Report between the legality of market timing and short term trading as opposed to late trading is very useful and should be highlighted. The definition of short term trading is also useful.
	Best Practice Standards	
5	The specific "tools" used by the CIS operator to conduct the monitoring, detection and deterrence of market timing and late trading practices should not necessarily be mandated. The CIS operator should be free to customize the tools to ensure they are appropriate for their investors.	INVESCO agrees that flexibility, including the ability to change the parameters and "tools", is an absolute necessity as potential offenders are often sophisticated enough to work around stated or fixed guidelines or rules.
8	<u>Market Timing</u> CIS operators will be expected to identify the risks of market timing for each CIS : (i) CIS operators should monitor trading patterns based on parameters such as deal number, size and frequency. (ii) CIS operators should monitor the CIS assets to determine if they present opportunities for time zone arbitrage e.g. the amount of foreign securities in the CIS. (iii) CIS operators should take measures, based on the	Sub-paragraph 8(i): The industry requires more explicit guidance in this area: - parameters: What timeframes most accurately represent the period between trades that may be suspicious (e.g., <10 days, <30 days)? There is no consistent regulatory guidance on this point. In addition, not only number, size and frequency of deals must be considered but also average holding period, in-and-out deals P&L, percentage of in-and-out deals among total trading volume as well and also whether particular types of funds are more susceptible to market timing (e.g., funds exposed to more volatile stocks or to US$ based investments).

No.	Extract from Consultation Report	INVESCO Comments
	risks identified and likely impact on the CIS, to prevent market timing or ameliorate its detrimental effects. (iv) CIS operators should monitor valuation methodologies to ensure that the CIS's NAV is accurate.	INVESCO's experience has highlighted a large variety of questionable trading activities: active small amount trading (below size pattern), loss making in-and-out deals, profitable short term arbitrage, and transactions concentrated on market-timing sensitive products. Therefore INVESCO believes, as is indicated in Standard 2, item 10, that monitoring indicators should be tailored by mixing items suggested by the Report including profit consideration. - pattern: As market timing has never been clearly defined as a legal wrong that breaches explicit rules, it can be difficult to detect. In particular, the definition of "short term" trading may vary between different countries, markets and regulators. We believe IOSCO should give the industry an indicative pattern to be considered as an acceptable basis for internal rules. On April 28th, 2005, INVESCO attended in Brussels a conference organised by EFAMA (European Fund and Asset Managers Association) on lessons that may be learned from the US experience where Mrs Ruth Epstein, Partner of Dechert LLP in Washington, DC (and former executive of the SEC) confirmed that no regulatory definition of market timing has been given and accordingly no harmonized definition exists in Europe. For instance, the French regulator has mentioned a 7-day pattern to monitor in-and-out deals while others refer to 30 days or more (according to Mrs. Epstein, the trend is to consider in-and-out deals from a 5 to 30 days pattern). Sub-paragraph 8(ii): The document should propose a methodology for assessing time zone arbitrage exposure of funds. The percentage of foreign securities is not sufficient. Other data such as the concentration of the portfolio from a

No.	Extract from Consultation Report	INVESCO Comments
		geographical or sectorial perspective should also be taken into account. Sub-paragraph 8(iii): The document should give guidelines regarding the escalation process in case of market timing suspicion as making allegations against a CIS investor can in itself be problematic from a regulatory perspective (for example, is the suspected investor being treated fairly when compared with other investors in the same CIS?).
16	<u>Portfolio Valuation</u> CIS operators must fair value when required by local regulation and, should consider using fair value when permitted but not required by regulation. Fair value pricing may be particularly relevant for securities for which closing prices may be stale, or may not reflect stock specific or general information that has become available after foreign markets close but before the CIS's valuation point. In making the decision to adopt fair value pricing, the CIS operator should weigh the benefits of using fair value pricing to reduce pricing discrepancies against the subjectivity involved in fair value pricing, as well as the detriment if the CIS does not fair value.	There is no consistent approach regarding fair value pricing requirements or methodologies between regulators. This raises significant practical difficulties for a CIS operator which distributes the CIS in multiple jurisdictions, as it is not at all clear which jurisdiction's fair value pricing regime should take precedence.
17	<u>Agreements with Distributors</u> CIS operators may use third party distributors (who may not be regulated) to sell their shares. It is the CIS operator's responsibility to ensure that market timing transactions are identified and so they should have legally enforceable arrangements which set out the distributor's role, and their procedures to identify market timing or to allow the CIS	In practice, many distributors are financial institutions which are regulated by their local banking regulators. Without an agreement between the securities regulators and the banking regulators, it will be very difficult for the CIS operators to require the distributors to implement procedures for identifying market timing. It is even more unlikely that the distributors will allow CIS operators to

No.	Extract from Consultation Report	INVESCO Comments
	operator the right to inspect the records of the distributor in respect of the identification and management of the risk of market timing.	inspect their books and records. Further, it is very common for CIS operators to distribute their CIS products through overseas distributors. These overseas distributors may not be subject to a comparable regulatory regime, or they may be subject to confidentiality requirements which may make the required distribution arrangement unenforceable. Notwithstanding the practical difficulties, INVESCO agrees with the recommended approach in theory, as the distributors are the front line practitioners who have sufficient knowledge of their clients, and are in a better position to review and monitor the trading pattern of their clients. However, the overall relationship between CIS operators and distributors (and especially the question of nominee clients) needs greater clarity to emphasise the need for co-operation and to demonstrate which party is ultimately accountable.
24	Disclosure CIS operators should include disclosure on the following subjects in the offering documents for the CIS: • Market Timing Policies and Procedures that describe: (i) the risks, if any, that frequent purchases and redemptions of CIS mshares may present for other security holders; (ii) whether or not the CIS's governing body/ CIS operator has adopted policies and procedures with respect to frequent purchases and redemptions of CIS securities and, if not, state the specific reasons why it is appropriate for the CIS not to have such policies and procedures; (iii) the policies and procedures for deterring frequent purchases and redemptions of CIS shares; and (iv) whether there are any arrangements to permit frequent purchases and redemptions of CIS	Very few regulators have given any explicit guidance regarding disclosure of CIS portfolio securities. This makes it difficult for CIS operators to develop detailed policies.

No.	Extract from Consultation Report	INVESCO Comments
	shares. • Fair Value Pricing policies and procedures, that describe whether and under what circumstances a CIS will use fair value pricing and the effects of using fair value pricing • CIS Portfolio Holding's information and a description of the policies and procedures relating to the disclosure of CIS portfolio securities and any ongoing arrangements to make information about portfolio securities available to any person.	
25	The regulatory regime should provide for a flexible range of anti market timing and anti short term trading tools. The regulators should aim to ensure that the steps taken are commensurate with the possible harm and CIS operators should be monitored for possible harm on an ongoing basis.	INVESCO agrees that the focus of analysis should be on whether a particular practice causes harm as a matter of fact given that it is quite possible to market time or short term trade a CIS without impacting on other CIS investors. Any such absence of harm should be taken into account when considering the action to be taken against suspected market timers or short term traders.

Hong Kong Investment Funds Association
Responses to the IOSCO Consultation Report –
Best Practices Standards on Anti Market Timing and Associated Issues for CIS

1. Definition of "market timing" (Introduction point 5)

According to the paper, the term "market timing" refers to instances where arbitrageurs have looked to take advantage of stale prices for portfolio securities that impact the calculation of a collective investment scheme's ("CIS's") net asset value ("NAV"), or where investors have bought units only to redeem them within a few days in order to exploit inefficiencies in the way CIS set their NAV.

In practice, although CIS operators usually have discretion to reject subscription applications, they do not usually have the right to reject redemption orders unless this has been expressly provided for by contract. Indeed it will most likely dampen investment appetite if investors realize that CIS operators may at their sole discretion reject redemption orders.

Without some quantifiable limits within the definition of "market timing", one CIS operator's definition may differ from that adopted by another CIS operator, resulting possibly on the attractiveness of one particular CIS operator over another. In practice, there is often a fine line between what constitutes market timing and what does not. While it is difficult to set quantifiable limits for market timing per se, market timing can be seen to compose of elements of frequent trading, late trading and/or stale pricing. Therefore policies that deter frequent trading and late trading and policies on fair valuation should together tackle market timing. Since it is possible to set quantifiable limits for what constitutes "frequent" and "late" in frequent and late trading, and it is equally possible to set quantifiable measures for fair valuation, we believe that IOSCO should issue guidance along these lines. Such quantifiable measures should be set by reference to common practices, and guidelines should be formulated only after consultation with industry participants.

2. Fair value pricing (Standard 2 point 14-16, 24)

Although it is generally agreed that fair value pricing is best practice, it is not permitted by certain regulators (such as Securities and Futures Bureau in Taiwan and Financial Services Agency in Japan) which prefer valuation on the basis of last trading price. This is particularly an issue for bonds in Taiwan where it is not uncommon for a fund to purchase the whole tranch of a bond.

While the paper suggests that CIS operators should use disclosure in offering documents to inform investors whether and under what circumstances a CIS will use fair value pricing and the effects thereof, it is suggested that IOSCO should at the same time engage in discussion with regulators who have not yet accepted fair value pricing so that they too will eventually recognize its value in deterring the manipulation of instrument prices.

3. Disclosure (Introduction point 12; Standard 2 point 24)

The paper suggests that market timing and late trading can occur when non-public information about the portfolio securities of CIS is provided to selected investors. The solution suggested by the paper is to disclose in the offering documents the policies and procedures relating to the disclosure of CIS portfolio securities and any ongoing arrangements to make information about portfolio securities available to any person.

We do not see any value in the disclosure of policies and procedures in offering documents when these are internal documents which should only be of interest to regulatory bodies and auditors. Indeed it is the responsibility of the regulators rather than the investors themselves to police the adequacy of licensed CIS operators' internal policies.

Another argument against the disclosure of anti-market timing policies is that it may give the impression that such policies are more important than internal controls on other compliance issues. Moreover, difficulties arise with the disclosure itself. For example with respect to policies for deterring "frequent purchases and redemptions", regulatory

guidelines will be necessary to determine what constitutes "frequent", otherwise CIS operators will have to set its own limits on an arbitrary basis.

From a commercial perspective it is not generally feasible for CIS operators to make information about portfolio securities available to any person, as this would be tantamount to the disclosure of trade secret. Instead, the general practice is to implement controls on the use of such price sensitive information, including measures to ensure that staff members of CIS operators, trustees and service providers do not use sensitive information in their possession to invest in funds.

In light of the above, we would suggest that it would be sufficient if the offering documents of CIS disclose the fact that conflict of interest exists and that CIS operators have policies in place to deal with market timing. Disclosure of such policies to investors should only be made on a voluntary basis or upon request at the most.

4. Analysis of the harm created (Standard 2 point 4)

Although the paper suggests that CIS operators must analyze the harm created by market timing and late trading practices, we believe that the key control would be to prevent market timing and late trading, and there is no separate need to analyze the harm created by such activities.

5. Independent oversight (Standard 2 point 22; Standard 3 point 30)

To address the conflict faced by the CIS operators, namely, the receipt of additional assets provided by market timers against the detriment to the CIS resulting from market timing, the paper suggests some form of independent oversight over the exercise of discretion in the management of the risk of market timing. We wish to seek IOSCO's clarification on what this independent oversight entails. Is it referring to external parties such as auditors and/or regulators, or internal parties such as internal audit, compliance and risk management who are not involved in the processing of the orders?

While we believe trustees may have the capability to review systems and controls established by CIS operators, external auditors may not have the capability to do the same. Members opine that one cannot reasonably expect external auditors to undertake to audit a CIS operators' internal Policies, and then make a statement as to whether in its opinion the policies are adequate to deter market timing. Such an undertaking would be tantamount to transferring the responsibility for such anti-market timing policies to the external auditors.

Since trustees/custodians are the guardians for CIS, it is more appropriate for them to take up the role of independent oversight. If in carrying out that role the trustee/custodian believes it is necessary to appoint external auditors to assist, then that would be a different matter.

6. Agreements with distributors (Standard 2 points 17 and 18)

The proposed use of legally enforceable arrangements appears to impose the responsibility of supervising the distributors on the CIS operators themselves. In effect this will gradually eliminate the distribution of CIS through third party distributors. Obviously third party distributors will resist the disclosure of their market timing procedures and they will also resist the inspection by CIS operators of their records. Indeed why should the responsibility of supervising the distributors fall on the CIS operators when such responsibility more properly belongs to regulators, whose powers have statutory backing? In Hong Kong, distributors are directly regulated by the Securities and Futures Commission. Therefore the use of legally enforceable arrangements should only be adopted by the parties voluntarily rather than on a mandatory basis.

It is common practice for distributors to aggregate all their clients' orders before submitting one consolidated order to the CIS operator. Therefore it is virtually impossible for CIS operators to realize whether suspicious transactions have been effected on behalf of market timers. At best, all that CIS operators can do is to rely on the adequacy and effectiveness of the third party distributors' anti-market timing policies.

7. Flexibility to select tools (Standard 3 points 26)

We totally agree that CIS operators should have the flexibility to select tools that they see as appropriate in addressing the risk of detriment to investors arising from market timing. However we are somewhat concerned with the suggested example of 10 days' notice of large purchases. This will effectively alter the dealing day from daily dealing to fortnightly dealing. It is also possible for investors of large purchases to split up their orders through two or more distributors, making it almost impossible to detect. Therefore, the effectiveness of any monitoring tool cannot be guaranteed.

8. Compensating investors (Standard 3 point 27)

The paper suggests that CIS operators have a duty to put investors back in the position they would have been in had the transaction that caused the dilution or loss not taken place. We believe that this is unfair to CIS operators because market timing may occur in different sets of circumstances which vary in their degree of improperness. The gravity of the penalty imposed should depend on the facts of each case (for example, whether the CIS operator could reasonably foresee that dilution or loss would be suffered by investors). It would be unfair for CIS operators to be penalized for faults that they did not originate or in circumstances where they could not possibly monitor the activities in question (for example, in the case of third party distributors).

We do not dispute that in certain circumstances it may be fair for a CIS operator to compensate investors for losses resulting from market timing. However the type of penalty issued by regulators for market timing should depend on the seriousness of the misconduct or indeed whether the CIS operator had reasonable opportunity to prevent it from happening. Therefore a regulator should only exercise its power to order compensation in appropriate circumstances. Otherwise other forms of regulatory action may be more appropriate (e.g. warning letter, reprimand).

Conclusion

Clear regulatory guidelines on how to deal with market timing and late trading are generally welcomed. However, such guidelines must take into account commercial realities and careful consideration should be given to whether they are in fact practically feasible or indeed, whether they will lead to excessive administrative burden on the industry.

(May 2005)

May 11, 2005

Mr. Philippe Richard
Secretary General
International Organization of Securities Commissions (IOSCO)
Oquendo 12, 28006 Madrid
Spain

Dear Mr. Richard,

Re: "Best Practices Standard on Anti Market Timing and Associated Issues for CIS" (February 2005)

We support the IOSCO's strenuous effort to prevent the market timing and late trading for the best interests of investors. However, as described below, if a country would have already established the adequate frameworks for preventing the market timing and late trading, we believe that some of the Best Practice Standards would not be necessary to apply to such country ---- especially, the monitor of market timing (No 8 of the Standards), the agreement with distributors (No 17), the compliance programs (No 19), the external auditors (No 22) and the disclosure of policies and procedures in offering documents (No 24).

In Japan, the effective system was already established so that unfair profits are not able to obtain by market timing trading.

1. The self-regulatory rules of the Association require the distributing companies to cut off the receipts of orders by/at 3:00 PM.
2. In case of funds investing mainly in Japanese stocks, the Net Asset Values (NAVs) must be calculated by valuing Japanese stocks by the closing prices of Tokyo market closing at 3:00 PM, and these NAVs must be applied to the orders received by/at 3:00 PM.
3. In case of funds investing mainly in foreign stocks, their NAVs must be

calculated by valuing foreign stocks by the closing prices of foreign markets closing after 3:00 PM, and these NAVs must be applied to the orders received by/at 3:00 PM. For example, if a customer orders the fund investing mainly in U.S. stocks by/at 3:00 PM on May 10, the NAV of the fund for this order must be calculated by valuing U.S. stocks by the closing prices of New York market closing at 6:00 AM on May 11 in JST, and this NAV must be applied to the order.

In relation to the late trading, the self-regulatory rules of the Association require the distributing companies to inform management companies of the large redemptions by/at 12:30 PM. It is said that the institutional investors such as hedge funds often involve in late trading, but such a problem has not occurred in Japan.

Yours sincerely,

Yoshiaki Kaneko
Vice Chairman
The Investment Trusts Association, Japan
2-1, Nihonbashi, Kabutocho, Chuo-ku
Tokyo 103-0026, Japan

(For your reference)
The Investment Trusts Association, Japan, is the self-regulatory organization whose membership includes 95 investment trust management companies and 12 securities firms.

Investment Management Association
ima

18 May 2005

Mr. Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Dear Mr. Richard

Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes

The IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (US$ 3.7 trillion, Euro 2.9 trillion) based in the UK, Europe and elsewhere, including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised collective investment schemes.

The IMA is pleased to comment on your Consultation Document on Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes.

By way of background it should be noted that, in October 2004, IMA published Guidelines for Managers of UK Authorised Collective Investment Schemes in relation to Market Timing. These Guidelines were drawn up under the sponsorship of the Board of IMA, with the assistance of a number of IMA member committees. The Guidelines were formally adopted by the IMA after consultation with its full membership, and a copy is attached to this letter.

After thorough consideration, IMA concluded that the UK Financial Services Authority's regulations applicable to UK collective investment schemes, together with the FSA Principles, provided UK CIS operators with a comprehensive regulatory toolkit, which they could apply to protect CIS investors' interests. The objective of the Guidelines was to discuss each of these tools in detail and to provide suggestions

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to CIS operators for a robust and demonstrably reasonable supervisory and control framework that would give them, and investors, comfort that steps are being taken to ensure that CIS are protected from the activities of market timers. The FSA supported IMA's approach and provided input to these Guidelines.

The IOSCO report proposes three best practice Standards:

- CIS operators should act in the best interest of CIS investors
- CIS operators should ensure that their operations and disclosure in respect of market timing and late trading are consistent with the first Standard
- The regulatory regime should allow operators appropriate flexibility in addressing the risk of detriment to investors arising from market timing

IMA agrees with these Standards at a general level, but is not comfortable with all the detailed supporting proposals, some of which, as far as the UK is concerned, go beyond what is necessary or proportionate to meet the Standards. Our concerns are described below.

1 CIS operators should act in the best interest of CIS investors

In general IMA supports the IOSCO proposals and is comfortable that this Standard is addressed by the FSA's "Principles" and "Senior Management Systems and Controls" rules. IMA suggests that this Standard should be amended to refer to **all** CIS investors, (i.e. incoming, outgoing and continuing investors) to make it clear that the duty is owed equally to all of them.

However, we do have some observations on some of the more detailed proposals.

Clause 1

Clause 1 sets out sensible responsibilities for CIS operators in respect of market timing. IMA is fully supportive of the accountability of CIS operators in matters of product design and operation where these are the responsibility of, and are controllable by, such operators.

IMA however suggests that those organisations or individuals that engage in or facilitate market timing should also be charged with a responsibility not to act in a manner that knowingly sets out to disadvantage investors (some of whom may be their own clients), be they private or institutional, in collective investment schemes. It needs to be acknowledged that in a number of jurisdictions, market timers or their accomplices, will be organisations or individuals that are authorised and supervised by regulatory bodies. UK-based market timers that are FSA authorised will be subject to the FSA Principles, including Principle 1 – "A firm must conduct its business with integrity" and Principle 5 – "A firm must observe proper standards of market conduct".

As it is generally acknowledged that market timers are sophisticated investors, IMA believes that it would be difficult for them to argue that they are not aware that their

activities cause direct detriment to the other investors in the funds that they are targeting. This knowledge places a quite different complexion on their activities as compared with the perfectly acceptable trading and arbitrage business conducted between market counterparties, who deal for their own account. IMA believes that market timing strategies, or facilitation of these strategies, do not sit easily with the FSA Principles, and would be surprised if this was not the same in a number of other jurisdictions. It would be helpful to see this balance reflected in the IOSCO Standard.

Clause 4

The paper proposes that a CIS operator should disclose to investors its policies for dealing with conflicts of interest in connection with market timing. We understand that in some jurisdictions inclusion of such policies within scheme documentation will enable a CIS operator to deter, discourage or penalise investors involved, or suspected of being involved with, market timing. Clearly, in such circumstances, disclosure is an appropriate course.

In the UK, however, such powers are already contained within the FSA regulations and CIS operators do not need to take any additional steps, e.g. disclosure, to utilise these powers. Whilst a number of CIS operators do refer to market timing within their scheme prospectus, there is general reluctance to give overly specific details of policies, trigger levels etc, as this can give potential market timers information to enable them to circumvent the CIS operator's controls. For example, disclosing the threshold at which a fund might swing its price could lead to market timers designing trading strategies that undercut that threshold.

2 CIS operators should ensure that their operations and disclosure in respect of market timing and late trading are consistent with Standard One

Once again, IMA is comfortable that in the UK, in general, this Standard is already addressed by the FSA's collective investment scheme rules. However, there are a number of detailed points on which IMA has comments.

Clause 6

This clause proposes that CIS operators should be required to disclose their policies and procedures relating to market timing and late trading, fair valuation and disclosure of portfolio holdings. UK regulations already require disclosure of fair valuation policies and a recent recommendation from a review of CIS Governance by IMA has recommended that CIS operators' policies in relation to portfolio disclosure should be stated in each fund prospectus (a copy of this review is attached to this letter). However, as noted under Clause 4 above, IMA believes that there is more potential detriment than benefit in detailed disclosure of CIS operators' policies and procedures relating to market timing and late trading.

Clause 8

Whilst IMA supports the proposition in Clause 8 (iv) that CIS operators should monitor valuation methodologies to ensure that the CIS's NAV is accurate, it would be helpful if this clause were expanded to cater for the principles of fair value pricing.

There is clearly no "accurate" fair value price and the key word in this definition is "estimate". Clause 8 (iv) could usefully be expanded to reflect the acknowledgement in Clauses 14 to 16 that "fair" rather than "accurate" valuations can provide a mechanism for deterring market timing.

Clause 17

This clause proposes that it is the CIS operator's responsibility to identify market timing transactions placed through third party distributors. IMA's understanding is that this responsibility is limited to the CIS operator having legally enforceable arrangements which either:

- set out the distributor's role, and their procedures to identify market timing; or
- allow the CIS operator the right to inspect the records of the distributor in respect of the identification and management of the risk of market timing.

In the UK, there are a number of different distribution models, but for the purposes of this paper we will address two versions. Firstly, there are distributors that are directly appointed by the CIS operator (e.g. fund supermarkets), where there is a formal two-way legal agreement instigated by the CIS operator. IMA accepts that as far as this category of distributor is concerned, it is not unreasonable for the distribution agreements to include such arrangements.

Secondly, there are organisations that act as agents for their own clients, and through their research and due diligence, have selected the CIS operator's products as suitable investments for their client-base. The UK has many such intermediaries and it is not uncommon for a CIS operator to receive orders from several thousand. Here, the only written arrangements are the CIS operators' Terms of Business, that primarily address remuneration arrangements and are not required to be formally accepted by the intermediaries. IMA believes that it would not be reasonable to require the CIS operator to put in place contractual arrangements with such intermediaries, as envisaged by clause 17, nor to expect the CIS operator to be responsible for identifying market timing that may not be evident within aggregated, netted-off trades from these intermediaries.

A further point that IMA would like to make is that in a number of jurisdictions, including the UK, distributors are regulated bodies. In these circumstances regulations can be extended to place a responsibility on distributors to take action to detect and deter activities that are recognised as detrimental to other investors.

Clause 18

This clause proposes that "where distributors aggregate orders, CIS operators should also take steps to deal with any potential problem caused by combining transactions for several investors, which may hide the activities of market timers. Whilst recognizing these difficulties, CIS operators must meet their obligations to their investors and satisfy themselves that potentially suspicious transactions are not effected on behalf of market timers".

Whilst IMA Members readily accept their responsibility to protect investors from market timers, individual trades placed through aggregators are often not distinguishable due to the aggregation and netting process, which makes any monitoring of trading activities extremely difficult. It should also be noted that the

process of aggregators netting off deals internally is the very function that makes them valuable to the CIS industry, and IMA Members would not wish any unnecessary obstacles to be put in their way.

In the UK the reaction of aggregators to market timing has generally been positive and many are actively assisting CIS operators in monitoring underlying transactions. However, this support is provided on a voluntary basis and, referring to our comments made on Clause 1, it should be noted that where aggregators are authorised and supervised by regulatory bodies, it would be difficult for them to argue that they are not aware that any support knowingly provided to market timers will cause direct detriment to the other investors in the funds targeted.

Clause 22

This clause proposes that external auditors and the depository or the trustee (where it exists) of CIS operators should review as part of their regular audit the systems and controls established by the operator and comment on their effectiveness. Whilst in the UK there is not a specific regulatory requirement in this regard, in practical terms depositaries/trustees already have an oversight responsibility for virtually all rules applicable to CIS. In one respect (the CIS operator's decision as to whether or not to apply a dilution levy to individual holder transactions), the recent IMA report on CIS Governance, a copy of which is attached to this letter, has recommended that the depositary/trustee oversight be extended to cover this aspect. The FSA is currently considering this recommendation, along with a number of other governance recommendations.

Clause 24

Please refer to our response to Clause 6 above.

3 The regulatory regime should allow operators appropriate flexibility in addressing the risk of detriment to investors arising from market timing

Clause 25

IMA's October 2004 Guidelines for Managers of UK Authorised Collective Investment Schemes in relation to Market Timing, concluded that the FSA regulations applicable to UK collective investment schemes, together with the FSA Principles, provide Managers with a comprehensive regulatory toolkit, which can be applied by CIS operators to protect CIS investors' interests.

Clause 27

This clause proposes that where market timing and associated issues cause CIS investors or a group of CIS investors to suffer loss, or the CIS suffers dilution, the CIS operator's duty should be to put them back in the position they would have been had there not been a failure to meet Standard 1, i.e. had the transaction that caused the dilution or loss not taken place. This may mean compensating investors direct and /or the CIS itself.

Whilst supporting this stance in principle, IMA wishes to emphasise that no matter how robust are the CIS operator's processes in pursuit of Standard One, detection of market timing cannot be guaranteed, especially when business is transacted through a number of different aggregators. Consequently, IMA believes that an absolute requirement for the CIS operator to compensate investors or the fund in every instance is unreasonable and that the paper should emphasise that the CIS operator should only bear liability where it has been in breach of its obligations, either in not having policies and procedures consistent with its regulator's requirements, or where it has not been adhering to such policies and procedures.

Clause 29

Please refer to our comments on disclosure under Clause 4.

We would be very happy to discuss the points raised above if you would find this helpful.

Yours sincerely

James Irving, Senior Adviser - Regulation

cc: Dan Waters, Asset Management Sector Leader, UK Financial Services Authority.
Ashley Kovas, Collective Investment Scheme Policy Unit, UK Financial Services Authority.

REVIEW OF THE GOVERNANCE ARRANGEMENTS OF UNITED KINGDOM AUTHORISED COLLECTIVE INVESTMENT SCHEMES

REPORT BY THE INVESTMENT MANAGEMENT ASSOCIATION

February 2005

Review of the Governance Arrangements of United Kingdom Authorised Collective Investment Schemes

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Definitions/abbreviations used in this report

ACD	Authorised corporate director of an *OEIC*
AUT	UK authorised unit trust
CIS	Collective Investment Scheme and, in this report, a generic term used to describe both *AUTs* and *OEICs*.
CIS SORP	Statement of Recommended Practice for *CIS*
Depositary	Except where expressly stated, this is a generic term used to describe both the Depositary of an *OEIC* and the *Trustee* of an *AUT*
FSA	The UK's Financial Services Authority
FSMA	Financial Services and Markets Act 2000
ICVC	UK authorised investment company with variable capital, also known as an *OEIC.*
IMA	The Investment Management Association, the trade body for the UK *CIS* and investment management industry
Investor	Except where expressly stated, this is a generic term used to describe both the unitholder of an *AUT* and the shareholder of an *OEIC*
IOSCO	International Organisation of Securities Commissions
Manager	Except where expressly stated, this is a generic term used to describe both the Manager of an *AUT* and the *ACD* of an *OEIC*
Members	Members of *IMA*
NAV	Net asset value
Non-UCITS retail fund	*CIS* which does not comply with the requirements of the *UCITS* Directive (see section 5.3.1)
OEIC	Except where expressly stated, this is a generic term used to describe both a UK authorised open-ended investment company and an *ICVC*
OEIC Regulations	OEIC Regulations 2001
PFDC	*IMA's* Pension Fund Disclosure Code
TER	Total Expense Ratio of a *CIS*
Trustee	The Trustee of an *AUT*
UCITS	*CIS* complying with the Undertakings for Collective Investment in Transferable Securities Directive (see section 5.3.1)
Working Party	*IMA's CIS* Governance Working Party

1 Introduction

In January 2004, the Board of Directors of the Investment Management Association ("*IMA*") set up a *Working Party* with a broad remit to consider whether there were changes that the *IMA* should be seeking to promote in the way that UK authorised collective investment schemes ("*CIS*") are governed, with a view to making recommendations to the Financial Services Authority ("*FSA*") and the *CIS* industry.

There were a number of considerations that triggered this decision. First, *IMA* was seeing an increasing demand and reliance on disclosure to institutional clients, for example in areas such as transaction costs and corporate governance, as a way of promoting transparency. This naturally raised the question how similar principles could be adopted for retail customers of *CIS*, and whether the existing role and duties of *Managers* and *Depositaries* could encompass these.

More generally, however, the *IMA* Board thought it an appropriate time, with:

- the *FSA's* move away from prescriptive rules towards principle based regulation, in particular the introduction of the New Collective Investment Scheme Sourcebook;
- the spotlight on fund governance in the United States and by other bodies such as *IOSCO;* and
- structural changes in the *CIS* industry,

to consider whether current rules and practice in relation to the protection of *Investor* interests continued to be fit for purpose. It was also felt that there had been considerable developments in the world of corporate governance since the question was last under review.

The *IMA* Board concluded that there was merit in taking the initiative on these matters by setting up a *Working Party* to examine the current *CIS* governance structure and to discuss alternative options.

The *Working Party* was established under the chairmanship of Lindsay Tomlinson, Chairman of *IMA*, and membership was drawn from senior industry practitioners from a range of backgrounds, including *CIS* management firms, investment managers, administrators, *Depositaries* and the legal profession. Terms of Reference for, and Membership of the *Working Party,* are detailed in Appendices 1 and 2 to this document. The FSA was made aware of IMA's plans and has supported this initiative.

Following consultation with *IMA Members* and consideration by the *Working Party* of *Member* feedback*,* the Board of *IMA* is now issuing a formal report, proposing industry standards and recommending changes to the existing regulatory regime. Whilst *IMA* is not able to enforce compliance on its *Members* as regards industry standards, experience from other initiatives, for example the *IMA* Pension Fund Disclosure Code ("*PFDC*"), has shown encouraging levels of take-up.

2. Scope and Objectives

The *Working Party* set a core objective of the maintenance and improvement of consumer confidence in the *CIS* industry, with any recommendations avoiding unnecessary cost, bureaucracy and duplication of effort.

Prior to detailed consideration and to ensure comprehensive coverage of activities relating to *CIS*, the *Working Party* drew together a table covering all activities in the *CIS* "Value Chain" (see Appendix 3), and noting for each activity:

- which party has prime responsibility;
- which party/ies have a beneficial interest;
- what potential there is for bias, or conflict of interest from those parties involved, i.e. to the detriment of the *Investor;*
- what potential there is for differing treatment between *Investors;*
- whether, to whom, and how the activity is disclosed;
- whether there is internal supervision;
- whether there is independent oversight.

Issues that the *Working Party* considered should be reviewed, fell into the following broad categories:

- *Investors'* understanding of costs charged to *CIS;*
- Responsibilities of *Managers*, *Depositaries* and auditors;
- Other *CIS* governance models;
- Role of independent directors.

Prior to consideration of each of the above categories, the *Working Party* addressed the potential for conflicts of interest within *CIS*. Failure to manage conflicts of interest risks eroding confidence in the *Manager's* ability to serve as fiduciary and potentially undermines the *CIS* industry as a whole. *Managers* often face conflicts of interest that could interfere with the objectivity of their decisions and actions and they can undertake multiple roles or may appoint others who do. The substantive question facing a *Manager* is definition of the principles that guide its fiduciary behaviour.

Issues considered by the *Working Party* and consequent recommendations are set out in summary in Section 4, and *Working Party* findings are discussed in detail in Sections 5 to 9 below.

3. Protecting Investor interests – the role of CIS Governance

The purpose of a *CIS* is to allow a group of individuals to pool their assets for more efficient and effective management. The legal character of the relationship is that each *Investor*, has an investment, the value of which represents a direct proportion of those assets. If an *Investor* wishes to redeem his investment, he can do so at a value based directly on the value of the underlying assets, i.e. the net asset value ("*NAV*").

The main reason why people invest in *CIS* is because they do not have the expertise to manage those assets themselves. People who buy *CIS* are buying the expertise of someone to look after their money, deciding what to invest in, and when. The diversified nature of the product also has the advantage of spreading risk, while at the same time opening up investment opportunities that are denied to the *Investor* as an individual, due to cost and inexperience.

CIS are the means by which most *Investors* purchase investment management expertise, and that expertise is not owned by the *CIS,* but purchased by it from an investment management house. The *CIS* is simply the delivery mechanism by which that expertise is delivered to the *Investor*.

A *CIS* is defined by, and exists, because of the provision of investment and other management by the investment management house. To speak of a *CIS* choosing or threatening to change *Managers*, is to misunderstand the nature of the relationship between the *Investor*, the *CIS*, the *Manager* and the *Depositary*.

The protection of *Investor* interests is achieved through a number of means:

- The valuation of *CISs* at their *NAV* means that *Investors* can realise their investment at a price related to the *NAV;*
- A regulatory regime that has developed which defines the rights and obligations of the participants in the process (see Section 5 below);
- Disclosure of pertinent information to *Investors* and their advisers on a prescribed and regular basis, so that the decision to invest, disinvest or remain invested, can be made on a fully informed basis;
- All fundamental alterations to the running of the *CIS* requiring a vote of *Investors*.

The governance structure in the UK, in common with many, is based on the use of checks and balances, with clear articulation of the responsibilities of the parties concerned. Section 5 of this report contains a review of the current *CIS* governance arrangements in the UK. The following provides a brief summary.

Day to day management of the *CIS* is the responsibility of the *Manager*. Although many of these activities can be delegated to other parties, the *Manager* still retains the regulatory responsibility. The *Manager* must comply with a set of rules designed to make the operation of the *CIS* fair and accountable.

Oversight of the *Manager* is provided in the first instance by the *Depositary*. In certain areas, such as setting the *NAV* and agreeing the inflows to and outflows from the *CIS*, the *Depositary* is involved in the daily running of the *CIS*. Alongside this runs a system of continuous review of matters such as compliance with the investment objectives of the *CIS* and monitoring for overdrafts. The *Depositary* is also responsible for the safeguarding of the assets of the *CIS*.

*Depositarie*s are, by market choice, subsidiaries or divisions within large banking groups (although regulation does not require them to be so). They are authorised by the *FSA* and have to follow conduct of business rules and abide by competence and financial resources requirements. In practice they represent a significant resource of professional, well-qualified people, supported by significant computer and processing resources.

In some countries, the role of the *Depositary*, as the UK understands it, is either significantly restricted or absent entirely. In many of those countries, the role undertaken by *Depositaries* in the UK, is performed, in part, by boards of directors, often independent (a topic discussed further in Section 6.5). While the majority of independent directors are experienced, thoughtful and active in their role, there has to be question whether they can perform as potent, as well resourced and as engaged an oversight function as the *Depositary*. The *Working Party* is not aware of any system involving the use of independent directors, that will, for example, sign off on the day's trading in the *CIS*, nor any independent board that takes such direct responsibility for the safety of the *CIS* assets and carries out regular on-site inspections of the *Manager's* activities.

The *Working Party* was very conscious that the UK has one of the most developed systems of rules and regulations designed to formulate, in very specific terms, the role of the overseer. As the nature and type of *CIS* becomes ever more complex, that system of rules has to keep pace, and inevitably will not always succeed. However, the UK governance system is capable of adapting within short timescales and without the need for regulatory intervention. This paper perhaps being a case in point: many of the recommendations do not need rule-making, but to become industry best practice.

Underpinning this substantial edifice of regulation is one simple proposition: that both the *Manager* and the *Depositary* have an obligation to act at all times in the best interests of *Investors,* disregarding their own interests where they conflict with those of the *Investor:* a fiduciary duty. Where solutions are developed in the marketplace (and they tend to be developed collegiately between the *Depositary* and the *Manager* after discussion with *Investor* representatives), it is a relatively simple matter to promulgate that solution throughout the *Depositary* world. This helps ensure consistency across the *CIS* industry. Contrast that with the mechanisms required to make new rules or build consensus amongst numerous individual independent directors.

No system of governance and disclosure will ever be perfect. However, the mere facts of scandals or *FSA* enforcement against firms are not of themselves evidence that the overall system is at fault. Such systems rely to a degree on people doing the right thing and none are immune from conspiracy and fraud – no system is. The *FSA* itself emphasises that it cannot provide a zero failure regime. The arrangement of checks and balances that characterises the UK *CIS* Governance system is designed to help ensure that if one of the key participants departs from regulatory and market standards, there is someone there to identify this and to call that person to account.

However, it would be foolish to believe that the *Depositary* is privy to every decision made, and every act undertaken, by the *Manager* and therefore can identify and question every non-compliant thought or act. As far as is reasonable, an environment can be created, where misbehaviour of any form is more difficult than compliance, and where the fear of being caught out acts as a deterrent. Essentially, the system is designed to provide a framework within which the honest will thrive and the dishonest be found out.

In this paper there is much analysis of the duties and obligations of the *Depositary* and the *Manager*. The *FSA* as the regulator, and in accordance with its statutory duties, also has a role to play in developing rules and in assisting in developing market standards. The *Working Party* hopes that this paper will assist in the first of these tasks and welcomes the involvement of the *FSA* in the governance debate by consulting on appropriate amendments to the regulatory regime.

Further, no system works without the engagement of all its participants. Disclosure, to be effective, needs to be well designed and meaningful, but if launched into an environment of apathy, will fail. It is therefore important to see the recommendations of this report as complementary to efforts by the *FSA* and others to improve the ability of *Investors* to understand and become active participants in those *CISs* in which they invest. The *IMA* and the *CIS* industry welcome informed engagement from *Investors* and their advisers, and the recommendations in this report on disclosure are designed to encourage that.

It would be an omission to address the subject of *CIS* governance without reflecting on events elsewhere in the world. A more detailed comparison of the UK model with others around the globe is in Sections 5 and 6 below, but a few observations are appropriate here.

The *IOSCO* Technical Committee was charged with carrying out a survey of governance models around the world. *IMA* welcomes the attention being paid to governance and hopes that this report will be a constructive contribution to the debate. The UK *CIS* industry recognises that theirs is one model among several, and clearly believes it works, but would not take the view that it is compatible with all markets and all regulatory regimes. *IMA* trusts that the *IOSCO* view will take due account of the diversity of ways to operate a *CIS*, and will focus on effectiveness at a substantive level and not homogeneity on the surface.

Elsewhere, the recent late trading and market timing scandal in the United States has underlined the importance of several matters that this paper seeks to address The US regulatory authorities have clearly concluded that there were sufficiently serious flaws in their system of governance for them to institute sweeping changes. Indeed, the resultant regulatory programme in the US probably represents the single largest overhaul of the US mutual fund regulatory regime since its inception in 1940.

The *Working Party* has however noted, that a very small number of mutual fund managers have been identified as at fault: the vast majority by number and assets under management, have seen no regulatory or legal enforcement action. Its conclusion is that with the right people and the right procedures in place, the previous governance system demonstrably worked.

Indeed it can be argued that some areas of corporate governance in other jurisdictions, notably independent directors, failed to prevent the behaviours complained of, or at least there does not appear to be any evidence that their existence acted as a deterrent to those behaviours. While not privy to the facts of every case, the *Working Party* is of the view that the lesson to be drawn is that the quality of resources brought to bear in governance is more important than any tick box type of approach to governance.

The *Working Party* has therefore spent much time in considering whether those charged with oversight responsibilities are equipped with the right environment, standards and tools with which to carry out their role, and how, through disclosure particularly, *Managers* can account more directly to *Investors* in respect of the role that they perform for them.

The *Working Party* believes that with the benefit of these recommendations, the UK *CIS* governance system represents a balanced and robust structure for the protection of *Investors* and the long-term health of the industry.

4. Summary of Recommendations

The detailed rationale for each recommendation is set out in the detailed section of the report. The recommendations have been grouped below by theme and do not necessarily follow the order of the detailed sections.

4.1 General

The *Working Party* found no basis for recommending a fundamental restructuring of the UK *CIS* Governance model.

No.		Report Section	Responsibility
1	There should be no change to the UK's current *CIS* governance model, other than in respect of those recommendations elsewhere in this paper to enhance, and better to define, the *Depositary's* and *Manager's* respective roles and responsibilities.	6	N/A

4.2 Addressing Balance of Powers

It is important that those charged with responsibilities under the governance model have the freedom to carry out their role.

No.		Report Section	Responsibility
2	As current *FSA CIS* regulations and trust deeds do not reflect actual practice with regard to the appointment or replacement of *AUT Trustees*, these should be amended, to mirror the contractual appointment of *Depositaries* by *ACDs* of *OEICs*.	7.2	*FSA*
3	*FSA CIS* regulations should be amended so that the *FSA*, once having received notification under *FSMA* (*AUTs*), or under the *OEIC Regulations* (*OEICs*), and prior to approving a proposal to change the *Depositary*, will <u>require</u> the *Depositary* to provide them with a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the *FSA* or, if it considers that there are no such circumstances, a statement that there are none.	7.3	*FSA*
5	*FSA CIS* regulations should be expanded to cater for circumstances in which the *Manager* wishes to replace the *Depositary*.	7.3	*FSA*

4.3 Improving Disclosure

Disclosure is, and will remain, a key component of the means by which firms address conflicts of interest. As noted elsewhere in this report, it is important not only that disclosure is made, but that those to whom it is made, read and respond.

No.		Report Section	Responsibility
4	*FSA CIS* regulations should be amended to require that in the *CIS* report and accounts following a change of *Depositary:* The *Manager* should disclose: • reasons for the change of *Depositary;* • any wider arrangements of which the change of *Depositary* is a part. Further: both the outgoing and incoming *Depositaries*, should supply a *Depositary* report covering the periods within the accounting period, for which they were responsible.	7.3	*FSA*
8	*Managers* should produce, and supply to the *Depositaries*, annual reports similar to the *PFDC* Level One disclosure, or the enhanced disclosure currently being developed with interested parties.	8.1.1	*Manager*
9	Amendments should be considered to the *CIS SORP* to require the disclosure in *CIS* report and accounts of the totals of broker commissions, taxes and any other charges included within portfolio purchases and sales.	8.1.1	*IMA's SORP* Working Group
10	Amendments should be considered to the *CIS SORP* to require a portfolio transaction report to be included as a note in *CIS* report and accounts, detailing in numerical terms the total of transaction volumes, analysed over the top ten counterparties by volume, and by net and commission based trading, and a remainder. Any counterparties that are affiliates of the *Manager* or the *Depositary* should be identified as such. Gross portfolio turnover and commissions in this table should reconcile to the total figures disclosed in *CIS* report and accounts following recommendation 9 above.	8.1.1	*IMA's SORP* Working Group

11	Contingent upon Enhanced Disclosure being adopted by *IMA* and accepted by the *FSA*, the *CIS SORP* should be amended to incorporate the *IMA* Enhanced Disclosure proposals, and the portfolio transaction report described in recommendation 10, should be expanded to include a split of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class.	8.1.2	*IMA's SORP* Working Group
12	*FSA CIS* regulations should be amended to require that the *Manager* includes within the *CIS* prospectus, a statement of its policy on box management, making clear the purposes for which the box is used.	8.1.3	*FSA*
18	Amendments should be considered to the *CIS SORP* to reflect the distinct nature of stock-lending income and related costs, by requiring that such income be reported net in the Statement of Total Return, and that related fees and expenses be separately disclosed, by way of a note, in *CIS* report and accounts.	9.1	*IMA's SORP* Working Group
19	Amendments should be considered to the *CIS SORP* to require that, in relation to any charges or costs levied, directly or indirectly, against the assets of a *CIS*, disclosure should be made in the report and accounts of any revenue sharing participated in by the *Manager*, *Depositary* or affiliates of either.	9.2	*IMA's SORP* Working Group
20	Amendments should be considered to the *CIS SORP* to require a note showing the calculation of the *TER* to be included in the audited annual report and accounts of *UCITS* and *non-UCITS retail funds*. In the event that the *Manager* believes that it is necessary to update the *TER*, an un-audited version of this calculation should be included in the interim report and accounts.	9.3	*IMA's SORP* Working Group
21	Upon implementation of the Simplified Prospectus regime for *UCITS*, *FSA* should also require disclosure of *TERs* in *non-UCITS retail fund* Key Facts/Key Features documents. This *TER* disclosure should replace the existing Reduction in Yield disclosure.	9.3	*FSA*

22	The *IMA* should encourage *Managers*, the *FSA*, *Investors* and their advisers to transfer their attention from the detailed *CIS* costs laid out in report and accounts, to *TERs*, which will be required to be disclosed in *CIS* Simplified Prospectus documents (when implemented), and short reports.	9.4	*Manager* *FSA*

4.4 Agreeing Standards

In a number of areas the *Working Party* found that a more formal and articulated approach towards certain issues would be of benefit.

6	*Managers* and *Depositaries* should establish formal governance and procedural structures in relation to *CIS* activities delegated by the *Manager* to affiliates of the *Depositary*, that require that any errors or regulatory breaches caused by the affiliate be reported first to the *Manager*, and subsequently, but promptly, by the *Manager* to the *Depositary*.	7.5	*Manager* *Depositary*
7	The Board of Directors of *IMA* should instigate a review to identify best practices, which, if adopted and adhered to, by UK investment managers, would demonstrate appropriate management of client mandates with potentially conflicting strategies.	7.6	*IMA*
16	*Managers* and *Depositaries* should adopt the statement of practice in relation to dilution levies and adjustments set out in Appendix 4.	8.2.2	*Manager* *Depositary*
23	*Managers* should establish, and monitor adherence to, a formal policy as to the frequency and timing of the release of portfolio details to *Investors*, or to classes of *Investors* (see *IMA*'s Market Timing Guidelines for Managers of Investment Funds issued 6 October 2004). The *Manager's* policy should be disclosed in the *CIS* prospectus.	9.5	*Manager*

4.5 Extending the role of the Depositary

While the role of the *Depositary* is defined by general considerations of fiduciary obligation as well as the *CIS* regulations, the *Working Party* felt that an explicit reference to the following areas would add value. We note that although oversight responsibility rests directly on the *Depositary*, *Managers* will also be required to make changes to accommodate these recommendations.

13	The *Depositary's* oversight role should be extended to review the *Manager's* use of the box and confirmation that it has been managed in accordance with the policy set out in the prospectus. The prospectus disclosure should be amended if it is not accurate or current.	8.1.3	*Depositary*
14	The *Depositary* oversight role should be extended to cover Level One disclosure, to ensure that the *Manager* has adequate procedures and controls in place. This oversight should include interrogation of the *Manager* as to its processes and reviews of the *Manager's* own internal monitoring programmes and the results of that monitoring, based on the information supplied in the *Manager's* Level One report (see recommendation no. 8 above).	8.2.1	*Depositary*
15	The *Depositary* oversight role should be extended to cover a review and appropriate questioning of the portfolio transaction report, including Enhanced Disclosure, described in recommendations 10 and 11.	8.2.1	*Depositary*
17	*FSA CIS* regulations should be amended to bring within the *Depositary's* oversight ambit, the *Manager's* compliance with its policy on charging dilution levies or other adjustments (see recommendation 16)	8.2.2	*FSA*

5 Current CIS Governance arrangements

5.1 UK authorised collective investment schemes

This report addresses the two categories of UK authorised collective investment schemes ("*CIS*"), namely authorised unit trusts ("*AUTs*") and open-ended investment companies ("*OEICs*").

An *AUT* is constituted under UK trust law, differing from a corporation in that it has no separate legal existence. *Investors* in *AUTs* are known as unitholders.

The other *CIS* vehicle is either called an *OEIC* or an Investment Company with Variable Capital ("*ICVC*"). For the purpose of this paper these vehicles will be referred to as *OEICs*. *OEICs* were first introduced in 1997, when new legislation came into force, to offer increased flexibility and simplicity, while retaining the tax structure enjoyed by *AUTs*.

OEICs have a corporate structure similar to that of a company. Within that structure, the *Depositar*y has broadly similar (but not identical) powers and responsibilities to the *AUT Trustee*. *Investors* within this structure are known as shareholders. In line with other corporate structures, *OEICs* may have boards of directors, and must have a minimum of one director, the Authorised Corporate Director ("*ACD*"). In practice there has been little enthusiasm for boards of directors and the *ACD* effectively acts in the same manner as the *Manager* of an *AUT*.

In many, if not most respects, the activities of and the regulatory framework surrounding *AUTS* and *OEICs* are virtually identical.

5.2 Key CIS participants

There are a number of key participants involved with *CIS* and *Investors*, *Managers* and *Depositaries* are discussed below in detail. Auditors also play an important role for CIS as do Standing Independent Valuers, who are required to value any real estate property held in a *CIS*.

5.2.1 *Investors*

This report uses the generic term *Investor*, except where there is varying treatment or rights for the unitholder of an *AUT* or the shareholder of an *OEIC*. Whilst not directly entitled to the underlying assets of the *CIS*, the *Investors* have a direct economic interest in the *CIS* assets, in proportion to their holding in the *CIS*.

In this report the term *Investor* is used to encompass a broader constituency than those who appear on the *CIS* register. Given the wide use of omnibus and other nominee arrangements that streamline the register, many *Investors'* names do not appear, so the term is taken to include the end or beneficial owner of the interests in the *CIS*.

5.2.2 *Managers* and *Depositaries*

Both the *Manager* and the *Depositary* have fiduciary obligations to the *Investor*, a concept that has come down through trust law, *CIS* Regulations and *FSA* Principles. While regulations attempt to codify and measure the performance of that fiduciary obligation, the core principle is that both the *Manager* and the *Depositary* must act in the best interest of the *Investors.* This principle is central to the nature of the relationship between *CIS* participants.

Both *Managers* and *Depositaries* are regulated in the UK by the *FSA* and are subject to threshold tests as regards fitness and properness, including integrity, competence and financial resources. Whilst both are permitted to delegate certain activities to third parties, they still retain ultimate regulatory responsibility.

> ***Fiduciary obligation***
>
> *This is an obligation of loyalty and good faith owed in dealings that affect another person. For a fiduciary this obligation means more than acting fairly and honestly, but that they must act solely with the overall interests of the beneficiaries in mind. Crucially, a fiduciary must always act to secure the beneficiaries' best interests and must not allow its own interests to affect its behaviour in any way that would conflict with the best interests of the beneficiaries. A fiduciary is permitted to charge for its services, provided that details of any remuneration, or other payments or benefits received as a result of the relationship, are disclosed.*

a) *Manager*

The *Manager*, which is also the promoter of the *CIS*, is responsible for making the investment decisions on the *CIS's* underlying portfolio, and is also responsible for most of the day-to-day administration of the *CIS*. Some of these activities are typically delegated.

b) *Depositary*

The *Depositary* is responsible for holding in safe custody, the assets of the *CIS*, principally investments and cash. The *Depositary* (or its nominee) is the registered owner of the *CIS's* investments. Economic benefits, such as dividends, are collected by the *Depositary* and subsequently distributed to the *Investors* upon receipt of appropriate instructions from the *Manager*. This separation of the management of the *CIS* assets from their possession and ownership is the most fundamental element of *Investor* protection provided by the *CIS* product.

The Depositary also has a responsibility for protecting the interests of incoming, outgoing and continuing *Investors*, including a duty of oversight over the activities of the *Manager*. Whilst not having a direct responsibility for the *Manager's* activities, the *Depositary* must take reasonable care to ensure that the *Manager* is properly discharging its own responsibilities. This is not the case for other mass savings products such as deposits, savings accounts or life policies.

The *Trustee* of an *AUT* also has prime responsibility under the *CIS* Sourcebook (see section 5.3.3), for the *AUT* registrar function, i.e. the maintenance of a current and correct list of *Investors* and their holdings. The COLL Sourcebook is more flexible, in allowing either the *Trustee* or the *Manager* of an *AUT* to take on this prime responsibility. In any event it is most unusual for *Trustees* to actually undertake this role, which is generally delegated either to the *Manager* or to an administrator, the *Trustee* (or possibly the *Manager* under the COLL Sourcebook rules), of course still retaining ultimate regulatory responsibility.

5.3 UK Regulatory framework

In the UK there are four levels of law and regulation that directly or indirectly affect *CIS:* European legislation; UK legislation (at both a primary and secondary level); *FSA* rules and guidance; and the *CIS's* own constitutive rules. These form a hierarchy of rules that at each level become progressively more detailed.

5.3.1 European legislation

At the European level the *UCITS* Directive governs *CIS* product regulation. The Directive is, except for certain provisions, a minimum harmonisation directive setting basic standards that all EU member states' funds must meet to qualify as *UCITS*, and thus to be passportable cross-border. Its provisions have been implemented into UK law. The Directive also identifies the management company (manager) and depositary and assigns certain requirements to each.

UCITS Directive

The Undertakings for Collective Investment in Transferable Securities Directive sets down common standards for funds wishing to be registered and offered for public sale throughout the European Economic Area.

Although primarily a Directive addressing product design and implementation (such as diversification and risk management) the Directive also identifies certain duties and obligations of the Manager. It should be noted though, that it stops short of mandating any specific governance structure and therefore there are several models that operate successfully within the UCITS standards, such as the UK.

So far as the relationship between the manager and depositary is concerned, it is a Directive requirement that no single company may act in both capacities and that each must act independently of the other. However, the Directive does not prevent two companies within the same group acting as manager and depositary, providing that the above fundamental conditions are satisfied. The UK regulatory regime, however, does not permit affiliates to act in both capacities with respect to the same *CIS*.

5.3.2 UK legislation

In the UK the main legislation affecting *CIS*, is the Financial Services and Markets Act 2000 ("*FSMA*"), which sets out the *FSA's* responsibilities, how a *Manager* may apply for authorisation of a *CIS* and who may act as a *Depositary*.

FSMA

FSMA sets out the basis under which AUTs operate and in particular it implements key provisions of the UCITS Directive and gives the FSA powers to make rules for AUTs and OEICs. There are also Statutory Instruments containing the OEIC Regulations under which OEICs operate.

Although originally trust law assigned fiduciary duties between the Managing Trustee and the Custodian Trustee, over time this has been modified in the case of *CIS* so that these responsibilities are apportioned between the *Trustee* and the *Manager* of an *AUT*, by regulation and the trust deed.

Thus, it is the *Manager* that establishes the *CIS* and appoints the *Depositary*, and unlike a conventional trust it is the *Manager*, rather than the *Depositary*, that is responsible for all investment decisions. *Managers* are also responsible for valuing the *CIS* and calculating dealing prices based on those valuations.

Within the *AUT* structure, the *Trustee* has responsibility for custody of or control of fund assets, oversight of the activities of the *Manager* and protection of the interests of the beneficiaries, i.e. incoming, ongoing and outgoing *Investors*. The duty of oversight ensures that there are no *Investor* protection issues arising from this division of responsibility. In practice most of the governance and regulatory principles applicable to the *AUT* have also been applied to the *OEIC*. There is, however, one fundamental difference, in that the *ACD* is a contractual appointment by an *OEIC*, whereas the *Manager* of an *AUT* is a party to the constitutive trust deed.

5.3.3 <u>*FSA* regulations</u>

Detailed rules and guidance that are directly related to the operation of the *CIS* itself are contained in the *FSA's* Collective Investment Schemes and New Collective Investment Schemes specialist Sourcebooks that form part of the *FSA* Handbook. These Sourcebooks are the main means of implementing the *UCITS* Directive and provide essential material to complement the corporate code for *OEICs*. Rules that govern the activities of the *Manager* are contained in a number of the *FSA's* Sourcebooks and Manuals, including the Conduct of Business Sourcebook.

Categories of fund falling under the *CIS* Sourcebook are *UCITS* I and III funds and *non-UCITS retail funds* e.g. futures and options funds, geared futures and options funds, property funds, money market funds and funds of funds. All may be marketed to retail *Investors*.

Categories of fund falling under the COLL Sourcebook are *UCITS* III funds and *non-UCITS retail* funds (targeted at retail *Investors*) and Qualifying Investor Schemes (targeted at institutional *Investors* and sophisticated private *Investors*), all of which can invest in a mixture of assets. All *CIS* will need to comply with the COLL Sourcebook by February 2007 at the latest. Those CIS that invest in real estate property also need to comply with the valuation methodology set out in the Royal Institute of Chartered Surveyors Appraisal and Valuation manual.

The "old" Collective Investment Schemes Sourcebook (CIS Sourcebook)

Applies to
1) CIS for which authorisation application was submitted prior to 1 April 2004;
2) CIS for which authorisation application was submitted after April 1 2004, but which have elected under the transitional provisions to comply with the CIS Sourcebook

The "new" Collective Investment Schemes Sourcebook (COLL Sourcebook)

Applies to:
1) CIS for which authorisation application was submitted after 1 April 2004;
2) CIS for which authorisation application was submitted prior to 1 April 2004, but which have subsequently exercised the right to convert to COLL.

5.3.4 <u>Fund constitutive documentation</u>

Each *CIS* also has its own constitutive documentation, a trust deed in the case of an *AUT* and an instrument of incorporation in the case of an *OEIC*. These documents provide a further layer of rules, detailing the powers of each *CIS*. Day to day operating rules are then set out in the prospectus of each *CIS*, e.g. detailed investment objectives, the investment policy for achieving those objectives, details of each particular share class (e.g. differing fee scales) etc. While many of the detailed terms of the prospectus and other constitutive documents are set by the *Manager* within parameters, or on the basis of choices set out within the *FSA* rules, both the *CIS* instrument and prospectus add an extra layer of requirements and a breach of any of their requirements is treated as a breach of *FSA* rules.

6 Other CIS Governance Models

The *Working Party* compared the UK governance model against those in the European Union, Australia and the United States, to ascertain whether any useful lessons could be learned. Further detail of the different models is set out in Appendix 5.

6.1 Australia

Under Australia's Managed Investments Act (subsequently incorporated into the Corporations Act) a manager may be appointed as the "Single Responsible Entity" for all its managed investment schemes (the local equivalent to *CIS*). As such it is in complete control and is totally responsible for all aspects of each of the funds. There is no requirement for a board of directors or a depositary.

The *Working Party* concluded that this particular model could not readily be imported into the UK, as it would not comply with the *UCITS* Directive, which prescribes that one corporate body may not act as both manager and depositary for *UCITS*. An attempt to change the *UCITS* Directive was not considered to be practicable.

6.2 United States

US mutual funds, authorised under the 1940 Investment Company Act, are governed by a board of directors, whose responsibility is to ensure that the manager executes its business affairs in the best interests of *Investors*. This responsibility has recently been supported by new rules regarding the reporting lines of a compliance officer direct to the board, and the emphasis on the ability of the board to acquire the services of whatever people or other resources it might need to discharge its role.

The board of directors must have a majority of independent directors, and following a recent rule change, the board's chairman must be one of the independent directors.

The role of the board of directors under the US model therefore appears to be essentially similar to that of the *Depositary* in the UK, except that the *Depositary* has day-to-day contact with the mutual fund, rather than just at periodic board meetings. As the *UCITS* Directive would still require the appointment of a *Depositary* for any *UCITS* funds, and bearing in mind that the majority of UK *CIS* are *UCITS*-compliant, the *Working Party* concluded that a combination of a *Depositary* and a board of directors for *OEICs* would be possible, but would add unnecessary duplication and would not be a cost-effective solution. It risked creating significant confusion about each participant's role and having the effect of increasing *Investor* costs, whilst actually

Independent Directors – 1995 - HM Treasury view

In the UK consideration was given to requiring independent directors during HM Treasury's April 1995 "Open Ended Investment Companies, Second Consultation Document". Feedback to this consultation indicated that "There was a real concern in the responses that a requirement for a majority of independent directors for each open ended investment company would expose a shortage of suitably qualified candidates which in turn could add to costs for newly created open ended investment companies". The Treasury, taking this into account, together with the industry view that the unit trust model of independent Trustee was tried and tested, included Boards of Directors only as an option for OEICs.

detracting from the quality of oversight. Due to the *AUT* structure, a board of directors would not be practicable.

The *Working Party* also noted that the existence of a majority of independent directors on fund boards in the US had not seemed to impair the growth of practices such as late trading and market timing, reinforcing its view that the focus should be on qualitative rather than quantitative or simple "tick box" approaches to governance.

6.3 The European Union

The majority of EU investment funds are *UCITS* compliant. The *UCITS* Directive states that the depositary is responsible for the safe keeping of a fund's assets and for ensuring that sales, redemptions, cancellations and issues of units, and the calculation of the value of units, are carried out in accordance with the law and rules of the fund. In this respect, UK regulation is super-equivalent to the *UCITS* Directive requirements and UK *Depositaries* have a significantly wider oversight role, both as set out in the various legislative and regulatory provisions which attach to the roles, and the general law duty when acting as a fiduciary.

As noted in 5.3.1, the *UCITS* Directive does not prevent two companies within the same group acting as manager and depositary, providing that the independence conditions are satisfied.

UK regulation is super-equivalent to the *UCITS* Directive requirement concerning the relationship between the manager and depositary. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and *Manager* of an *AUT* and with regard to *OEICs* the *Depositary*, the *OEIC* and the directors respectively. The UK is, as far as the *Working Party* is aware, the only country to be super-equivalent in this way.

Recent changes in the structure of the UK *CIS* industry may, however, have made the *FSA's* stance on independence more difficult to sustain. Firstly, there has been a marked consolidation amongst the *Depositary* providers down to eight, only six of which currently have significant business. Secondly, the success of the full service provider concept means that it is not uncommon for many, if not all, *CIS* activities, other than investment management, to be delegated by a *Manager* to fellow subsidiaries of the *Depositary*, typically within large banking/custody groups.

Defining independence

The FSA CIS and COLL Sourcebooks identify three areas to consider:

Directors in common: *Independence may be lost if, by means of executive power, either relevant party could exercise effective control over the actions of the other;*

Cross-shareholdings: *Independence may be lost if either of the relevant parties could control the actions of the other by means of shareholders' votes. The FSA considers this would happen if any shareholding by one relevant party and their respective associates in the other exceeds 15% of the voting share capital;*

Contractual commitments: *The FSA encourages parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, directly or indirectly.*

6.4 Manager and Depositary – degrees of separation

The *Working Party* considered whether a model which removed the UK's current super-equivalence to the *UCITS* Directive in the matter of independence, was potentially a workable solution for the UK, and might also address the structural changes and competitive issues described above.

It is not uncommon within the EU for the manager and depositary to be fellow-subsidiaries. Many continental European investment management companies are subsidiaries of banks, which brand their funds for distribution, and also have existing in-house custody and administration operations.

It is also not uncommon for UK *Managers* to be subsidiaries within a wider group of companies containing other *FSA* regulated subsidiaries undertaking investment management activities or administration, and supported by a group-wide compliance function, adequately resourced with experienced compliance personnel, and reporting to the parent company board.

The reality is that it is increasingly difficult for any participant within the *CIS* structure to stand, alone and aloof, from other players whose roles and participation may intersect or conflict with the obligations it owes to *Investors*. Increasingly, independence has to be characterised and evaluated as a state of mind and style of behaviour, as opposed to a quantitative measuring economic interrelationships.

The *UCITS* Directive allows a structure where the manager is one subsidiary company and the depositary is another subsidiary. To operate within the UK, such a *Depositary* would need to be subject to independent capital requirements, and be required to demonstrate possession of the same resources and expertise as the current *Depositary* providers.

Such a model might be attractive to the larger UK investment management groups. Smaller *CIS* operators with less access to internal compliance resources might find this less attractive and continue to use the specialist independent *Depositary* providers and the resources, upon which as large corporations, they are able to draw.

It has to be said, however, that independence is a significant issue in terms of international credibility and *Investor* confidence, and it is difficult to envisage fund industry harmonisation without a very robust alternative to the current separation of functions.

After lengthy consideration, the *Working Party* narrowed the options down to:

- Modified EU model, i.e. the *Depositary* could be a fellow-subsidiary of the *Manager*, subject to adequate resources and regulatory capital;
- Modified EU model, as above, but with a requirement that *CIS* assets could not be held by an affiliate of the *Manager;*
- Current UK model, but with *Depositary* responsibilities cut back to the *UCITS* Directive requirements;
- Current UK model;
- Current UK model, extended by those proposals laid out in this report.

The *Working Party's* final conclusion (see recommendation 1 below) was coloured by decisions taken on other issues, e.g. to recommend further enhancement to the *Depositary's* role and responsibilities.

6.5 Independent Directors

In line with other corporate structures, *OEICs* may have boards of directors, and must have a minimum of one director, entitled the *ACD*. In practice there has been very little enthusiasm for boards of directors and the *ACD* effectively acts in the same manner as the *Manager* of an *AUT*.

The role of independent directors within *OEICs* was considered at length during HM Treasury's two consultations on *OEICs* in the 1990's (see inset box, page 19). As noted above, HM Treasury eventually permitted *OEICs* to appoint independent directors, but did not require them to do so. This flexible approach to the composition of the board was counterbalanced by a stronger role for an independent *Depositary*. Virtually all firms have selected the option of the single *ACD*.

FSA regulations give the *ACD* responsibility for complying with *FSA's Investor* protection regulations, certain provisions of the *OEIC Regulations* and dealing with the *OEIC's* everyday business, including managing the *OEIC's* investments, selling and repurchasing the *OEIC's* own shares on demand, and ensuring accurate pricing of these shares at *NAV*.

As a counterbalance, HM Treasury took the view that the role of the *Depositary* would be crucial to the stability and successful running of an *OEIC*. For this reason, the *OEIC Regulations* permit the *Depositary* to convene and attend shareholder meetings, to receive any relevant board papers and to attend any directors' meetings which concern its business as *Depositary* (except those where the *Depositary's* terms of appointment are to be discussed).

Such an *OEIC* bears a strong resemblance to an *AUT*, which has no board of directors. The *Working Party* understands that HM Treasury remains satisfied that the authorisation of the *OEIC*, its *Depositary* and *ACD* delivers high business standards and so provides adequate protection, not only to the *OEIC's Investors,* but also to others doing business with it. Further consideration of *CIS* governance and the role of single corporate directors, was undertaken by the *FSA* during its research prior to issuing CP185: The New CIS Sourcebook. The *FSA* concluded that the current *CIS* governance model works well and provides effective *Investor* protection.

The *Working Party* saw no need to dissent from the publicly held view of both HM Treasury and the *FSA.*

Recommendation No.1 - The need for fundamental change

There should be no change to the UK's current *CIS* governance model, other than in respect of those recommendations elsewhere in this paper to enhance, and better to define, the *Depositary's* and *Manager's* respective roles and responsibilities.

7 Key CIS participants – appointment and replacement

7.1 Manager

From time to time suggestions are made that *Investors* in poorly performing *CIS* should be able to replace the *Manager* by means of a vote at a *CIS* general meeting. Similar suggestions have recently been made in the US, following the revelation of mutual fund abuses by Elliott Spitzer, the New York Attorney General. Supporters of such an approach however, risk losing sight of how the *CIS* industry works and was designed to work. (see sections 3 and 5 above).

Whilst the *Working Party* does not accept the need to put *Managers* on some form of continuous probation in respect of purely business matters, there remains a need to ensure that in cases of egregious and abusive behaviour there is an ability to address the *Manager's* shortcomings, even to the extent of dismissal.

In the view of the *Working Party*, sufficient powers already exist for the *Depositary* (often in conjunction with the *FSA*) to address any threats to the safety of *Investor* assets. There are both policy and technical objections to the *Depositary* taking a view on commercial matters such as the level of the *Manager's* fee or the quality of performance of the *CIS*. As noted elsewhere in this paper, the *Investor* is entirely at liberty to exit a relationship that he or she regards as no longer fit for his or her purpose.

7.2 Depositary

Whilst the *Depositary* has a responsibility for protecting *Investors* by overseeing the activities of the *Manager*, the replacement of the *Depositary* is, in practice, a decision of the *Manager*. Usually a decision to replace a *Depositary* is commercial, based on the competitiveness of fees and service levels, or as part of a wider arrangement. However, there is a theoretical potential for such a change to be made for other reasons, e.g. the *Manager* being uncomfortable with the *Depositary's* strict interpretation and enforcement of the regulations.

There are already safeguards in place for such situations. Any *Depositary* replacement must be authorised by the *FSA* and the replacement *Depositary* will be subject to the same regulations and fiduciary obligations as the first *Depositary*. So while there may be subtle differences in interpretation, the baseline standards of *Investor* protection will remain unchanged.

There are however some anomalies under current regulations as between the replacement of the *Trustee* of an *AUT* and the replacement of a *Depositary* of an *OEIC*, as well as in comparison to the replacement of a *CIS* auditor.

> **_Statement by Depositary ceasing to hold office_**
>
> _"Where the Depositary of a company ceases, for any reason other than by virtue of a court order made under regulation 26, to hold office, it **may** deposit at the head office of the company a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the shareholders or creditors of the company or, if it considers that there are no such circumstances, a statement that there are none" (emphasis added)_

In contrast with the arrangements for *AUTs* (see below), the appointment of the *Depositary* of an *OEIC* is a contractual arrangement between the *OEIC* (acting through the *ACD*) and the *Depositary*. The replacement of a *Depositary* is simply the termination of a contract on the basis set out in that contract.

This status of the *Depositary* is recognised within the *OEIC Regulations*, which provide for a document described as a "Statement by Depositary ceasing to hold office" (see insert box) and goes on to provide how such a statement should be circulated to the shareholders or creditors, together with notification to the *FSA*.

The regulations also provide for the *OEIC* to give written notice to the *FSA* of any proposal to replace the *Depositary*.

In the case of an *AUT*, the *Manager* and the *Trustee* become appointed by being the parties to the trust deed constituting the trust, and *FSA* regulations give the *Trustee* the power to replace the *Manager* in exceptional circumstances. In practice, however, the *Manager* controls the process and although they are not legally entitled to dismiss the *Trustee*, they are able to bring commercial pressure to bear to persuade a *Trustee* to resign.

The potential problems relating to replacement of a *Trustee* is recognised within *FSMA*, which states, "The Manager of an authorised unit trust scheme *must* give written notice to the Authority of any proposal to alter the scheme *or to replace its Trustee."* (emphasis added) and *FSMA* places some responsibility onto the *FSA* by providing that "The Authority must not approve a proposal to replace the Manager or the Trustee of an authorised unit trust scheme unless it is satisfied that, if the proposed replacement is made, the scheme will continue to comply with the requirements of section 243(4) to (7)".

AUTs have no provisions for whistle-blowing direct to *Investors* similar to that available through the "Statement by Depositary ceasing to hold office" provision described above. The differing treatment between the two *CIS* structures is unhelpful.

> **Recommendation No 2 - Addressing Balance of Powers**
>
> As current *FSA CIS* regulations and trust deeds do not reflect actual practice with regard to the appointment or replacement of *AUT Trustees*, these should be amended, to mirror the contractual appointment of *Depositaries* by *ACDs* of *OEICs*.

7.3 Comparison of treatment of *Depositary* change with change of auditors

The regulations relating to the replacement of auditors are more robust than those for replacing *Depositaries*. Schedule 5, paragraph 18 (1) of the *OEIC* Regulations – (Statement by auditor ceasing to hold office), provides that "Where an auditor ceases for any reason to hold office, he ***must*** deposit at the head office of the company a statement of any circumstances connected with his ceasing to hold office which he

considers should be brought to the attention of the shareholders or creditors of the company or, if he considers that there are no such circumstances, a statement that there are none" (emphasis added).

In a similar manner to dealing with replacement of a *Depositary*, the *OEIC Regulations* go on to provide how a statement, which the auditor considers should be brought to the attention of the shareholders or creditors, should be circulated to those persons, together with notification to the *FSA*.

The *FSA* Supervision Manual (a module of the *FSA* Handbook) also states that "If an auditor ceases to be, or is formally notified that he will cease to be, the auditor of a firm, he *must* notify the *FSA* without delay: (1) of any matter connected with his so ceasing which he thinks ought to be drawn to the *FSA's* attention; or (2) that there is no such matter".

The *Working Party* believes it would be advantageous to improve the current regime regarding the statement provided by the *Depositary* on leaving office, and apply this to both *OEICs* and *AUTs*, in line with the current regime for auditor changes.

Recommendation No.3 – Addressing Balance of Powers

FSA CIS regulations should be amended so that the *FSA*, once having received notification under *FSMA* (*AUTs*), or under the *OEIC Regulations* (*OEICs*), and prior to approving a proposal to change the *Depositary*, will require the *Depositary* to provide them with a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the *FSA* or, if it considers that there are no such circumstances, a statement that there are none.

The *Working Party* also believes that ensuring the transparency of any such change will helpfully inform *Investors*.

Recommendation No.4 – Improving Disclosure

FSA CIS Regulations should be amended to require that in the *CIS* report and accounts following a change of *Depositary:*
The *Manager* should disclose:

- reasons for the change of *Depositary;*
- any wider arrangements of which the change of *Depositary* is a part.

Further:
both the outgoing and incoming *Depositaries*, should supply a *Depositary* report covering the periods within the accounting period, for which they were responsible.

The new COLL Sourcebook, within "Operating duties and responsibilities", has rules relating to the "Retirement of the Depositary", using *Depositary* as a generic term for both the *Depositary* of an *OEIC* and the *Trustee of an AUT*. These rules, however, are limited to circumstances in which the *Depositary* wishes to retire voluntarily, and does not contemplate a situation when the *Manager* might wish to replace the *Depositary*. Given that the safeguards around *Depositary* changes will be improved if the recommendations of this report are followed, the *Working Party* believes that it is

appropriate to give the *Manager* the power to replace the *Depositary* in the normal run of business.

> **Recommendation No. 5 – Addressing Balance of Powers**
>
> *FSA CIS* Regulations should be expanded to cater for circumstances in which the *Manager* wishes to replace the *Depositary*.

7.4 Auditors - appointment and replacement

As the annual audit of a *CIS* is an oversight function, the *Working Party* considered whether the appointment and remuneration of *CIS* auditors should be the responsibility of the *Depositary* rather than the *Manager*.

After careful consideration, the *Working Party* concluded that such a change could give rise to significant policy and practical problems.

As an oversight function, the annual audit is just as likely to be a commentary on the effectiveness of the *Depositary's* oversight as much as the *Manager's* conduct. The essential conflict is not altered, merely relocated, by making the *Depositary* responsible for appointment and remuneration of the auditor.

It is not uncommon for the same firm of auditors to act both for the *CIS* and its *Manager*, and in such cases each audit is usually the responsibility of a separate partner. Having the same audit firm performing both audits usually means significant improvements in efficiency and effectiveness of the audit, and also reduces costs as work done in areas such as transfer agency and fund accounting can serve both purposes. It is doubtful whether auditors reviewing a fund, but insufficiently familiar with the processes and procedures of the *Manager*, would be able to provide a more in-depth evaluation.

The *Working Party* also took comfort from the fact that auditors are bound by their own professional standards that govern their resigning from assignments and accepting assignments from outgoing auditors, as well as the regulatory disclosure to the *FSA* required by its Supervision Manual.

Overall, the *Working Party* was of the opinion that there are sufficient safeguards for *Investors* provided by the current system, that no alternative offered better levels of protection and that all were likely to generate more costs, which would ultimately, of course, be borne by *Investors*.

7.5 Affiliates of the Manager and Depositary undertaking CIS activities

Depositaries carry out an important oversight role and also, tend to be subsidiaries of banking groups engaged in a variety of financial service businesses. Indeed, in several instances, affiliates of the *Depositary* provide other services, bundled into the services provided by the *Depositary*.

The *Working Party* noted a potential conflict of interest in circumstances where the *Manager* delegates operational activities for which it is responsible, to affiliates of the *Depositary*, e.g. fund accounting, valuation and pricing. In the event that such an affiliate was to make an error or breach the relevant regulations it would be accountable to the *Manager*, which in turn is accountable to the *CIS's Investors* and the *FSA*. There was a concern that where such an activity was performed by an affiliate of the *Depositary*, there could be an *Investor* perception that the *Depositary* might be inclined to influence a decision to make any correction or pay compensation, which inclination might be coloured by its affiliation rather than driven by its fiduciary obligations.

It is impractical to seek to ban dealing with the affiliates of *Depositaries* and so the *Working Party* is recommending improvement of the management of the arising conflicts.

Recommendation No. 6 - Agreeing Standards

Managers and *Depositaries* should establish formal governance and procedural structures in relation to *CIS* activities delegated by the *Manager* to affiliates of the *Depositary*, that require that any errors or regulatory breaches caused by the affiliate be reported first to the *Manager*, and subsequently, but promptly, by the *Manager* to the *Depositary*.

The *Working Party* concluded that with one exception, current regulations provide adequate disclosure of activities undertaken by affiliates of the *Manager* or the *Depositary* in the *CIS* prospectus and related fees/charges in the *CIS* report and accounts.

The one exception noted was in respect of portfolio transactions placed with counterparties that are affiliates of the *Manager* or of the *Depositary*. This is addressed by recommendation 10, below.

7.6 Investment managers managing CIS and other funds with potentially conflicting strategies

The *Manager* of a *CIS* frequently does not undertake the investment management activity, typically delegating this to an affiliated investment management company. The *Working Party* considered the potential conflicts within the *Manager* or the investment manager in the event that it also manages client mandates that:

- are able to take short positions in the same stocks that the *CIS* holds; or,
- pay the investment manager performance fees, rather than ad valorem fees.

Despite noting the proposals in the US to prohibit investment advisers from acting on behalf of hedge funds and mutual funds, the *Working Party* concluded that current UK regulations already require investment managers to have policies and controls in place to address customer order priority, fair allocation, release of internal analyst's recommendations, access to portfolio positions between staff managing different types of fund etc. However, the *Working Party* also concluded that this was wider than just a *CIS* issue, and that management and explanation of such conflicts was critical for the maintenance of *Investor* confidence in the UK investment management industry.

Recommendation no. 7 - Agreeing Standards

The Board of Directors of *IMA* should instigate a review to identify best practices, which, if adopted and adhered to, by UK investment managers, would demonstrate appropriate management of client mandates with potentially conflicting strategies.

8 Key CIS participants - responsibilities

The *Working Party* reviewed the *CIS* value chain document (see Appendix 3) to ascertain whether there was clear understanding of all relevant responsibilities, by the parties involved. In particular, it considered whether:

- the responsibilities for all activities and the responsible parties involved are clearly understood by the industry, *Investors* and the *FSA*;
- there are activities where independent oversight could be extended to add value;
- there are any over-lapping responsibilities which could be rationalised with reduction in potential confusion of roles and with potential cost savings;
- there are instances where, due to current regulations, the responsibilities of *Trustees* and *Depositaries* significantly differ, and if so, whether regulatory change is desirable to bring these into line;
- recommended changes could be achieved by industry agreement, or whether regulatory change would be either needed or desirable.

8.1 Manager

8.1.1 Costs disclosure

In May 2002 following consultation with *IMA Members*, the *PFDC* was adopted by the Board of *IMA*. The objective of the *PFDC* is transparency in order to assist pension fund trustees' understanding of the charges and costs levied on pension fund assets, facilitated by comprehensive, clear and standardised disclosure that will allow pension fund trustees and their advisers to monitor and compare all costs incurred during the management of the fund's assets. Appendix 6 details the narrative (Level One) disclosure currently being produced by managers of pension funds, and is likely, in due course, to require some expansion to take account of *IMA's* Enhanced Disclosure proposals (see section 8.1.2).

> **Level One Disclosure**
>
> *PFDC* Level One disclosure is not client specific, but comprises a generic narrative description of the investment manager's internal processes and policies in relation to a number of investment management activities, e.g. best execution, broker selection, transaction cost analysis etc. This is produced in a formal report to the pension fund trustees.

IMA Members have commented that as this information has been found to be valuable to pension fund trustees, it would seem logical that similar disclosure is extended to *CIS*, to ensure that the economic interests of their *Investors* are protected. The questions are, to whom should disclosure be made and who should do the monitoring, as it has to be acknowledged that *Investors* are generally unlikely to be able to fulfil this function. The *Working Party* also noted that many *Managers'* affiliated investment managers were already producing Level One reports for their pension fund client base, and that for practical purposes Level One reports for *CIS* would be identical with these and would not require significant additional effort.

> **Recommendation no. 8 – Improving Disclosure**
>
> *Managers* should produce, and supply to the *Depositaries*, annual reports similar to the *PFDC* Level One disclosure, or the enhanced disclosure currently being developed with interested parties (see section 8.1.2 and recommendation 11).

Recommendation No. 15 also requires a proportionate degree of increased oversight by the *Depositary*.

The *CIS SORP* ensures that management, *Depositary*, audit fees and other charges against income are already disclosed in *CIS* report and accounts, to a similar level of detail as required by the *PFDC* Level Two disclosure (see Appendix 7 and insert box). The *CIS SORP* currently only requires disclosure of the total cost of portfolio purchases and net proceeds of sales, and not the level of detail required by *PFDC* Level Two (Appendix 3). The *Working Party* took the view that it was appropriate to include further and better information in *CIS* report and accounts.

Level Two transaction Disclosure (see Appendix 7)

This is a report of client specific data, showing, in tabular format: Fees and other costs of management; A summary of portfolio transactions during the period, including trades through top ten brokers, net and commission business, deals through affiliates etc. FX costs are included if material.

Recommendation No. 9 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require the disclosure in *CIS* report and accounts of the totals of broker commissions, taxes and any other charges included within portfolio purchases and sales.

Recommendation No. 10 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require a portfolio transaction report to be included as a note in *CIS* report and accounts, detailing in numerical terms the total of transaction volumes, analysed over the top ten counterparties by volume, and by net and commission based trading, and a remainder. Any counterparties that are affiliates of the *Manager* or the *Depositary* should be identified as such.

Gross portfolio turnover and commissions in this table should reconcile to the total figures disclosed in *CIS* report and accounts following recommendation 9 above.

The *Working Party* bore in mind the concern that whilst many *CIS Investors* would be interested in this additional information, some may not be sufficiently experienced to make informed judgements on it. However, it is thought that many advisers and not a small proportion of *Investors* will find the information of benefit. Recommendation No. 15 addresses this particular point by requiring a proportionate degree of increased oversight by the *Depositary*.

8.1.2 <u>Portfolio transaction costs – Enhanced Disclosure</u>

IMA's response to *FSA* CP176: Bundled brokerage and soft commission arrangements, proposed a disclosure regime entitled "Enhanced Disclosure", which effectively is an expansion of the *PFDC* Level One disclosure (see section 8.1.1) and Level Two transaction analysis. This *IMA* proposal will require a sub-division of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class. The proposal recognises that investment managers may have to produce reports for a number of different categories of client, potentially with different reporting periods, and suggests

that investment managers may select one standard reporting period for their full client base comparison.

The *FSA* has made it clear that it did not intend CP176 to apply to pension funds only, and has stated that it intends "to review current arrangements and standards for the governance of retail funds and that action in that area could help to deliver the benefits of enhanced disclosure to, private investors, who are unlikely to have the knowledge or market power to engage directly with fund managers on these issues".

FSA had discussed the Enhanced Disclosure proposals with the *IMA* and went on to state, "We are aware that the IMA has itself begun work in this area and we look forward to the results of this work". Subsequently, Lindsay Tomlinson, Chairman of *IMA*, wrote to John Tiner, Chief Executive of the *FSA*, on 31 March 2004, outlining *IMA's CIS* Governance project and reiterating that Enhanced Disclosure would be addressed.

IMA is carrying out a separate consultation with *Members* on Enhanced Disclosure. Full details can be found in *IMA* Circulars 243/04 (issued on 28 October 2004) and 005/06 (issued on 12 January 2006).

Recommendation No. 11 – Improving Disclosure

Contingent upon Enhanced Disclosure being adopted by *IMA* and accepted by the *FSA*, the *CIS SORP* should be amended to incorporate the *IMA* Enhanced Disclosure proposals, and the portfolio transaction report described in recommendation 10, should be expanded to include a split of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class.

The *Working Party* bore in mind the concern that whilst many *Investors* would be interested in this additional information, some may not be sufficiently experienced to make informed judgements on it. However, it is thought that many advisers and not a small proportion of *Investors* will find the information of benefit. Recommendation No. 15 addresses this particular point by requiring a proportionate degree of increased oversight by the *Depositary*.

8.1.3 Manager's box – trading in units as principal

It is common in the UK for the *Manager* to run a principal position in the units or shares of the *CIS:* this is called the *Manager's* box. Most boxes are designed as administrative buffers, with the flows of *Investor* deals netting down to the same, or a similar position, each day. In practice they can provide a source of administrative convenience, especially given the time constraints under which, currently, *Managers* must advise *Depositaries* of the day's dealing in the *CIS*. They are particularly helpful in assisting the *Manager* to avoid negative boxes (a short position in the units or shares), which can arise from administrative errors, such as simple deal input errors, and which is a breach of *CIS* regulations.

While the practice is for most boxes to be run in this way, there is a no specific prohibition on taking a more aggressive approach and accepting more substantial box positions than administrative convenience itself would suggest.

The *FSA*, in CP131 (on single pricing), stated "boxes can, as suggested by many respondents, serve a useful function for the efficient operation of a fund…"

Nevertheless, the *Manager's* box can generate both profits and losses resulting from the market movement in the *CIS* itself and the prices at which it buys and sells shares and units for and from the box.

The *Working Party* believes that it is important to recognise that these arrangements have from time to time given rise to perceptions of conflict of interest. In order to address this, the *Working Party* has decided to make recommendations regarding the disclosure of the *Manager's* policy and extending the oversight role of the *Depositary*. The *Working Party* also suggests that, in the interests of transparency, *Managers* may wish to make available, upon request from *Investors*, copies of their own report and accounts, including details of profits or losses made on boxes across the *Manager's* range of UK authorised *CIS*.

Recommendation No. 12 – Improving Disclosure

FSA CIS regulations should be amended to require that the *Manager* includes within the *CIS* prospectus, a statement of its policy on box management, making clear the purposes for which the box is used.

Recommendation No. 13 – Extending the role of the Depositary

The *Depositary's* oversight role should be extended to review of the *Manager's* use of the box and confirmation that it has been managed in accordance with the policy set out in the prospectus. The prospectus disclosure should be amended if it is not accurate or current.

8.2 Depositary

8.2.1 Oversight of investment management activities

As noted in section 8.1.1 above, following consultation with its *Members*, the *PFDC* was adopted by the Board of *IMA* in May 2002.

To date, these investment management activities have fallen outside the scope of detailed *Depositary* oversight. *Members* have commented that, as this information has been found to be valuable to pension fund trustees, it would seem logical that these areas are also monitored for *CIS*, to ensure that the economic interests of *Investors* are protected, in the same way as pension fund beneficiaries.

Recommendation No. 14 – Extending the role of the Depositary

The *Depositary* oversight role should be extended to cover Level One disclosure, to ensure that the *Manager* has adequate procedures and controls in place. This oversight should include interrogation of the *Manager* as to its processes and reviews of the *Manager's* own internal monitoring programmes and the results of that monitoring, based on the information supplied in the *Manager's* Level One report (see recommendation no. 8 above).

Recommendation No. 15 – Extending the Role of the Depositary

The *Depositary* oversight role should be extended to cover a review and appropriate questioning of the portfolio transaction report, including Enhanced Disclosure, described in recommendations 10 and 11.

8.2.2 Dilution levies and adjustments

CIS regulations provide that the *Depositary* has responsibility for oversight of the activities of the *Manager* in relation to the *CIS* and protection of the interests of the beneficiaries, i.e. incoming, ongoing and outgoing *Investors*. Current regulations specifically require the *Depositary* to ensure that the *Manager* considers whether or not to apply a dilution levy (or other dilution adjustment), taking account of all factors to protect single-priced *CISs*. However, the *Depositary* is directly excluded from any duty in ensuring that the conclusion reached by the *Manager* is in the interests, of *Investors*.

Recommendation No. 16 – Agreeing Standards

Managers and *Depositaries* should adopt the statement of practice in relation to dilution levies and adjustments set out in Appendix 4.

Recommendation No. 17 – Extending the Role of the Depositary

FSA CIS regulations should be amended to bring within the *Depositary's* oversight ambit, the *Manager's* compliance with its policy on charging dilution levies or other adjustments (see recommendation 16).

9. Transparency

The *Working Party* considered whether there are adequate mechanisms in place to ensure the appropriateness of all material fees and expenses charged to *CIS*, and in particular:

- whether all costs/income noted in the *CIS* value chain document (see Appendix 3) are appropriate to be borne/received by the *CIS*, including all earnings from *CIS* assets, even if not generated directly by the *CIS*, e.g. revenue sharing on stock-lending fees;
- how each cost is currently disclosed, including those costs that are levied by one party and subsequently shared with another party, and how accessibility of this disclosure could be improved;

The *Working Party* was not interested in setting pricing benchmarks which it sees as a function of the market, but focussed rather on whether a mechanism existed to ensure that costs were transparent, correctly accounted for and adequately disclosed.

9.1 Income and fees - stock-lending

Stock-lending provides a distinct revenue stream, differing from dividends and interest earned from standard investment management activities. The costs associated with stock-lending are also different in that they are only incurred by the lender if revenues have been earned, and are then deducted directly from those revenues. Stock-lending income is, however, sometimes, included in *CIS* report and accounts as a net figure without disclosure of related costs and sometimes gross, with costs shown separately. Such varying treatment is unhelpful in ensuring standardised disclosure.

Recommendation No. 18 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to reflect the distinct nature of stock-lending income and related costs, by requiring that such income be reported net in the Statement of Total Return, and that related fees and expenses be separately disclosed, by way of a note, in *CIS* report and accounts.

9.2 Revenue sharing

Stock-lending fee revenues, whilst being disclosed in *CIS* report and accounts as a payment to the stock-lending agent, may subsequently be shared with the *Manager*, *Depositary* or affiliate of either. The *Working Party* concluded that potentially there might be other charges levied against funds that could be shared between key participants.

Recommendation No. 19 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require that, in relation to any charges or costs levied, directly or indirectly, against the assets of a *CIS*, disclosure should be made in the report and accounts of any revenue sharing participated in by the *Manager*, *Depositary* or affiliates of either.

9.3 Fees and Expenses - Total Expense Ratios ("TERs")

Included within *FSA's* Consultation Paper 04/18: Implementation of the Simplified Prospectus requirements in the UCITS Management Company Directive, is a proposal that *TERs* will in future be disclosed in the Simplified Prospectus. The paper also sets out an EU standard formula for calculating the *TER*, using data disclosed in the *CIS* report and accounts. The *FSA* already requires disclosure of *TERs* in *CIS* short reports.

The *Working Party* considers the *TER* to be a vital source of *Investor* information and noted that the necessary data for calculating *TERs* will be included in the audited report and accounts. The *Working Party* also noted that disclosure of the *TER* is only a requirement for *UCITS*, and that it would also be a valuable source of information for *Investors* in *non-UCITS retail funds* and would facilitate cost comparison across the full range of those *CIS* products targeted at retail *Investors*, more effectively than the existing Reduction in Yield disclosure, which requires comparison of an arbitrary projection with a rate of return which is entirely theoretical. It is noted, however, that some clarification will be required for the calculation of *TERs* for *CIS* invested in property, in particular clarification as to which costs can be excluded from the *TER* as expenses rather than charges.

Recommendation No. 20 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require a note showing the calculation of the *TER* to be included in the audited annual report and accounts of *UCITS* and *non-UCITS retail funds*. In the event that the *Manager* believes that it is necessary to update the *TER*, an un-audited version of this calculation should be included in the interim report and accounts.

Recommendation No. 21 – Improving Disclosure

Upon implementation of the Simplified Prospectus regime for UCITS, *FSA* should also require disclosure of *TERs* in *non-UCITS retail fund* Key Facts/Key Features documents. This *TER* disclosure should replace the existing Reduction in Yield disclosure.

9.4 Fees and Expenses – level playing field

The CIS Sourcebook rules for *OEICs* and the COLL Sourcebook rules for both *OEICs* and *AUTs,* give *Managers* more latitude in charging costs to *CIS* than is currently available to *Managers* of *AUTS* operating under the CIS Sourcebook. Examples of the costs that may be charged to *OEICs* and new *AUTs* include the production costs of report and accounts, prospectus and short reports and additional administration fees.

The *Working Party* was concerned that these differing standards would make it problematic for an *Investor* or their adviser to make a sensible fund expense comparison. Recognising that this lack of clarity will persist until 2007, when all *CIS* must have converted to the COLL Sourcebook, the *Working Party* considered the impact of standardised *TERs*.

Recommendation No. 22 – Improving Disclosure

The *IMA* should encourage *Managers*, the *FSA*, *Investors* and their advisers to transfer their attention from the detailed *CIS* costs laid out in report and accounts, to *TERs*, which will be required to be disclosed in *CIS* Simplified Prospectus documents (when implemented), and short reports.

9.5 Provision of portfolio details to Investors

The *Working Party* considered issues arising out of the supply, by *Managers*, of *CIS* portfolio details to investment managers of fund of funds, who, for good commercial reasons, wish to have such data updated on a regular and frequent basis. The provision of such information may involve disclosure at a level of detail or with a frequency greater than that with which more general disclosures of information are made.

The *Working Party* considered whether the same disciplines that inform the way listed companies disclose material information should be applied by analogy to *CIS*, and whether the *CIS* industry should attempt to set a common portfolio disclosure standard.

It was agreed that any disclosure policy should strike the right balance between the legitimate enquiries and demands for information of *Investors* and would-be *Investors*, and the protection of the intellectual property of the *CIS,* from which its *Investors* benefit. Whilst different *Investors* have different information requirements, the obligation to treat *Investors* fairly would argue that any selective disclosure must be handled very carefully. If particular *Investors* are able to take advantage of any information that is not made available to other *Investors*, this could be regarded as "unfair".

The *Working Party* also noted the strong argument that the *CIS* market might operate more fairly and more efficiently if material information was made available to all *Investors* at the same point in time. This would still allow *Investors* with quicker response times and smarter investment decision-making to prosper.

Recommendation No. 23 – Agreeing Standards

Managers should establish, and monitor adherence to, a formal policy as to the frequency and timing of the release of portfolio details to *Investors*, or to classes of *Investors* (see *IMA's* Market Timing Guidelines for Managers of Investment Funds issued 6 October 2004). The *Manager's* policy should be disclosed in the *CIS* prospectus.

Appendix 1

IMA CIS GOVERNANCE WORKING PARTY - TERMS OF REFERENCE

To review the present arrangements for oversight of *AUTs* and *OEICs*, in particular in relation to actions that might be detrimental to the interests of *Investors*, individually or collectively, including any that might arise from conflicts of interest.

To benchmark these arrangements against international best practice.

To consider whether changes would be desirable, either through new regulation, or through the adoption of best industry practice, taking due account of the cost effectiveness of such changes.

To make appropriate recommendations to the Board of Directors of *IMA*.

Appendix 2

CIS GOVERNANCE WORKING PARTY - MEMBERS

Chairman – Lindsay Tomlinson – Chairman of IMA and Vice Chairman Europe, Barclays Global Investors

Alan Ainsworth – Deputy Chairman, Threadneedle Investment Services

Clive Brown – Head of Europe, Asia and Japan, JP Morgan Fleming Asset Management

Jeremy Burchill – Member of IMA's General Regulations Committee and Head of Group Legal, Aberdeen Asset Management

Peter Craft – Chairman of the Depositary and Trustee Association (September 2003 – August 2004) and Director, RBS Trustee and Depositary Services

Tim Gandy – Chairman of the Depositary and Trustee Association September 2004 to date) and Senior Vice President and Managing Director, J.P. Morgan Trustee and Depositary Company Limited

Simon Ellis – Chairman of IMA's Investment Funds Committee and Head of Retail, AXA Investment Managers

Tim Herrington – Partner, Clifford Chance

Keith Marsden - Chairman of IMA's Product Development Committee and Head of Sales, Fund Administration, Barings

Colin McLatchie – Managing Director, Aegon Asset Management

Jane Petkovic – Member of IMA's Investment Funds Committee and Joint Managing Director, Jupiter Unit Trust Managers

Richard Wastcoat – Member of IMA's Investment Funds Committee and Managing Director, UK Mutual Funds Business, Fidelity

Jeremy Willoughby – Group Compliance and Risk Director, Schroders plc

Secretaries to the Working Party – Jim Irving, Senior Adviser – Regulation, and Ros Clark, Technical Adviser, Investment Management Association.

CIS VALUE CHAIN

APPENDIX 3

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Structure						
Manager replacement etc	I	*CIS*	P, RA, KFD	N/A	N/A	CIS is *Manager's* branded product. **See sections 3 and 7.1**.
Depositary - selection/change	M	*CIS*	P, RA, KFD			Oversight role but not an independent appointment and whilst regulations do not envisage the *Manager* replacing the *Depositary*, in practice this is a commercial issue and is the case. **See sections 7.2 – 7.3 and recommendations 2, 3, 4 and 5.**
						Change of *Depositary* may be part of a wider arrangement involving affiliates of *Manager* and/or *Depositary*. **See section 7.3 and recommendation 4.**
Depositary – fee levels	M	*CIS*	P, RA			No identified issues.
Appointment of affiliates of *Manager* or *Depositary* to carry out any activities on behalf of fund	M	*CIS*	P, RA	MC	T	Potential conflicts of interest. Current rules require disclosure in P of all affiliate arrangements. **See section 7.5 and recommendation 6.**
						Not all payments to affiliates (e.g. broking commissions) are required to be disclosed in RA**. See section 8.1.1 and recommendation 10.**
						Affiliates of *Depositary* (that has oversight role) may be appointed to carry out fund activities. **See section 7.5 and recommendation 6.**

KEY

C – Custodian
FA – Fund auditor
IC – Investment Adviser's Compliance Unit
MA – M's auditor
RA – Report and accounts
TC – T's Compliance Unit
CN – Contract Note
I - *Investor*
KFD – Key Features Document
MC – M's Compliance Unit
SP – Simplified Prospectus
V – Standing Independent Valuer
CIS – Collective Investment Scheme
IA – Investment Adviser
M - *Manager*
P - Prospectus
T – Trustee / *Depositary*

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Fund management						
Investment manager - selection	M	M	P, RA, KFD		T	*Depositary* reviews *Manager's* due diligence if a third party appointment.
Investment manager – fees	M	M or *CIS*	P, RA, KFD		T	If paid out of *Manager's* fee no issue. If paid direct by CIS, will be disclosed in P and subject to *Depositary* oversight.
Investment manager – also managing other types of funds	M	*CIS*		MC		Potential for conflict of interest if investment manager also manages other types of funds, with potentially conflicting strategies, e.g. hedge funds or other *CIS* funds with performance fees. **See section 7.6 and recommendation 7.**
Performance	IA,M	*CIS*, IA, M	RA, SP	M		
Corporate actions decisions	IA,M	*CIS*		IC, MC		
Voting on *CIS* portfolio holdings	IA,M	*CIS*		IC, MC		*Depositary* executes documents on instructions from *Manager*. Direct responsibility of *Depositary* when vote is in relation to a holding in another fund managed by the *Manager*.
Adherence to investment objective and policy	IA,M	M	RA	IC, MC, FA	T, FA	No identified issues. *Depositary* has day-to-day oversight responsibility and will note material breaches in its report in RA. The *CIS* auditor will review at the accounting year-end.
Placing of deposits	IA,M	*CIS*	RA	IC, MC	T	*Depositary* will place deposits on instruction of investment *Manager*. Potential for conflict of interest if counterparties are affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**
Borrowing	IA,M	*CIS*	RA	IC, MC, FA	T	*Depositary* ensures interest charges on unnecessary borrowing arising from mismatches between portfolio buy and sell trades or breaches of 10% borrowing limits reimbursed by the *Manager*. Potential conflict if borrowing is from affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Portfolio dealing						
Transactions costs - general	IA,M	*CIS*		MC		Current *CIS SORP* does not require disclosure of gross portfolio transactions and related costs e.g. commissions, stamp duty, etc in the RA. Only gross totals are shown. **See section 8.1.1 and recommendations 8 to 11.**
Choice of dealing venues, e.g. brokers/ crossing networks etc	IA,M	*CIS*		IC, MC		*Manager's* choice of cheapest /most efficient venues, e.g. crossing networks, dealing for commission or net etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers - selection	IA,M	*CIS*		IC, MC		*Manager's* choice of counterparties, potentially affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.** Potential for inducements. CP 176. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers selection - access to initial public offerings and underwriting	IA,M	*CIS*		IC, MC		Potential for fund volumes to be used for benefit of other clients **See section 8.2 and recommendations 14 and 15.**
Brokers - allocation of transaction targets	IA,M	*CIS*		IC, MC		Reciprocation, i.e. direction of commissions to broker in return for promotion of fund. CP 176. Commission direction to reimburse brokers for absorbing a *Manager's* loss. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers – turnover levels	IA,M	*CIS*	RA	IC, MC, FA		Potential for churning to achieve commission targets required by *Manager* for soft commissions, access to research, initial public offerings, etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Brokers - negotiation of commission rates	IA,M	*CIS*		IC, MC		Potential for commission rates to be agreed to achieve targets required by *Manager* for soft commissions, access to research, initial public offerings, etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Transaction costs (commissions, market impact, opportunity costs) analysis and management	IA,M	*CIS*				Effectiveness of *Manager's* transaction cost analysis and consequential impact on transaction costs of funds. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Best execution	IA,M	*CIS*		IC, MC	T (limited)	Effectiveness of controls. Directed brokerage (softing /reciprocation). **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Customer order priority/fair allocation	IA,M	*CIS*		IC, MC	T (limited)	Effectiveness of controls for fair dealing between customers. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Timely allocation (including late trade notification)	IA,M	*CIS*		IC. MC	T (limited)	Effectiveness of controls. Re-imbursement for interest charges levied on late/failed trades. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Fund accounting						
Fund accountants - selection	M	M				Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Fund accountants – fee negotiation	M	M	X (*AUT*) RA if separate fee in *OEIC*			Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Fund auditors – selection	M	*CIS*	RA		T	Oversight role but not an independent appointment. Potential for conflict of interest if also *Manager's* auditors. **See Section 7.4.**
Fund auditors – fees	M	*CIS*	RA		T	Fund Auditors have an Oversight role but their remuneration is negotiated with the *Manager*. **See section 7.4.**
Long Form Report and Accounts	M	*CIS*	RA		FA, T	Technical financial reporting often too complex for *Investors*. Otherwise, no issues. **See short report below.**
Short Reports	M	*CIS*	N/A	MC	X	Simplified reporting targeted at areas of interest to *Investors*. No issues. Have to be produced by February 2007 at the latest. No issues.
Total Expense Ratio (*TER*)	M	*CIS*, I	SP, SR	MC	X	Standard format set out in EU Simplified Prospectus rules. Based on figures in RA. **See section 9.3 and recommendations 20 and 21.**
Calculation of distributions	M	*CIS*	RA	TC, MC	FA, T	No issues.
Valuation - securities	M	*CIS*, I		TC, MC	T	Market Timing – oversight by *Depositary* of valuation process, including the use of fair value pricing where appropriate.
Valuation - property	V	*CIS*, I	P	MC	T	Appointed by Manager. Must comply with Royal Institution of Chartered Surveyors' Appraisal and Valuation manual.
Pricing – daily calculations	M	*CIS*, I	CN, Press	TC, MC	T	Potential for conflict of interest if errors are made and administrators or fund accountants are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Pricing – publication of prices	M	*CIS*		MC	T	Prices can be published in national newspaper or on internet.

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Investor dealing						
Third party administrator selection	M	M		MC	T	Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.** If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Dealing – daily activities	M	*CIS*, I	CN	TC, MC	T	Late trading controls. Market timing policy and controls. Potential for conflict of interest if errors are made and administrators are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Dilution levy/adjustment – policy	M	*CIS*, I	P, KFD	MC	T	Risk of Market Timing. **See section 8.2.2 and recommendations 16 and 17.**
Dilution levy/adjustment – application	M	*CIS*, I	CN	TC, MC		Market Timing. Levied at the discretion of the *Manager*, but direct impact on fund and incoming /outgoing *Investors*. **See section 8.2.2 and recommendations 16 and 17.**
Market timing – *Manager's* detection and preventative procedures	M	*CIS*, I		MC		Effectiveness of controls. **See section 8.2.2 and recommendations 16 and 17.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Registration						
Registrar selection – *AUT*	T (CIS Sourcebook) M or T (COLL Sourcebook)	*CIS*	P	MC	T	Potential for conflict of interest if affiliates of *Depositary* **See Appointment of Affiliates under Structure above.** If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Registrar selection – *OEIC*	M	*CIS*	P	MC	T	*Manager's* direct responsibility. Potential for conflict of interest if affiliates of *Depositary* – **see Appointment of Affiliates under Structure above**. If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Registrar – fees	M, T	*CIS*	P	MC	T	No issues.
Registration fees charged by fund supermarkets	M	*CIS*	P, RA	MC	T	Prohibited under new COLL Sourcebook rules. Permitted under old CIS Sourcebook rules when disclosed in P of new *OEIC* or approved at holders' meeting.
Registration activity	M, T	*CIS*		TC, MC	T	Potential for conflict of interest if errors are made and registrars are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Custody						
Custodian and sub-custodian selection	T	*CIS*	P	T	N/A	Direct responsibility of the *Depositary*. Potential for conflict of interest if affiliates of *Depositary* – **See Appointment of Affiliates under Structure above.**
Custodian/sub-custodian – fees	T	*CIS*	RA	T	N/A	Fee level disclosed in P. Potential for conflict of interest if affiliates of *Depositary* **– See Appointment of Affiliates under Structure above.**
Settlement	T	*CIS*	N/A	T	N/A	Potential for conflict of interest if errors are made by a custodian that is an affiliate of *Depositary* – **see Appointment of Affiliates under Structure above.**
Corporate actions - processing	T	*CIS*	N/A	T	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Foreign exchange transactions	M, T	*CIS*	X (included within transaction costs)	MC	T	Potential for conflict of interest if affiliate of *Depositary* – **see Appointment of Affiliates under Structure above.**
Income collection	T	*CIS*	RA	TC, MC	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Distribution payments	T	*CIS*, I	RA	TC, MC	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Stock lending agent selection	M, T	*CIS*		MC	T	Potential for conflict of interest if affiliates of *Depositary* or *Manager* **– see Appointment of Affiliates under Structure above.**
Stock-lending net income	SA	*CIS*	RA	MC	T	Potential for conflict of interest if stock-lending agent is affiliate of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Stock-lending fees	M,T	*CIS*	X	MC	T	Potential for conflict of interest if only net income after deduction of fees is disclosed (n.b. not permitted in *AUTs*). **See section 9.1 and recommendation 18.**
Stock-lending fee sharing arrangements	M, T	SA, M			T	Potential for conflict of interest if *Manager* shares stock lending agent's fees without disclosure **See section 9.1 and recommendations 18 and 19.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Management company activities						
Advertising/promotional payments	M	M	N/A	MC	X	Outside the Scope of this project. Costs paid by *Manager*.
Fund Prospectus	M	M	N/A	MC	T	*Depositary* will review it for accuracy, as it is part of fund constitutional documentation.
Schemes of Arrangement (fund mergers)	M	*CIS*	SAD	MC	T, FSA	Subject to approval of *Depositary*, *FSA* and *Investors* of discontinuing fund.
Management fees	M	*CIS*, M	P	MC	T	Rate disclosed in P. *AUTs* operating under the CIS Sourcebook are much more restricted in the costs that can be charged to the fund than *OEICs* or any new *AUTS* operating under the COLL Sourcebook. Comparison between funds by an *Investor* is thus challenging. **See section 9.4 and recommendation 22.**
Registrar fees, ad valorem administration fees, production costs of Prospectus, Long Form Report and Accounts, Short reports	M	*CIS*	P, SP, KFD, RA	MC	T	Not permitted in *AUTs* operating under the CIS Sourcebook, but permitted in *OEICs* and *AUTs* operating under the COLL Sourcebook. **See section 9.4 and recommendation 22.**
Manager's auditor – selection	M	M	N/A	N/A		Potential for conflict of interest if also fund auditors. **See section 7.4.**
Manager's auditor – fees	M	M	N/A	M		Potential for conflict of interest if also fund auditors. **See section 7.4.**
Box management	M	M		MC	T	Box activities and profits not required to be disclosed. **See section 8.1.3 and recommendations 12 and 13.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
IFA commission payments	M	M	CN, KFD	MC		Effectiveness of current disclosure of initial and annual commission
Revenue sharing arrangements	M	M				No disclosure requirements. **See section 9.2 and recommendation 19.**
Provision of portfolio details to *Investors*	M	*CIS*, I	RA	TC, MC		Market Timing. Encouragement of fund sales for benefit of *Manager*. Fund of Fund investment managers need regular portfolio details. Equal treatment of all *Investors*. **See section 9.5 and recommendation 23.**
Soft commissions – benefits received	M	*CIS*		MC		Currently no disclosure. Likely that Simplified Prospectus will require soft commission benefits to be included within *TER*.
Staff personal dealing	M	N/A	N/A	MC		Market Timing. Front running. **See section 8.2.1 and recommendation 14.**

Appendix 4

JOINT IMA/DATA DRAFT STATEMENT OF PRACTICE IN RESPECT OF THE APPLICATION OF DILUTION LEVIES AND ADJUSTMENTS TO AUTHORISED INVESTMENT FUNDS

Manager's Dilution Policy

The effective implementation of the *Depositary's* oversight responsibilities in relation to dilution levies/adjustments can only be achieved if the *Manager* has a clearly defined policy.

Where these policies require disclosure in the prospectus, it is recognised that *Managers* may prefer to keep such disclosure at a high-level (consistent with the relevant rules) because it is impossible to cover every conceivable scenario in such a document. However, where this is the case, *Managers* would be expected to maintain a separate document setting out their detailed policy. This will enable the *Manager* to demonstrate their compliance with the policy concerned and facilitate monitoring by the *Depositary* as part of their oversight responsibilities.

Policy decisions made by *Managers* must be documented, supported by appropriate evidence and subject to review at appropriate intervals.

For example, when a *Manager* asserts that dilution has no material effect on the *CIS*, this must be supported by evidence confirming that this is the case. The *Manager* should periodically revisit any calculations used on a continuing basis to ensure that the basis of calculating the effect of dilution remains valid.

Effectiveness of Manager's Dilution Policy

The *Manager* should retain appropriate evidence that the policy is operating effectively. One way of demonstrating this would be evidence that:

- adherence to the policy matter is included in the *Manager's* own internal audit/compliance monitoring programme ("CMP");
- monitoring reviews are performed in accordance with the CMP timetable; and
- any findings resulting from the CMP are tracked until satisfactory resolution is achieved.

Depositary monitoring

In line with its duty of oversight, the *Depositary* will undertake monitoring of the *Manager's* policies and procedures and of the effectiveness of those procedures. How this is achieved will be at the discretion of the *Depositary*, but this may include testing, on a sample basis, of individual decisions of the *Manager* to impose or not impose, a dilution levy or adjustment.

Appendix 5

ALTERNATIVE CIS GOVERNANCE MODELS

Australia

Under Australia's Managed Investments Act (subsequently incorporated into the Corporations Act) a manager may be appointed as the "Single Responsible Entity" for all its managed investment schemes. As such it is in complete control and is totally responsible for all aspects of each of the funds. There is no requirement for a board of directors or a depositary.

Whilst the manager may outsource custody for its funds, together with investment management, fund accounting and unit pricing, it retains full regulatory responsibility for these activities and must have in place a rigorous monitoring program over each provider's activities, including compliance review inspection visits and formal compliance reporting.

The regulations also set out detailed requirements for the manager's compliance plan, which has to be made publicly available, and for independent compliance committees in respect of each registered fund, if less than half of the directors of the Responsible Entity are independent directors. The compliance committee must comprise at least three members, the majority of whom must be independent, and is charged with monitoring adherence with the compliance plan of the particular fund.

If, in the compliance committee's view, the Responsible Entity does not take appropriate steps or propose to address a requirement of either the Corporations Act, or the fund's constitution, the committee is obliged to report the position to the Australian Securities and Investments Commission. The committee must also assess the compliance plan to ensure its adequacy and recommend changes if appropriate.

United States

US mutual funds, authorised under the 1940 Investment Company Act, are governed by a board of directors, whose responsibility is to ensure that the manager executes its business affairs in the best interests of *Investors*. This responsibility has recently been supported by new rules regarding the reporting lines of a compliance officer direct to the board, and the emphasis on the ability of the board to acquire the services of whatever people or other resources it might need to discharge its role.

The board of directors must have a majority of independent directors, and following a recent rule change, the board's chairman must be one of the independent directors.

Directors must exercise the care that a reasonably prudent person would take with his or her own money. They are expected to obtain adequate information, exercise sound business judgment, approve policies and procedures, and undertake oversight and review of the performance of the manager and other entities that perform services for the fund.

European Union/ United Kingdom

The *UCITS* Directive establishes minimum standards for governance of *UCITS* registered *CISs*. The Directive states that the depositary is responsible for the safe keeping of a fund's assets and for ensuring that sales, redemptions, cancellations and issues of units and the calculation of the value of units are effected in accordance with the law and rules of the fund. In this respect, UK regulation is super-equivalent to the *UCITS* Directive requirements and UK *Depositaries* have a significantly wider oversight role.

So far as the relationship between the manager and the depositary is concerned, it is a Directive requirement that no single company may act in both capacities and they must act independently of each other. However, the Directive does not prevent two companies within the same group acting as manager and depositary. The UK is, as far as we know, the only country to be super-equivalent in this way.

UK regulation is also super-equivalent to the *UCITS* Directive requirement concerning the relationship between the *Manager* and *Depositary*. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and *Manager* of an *AUT* and the *Depositary*, the *OEIC* and the Directors of an *OEIC* respectively. The CIS and COLL Sourcebooks identify three potential links between these parties:

- Directors in common - independence may be lost if, by means of executive power, either relevant party could exercise effective control the action of the other;
- Cross-shareholdings - independence may be lost if either of the relevant parties could control the actions of the other by means of shareholders' votes. The *FSA* considers this would happen if any shareholding by one relevant party and their respective associates in the other exceeds 15% of the voting share capital;
- Contractual commitments - the *FSA* would encourage relevant parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, whether directly or indirectly.

It is not uncommon within the EU, and in compliance with the *UCITS* Directive, for the manager and depositary to be fellow-subsidiaries of the same Group of companies. Historically of course, many continental European fund management companies were subsidiaries of banks, which branded their funds for distribution, and also already had in-house custody and administration operations.

Appendix 6

PENSION FUND DISCLOSURE CODE - LEVEL ONE DISCLOSURE

INVESTMENT MANAGER'S POLICIES, PROCEDURES AND CONTROL PROCESSES

Dealing venues and methods – description of the various dealing venues used, e.g. different types of brokers, dealing for commission and dealing net, programme trading, internal crossing, crossing networks, etc. How the investment manager decides between these alternatives and the impact that these decisions have on client transaction costs.

Broker selection and transaction volume allocation process – investment manager's processes, policy on credit ratings, how brokers' relative competence is established with regard to execution, research, etc. How this results in business level targets for each broker/dealing avenue, how this is split between commission bearing, soft commission and net dealing and how progress towards and variations from these targets are monitored on an ongoing basis.

Variations in rates of commission – investment manager's processes for negotiating commission rates and the impact on rates of commissions in different markets, e.g. UK/overseas, bond/equity, liquid/illiquid.

Soft commissions – investment manager's internal policy, justification (i.e. against potential lower commissions) and control processes to ensure compliance with current FSA regulations

Commission recapture – if applicable to the particular client, a description of the process.

Dealing Efficiency Monitoring - investment manager's policy and procedures designed to maximise the value of client portfolios and to control transaction costs while still trading effectively. This will include policy, procedures and assumptions for assessing execution costs, including bid/offer spreads, market impact and opportunity costs, whether the investment manager measures these and how the results are used.

Conflicts of interest - procedures for complying with *FSA* requirements for fair treatment of clients in the execution of orders and allocation of trades, and procedures to identify and manage actual and potential conflicts of interest (including dealing through associates). How the investment manager complies with current *FSA* regulations on inducements. An approximate number, type and overall value of inducements logged over the period.

External and internal research – investment manager's policy on using external research, how the benefit of that research is assessed and how it is funded.

Access to and allocation of Initial Public Offerings and underwriting – investment manager's policy plus procedures for complying with relevant *FSA* regulations and the extent to which securing allocations of initial public offerings and underwriting influences trading patterns.

Custody services - where the investment manager appointed the custodian, an outline of the investment manager's selection, monitoring and review processes.

Placing of deposits – investment manager's policy on spreading deposits, in particular as regards placing deposits with associates, policy on credit ratings, use of money-market funds.

Foreign exchange transactions – investment manager's policy in spreading foreign exchange transactions, in particular as regards placing these through associates, and policy on credit ratings.

N.B. As noted in Section 8.1.2, the IMA's Enhanced Disclosure project may require expansion from the current Level One disclosure requirements.

Appendix 7

PENSION FUND DISCLOSURE CODE - LEVEL TWO TRANSACTION DISCLOSURE

SUMMARY OF TRADING VOLUMES, COMMISSIONS AND FEES

Period to which disclosure relates:

Counterparty	**Trading volume for period**			**Commissions and fees paid during period**			
	Total	*Traded net*	*Subject to commissions*	*Total*	*Under softing arrangements*	*Under /directed or recapture arrangements*	*Other*
	£000	*£000*	*£000*	*£000*	*£000*	*£000*	*£000*
1							
2							
:							
9							
10							
Others > 5%							
:							
Others (total)							
Total							
% age	100%	[ ]%	[ ]%	100%	[ ]%	[ ]%	[ ]%

Guidance notes:

Disclosure is required of volumes undertaken through, and also commission paid to, different counterparties during the period. For each of these two categories, the top ten counterparties, plus any others representing over 5% of the overall total, should be listed. In this regard, counterparties include brokers (any associates of the investment manager being clearly noted), crossing networks and as a distinct category, the total of trades internally crossed by the investment manager. Clearly, different counterparties may feature in the table for different disclosure elements. The proforma will need to be customised accordingly.

MARKET TIMING

GUIDELINES FOR MANAGERS OF INVESTMENT FUNDS

September 2004

MARKET TIMING

GUIDELINES FOR MANAGERS OF INVESTMENT FUNDS

Introduction

Market Timing is not a precisely defined term, but generally refers to a trading strategy, often coupled with frequent purchases and sales of units/shares, in open-ended funds with the intention of anticipating changes in market prices. The generic term Market Timing, used in these Guidelines, describes two distinct activities, arbitrage and short-term trading.

Arbitrage can occur when an investor is aware that the security prices upon which a fund's dealing price is calculated do not take account of the most recently available market information. An example would be when a fund is priced using end of day prices from a market which closed for trading for a material period prior to the fund valuation point, e.g. a UK unit trust which is invested into US stocks, valuing at 12 noon UK time and using US market closing prices from 9.00 p.m. the previous trading day. During this period arbitrageurs may have concluded that prices will change significantly when the market reopens, perhaps based on Wall Street results releases, some global event after market hours or on indications from the global futures markets. Alternatively they may have taken a view on correlation between markets in different time zones, e.g. in a Far East fund by anticipating that if Wall Street falls a certain percentage, then Far Eastern markets may follow suit by perhaps a smaller, or a larger, margin. In the UK CIS industry, trades placed with funds by arbitrageurs are not illegal, but are generally regarded as being sharp practice.

Arbitrage can be distinguished from short-term trading, when investors take short-term trading positions, e.g. 5 to 10 days, based upon their own independent views, often resulting from quantitative analysis, as to future market directions.

Both arbitrage and short-term trading can be disruptive to fund management and can cause dilution in the fund to the detriment of long-term investors. The fund, and investors' interests, can be harmed by these activities, which can compel the Manager to retain a higher level of liquidity than would be ideal, or to buy and sell holdings more frequently than desirable, thereby incurring broker commissions, market spreads, market impact etc. The short-term trader adds to the friction of running the fund, the arbitrageur takes profits from the fund and actively picks the pockets of long-term investors.

Anecdotal evidence suggests that due to the UK's position in global time zones, what Market Timing has been detected in the UK has related to funds invested in the US or Far East markets, or into a European market that happens to be closed for a particular day whilst the fund itself is still open for trading. Clearly, the recent trend towards lower front-end fees has also made funds more attractive to investors with short time horizons. Approaches by Market Timers to Managers of dual priced funds may include a request that trading is retained within the Manager's box, so that the Market Timer is not hit by the bid/offer spread.

Market Timing and UK Regulatory Principles

Whilst Market Timing is not explicitly a breach of UK regulations, Managers are subject to over-riding fiduciary responsibilities and should also take note of the FSA Principles, in particular Principle 6, "A firm must pay due regard to the interests of its customers and treat them fairly" and Principle 8, "A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client". Principle 8 would

become especially relevant if Managers were to contemplate offering privileged access to the Market Timer.

The potentially harmful impact of such Market Timing needs to be understood by Managers of UK Investment Funds. Clearly, high value Market Timing has a cost impact on funds, and even if the costs are recouped by operation of a dilution levy/adjustment, the Market Timer, especially the arbitrageur, will in all likelihood still be benefiting at the expense of long-term investors. Even if the Manager has not afforded any special treatment to the Market Timer, he still has a fiduciary obligation to take all reasonable steps to discourage such traders.

The Senior Management Arrangements, Systems and Controls ("SYSC") module of the FSA Handbook notes that the FSA introduced these particular rules to encourage firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FSA because they impinge on the FSA's functions under the Act. The main matters of interest to the FSA are those which "relate to confidence in the financial system; to the fair treatment of a firm's customers; to the protection of consumers; and to the use of the financial system in connection with financial crime".

The FSA have seen this document and provided input to the production of these Guidelines.

The FSA carried out a review of Market Timing in winter 2003/04 and set out its findings and conclusions in a Press release on 18 March 2004, which is attached as an Appendix to this paper.

Purpose of these IMA Guidelines

These Guidelines have been drawn up under the sponsorship of the Board of IMA, and with the assistance of IMA's Investment Funds Committee, Product Development and Regulations Committee and General Regulations Committee. The Guidelines have been formally adopted by the IMA after full consultation with its Members.

The objective of the Guidelines is to provide Members with suggestions for a robust and demonstrably reasonable control framework that will give them, and the investors in their funds, comfort that Managers are taking all reasonable steps to help ensure that funds are being protected from the activities of Market Timers. Whilst these Guidelines have been prepared for the benefit of IMA's membership, they do not have the status of regulation and accordingly are neither binding nor evidential. Following these Guidelines may not demonstrate compliance with FSA rules and not following them, in itself, will not represent a breach of an FSA rule nor lead to regulatory action.

Each IMA Member should assess the risk represented to their funds and the funds' long-term investors by Market Timing activity and the extent to which the Member adopts these Guidelines will in large part be conditioned by that risk assessment. Not all the suggestions are appropriate to all business or operational models, but in aggregate, they represent a toolkit of policies and processes that could assist Members in protecting their funds.

Clearly, several of the policies and processes suggested are complex and require costly and sophisticated structures in which to function. Members are entitled to consider the cost implications of adopting any of these Guidelines in the light of the risk represented to their funds by Market Timing.

IMPORTANT NOTE

This document is intended to provide a helpful indication of some of the kinds of controls and procedures that may be adopted by Managers of Investment Funds to counter Market Timing.

The Guidelines do not purport to set out a minimum standard of conduct for Managers, neither would adoption of them necessarily represent any form of safe harbour under FSA Rules.

The Guidelines are in no way conclusive or exhaustive, and in many cases will need to be adapted to fit the operational and business model of the Manager, the expertise of the Manager's staff and any requirements that may be imposed upon the investment funds and/or the Manager either contractually or by regulation.

Managers should consider seeking appropriate external professional advice as regards the procedures, practices and controls they wish to adopt to combat Market Timing.

Whilst these Guidelines are aimed at providing assistance in the context of UK regulated funds, many of the policies and processes suggested could usefully be employed in respect of either unregulated or non-UK funds. However, we would caution Members to ensure that they consider any local restrictions and conditions that might mean that certain of these Guidelines may not be followed as here set out.

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Definitions

For sake of simplicity this document uses the following generic terms:

- *Board* – governing body of the Manager
- *Depositary* – a unit trust trustee or a depositary of an open-ended investment company
- *DATA* – the Depositary and Trustee Association
- *Fund* - a UK authorised unit trust or a UK authorised open-ended investment company
- *FSA* – UK's Financial Services Authority
- *Manager* – a manager of a UK authorised unit trust or an authorised corporate director of a UK authorised open-ended investment company

The Investment Management Association (IMA)

The IMA represents the UK collective investment scheme and investment management industry.

The IMA was formed on 1st February 2002 when the Association of Unit Trusts and Investment Funds (AUTIF) and the Fund Managers Association (FMA) merged to establish a new association.

IMA's key objectives are to:

- make representations to the UK Government on legislative, regulatory and taxation matters which affect the business interests of its members;
- liaise with the Financial Services Authority and other organisations in the UK and Europe on regulatory issues affecting investment funds and asset management;
- increase the public awareness and understanding of investment funds;
- seek to improve the standards of training in the industry;
- add value to member companies by providing them with information, guidance and assistance in matters related to their business;
- offer an information service to external parties interested in the activities of the UK investment funds industry.

Further information on the IMA can be obtained from its website (www.investmentuk.org).

1 Scope

These Guidelines are designed for the Managers of all UK Authorised Investment Funds ("Funds"), i.e. unit trusts or open-ended investment companies ("OEICs") and will assist them in discharging their responsibilities. Firms may wish to consider applying these Guidelines more broadly, although they have been developed within the context of the UK regulatory regime and not all recommendations will be appropriate in all jurisdictions.

2 Appropriate Supervisory Structure

Managers need to have a robust structure in place to defend against, identify and deal with Market Timing. This structure should include the following:

- Assigned responsibility of a member of senior management to have oversight of the policy, procedures and processes for ensuring effective controls are in place against Market Timing
- Formal acknowledgement of responsibility of all relevant staff (e.g. client facing staff and fund managers) to escalate potential or suspected abuses/suspicious approaches, to the above or another nominated member of senior management.
- A formal and approved policy on special dealing terms and procedures under which only nominated members of senior management may give approval for granting such terms
- Robust identification and escalation procedures including notification to senior management by the Manager's dealing desk of investor deals falling within certain parameters designed to filter out inappropriate trading patterns
- A formal and approved policy on the provision of detailed portfolio positions
- Comprehensive staff awareness and procedural training
- A clearly set out internal staff dealing policy/code of ethics in relation to dealing in Funds by members of staff. This could include a fixed holding period of sufficient length to prevent short-term trading, or a pre-approval process that would effectively prohibit arbitrage or short-term trading except in specified cases such as financial emergencies.
- A clear policy stating that the Manager's own investment strategies will not include Market Timing of investment funds, whether or not they are managed by the Manager or Associates.
- A formal policy in relation to box management, to ensure that any box management does not intentionally take advantage of time zone arbitrage variances or unintentionally afford greater facility to Market Timers.

In most cases the appropriate body for approving the relevant policy will be the Board of the Manager. References to senior management should be read as requiring someone of sufficient seniority and experience to be able to discharge the role competently.

3 Identifying Market Timing

Managers may wish to monitor trading patterns in the funds based upon parameters such as deal size and frequency. What measures are taken should be based on the Manager's assessment of the risk of the occurrence of Market Timing and the likely effect on the funds. Whatever steps are agreed upon, the details should remain confidential to the Manager to avoid Market Timers operating just outside the limits set.

As well as looking at individual trading patterns Managers should also consider the following high-level analytical tools:

- monitoring the level of deals in and out of the fund as a percentage of Total Net Assets. Funds vulnerable to Market Timers will often have higher than usual fund turnover rates
- monitoring the ratio of sales to redemptions. Consistent 1:1 ratios might be indicative of a Market Timer dipping in and out of the fund

The nature, investor profile and investment objective of the fund should be taken into account in setting the benchmarks for such monitoring

One of the difficulties facing Managers is the omnibus nature of many of the accounts that supply them with deal instructions. Overwhelmingly such accounts are for legitimate purposes and add to the cost-effectiveness of fund distribution. However, the US experience shows that Market Timers will use such accounts to camouflage and offset their dealing, making their dealing patterns more difficult to detect.

While Managers will not be able to look through to the underlying accounts, they should consider having a policy that:

- their terms of business with such holders of omnibus and nominee account holders set out the Manager's policy on Market Timing and the consequences of that account holder undertaking any activity designed to circumvent them
- omnibus accounts are subjected to an appropriate monitoring process

There is no golden rule as to how such accounts may be analysed. For the purposes of any redemption or short-term trading fee it may be appropriate to use a FIFO (first in first out) methodology so that charges are not levied on assets redeemed that have in fact been held for some time. However, it is also arguable that LIFO (last in first out) might be a better identification methodology for picking up round trips done from within an omnibus account, and provide a basis for further investigation.

4 Addressing Market Timing

In the event that a Manager has identified Market Timing, or has been approached with proposals to facilitate such activity, e.g. by way of a guaranteed waiver of dilution levy/adjustment or regular provision of detailed portfolio listings, doing nothing is not a supportable option. In the case of an approach this should be rebutted and consideration given as to whether there is a case for reporting the approach. Managers should be aware that short-term trading patterns may be linked to certain money-laundering methodologies and typologies and should bear in mind their obligations under the general law, the JMLSG Guidance Notes and the FSA's Money Laundering Sourcebook.

Fortunately there are existing rules that Managers can call upon to assist with one of two strategies, i.e. firstly, reducing the attractiveness of the Fund for Market Timing and, secondly, if a Market Timer is identified and does not amend their behaviour, turning them away.

A complication in dealing with such activities is that, as noted in 3 above, Market Timers may attempt to conceal their transactions within omnibus accounts operated by intermediaries. If the Manager applies some of the options described below in too draconian a manner, an unfortunate side effect can be that other innocent investors will also be impacted. The

Manager has to strike a balance between making the funds unpalatable for Market Timers and continuing to offer the hallmark virtues of mutual funds - access and liquidity - to all legitimate investors.

5 Reducing the attractiveness of Funds for Market Timing

5.1 Dual Pricing

As Market Timing is primarily, but not exclusively, targeted at single priced funds, Managers of dual priced funds may readily be able to confirm that their investors are not suffering such detriment. If this is the case, these Managers should not need to apply the additional controls suggested in this paper. To gain this comfort, Managers will need to monitor fund activity and ensure that their spread setting process is sufficiently robust to address the risk that Market Timers, particularly arbitrageurs, may try to take advantage of an insufficient spread or where the level of staleness renders the defence of dual-pricing inadequate.

Managers contemplating conversion from dual to single pricing should, before they make a decision and, most importantly, before they implement any such change, review what additional safeguards might need to be put in place to address potential Market Timing.

5.2 Review of valuation points

Whilst it may be administratively convenient for Managers to set the same valuation points for all its unit trusts and OEIC funds and sub-funds, there is no regulatory requirement for them to be the same. To limit opportunities for time zone arbitrage, Managers should review the valuation points for funds invested into overseas markets and consider the benefits, costs and practicalities of setting valuation points at times when the relevant securities markets are open.

Before making changes to valuation points Managers need to consider the cost and operational impact of changes weighed against the risks, any volume constraints on third party providers coping with amended valuation points, management of investor switches between funds/sub-funds on different valuation points and notification to investors of any change in valuation points. It should be noted that having differing valuation points does not necessitate different dealing cut-off points and it is possible to mitigate the complexity of varying valuation points on clients and client administration (see 5.3 below).

It is recognised that such an approach may not always fit with the Manager's operational model, and its scope is limited in respect of funds that invest, or might invest, in markets in more than one time zone (e.g. a sector or industry fund). In such cases Managers should consider Fair Value Pricing (see 5.4 below).

5.3 Dealing cut-off points

New regulations introduced into the UK in April 2004 give Managers flexibility to determine the interaction between the dealing day and the valuation point by enabling them to set a cut-off point before the relevant fund valuation point for deals. Such a process can be used to ensure that investors are unable to place a trade during all or part of the period when underlying markets are closed. It introduces more uncertainty into the Market Timer's model and would help preclude the type of arbitrage where the Market Timer buys the fund and sells the relevant index by way of a future at the dealing/valuation point. It will not of itself deter the short-term trader.

The rules permit Managers to set a dealing cut-off point at or before the time of the relevant market close, as far back as the close of the Manager's previous business day. This could effectively close the time zone arbitrage opportunities described above. However, before introducing dealing cut-off points, Managers should consider whether this would unduly inconvenience significant legitimate investors, e.g. fund-supermarkets and funds of funds, and carefully evaluate the operational implications of doing so. However, Managers should note that this flexibility only applies to those funds that have been launched under, or converted to, the FSA's new COLL Sourcebook. Managers of funds complying with the earlier CIS Sourcebook who believe that a dealing cut-off point may help to protect investors, should apply to the FSA for a rules waiver to enable them to make use of this facility, but, to be successful, Managers will need to demonstrate why their circumstances meet the criteria set out for granting a waiver of FSA's rules.

Managers should further not enter into arrangements with third parties – unless they are agents of the Manager, such as its third party fund administrator – permitting them to submit deals late, even if they are prepared to certificate the deals as having been received prior to the valuation point, or dealing cut-off point if earlier. Processing of late deals by the third party administrator should also be prohibited except where the Manager has satisfied itself as to the cut-off procedures in place or there is clear documented evidence that the order was received prior to the valuation point, or dealing cut-off point if earlier.

5.4 Fair value pricing

Where a fund is valued either using previous day prices for a market which is closed for a particular day, or, due to time zone differences, closed for normal trading materially prior to the fund valuation point, and where subsequent events indicate that prices have moved by the valuation point, Managers are permitted to make an appropriate adjustment to the valuation to reflect more accurately the current value of the portfolio. Managers are also permitted to make adjustments if they believe that the quoted prices for a particular stock are unrealistic, e.g. because it is suspended, illiquid and/or infrequently traded.

IMA, jointly with the Depositary and Trustee Association ("DATA"), have issued Fair Value Pricing Guidelines for Managers of UK domiciled Investment Funds. These Guidelines can be found on the IMA and DATA web-sites under Industry Standards.

5.5 Dealing over local public holidays

Managers of funds that are invested overseas will frequently find that stock markets on which the fund investments are quoted are closed for local public holidays, e.g. Thanksgiving Day in the USA, Golden Week in Japan etc. To avoid the risk of valuing such funds on stale prices, Managers could consider noting in the fund prospectus that the fund will not be valued on such specified days, (particularly if fair valuing is problematic because there is no proxy or well-correlated index to use) and that any investor deals received by the Manager during those days will be carried forward to the next valuation point. CIS Regulations do not currently permit sub-funds of OEICs to have different dealing days, but Managers may apply to the FSA for a waiver to do so.

5.6 Publication of fund portfolios

Managers may on occasion receive requests for fund portfolio positions, particularly from multi-managers, who use the detail to enable them to match their target asset allocations or assess portfolio risk and have no intention to cause detriment to fund investors. However, up to date portfolio details provide invaluable information for potential Market Timers, and Managers need to be careful to whom they provide portfolio details. Managers should

consider the essential obligation to treat all investors equally and, as noted in Appropriate Supervisory Structure above, a formal company policy should be established and adherence to it monitored.

The policy will need to strike a balance between an appropriate level of transparency and prompting dealing of an inappropriate frequency. The policy should cover full portfolio positions and also summary information, e.g. top ten holdings, geographical/industrial sector analysis or in the case of bond funds, duration or currency analysis. The policy should establish a set publication frequency, together with a set time lag that will limit the value of the information to potential Market Timers whilst still being useful to genuine investors.

5.7 Dilution levy or dilution adjustment

A further option that is available to Managers, probably will not be effective on its own in deterring Market Timers, but may make their activities less profitable and consequently make the fund concerned a less attractive target, is a dilution levy or adjustment.

Under the CIS rules Managers may charge a dilution levy or move a swinging price by way of dilution adjustment, only in so far as it is necessary to protect a Fund from the effects of dilution. The Manager's policy on when to apply, or to not apply, dilution levies/adjustments, has to be set out in the Fund Prospectus. Typically the Prospectus will also set a trigger level of net sales or redemptions, above which the dilution levy/adjustment will be applied, and consequently Market Timing of sufficient size to hit this trigger level will be made less profitable and attractive.

As the trigger level will be publicly disclosed, Market Timers may of course ensure their transactions fall below this trigger level. However, the event that the Manager starts to receive frequent sales and repurchases below this trigger level, the assumptions and calculations upon which the dilution levy/adjustment policy has been based may need to be revisited, rather than simply left until the next periodic review. A substantial increase in turnover may make a significant difference to fund dilution and consequently to "the future growth of the fund", which could influence the Manager to change his policy, not just on the frequency/circumstances of imposing a levy, but potentially to commence imposing a levy for the first time.

Those Managers that have an element of discretion in their fund dilution policies may need to emphasise to their staff that any pressure to waive a dilution levy/adjustment to close a potential deal should be questioned, as this may be detrimental to ongoing investors. Such decisions should only be taken at an appropriately senior level.

Managers may be requested by fund supermarkets, or other aggregators, to agree that dilution levies will never be applied to their transactions, on the basis that these are a bundling of a number of smaller individual deals each of which on their own would not trigger the dilution levy. If they wish to enter into such arrangements, Managers should ensure that this is formalised by legally enforceable agreement, under which the aggregator commits to place separate orders for any individual transactions, or string of transactions, that would cumulatively trigger the dilution levy threshold. As part of this agreement Managers should obtain the right to inspect the aggregator's records to confirm that the agreement is being adhered to although the Manager should confirm that this is permitted under relevant data protection legislation.

5.8 Redemption fees

As noted above, a dilution levy is designed only to recoup for the fund the extra costs generated by certain large deals. It does not seek to remove the arbitrageur's profit and it tends not to penalise the less large, but frequent, pattern of trading that Market Timers can adopt to avoid such levies. A Manager may choose to take the power to levy a redemption fee on redemptions in respect of positions that have only been in the fund for a brief period of time.

Managers may wish to consider the use of a redemption fee (on either a strict or a discretionary basis). However, without a clear regulatory mandate as to the level of the fee, the methodology to be used, the time scale over which it might apply, and that, unlike dilution levies, which are paid into the fund, redemption fees can be paid to the Manager, there is the danger that this could expose the Manager to complaints from legitimate clients who happen to have needed to redeem early.

6 Deterring identified Market Timers

6.1 Refusing to deal with the Market Timer

Despite the fundamental principle that open-ended funds should be available to investors at all times during the dealing day, Managers are permitted to turn away business from investors that they know, or suspect, are Market Timers. Anecdotal evidence suggests that this particular rule is the one that Managers most frequently apply when deterring such practices.

This rule states that the Manager's obligation to sell units at all times during the dealing day does not apply if the Manager has reasonable grounds for refusing to sell units to the person concerned. The rule has a wide interpretation, and includes not just the circumstances of the potential investor, but also their intentions.

Managers should nevertheless be sensible in recording and communicating the justification for rebutting an investor or potential investor, as terms such as "market timer" are increasingly pejorative and possibly defamatory if communicated or published. Refusal to deal should be framed in the context of the products being long-term investments and not appropriate for short-term trading.

6.2 Requiring settlement in advance of order

Any person identified as a Market Timer, or potentially as a Market Timer, should not be offered any non-standard credit dealing privileges, and any non-standard credit privileges previously accorded should be withdrawn. Managers may be exposed if they have afforded special credit terms to an investor they know or suspect is damaging the fund.

If an identified Market Timer periodically switches within the Manager's fund family, i.e. is not using proceeds from a repurchase to fund a further purchase, the Manager may require that the reinvestment side of that switch is settled in advance of the order being processed. At the very least this would be an inconvenience to the Market Timer.

6.3 *In specie* transfers

A further option available to some Managers is the threat of settling redemptions by *in specie* transfers rather than cash, although, as *in specie* transfers represent a significant operational burden for the Manager, this option probably would only be used as a last resort. Clearly for this to be a thoroughly effective deterrent, the trigger level disclosed in the fund prospectus above which the Manager may impose *in specie* redemption will need to be quite low, as anecdotal evidence suggest that Market Timers may deal at low, but frequent volumes.

6.4 Terms of Business (TOBs)

Managers may enter into TOBs setting out legally binding arrangements with certain clients and distributors (such as fund supermarkets). It will be necessary to ensure that any TOBs allow for Managers to implement any required measures to protect the fund. They should not, for example, compel the Manager to pay commission or offer discounts on loads in respect of transactions or assets that the Manager has identified as related to Market Timing. One way of doing this would be to insert a clause into all TOBs that states that in the event of a conflict between the terms of the TOB and the prospectus, the prospectus would prevail. This would permit the Manager to keep its Market Timing "toolkit" up to date without having to revisit all TOBs on each occasion.

APPENDIX

FSA Statement on Market Timing

18 March 2004

The Financial Services Authority's investigation into market timing has found no evidence of illegal, late trading but has found some evidence of market timing in UK authorised collective investment schemes (CIS). Market timing does not appear to have been a major source of detriment to long-term investors.

Most occurrences have been short-lived with fund managers taking swift action to terminate relationships where clients have attempted to time funds. The FSA has asked fund managers to calculate the effect of market timing and it is expected that this will form the basis for compensating payments to be made to the funds in some cases.

Total amounts involved are still being calculated but are likely to be less than £5 million.

Michael Foot, FSA Managing Director, said:

> "The picture we have uncovered is generally quite an encouraging one. Although there is evidence of market timing having occurred within our authorised funds, looking at all the evidence we have amassed, we can find no sign either that market timing is widespread or that it has been a major source of detriment to long term investors."

Key Findings

While some evidence of limited market timing activity was uncovered, the relationships between the UK CIS fund managers concerned and the market timing clients appear to be of a different nature to those uncovered in the US, where there has been evidence of significant financial benefit to fund managers as a result of their relationships. In the UK, we examined 9,620 transactions as part of our investigation. In fact, only 118 eventually required follow up during on site visits.

The FSA's work found no evidence of late trading in the UK authorised CIS. It appears this is due in large part to the industry framework: where deals are placed directly with the fund manager before valuation points, and the important control function provided by the trustee in UK funds. The FSA will be undertaking further work to confirm its view of trustee oversight.

We believe that our Principles and Rules provide sufficient tools to enable firms to manage the conflicts of interests posed by market timers. Among these tools are the ability to price underlying assets at a fair value and the ability to refuse to sell units to suspected market timers, as well as a number of measures to reduce dilution and to otherwise increase the cost (and so decrease the attractiveness) of market timing activity.

Mr Foot went on to say:

> "We have amassed a considerable amount of evidence which leads us to this broadly reassuring conclusion and in doing so it would not be surprising if we have sensitised fund managers to the risks they run with respect to market timing and to the need for robust controls and active monitoring. But we will also undoubtedly have alerted some potential market timers. Doing nothing more in this area is therefore not an option for us."

Next steps

The FSA is undertaking further work on a number of issues: The FSA will continue to look to fund managers to demonstrate management of conflicts of interest in accordance with the FSA's Principles-based regime. Potential conflicts arise whenever market professionals are permitted to invest in funds at the potential expense of long term investors. Steps to manage conflicts could include not dealing with market professionals if there are any questions about their motives or the potential impact on long term investors.

The FSA will be pushing ahead with the package of reforms to the regulation of funds in the UK (CP 185) that were published last year. This included amendments to the rules that would clarify the measures available to deter market timing. These measures include the use of fair value pricing (use of a best estimate where underlying prices are likely to have moved materially) and clarification of the scope for declining to deal. We have been particularly encouraged by the willingness of industry participants to embrace fair value pricing and we are looking to them to work up concrete proposals for this. The firms asked that we implement the proposals on fair value pricing that we made in CP185 for existing funds and this, subject to the approval of the FSA's board, is something we intend to do.

The FSA is encouraging managers of unit linked funds that are not covered by the more detailed CIS regime to adopt the tools in the CIS regime to allow them to avoid potential detriment to investors from market timing. Firms are reminded that the FSA Principles apply.

Firms have pointed out the problem caused by order aggregators who place combined deals for several customers, which may hide the activities of market timers. While recognising these difficulties, we remind firms of their obligations. If fund managers are unable to satisfy themselves that potentially suspicious deals are not on behalf of market timers, we suggest they use the range of tools at their disposal and do not allow any unduly preferential dealing arrangements.

SJ - n° 2003/Div.

Mr Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Espagne

Paris, May 16 2005

AFG RESPONSE TO IOSCO CONSULTATION REGARDING BEST PRACTICES STANDARDS ON ANTI MARKET TIMING AND ASSOCIATED ISSUES FOR CIS

Dear Mr Richard,

The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include management companies and investment companies. They are entrepreneurial firms or belong to French or foreign banking, insurance or asset management groups. AFG members are responsible for the management of over 1800 billion euros in the field of investment management - making the French industry a leader in Europe (for collective investment in particular, with more than 20% of EU investment funds assets under management) and one of the top ones at global level. In the field of collective investment, our industry includes – beside UCITS – a significant part of products such as regulated hedge funds and private equity funds. We are also a member of the European Fund and Asset Management Association (EFAMA).

Therefore, we hope that AFG (through the size and diversity of its membership) can provide with a helpful contribution to IOSCO, based on our members' experience.

We appreciate the opportunity to support IOSCO's consultation paper on "*Anti market timing and associated issues for CIS*".

We agree with IOSCO's approach to describe market timing and its associated issues and to identify best practice standards relating to CIS and market timing. We would like to stress, however, that important matters, such as the negative effects of directed brokerage, will also have to be addressed.

Any such standard should be assessed in terms of efficiency, taking full account of its – direct and indirect – costs of implementation, which are ultimately borne by investors. In terms of cost/benefit analysis, IOSCO must be aware that in many jurisdictions (including France) the case was not made for market timing practices and therefore that any relevant additional organisational requirement might constitute over-prescription as compared to the reality of the phenomenon.

Two crucial elements must be kept in mind. First, the average size of funds in Europe (e.g. in France) is much smaller than in some non-European jurisdictions – reducing the economic interest of market timing practices. Second, the system of distribution, resting almost entirely on banking networks and not on brokerage, make it also extremely difficult to indulge in market timing activities.

On the substance, we wish to raise two main points. On the one hand, we acknowledge that it is the duty of the management company to *check* the processes dedicated to prevent the occurrence of market timing – while the entity in charge of *putting in place and complying* with such processes internally should be the centralisator. On the other hand, we have to recall that it is only possible to set up processes in order to prevent market timing: prevention of market timing cannot guarantee that market timing will never occur in practice and have to recognise that a significant part of the responsibility will always rest within the distributor, especially when it is a regulated entity (bank, broker, IFA, etc.).

On a more specific level, we would like to raise some points relating to the wording – and not to the substance – of IOSCO's paper:

- *Standard 1.4* should not be understood as stating that the fact that the CIS operator is compensated on the basis of the CIS net assets leads to a conflict of interest: the opposite is, in facts, generally true
- *Standard 2.8 (iv), 2.14*: the word "*accuracy*" should not be understood as implying that an "exact" valuation must be found at all time, as market prices are not always available at all time, might differ if assets are trade on different markets or might be not available at all (non listed shares, bonds, money market instruments, derivatives, real estate, etc.).

We would finally suggest IOSCO to stay at the level of recommendations. AFG, for its part, has issued for its members strong recommendations, from which we extract some of the following, that IOSCO might find useful to take on board:

- **Market timing** (para 8 of IOSCO document):
    - o *"CIS operators should identify the CIS involving a significant risk of market timing and should take relevant measures to manage this risk – in particular the monitoring*

of the risk. Depending on the risks involved and on specificities of its organization, these measures should include at least:
  - *the provisions concerning the subscriptions/redemptions, the accounting provisions and valuation of CIS, in order to ensure that subscriptions/redemptions are carried out with forward prices (with an exemption for monetary funds);*
  - *a specific monitoring system based on appropriate processes and information tools"*

- **Late trading** (para 11 of IOSCO document):

  - *"Whatever are the organization of distribution of the CIS and the complexity or multiplicity of transmission processes of orders to the centralisator in order to subscribe/redeem, the CIS operator should, as far as possible, take all necessary measures to check the compliance of equal treatment among holders. In particular, the CIS operator should ensure that the depositary and/or the centralisator has put in place the appropriate monitoring processes which are necessary to comply with this principle.*

  - *The possibility, in exceptional circumstances, of a specific exemption regarding the time limit concerning the centralisation of subscriptions/redemptions should lead the CIS operator to put in place, jointly with the centralisator, a specific process giving details on at least:*

    - *The information to be received from the centralisator in relation to any exceptional technical disorder having occurred in the orders transmission process, giving details on:*
      - *the identity of the relevant person having received/transmitted the orders, the reasons and the deadline for non-functioning of the systems, the information on the relevant deals,*
      - *the fact that the delay for transmission is related to subscriptions/redemptions orders which had been communicated to it before the time limit.*

    - *The list of CIS operator managers authorized to deliver an agreement for exemption*

    - *The information of the depositary when it is not the centralisator.*

  - *Beyond the deadlines forecast for the technical reason as referred to above, the CIS operator should prevent from contract with third parties such as distributors or any person transmitting orders which provides for a possible permanent exemption regarding the time limit as stated in information notes of prospectuses of the CIS it operates."*

- **Portfolio Valuation** (para 14 of the IOSCO document):

  - *"The CIS operator should undertake its best efforts in order to check the fair value quality of the valuation of CIS it operates. He should take reasonable care to ensure that:*
    - *the organization of the system which transmits the necessary information to the valuator ensures appropriate accounting treatment for investment*

and disinvestment operations, in particular for the CIS the most exposed to market timing

- *non significant market prices be modified if necessary."*

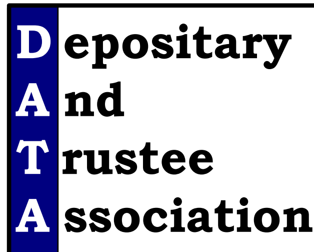
We hope that our comments will be found helpful and are now looking forward to reading the next version of the paper on the subject. Do not hesitate to ask us sharing our experience and our members' one with IOSCO team and members if you find it helpful.

If you would like to discuss the contents of this letter with us, please contact myself on 00 33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), or Stéphane Janin on 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr).

Yours sincerely.

(signed)

Pierre Bollon



18 May 2005

Mr. Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Dear Mr. Richard

Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes

The Depositary and Trustee Association (DATA) represents the depositaries and trustees of authorised unit trusts and investment companies with variable capital (ICVCs). At the end of March 2005, the members of DATA were responsible for the safeguarding of £280 billion of funds under management.

DATA is pleased to comment on your Consultation Document on Best Practice Standards on Anti-Market Timing and Associated Issues for Collective Investment Schemes.

The IOSCO report proposes three best practice Standards:

- CIS operators should act in the best interest of CIS investors
- CIS operators should ensure that their operations and disclosure in respect of market timing and late trading are consistent with the first Standard
- The regulatory regime should allow operators appropriate flexibility in addressing the risk of detriment to investors arising from market timing

DATA agrees with the above standards at a general level, but is not comfortable with all the detailed supporting proposals, some of which, so far as the UK is concerned, go beyond what is necessary or proportionate to meet the Standards. DATA's concerns are described below.

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1 CIS operators should act in the best interest of CIS investors

In general DATA is comfortable that this standard is addressed by the FSA's "Principles" and "Senior Management Systems and Controls" rules. However, we have some observations on the more detailed proposals in the paper.

Clause 4

The paper proposes that a CIS operator should disclose to investors its policies for dealing with conflicts of interest in connection with market timing. We understand that in some jurisdictions inclusion of such policies within scheme documentation will enable a CIS operator to deter, discourage or penalise investors involved, or suspected of being involved with, market timing. Clearly, in such circumstances, disclosure is an appropriate course.

In the UK, however, such powers are already contained within the FSA regulations and CIS operators do not need to take any additional steps, e.g. disclosure, to utilise these powers. Whilst a number of CIS operators do refer to market timing within their scheme Prospectus, there is general reluctance to give overly specific details of policies, trigger levels etc, as this can give potential market timers information to enable them to circumvent the CIS operator's controls. For example, disclosing the threshold at which a fund might swing its price could lead to market timers designing trading strategies that undercut that threshold.

2 CIS operators should ensure that their operations and disclosure in respect of market timing and late trading are consistent with Standard One

Once again, DATA is comfortable that, in general, this Standard is already addressed by the FSA's collective investment scheme rules. However, there are a number of detailed points with which DATA disagrees.

Clause 6

This clause proposes that CIS operators should be required to disclose their policies and procedures relating to market timing and late trading, fair valuation and disclosure of portfolio holdings. UK regulations already require disclosure of fair valuation policies and a recent recommendation from a review of CIS Governance by the Investment Management Association (the UK investment management industry trade body), in which DATA participated, has recommended that CIS operators' policies in relation to portfolio disclosure should be stated in each fund Prospectus (a copy of this review is attached to this letter). However, as noted under clause 4 above, DATA believes that there is more potential detriment than benefit in detailed disclosure of CIS operators' policies and procedures relating to market timing and late trading.

Clause 8

Whilst DATA supports the proposition in Clause 8 (iv) that CIS operators should monitor valuation methodologies to ensure that the CIS's NAV is accurate, it would be helpful if this clause were expanded to cater for the principles of fair value pricing. There is clearly no "accurate" fair value price and the key word in this definition is "estimate". Clause 8 (iv)

could usefully be expanded to propose that CIS operators should follow robust and consistent fair value processes that are regularly reviewed.

Clauses 11 to 13

Clauses 11 to 13 relate to late trading, an activity, which in the UK, is barred by regulation and to which depositaries and trustees of UK collective investment schemes give particular attention during their monitoring reviews. UK regulations give no additional latitude to intermediary trades, which must be received by the CIS operator at the same cut-off point as trades received from direct investors.

Clause 22

This clause proposes that external auditors and the depository or the trustee (where it exists) of CIS operators should review as part of their regular audit the systems and controls established by the operator and comment on their effectiveness. Whilst in the UK there is not a specific regulatory requirement in this regard, in practical terms depositaries/trustees already have an oversight responsibility for virtually all rules applicable to CIS. In one respect (the CIS operator's decision as to whether or not to apply a dilution levy to individual holder transactions) the IMA report on CIS Governance referred to above, has recommended that the depositary/trustee oversight be extended to cover this aspect. The FSA is currently considering this recommendation, along with a number of other governance recommendations.

Clause 24

Please refer to our response to Clause 6 above.

3 The regulatory regime should allow operators appropriate flexibility in addressing the risk of detriment to investors arising from market timing

Clause 25

DATA's view is that the FSA regulations applicable to UK collective investment schemes, together with the FSA Principles, provide CIS operators with a comprehensive regulatory toolkit, which can be applied to protect CIS investors' interests.

Clause 27

This clause proposes that where market timing and associated issues cause CIS investors or a group of CIS investors to suffer loss, or the CIS suffers dilution, the CIS operator's duty should be to put them back in the position they would have been had there not been a failure to meet Standard 1, i.e. had the transaction that caused the dilution or loss not taken place. This may mean compensating investors direct and /or the CIS itself.

Whilst supporting this stance in principle, DATA suggests that the paper takes into account that no matter how robust the CIS operator's processes, detection of market timing cannot be guaranteed, especially when business is transacted through a number of different aggregators. Consequently, DATA believes that an absolute requirement for the CIS operator to compensate investors or the fund in every instance may be unreasonably harsh and that the CIS operator should only bear liability where it has been in breach of its

obligations, either in not having policies and procedures consistent with its regulator's requirements, or indeed where it has not been adhering to such policies and procedures.

Clause 29

Please refer to our comments on disclosure under Clause 4.

We would be very happy to discuss the points raised above if you would find this helpful.

Yours sincerely

Tim Gandy
Chairman, Depositary and Trustee Association

cc: Dan Waters, Asset Management Sector Leader, UK Financial Services Authority.
Ashley Kovas, Collective Investment Scheme Policy Unit, UK Financial Services Authority.

REVIEW OF THE GOVERNANCE ARRANGEMENTS OF UNITED KINGDOM AUTHORISED COLLECTIVE INVESTMENT SCHEMES

REPORT BY THE INVESTMENT MANAGEMENT ASSOCIATION

February 2005

Review of the Governance Arrangements of United Kingdom Authorised Collective Investment Schemes

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Definitions/abbreviations used in this report

ACD	Authorised corporate director of an *OEIC*
AUT	UK authorised unit trust
CIS	Collective Investment Scheme and, in this report, a generic term used to describe both *AUTs* and *OEICs*.
CIS SORP	Statement of Recommended Practice for *CIS*
Depositary	Except where expressly stated, this is a generic term used to describe both the Depositary of an *OEIC* and the *Trustee* of an *AUT*
FSA	The UK's Financial Services Authority
FSMA	Financial Services and Markets Act 2000
ICVC	UK authorised investment company with variable capital, also known as an *OEIC.*
IMA	The Investment Management Association, the trade body for the UK *CIS* and investment management industry
Investor	Except where expressly stated, this is a generic term used to describe both the unitholder of an *AUT* and the shareholder of an *OEIC*
IOSCO	International Organisation of Securities Commissions
Manager	Except where expressly stated, this is a generic term used to describe both the Manager of an *AUT* and the *ACD* of an *OEIC*
Members	Members of *IMA*
NAV	Net asset value
Non-UCITS retail fund	*CIS* which does not comply with the requirements of the *UCITS* Directive (see section 5.3.1)
OEIC	Except where expressly stated, this is a generic term used to describe both a UK authorised open-ended investment company and an *ICVC*
OEIC Regulations	OEIC Regulations 2001
PFDC	*IMA's* Pension Fund Disclosure Code
TER	Total Expense Ratio of a *CIS*
Trustee	The Trustee of an *AUT*
UCITS	*CIS* complying with the Undertakings for Collective Investment in Transferable Securities Directive (see section 5.3.1)
Working Party	*IMA's CIS* Governance Working Party

Review of the Governance Arrangements of United Kingdom Authorised Collective Investment Schemes

1 Introduction

In January 2004, the Board of Directors of the Investment Management Association ("*IMA*") set up a *Working Party* with a broad remit to consider whether there were changes that the *IMA* should be seeking to promote in the way that UK authorised collective investment schemes ("*CIS*") are governed, with a view to making recommendations to the Financial Services Authority ("*FSA*") and the *CIS* industry.

There were a number of considerations that triggered this decision. First, *IMA* was seeing an increasing demand and reliance on disclosure to institutional clients, for example in areas such as transaction costs and corporate governance, as a way of promoting transparency. This naturally raised the question how similar principles could be adopted for retail customers of *CIS*, and whether the existing role and duties of *Managers* and *Depositaries* could encompass these.

More generally, however, the *IMA* Board thought it an appropriate time, with:

- the *FSA's* move away from prescriptive rules towards principle based regulation, in particular the introduction of the New Collective Investment Scheme Sourcebook;
- the spotlight on fund governance in the United States and by other bodies such as *IOSCO;* and
- structural changes in the *CIS* industry,

to consider whether current rules and practice in relation to the protection of *Investor* interests continued to be fit for purpose. It was also felt that there had been considerable developments in the world of corporate governance since the question was last under review.

The *IMA* Board concluded that there was merit in taking the initiative on these matters by setting up a *Working Party* to examine the current *CIS* governance structure and to discuss alternative options.

The *Working Party* was established under the chairmanship of Lindsay Tomlinson, Chairman of *IMA*, and membership was drawn from senior industry practitioners from a range of backgrounds, including *CIS* management firms, investment managers, administrators, *Depositaries* and the legal profession. Terms of Reference for, and Membership of the *Working Party,* are detailed in Appendices 1 and 2 to this document. The FSA was made aware of IMA's plans and has supported this initiative.

Following consultation with *IMA Members* and consideration by the *Working Party* of *Member* feedback*,* the Board of *IMA* is now issuing a formal report, proposing industry standards and recommending changes to the existing regulatory regime. Whilst *IMA* is not able to enforce compliance on its *Members* as regards industry standards, experience from other initiatives, for example the *IMA* Pension Fund Disclosure Code ("*PFDC*"), has shown encouraging levels of take-up.

2. Scope and Objectives

The *Working Party* set a core objective of the maintenance and improvement of consumer confidence in the *CIS* industry, with any recommendations avoiding unnecessary cost, bureaucracy and duplication of effort.

Prior to detailed consideration and to ensure comprehensive coverage of activities relating to *CIS*, the *Working Party* drew together a table covering all activities in the *CIS* "Value Chain" (see Appendix 3), and noting for each activity:

- which party has prime responsibility;
- which party/ies have a beneficial interest;
- what potential there is for bias, or conflict of interest from those parties involved, i.e. to the detriment of the *Investor;*
- what potential there is for differing treatment between *Investors;*
- whether, to whom, and how the activity is disclosed;
- whether there is internal supervision;
- whether there is independent oversight.

Issues that the *Working Party* considered should be reviewed, fell into the following broad categories:

- *Investors'* understanding of costs charged to *CIS;*
- Responsibilities of *Managers*, *Depositaries* and auditors;
- Other *CIS* governance models;
- Role of independent directors.

Prior to consideration of each of the above categories, the *Working Party* addressed the potential for conflicts of interest within *CIS*. Failure to manage conflicts of interest risks eroding confidence in the *Manager's* ability to serve as fiduciary and potentially undermines the *CIS* industry as a whole. *Managers* often face conflicts of interest that could interfere with the objectivity of their decisions and actions and they can undertake multiple roles or may appoint others who do. The substantive question facing a *Manager* is definition of the principles that guide its fiduciary behaviour.

Issues considered by the *Working Party* and consequent recommendations are set out in summary in Section 4, and *Working Party* findings are discussed in detail in Sections 5 to 9 below.

3. Protecting Investor interests – the role of CIS Governance

The purpose of a *CIS* is to allow a group of individuals to pool their assets for more efficient and effective management. The legal character of the relationship is that each *Investor*, has an investment, the value of which represents a direct proportion of those assets. If an *Investor* wishes to redeem his investment, he can do so at a value based directly on the value of the underlying assets, i.e. the net asset value ("*NAV*").

The main reason why people invest in *CIS* is because they do not have the expertise to manage those assets themselves. People who buy *CIS* are buying the expertise of someone to look after their money, deciding what to invest in, and when. The diversified nature of the product also has the advantage of spreading risk, while at the same time opening up investment opportunities that are denied to the *Investor* as an individual, due to cost and inexperience.

CIS are the means by which most *Investors* purchase investment management expertise, and that expertise is not owned by the *CIS,* but purchased by it from an investment management house. The *CIS* is simply the delivery mechanism by which that expertise is delivered to the *Investor*.

A *CIS* is defined by, and exists, because of the provision of investment and other management by the investment management house. To speak of a *CIS* choosing or threatening to change *Managers*, is to misunderstand the nature of the relationship between the *Investor*, the *CIS*, the *Manager* and the *Depositary*.

The protection of *Investor* interests is achieved through a number of means:

- The valuation of *CISs* at their *NAV* means that *Investors* can realise their investment at a price related to the *NAV;*
- A regulatory regime that has developed which defines the rights and obligations of the participants in the process (see Section 5 below);
- Disclosure of pertinent information to *Investors* and their advisers on a prescribed and regular basis, so that the decision to invest, disinvest or remain invested, can be made on a fully informed basis;
- All fundamental alterations to the running of the *CIS* requiring a vote of *Investors*.

The governance structure in the UK, in common with many, is based on the use of checks and balances, with clear articulation of the responsibilities of the parties concerned. Section 5 of this report contains a review of the current *CIS* governance arrangements in the UK. The following provides a brief summary.

Day to day management of the *CIS* is the responsibility of the *Manager*. Although many of these activities can be delegated to other parties, the *Manager* still retains the regulatory responsibility. The *Manager* must comply with a set of rules designed to make the operation of the *CIS* fair and accountable.

Oversight of the *Manager* is provided in the first instance by the *Depositary*. In certain areas, such as setting the *NAV* and agreeing the inflows to and outflows from the *CIS*, the *Depositary* is involved in the daily running of the *CIS*. Alongside this runs a system of continuous review of matters such as compliance with the investment objectives of the *CIS* and monitoring for overdrafts. The *Depositary* is also responsible for the safeguarding of the assets of the *CIS*.

*Depositarie*s are, by market choice, subsidiaries or divisions within large banking groups (although regulation does not require them to be so). They are authorised by the *FSA* and have to follow conduct of business rules and abide by competence and financial resources requirements. In practice they represent a significant resource of professional, well-qualified people, supported by significant computer and processing resources.

In some countries, the role of the *Depositary*, as the UK understands it, is either significantly restricted or absent entirely. In many of those countries, the role undertaken by *Depositaries* in the UK, is performed, in part, by boards of directors, often independent (a topic discussed further in Section 6.5). While the majority of independent directors are experienced, thoughtful and active in their role, there has to be question whether they can perform as potent, as well resourced and as engaged an oversight function as the *Depositary*. The *Working Party* is not aware of any system involving the use of independent directors, that will, for example, sign off on the day's trading in the *CIS*, nor any independent board that takes such direct responsibility for the safety of the *CIS* assets and carries out regular on-site inspections of the *Manager's* activities.

The *Working Party* was very conscious that the UK has one of the most developed systems of rules and regulations designed to formulate, in very specific terms, the role of the overseer. As the nature and type of *CIS* becomes ever more complex, that system of rules has to keep pace, and inevitably will not always succeed. However, the UK governance system is capable of adapting within short timescales and without the need for regulatory intervention. This paper perhaps being a case in point: many of the recommendations do not need rule-making, but to become industry best practice.

Underpinning this substantial edifice of regulation is one simple proposition: that both the *Manager* and the *Depositary* have an obligation to act at all times in the best interests of *Investors,* disregarding their own interests where they conflict with those of the *Investor:* a fiduciary duty. Where solutions are developed in the marketplace (and they tend to be developed collegiately between the *Depositary* and the *Manager* after discussion with *Investor* representatives), it is a relatively simple matter to promulgate that solution throughout the *Depositary* world. This helps ensure consistency across the *CIS* industry. Contrast that with the mechanisms required to make new rules or build consensus amongst numerous individual independent directors.

No system of governance and disclosure will ever be perfect. However, the mere facts of scandals or *FSA* enforcement against firms are not of themselves evidence that the overall system is at fault. Such systems rely to a degree on people doing the right thing and none are immune from conspiracy and fraud – no system is. The *FSA* itself emphasises that it cannot provide a zero failure regime. The arrangement of checks and balances that characterises the UK *CIS* Governance system is designed to help ensure that if one of the key participants departs from regulatory and market standards, there is someone there to identify this and to call that person to account.

However, it would be foolish to believe that the *Depositary* is privy to every decision made, and every act undertaken, by the *Manager* and therefore can identify and question every non-compliant thought or act. As far as is reasonable, an environment can be created, where misbehaviour of any form is more difficult than compliance, and where the fear of being caught out acts as a deterrent. Essentially, the system is designed to provide a framework within which the honest will thrive and the dishonest be found out.

In this paper there is much analysis of the duties and obligations of the *Depositary* and the *Manager*. The *FSA* as the regulator, and in accordance with its statutory duties, also has a role to play in developing rules and in assisting in developing market standards. The *Working Party* hopes that this paper will assist in the first of these tasks and welcomes the involvement of the *FSA* in the governance debate by consulting on appropriate amendments to the regulatory regime.

Further, no system works without the engagement of all its participants. Disclosure, to be effective, needs to be well designed and meaningful, but if launched into an environment of apathy, will fail. It is therefore important to see the recommendations of this report as complementary to efforts by the *FSA* and others to improve the ability of *Investors* to understand and become active participants in those *CISs* in which they invest. The *IMA* and the *CIS* industry welcome informed engagement from *Investors* and their advisers, and the recommendations in this report on disclosure are designed to encourage that.

It would be an omission to address the subject of *CIS* governance without reflecting on events elsewhere in the world. A more detailed comparison of the UK model with others around the globe is in Sections 5 and 6 below, but a few observations are appropriate here.

The *IOSCO* Technical Committee was charged with carrying out a survey of governance models around the world. *IMA* welcomes the attention being paid to governance and hopes that this report will be a constructive contribution to the debate. The UK *CIS* industry recognises that theirs is one model among several, and clearly believes it works, but would not take the view that it is compatible with all markets and all regulatory regimes. *IMA* trusts that the *IOSCO* view will take due account of the diversity of ways to operate a *CIS*, and will focus on effectiveness at a substantive level and not homogeneity on the surface.

Elsewhere, the recent late trading and market timing scandal in the United States has underlined the importance of several matters that this paper seeks to address The US regulatory authorities have clearly concluded that there were sufficiently serious flaws in their system of governance for them to institute sweeping changes. Indeed, the resultant regulatory programme in the US probably represents the single largest overhaul of the US mutual fund regulatory regime since its inception in 1940.

The *Working Party* has however noted, that a very small number of mutual fund managers have been identified as at fault: the vast majority by number and assets under management, have seen no regulatory or legal enforcement action. Its conclusion is that with the right people and the right procedures in place, the previous governance system demonstrably worked.

Indeed it can be argued that some areas of corporate governance in other jurisdictions, notably independent directors, failed to prevent the behaviours complained of, or at least there does not appear to be any evidence that their existence acted as a deterrent to those behaviours. While not privy to the facts of every case, the *Working Party* is of the view that the lesson to be drawn is that the quality of resources brought to bear in governance is more important than any tick box type of approach to governance.

The *Working Party* has therefore spent much time in considering whether those charged with oversight responsibilities are equipped with the right environment, standards and tools with which to carry out their role, and how, through disclosure particularly, *Managers* can account more directly to *Investors* in respect of the role that they perform for them.

The *Working Party* believes that with the benefit of these recommendations, the UK *CIS* governance system represents a balanced and robust structure for the protection of *Investors* and the long-term health of the industry.

4. Summary of Recommendations

The detailed rationale for each recommendation is set out in the detailed section of the report. The recommendations have been grouped below by theme and do not necessarily follow the order of the detailed sections.

4.1 General

The *Working Party* found no basis for recommending a fundamental restructuring of the UK *CIS* Governance model.

No.		Report Section	Responsibility
1	There should be no change to the UK's current *CIS* governance model, other than in respect of those recommendations elsewhere in this paper to enhance, and better to define, the *Depositary's* and *Manager's* respective roles and responsibilities.	6	N/A

4.2 Addressing Balance of Powers

It is important that those charged with responsibilities under the governance model have the freedom to carry out their role.

No.		Report Section	Responsibility
2	As current *FSA CIS* regulations and trust deeds do not reflect actual practice with regard to the appointment or replacement of *AUT Trustees*, these should be amended, to mirror the contractual appointment of *Depositaries* by *ACDs* of *OEICs*.	7.2	*FSA*
3	*FSA CIS* regulations should be amended so that the *FSA*, once having received notification under *FSMA* (*AUTs*), or under the *OEIC Regulations* (*OEICs*), and prior to approving a proposal to change the *Depositary*, will <u>require</u> the *Depositary* to provide them with a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the *FSA* or, if it considers that there are no such circumstances, a statement that there are none.	7.3	*FSA*
5	*FSA CIS* regulations should be expanded to cater for circumstances in which the *Manager* wishes to replace the *Depositary*.	7.3	*FSA*

4.3 Improving Disclosure

Disclosure is, and will remain, a key component of the means by which firms address conflicts of interest. As noted elsewhere in this report, it is important not only that disclosure is made, but that those to whom it is made, read and respond.

No.		Report Section	Responsibility
4	*FSA CIS* regulations should be amended to require that in the *CIS* report and accounts following a change of *Depositary:* The *Manager* should disclose: • reasons for the change of *Depositary;* • any wider arrangements of which the change of *Depositary* is a part. Further: both the outgoing and incoming *Depositaries*, should supply a *Depositary* report covering the periods within the accounting period, for which they were responsible.	7.3	*FSA*
8	*Managers* should produce, and supply to the *Depositaries*, annual reports similar to the *PFDC* Level One disclosure, or the enhanced disclosure currently being developed with interested parties.	8.1.1	*Manager*
9	Amendments should be considered to the *CIS SORP* to require the disclosure in *CIS* report and accounts of the totals of broker commissions, taxes and any other charges included within portfolio purchases and sales.	8.1.1	*IMA's SORP* Working Group
10	Amendments should be considered to the *CIS SORP* to require a portfolio transaction report to be included as a note in *CIS* report and accounts, detailing in numerical terms the total of transaction volumes, analysed over the top ten counterparties by volume, and by net and commission based trading, and a remainder. Any counterparties that are affiliates of the *Manager* or the *Depositary* should be identified as such. Gross portfolio turnover and commissions in this table should reconcile to the total figures disclosed in *CIS* report and accounts following recommendation 9 above.	8.1.1	*IMA's SORP* Working Group

11	Contingent upon Enhanced Disclosure being adopted by *IMA* and accepted by the *FSA*, the *CIS SORP* should be amended to incorporate the *IMA* Enhanced Disclosure proposals, and the portfolio transaction report described in recommendation 10, should be expanded to include a split of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class.	8.1.2	*IMA's SORP* Working Group
12	*FSA CIS* regulations should be amended to require that the *Manager* includes within the *CIS* prospectus, a statement of its policy on box management, making clear the purposes for which the box is used.	8.1.3	*FSA*
18	Amendments should be considered to the *CIS SORP* to reflect the distinct nature of stock-lending income and related costs, by requiring that such income be reported net in the Statement of Total Return, and that related fees and expenses be separately disclosed, by way of a note, in *CIS* report and accounts.	9.1	*IMA's SORP* Working Group
19	Amendments should be considered to the *CIS SORP* to require that, in relation to any charges or costs levied, directly or indirectly, against the assets of a *CIS*, disclosure should be made in the report and accounts of any revenue sharing participated in by the *Manager*, *Depositary* or affiliates of either.	9.2	*IMA's SORP* Working Group
20	Amendments should be considered to the *CIS SORP* to require a note showing the calculation of the *TER* to be included in the audited annual report and accounts of *UCITS* and *non-UCITS retail funds*. In the event that the *Manager* believes that it is necessary to update the *TER*, an un-audited version of this calculation should be included in the interim report and accounts.	9.3	*IMA's SORP* Working Group
21	Upon implementation of the Simplified Prospectus regime for *UCITS*, *FSA* should also require disclosure of *TERs* in *non-UCITS retail fund* Key Facts/Key Features documents. This *TER* disclosure should replace the existing Reduction in Yield disclosure.	9.3	*FSA*

22	The *IMA* should encourage *Managers*, the *FSA*, *Investors* and their advisers to transfer their attention from the detailed *CIS* costs laid out in report and accounts, to *TERs*, which will be required to be disclosed in *CIS* Simplified Prospectus documents (when implemented), and short reports.	9.4	*Manager* *FSA*

4.4 Agreeing Standards

In a number of areas the *Working Party* found that a more formal and articulated approach towards certain issues would be of benefit.

6	*Managers* and *Depositaries* should establish formal governance and procedural structures in relation to *CIS* activities delegated by the *Manager* to affiliates of the *Depositary*, that require that any errors or regulatory breaches caused by the affiliate be reported first to the *Manager*, and subsequently, but promptly, by the *Manager* to the *Depositary*.	7.5	*Manager* *Depositary*
7	The Board of Directors of *IMA* should instigate a review to identify best practices, which, if adopted and adhered to, by UK investment managers, would demonstrate appropriate management of client mandates with potentially conflicting strategies.	7.6	*IMA*
16	*Managers* and *Depositaries* should adopt the statement of practice in relation to dilution levies and adjustments set out in Appendix 4.	8.2.2	*Manager* *Depositary*
23	*Managers* should establish, and monitor adherence to, a formal policy as to the frequency and timing of the release of portfolio details to *Investors*, or to classes of *Investors* (see *IMA*'s Market Timing Guidelines for Managers of Investment Funds issued 6 October 2004). The *Manager's* policy should be disclosed in the *CIS* prospectus.	9.5	*Manager*

4.5 Extending the role of the Depositary

While the role of the *Depositary* is defined by general considerations of fiduciary obligation as well as the *CIS* regulations, the *Working Party* felt that an explicit reference to the following areas would add value. We note that although oversight responsibility rests directly on the *Depositary*, *Managers* will also be required to make changes to accommodate these recommendations.

13	The *Depositary's* oversight role should be extended to review the *Manager's* use of the box and confirmation that it has been managed in accordance with the policy set out in the prospectus. The prospectus disclosure should be amended if it is not accurate or current.	8.1.3	*Depositary*
14	The *Depositary* oversight role should be extended to cover Level One disclosure, to ensure that the *Manager* has adequate procedures and controls in place. This oversight should include interrogation of the *Manager* as to its processes and reviews of the *Manager's* own internal monitoring programmes and the results of that monitoring, based on the information supplied in the *Manager's* Level One report (see recommendation no. 8 above).	8.2.1	*Depositary*
15	The *Depositary* oversight role should be extended to cover a review and appropriate questioning of the portfolio transaction report, including Enhanced Disclosure, described in recommendations 10 and 11.	8.2.1	*Depositary*
17	*FSA CIS* regulations should be amended to bring within the *Depositary's* oversight ambit, the *Manager's* compliance with its policy on charging dilution levies or other adjustments (see recommendation 16)	8.2.2	*FSA*

5 Current CIS Governance arrangements

5.1 UK authorised collective investment schemes

This report addresses the two categories of UK authorised collective investment schemes ("*CIS*"), namely authorised unit trusts ("*AUTs*") and open-ended investment companies ("*OEICs*").

An *AUT* is constituted under UK trust law, differing from a corporation in that it has no separate legal existence. *Investors* in *AUTs* are known as unitholders.

The other *CIS* vehicle is either called an *OEIC* or an Investment Company with Variable Capital ("*ICVC*"). For the purpose of this paper these vehicles will be referred to as *OEICs*. *OEICs* were first introduced in 1997, when new legislation came into force, to offer increased flexibility and simplicity, while retaining the tax structure enjoyed by *AUTs*.

OEICs have a corporate structure similar to that of a company. Within that structure, the *Depositar*y has broadly similar (but not identical) powers and responsibilities to the *AUT Trustee*. *Investors* within this structure are known as shareholders. In line with other corporate structures, *OEICs* may have boards of directors, and must have a minimum of one director, the Authorised Corporate Director ("*ACD*"). In practice there has been little enthusiasm for boards of directors and the *ACD* effectively acts in the same manner as the *Manager* of an *AUT*.

In many, if not most respects, the activities of and the regulatory framework surrounding *AUTS* and *OEICs* are virtually identical.

5.2 Key CIS participants

There are a number of key participants involved with *CIS* and *Investors*, *Managers* and *Depositaries* are discussed below in detail. Auditors also play an important role for CIS as do Standing Independent Valuers, who are required to value any real estate property held in a *CIS*.

5.2.1 *Investors*

This report uses the generic term *Investor*, except where there is varying treatment or rights for the unitholder of an *AUT* or the shareholder of an *OEIC*. Whilst not directly entitled to the underlying assets of the *CIS*, the *Investors* have a direct economic interest in the *CIS* assets, in proportion to their holding in the *CIS*.

In this report the term *Investor* is used to encompass a broader constituency than those who appear on the *CIS* register. Given the wide use of omnibus and other nominee arrangements that streamline the register, many *Investors'* names do not appear, so the term is taken to include the end or beneficial owner of the interests in the *CIS*.

5.2.2 *Managers* and *Depositaries*

Both the *Manager* and the *Depositary* have fiduciary obligations to the *Investor*, a concept that has come down through trust law, *CIS* Regulations and *FSA* Principles. While regulations attempt to codify and measure the performance of that fiduciary obligation, the core principle is that both the *Manager* and the *Depositary* must act in the best interest of the *Investors.* This principle is central to the nature of the relationship between *CIS* participants.

> ***Fiduciary obligation***
>
> *This is an obligation of loyalty and good faith owed in dealings that affect another person. For a fiduciary this obligation means more than acting fairly and honestly, but that they must act solely with the overall interests of the beneficiaries in mind. Crucially, a fiduciary must always act to secure the beneficiaries' best interests and must not allow its own interests to affect its behaviour in any way that would conflict with the best interests of the beneficiaries. A fiduciary is permitted to charge for its services, provided that details of any remuneration, or other payments or benefits received as a result of the relationship, are disclosed.*

Both *Managers* and *Depositaries* are regulated in the UK by the *FSA* and are subject to threshold tests as regards fitness and properness, including integrity, competence and financial resources. Whilst both are permitted to delegate certain activities to third parties, they still retain ultimate regulatory responsibility.

a) *Manager*

The *Manager*, which is also the promoter of the *CIS*, is responsible for making the investment decisions on the *CIS's* underlying portfolio, and is also responsible for most of the day-to-day administration of the *CIS*. Some of these activities are typically delegated.

b) *Depositary*

The *Depositary* is responsible for holding in safe custody, the assets of the *CIS*, principally investments and cash. The *Depositary* (or its nominee) is the registered owner of the *CIS's* investments. Economic benefits, such as dividends, are collected by the *Depositary* and subsequently distributed to the *Investors* upon receipt of appropriate instructions from the *Manager*. This separation of the management of the *CIS* assets from their possession and ownership is the most fundamental element of *Investor* protection provided by the *CIS* product.

The Depositary also has a responsibility for protecting the interests of incoming, outgoing and continuing *Investors*, including a duty of oversight over the activities of the *Manager*. Whilst not having a direct responsibility for the *Manager's* activities, the *Depositary* must take reasonable care to ensure that the *Manager* is properly discharging its own responsibilities. This is not the case for other mass savings products such as deposits, savings accounts or life policies.

The *Trustee* of an *AUT* also has prime responsibility under the *CIS* Sourcebook (see section 5.3.3), for the *AUT* registrar function, i.e. the maintenance of a current and correct list of *Investors* and their holdings. The COLL Sourcebook is more flexible, in allowing either the *Trustee* or the *Manager* of an *AUT* to take on this prime responsibility. In any event it is most unusual for *Trustees* to actually undertake this role, which is generally delegated either to the *Manager* or to an administrator, the *Trustee* (or possibly the *Manager* under the COLL Sourcebook rules), of course still retaining ultimate regulatory responsibility.

5.3 UK Regulatory framework

In the UK there are four levels of law and regulation that directly or indirectly affect *CIS:* European legislation; UK legislation (at both a primary and secondary level); *FSA* rules and guidance; and the *CIS's* own constitutive rules. These form a hierarchy of rules that at each level become progressively more detailed.

5.3.1 European legislation

At the European level the *UCITS* Directive governs *CIS* product regulation. The Directive is, except for certain provisions, a minimum harmonisation directive setting basic standards that all EU member states' funds must meet to qualify as *UCITS*, and thus to be passportable cross-border. Its provisions have been implemented into UK law. The Directive also identifies the management company (manager) and depositary and assigns certain requirements to each.

So far as the relationship between the manager and depositary is concerned, it is a Directive requirement that no single company may act in both capacities and that each must act independently of the other. However, the Directive does not prevent two companies within the same group acting as manager and depositary, providing that the above fundamental conditions are satisfied. The UK regulatory regime, however, does not permit affiliates to act in both capacities with respect to the same *CIS*.

> ***UCITS Directive***
>
> *The Undertakings for Collective Investment in Transferable Securities Directive sets down common standards for funds wishing to be registered and offered for public sale throughout the European Economic Area.*
>
> *Although primarily a Directive addressing product design and implementation (such as diversification and risk management) the Directive also identifies certain duties and obligations of the Manager. It should be noted though, that it stops short of mandating any specific governance structure and therefore there are several models that operate successfully within the UCITS standards, such as the UK.*

5.3.2 UK legislation

In the UK the main legislation affecting *CIS*, is the Financial Services and Markets Act 2000 ("*FSMA*"), which sets out the *FSA's* responsibilities, how a *Manager* may apply for authorisation of a *CIS* and who may act as a *Depositary*.

Although originally trust law assigned fiduciary duties between the Managing Trustee and the Custodian Trustee, over time this has been modified in the case of *CIS* so that these responsibilities are apportioned between the *Trustee* and the *Manager* of an *AUT*, by regulation and the trust deed.

> ***FSMA***
>
> *FSMA sets out the basis under which AUTs operate and in particular it implements key provisions of the UCITS Directive and gives the FSA powers to make rules for AUTs and OEICs. There are also Statutory Instruments containing the OEIC Regulations under which OEICs operate.*

Thus, it is the *Manager* that establishes the *CIS* and appoints the *Depositary*, and unlike a conventional trust it is the *Manager*, rather than the *Depositary*, that is responsible for all investment decisions. *Managers* are also responsible for valuing the *CIS* and calculating dealing prices based on those valuations.

Within the *AUT* structure, the *Trustee* has responsibility for custody of or control of fund assets, oversight of the activities of the *Manager* and protection of the interests of the beneficiaries, i.e. incoming, ongoing and outgoing *Investors*. The duty of oversight ensures that there are no *Investor* protection issues arising from this division of responsibility. In practice most of the governance and regulatory principles applicable to the *AUT* have also been applied to the *OEIC*. There is, however, one fundamental difference, in that the *ACD* is a contractual appointment by an *OEIC*, whereas the *Manager* of an *AUT* is a party to the constitutive trust deed.

5.3.3 *FSA* regulations

Detailed rules and guidance that are directly related to the operation of the *CIS* itself are contained in the *FSA's* Collective Investment Schemes and New Collective Investment Schemes specialist Sourcebooks that form part of the *FSA* Handbook. These Sourcebooks are the main means of implementing the *UCITS* Directive and provide essential material to complement the corporate code for *OEICs*. Rules that govern the activities of the *Manager* are contained in a number of the *FSA's* Sourcebooks and Manuals, including the Conduct of Business Sourcebook.

Categories of fund falling under the *CIS* Sourcebook are *UCITS* I and III funds and *non-UCITS retail funds* e.g. futures and options funds, geared futures and options funds, property funds, money market funds and funds of funds. All may be marketed to retail *Investors*.

Categories of fund falling under the COLL Sourcebook are *UCITS* III funds and *non-UCITS retail* funds (targeted at retail *Investors*) and Qualifying Investor Schemes (targeted at institutional *Investors* and sophisticated private *Investors*), all of which can invest in a mixture of assets. All *CIS* will need to comply with the COLL Sourcebook by February 2007 at the latest. Those CIS that invest in real estate property also need to comply with the valuation methodology set out in the Royal Institute of Chartered Surveyors Appraisal and Valuation manual.

The "old" Collective Investment Schemes Sourcebook (CIS Sourcebook)

Applies to
1) CIS for which authorisation application was submitted prior to 1 April 2004;
2) CIS for which authorisation application was submitted after April 1 2004, but which have elected under the transitional provisions to comply with the CIS Sourcebook

The "new" Collective Investment Schemes Sourcebook (COLL Sourcebook)

Applies to:
1) CIS for which authorisation application was submitted after 1 April 2004;
2) CIS for which authorisation application was submitted prior to 1 April 2004, but which have subsequently exercised the right to convert to COLL.

5.3.4 Fund constitutive documentation

Each *CIS* also has its own constitutive documentation, a trust deed in the case of an *AUT* and an instrument of incorporation in the case of an *OEIC*. These documents provide a further layer of rules, detailing the powers of each *CIS*. Day to day operating rules are then set out in the prospectus of each *CIS*, e.g. detailed investment objectives, the investment policy for achieving those objectives, details of each particular share class (e.g. differing fee scales) etc. While many of the detailed terms of the prospectus and other constitutive documents are set by the *Manager* within parameters, or on the basis of choices set out within the *FSA* rules, both the *CIS* instrument and prospectus add an extra layer of requirements and a breach of any of their requirements is treated as a breach of *FSA* rules.

6 Other CIS Governance Models

The *Working Party* compared the UK governance model against those in the European Union, Australia and the United States, to ascertain whether any useful lessons could be learned. Further detail of the different models is set out in Appendix 5.

6.1 Australia

Under Australia's Managed Investments Act (subsequently incorporated into the Corporations Act) a manager may be appointed as the "Single Responsible Entity" for all its managed investment schemes (the local equivalent to *CIS*). As such it is in complete control and is totally responsible for all aspects of each of the funds. There is no requirement for a board of directors or a depositary.

The *Working Party* concluded that this particular model could not readily be imported into the UK, as it would not comply with the *UCITS* Directive, which prescribes that one corporate body may not act as both manager and depositary for *UCITS*. An attempt to change the *UCITS* Directive was not considered to be practicable.

6.2 United States

US mutual funds, authorised under the 1940 Investment Company Act, are governed by a board of directors, whose responsibility is to ensure that the manager executes its business affairs in the best interests of *Investors*. This responsibility has recently been supported by new rules regarding the reporting lines of a compliance officer direct to the board, and the emphasis on the ability of the board to acquire the services of whatever people or other resources it might need to discharge its role.

The board of directors must have a majority of independent directors, and following a recent rule change, the board's chairman must be one of the independent directors.

The role of the board of directors under the US model therefore appears to be essentially similar to that of the *Depositary* in the UK, except that the *Depositary* has day-to-day contact with the mutual fund, rather than just at periodic board meetings. As the *UCITS* Directive would still require the appointment of a *Depositary* for any *UCITS* funds, and bearing in mind that the majority of UK *CIS* are *UCITS*-compliant, the *Working Party* concluded that a combination of a *Depositary* and a board of directors for *OEICs* would be possible, but would add unnecessary duplication and would not be a cost-effective solution. It risked creating significant confusion about each participant's role and having the effect of increasing *Investor* costs, whilst actually

Independent Directors – 1995 - HM Treasury view

In the UK consideration was given to requiring independent directors during HM Treasury's April 1995 "Open Ended Investment Companies, Second Consultation Document". Feedback to this consultation indicated that "There was a real concern in the responses that a requirement for a majority of independent directors for each open ended investment company would expose a shortage of suitably qualified candidates which in turn could add to costs for newly created open ended investment companies". The Treasury, taking this into account, together with the industry view that the unit trust model of independent Trustee was tried and tested, included Boards of Directors only as an option for OEICs.

detracting from the quality of oversight. Due to the *AUT* structure, a board of directors would not be practicable.

The *Working Party* also noted that the existence of a majority of independent directors on fund boards in the US had not seemed to impair the growth of practices such as late trading and market timing, reinforcing its view that the focus should be on qualitative rather than quantitative or simple "tick box" approaches to governance.

6.3 The European Union

The majority of EU investment funds are *UCITS* compliant. The *UCITS* Directive states that the depositary is responsible for the safe keeping of a fund's assets and for ensuring that sales, redemptions, cancellations and issues of units, and the calculation of the value of units, are carried out in accordance with the law and rules of the fund. In this respect, UK regulation is super-equivalent to the *UCITS* Directive requirements and UK *Depositaries* have a significantly wider oversight role, both as set out in the various legislative and regulatory provisions which attach to the roles, and the general law duty when acting as a fiduciary.

As noted in 5.3.1, the *UCITS* Directive does not prevent two companies within the same group acting as manager and depositary, providing that the independence conditions are satisfied.

UK regulation is super-equivalent to the *UCITS* Directive requirement concerning the relationship between the manager and depositary. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and *Manager* of an *AUT* and with regard to *OEICs* the *Depositary*, the *OEIC* and the directors respectively. The UK is, as far as the *Working Party* is aware, the only country to be super-equivalent in this way.

Recent changes in the structure of the UK *CIS* industry may, however, have made the *FSA's* stance on independence more difficult to sustain. Firstly, there has been a marked consolidation amongst the *Depositary* providers down to eight, only six of which currently have significant business. Secondly, the success of the full service provider concept means that it is not uncommon for many, if not all, *CIS* activities, other than investment management, to be delegated by a *Manager* to fellow subsidiaries of the *Depositary*, typically within large banking/custody groups.

Defining independence

The FSA CIS and COLL Sourcebooks identify three areas to consider:

Directors in common: *Independence may be lost if, by means of executive power, either relevant party could exercise effective control over the actions of the other;*

Cross-shareholdings: *Independence may be lost if either of the relevant parties could control the actions of the other by means of shareholders' votes. The FSA considers this would happen if any shareholding by one relevant party and their respective associates in the other exceeds 15% of the voting share capital;*

Contractual commitments: *The FSA encourages parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, directly or indirectly.*

6.4 Manager and Depositary – degrees of separation

The *Working Party* considered whether a model which removed the UK's current super-equivalence to the *UCITS* Directive in the matter of independence, was potentially a workable solution for the UK, and might also address the structural changes and competitive issues described above.

It is not uncommon within the EU for the manager and depositary to be fellow-subsidiaries. Many continental European investment management companies are subsidiaries of banks, which brand their funds for distribution, and also have existing in-house custody and administration operations.

It is also not uncommon for UK *Managers* to be subsidiaries within a wider group of companies containing other *FSA* regulated subsidiaries undertaking investment management activities or administration, and supported by a group-wide compliance function, adequately resourced with experienced compliance personnel, and reporting to the parent company board.

The reality is that it is increasingly difficult for any participant within the *CIS* structure to stand, alone and aloof, from other players whose roles and participation may intersect or conflict with the obligations it owes to *Investors*. Increasingly, independence has to be characterised and evaluated as a state of mind and style of behaviour, as opposed to a quantitative measuring economic interrelationships.

The *UCITS* Directive allows a structure where the manager is one subsidiary company and the depositary is another subsidiary. To operate within the UK, such a *Depositary* would need to be subject to independent capital requirements, and be required to demonstrate possession of the same resources and expertise as the current *Depositary* providers.

Such a model might be attractive to the larger UK investment management groups. Smaller *CIS* operators with less access to internal compliance resources might find this less attractive and continue to use the specialist independent *Depositary* providers and the resources, upon which as large corporations, they are able to draw.

It has to be said, however, that independence is a significant issue in terms of international credibility and *Investor* confidence, and it is difficult to envisage fund industry harmonisation without a very robust alternative to the current separation of functions.

After lengthy consideration, the *Working Party* narrowed the options down to:

- Modified EU model, i.e. the *Depositary* could be a fellow-subsidiary of the *Manager*, subject to adequate resources and regulatory capital;
- Modified EU model, as above, but with a requirement that *CIS* assets could not be held by an affiliate of the *Manager;*
- Current UK model, but with *Depositary* responsibilities cut back to the *UCITS* Directive requirements;
- Current UK model;
- Current UK model, extended by those proposals laid out in this report.

The *Working Party's* final conclusion (see recommendation 1 below) was coloured by decisions taken on other issues, e.g. to recommend further enhancement to the *Depositary's* role and responsibilities.

6.5 Independent Directors

In line with other corporate structures, *OEICs* may have boards of directors, and must have a minimum of one director, entitled the *ACD*. In practice there has been very little enthusiasm for boards of directors and the *ACD* effectively acts in the same manner as the *Manager* of an *AUT*.

The role of independent directors within *OEICs* was considered at length during HM Treasury's two consultations on *OEICs* in the 1990's (see inset box, page 19). As noted above, HM Treasury eventually permitted *OEICs* to appoint independent directors, but did not require them to do so. This flexible approach to the composition of the board was counterbalanced by a stronger role for an independent *Depositary*. Virtually all firms have selected the option of the single *ACD*.

FSA regulations give the *ACD* responsibility for complying with *FSA's Investor* protection regulations, certain provisions of the *OEIC Regulations* and dealing with the *OEIC's* everyday business, including managing the *OEIC's* investments, selling and repurchasing the *OEIC's* own shares on demand, and ensuring accurate pricing of these shares at *NAV*.

As a counterbalance, HM Treasury took the view that the role of the *Depositary* would be crucial to the stability and successful running of an *OEIC*. For this reason, the *OEIC Regulations* permit the *Depositary* to convene and attend shareholder meetings, to receive any relevant board papers and to attend any directors' meetings which concern its business as *Depositary* (except those where the *Depositary's* terms of appointment are to be discussed).

Such an *OEIC* bears a strong resemblance to an *AUT*, which has no board of directors. The *Working Party* understands that HM Treasury remains satisfied that the authorisation of the *OEIC*, its *Depositary* and *ACD* delivers high business standards and so provides adequate protection, not only to the *OEIC's Investors,* but also to others doing business with it. Further consideration of *CIS* governance and the role of single corporate directors, was undertaken by the *FSA* during its research prior to issuing CP185: The New CIS Sourcebook. The *FSA* concluded that the current *CIS* governance model works well and provides effective *Investor* protection.

The *Working Party* saw no need to dissent from the publicly held view of both HM Treasury and the *FSA.*

Recommendation No.1 - The need for fundamental change

There should be no change to the UK's current *CIS* governance model, other than in respect of those recommendations elsewhere in this paper to enhance, and better to define, the *Depositary's* and *Manager's* respective roles and responsibilities.

7 Key CIS participants – appointment and replacement

7.1 Manager

From time to time suggestions are made that *Investors* in poorly performing *CIS* should be able to replace the *Manager* by means of a vote at a *CIS* general meeting. Similar suggestions have recently been made in the US, following the revelation of mutual fund abuses by Elliott Spitzer, the New York Attorney General. Supporters of such an approach however, risk losing sight of how the *CIS* industry works and was designed to work. (see sections 3 and 5 above).

Whilst the *Working Party* does not accept the need to put *Managers* on some form of continuous probation in respect of purely business matters, there remains a need to ensure that in cases of egregious and abusive behaviour there is an ability to address the *Manager's* shortcomings, even to the extent of dismissal.

In the view of the *Working Party*, sufficient powers already exist for the *Depositary* (often in conjunction with the *FSA*) to address any threats to the safety of *Investor* assets. There are both policy and technical objections to the *Depositary* taking a view on commercial matters such as the level of the *Manager's* fee or the quality of performance of the *CIS*. As noted elsewhere in this paper, the *Investor* is entirely at liberty to exit a relationship that he or she regards as no longer fit for his or her purpose.

7.2 Depositary

Whilst the *Depositary* has a responsibility for protecting *Investors* by overseeing the activities of the *Manager*, the replacement of the *Depositary* is, in practice, a decision of the *Manager*. Usually a decision to replace a *Depositary* is commercial, based on the competitiveness of fees and service levels, or as part of a wider arrangement. However, there is a theoretical potential for such a change to be made for other reasons, e.g. the *Manager* being uncomfortable with the *Depositary's* strict interpretation and enforcement of the regulations.

There are already safeguards in place for such situations. Any *Depositary* replacement must be authorised by the *FSA* and the replacement *Depositary* will be subject to the same regulations and fiduciary obligations as the first *Depositary*. So while there may be subtle differences in interpretation, the baseline standards of *Investor* protection will remain unchanged.

There are however some anomalies under current regulations as between the replacement of the *Trustee* of an *AUT* and the replacement of a *Depositary* of an *OEIC*, as well as in comparison to the replacement of a *CIS* auditor.

In contrast with the arrangements for *AUTs* (see below), the appointment of the *Depositary* of an *OEIC* is a contractual arrangement between the *OEIC* (acting through the *ACD*) and the *Depositary*. The replacement of a *Depositary* is simply the termination of a contract on the basis set out in that contract.

> ***Statement by Depositary ceasing to hold office***
>
> *"Where the Depositary of a company ceases, for any reason other than by virtue of a court order made under regulation 26, to hold office, it **may** deposit at the head office of the company a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the shareholders or creditors of the company or, if it considers that there are no such circumstances, a statement that there are none" (emphasis added)*

This status of the *Depositary* is recognised within the *OEIC Regulations*, which provide for a document described as a "Statement by Depositary ceasing to hold office" (see insert box) and goes on to provide how such a statement should be circulated to the shareholders or creditors, together with notification to the *FSA*.

The regulations also provide for the *OEIC* to give written notice to the *FSA* of any proposal to replace the *Depositary*.

In the case of an *AUT*, the *Manager* and the *Trustee* become appointed by being the parties to the trust deed constituting the trust, and *FSA* regulations give the *Trustee* the power to replace the *Manager* in exceptional circumstances. In practice, however, the *Manager* controls the process and although they are not legally entitled to dismiss the *Trustee*, they are able to bring commercial pressure to bear to persuade a *Trustee* to resign.

The potential problems relating to replacement of a *Trustee* is recognised within *FSMA*, which states, "The Manager of an authorised unit trust scheme *must* give written notice to the Authority of any proposal to alter the scheme *or to replace its Trustee.*" (emphasis added) and *FSMA* places some responsibility onto the *FSA* by providing that "The Authority must not approve a proposal to replace the Manager or the Trustee of an authorised unit trust scheme unless it is satisfied that, if the proposed replacement is made, the scheme will continue to comply with the requirements of section 243(4) to (7)".

AUTs have no provisions for whistle-blowing direct to *Investors* similar to that available through the "Statement by Depositary ceasing to hold office" provision described above. The differing treatment between the two *CIS* structures is unhelpful.

> **Recommendation No 2 - Addressing Balance of Powers**
>
> As current *FSA CIS* regulations and trust deeds do not reflect actual practice with regard to the appointment or replacement of *AUT Trustees*, these should be amended, to mirror the contractual appointment of *Depositaries* by *ACDs* of *OEICs*.

7.3 Comparison of treatment of *Depositary* change with change of auditors

The regulations relating to the replacement of auditors are more robust than those for replacing *Depositaries*. Schedule 5, paragraph 18 (1) of the *OEIC* Regulations – (Statement by auditor ceasing to hold office), provides that "Where an auditor ceases for any reason to hold office, he ***must*** deposit at the head office of the company a statement of any circumstances connected with his ceasing to hold office which he

considers should be brought to the attention of the shareholders or creditors of the company or, if he considers that there are no such circumstances, a statement that there are none" (emphasis added).

In a similar manner to dealing with replacement of a *Depositary*, the *OEIC Regulations* go on to provide how a statement, which the auditor considers should be brought to the attention of the shareholders or creditors, should be circulated to those persons, together with notification to the *FSA*.

The *FSA* Supervision Manual (a module of the *FSA* Handbook) also states that "If an auditor ceases to be, or is formally notified that he will cease to be, the auditor of a firm, he *must* notify the *FSA* without delay: (1) of any matter connected with his so ceasing which he thinks ought to be drawn to the *FSA's* attention; or (2) that there is no such matter".

The *Working Party* believes it would be advantageous to improve the current regime regarding the statement provided by the *Depositary* on leaving office, and apply this to both *OEICs* and *AUTs*, in line with the current regime for auditor changes.

Recommendation No.3 – Addressing Balance of Powers

FSA CIS regulations should be amended so that the *FSA*, once having received notification under *FSMA* (*AUTs*), or under the *OEIC Regulations* (*OEICs*), and prior to approving a proposal to change the *Depositary*, will require the *Depositary* to provide them with a statement of any circumstances connected with its ceasing to hold office which it considers should be brought to the attention of the *FSA* or, if it considers that there are no such circumstances, a statement that there are none.

The *Working Party* also believes that ensuring the transparency of any such change will helpfully inform *Investors*.

Recommendation No.4 – Improving Disclosure

FSA CIS Regulations should be amended to require that in the *CIS* report and accounts following a change of *Depositary:*
The *Manager* should disclose:
- reasons for the change of *Depositary;*
- any wider arrangements of which the change of *Depositary* is a part.

Further:
both the outgoing and incoming *Depositaries*, should supply a *Depositary* report covering the periods within the accounting period, for which they were responsible.

The new COLL Sourcebook, within "Operating duties and responsibilities", has rules relating to the "Retirement of the Depositary", using *Depositary* as a generic term for both the *Depositary* of an *OEIC* and the *Trustee of an AUT*. These rules, however, are limited to circumstances in which the *Depositary* wishes to retire voluntarily, and does not contemplate a situation when the *Manager* might wish to replace the *Depositary*. Given that the safeguards around *Depositary* changes will be improved if the recommendations of this report are followed, the *Working Party* believes that it is

appropriate to give the *Manager* the power to replace the *Depositary* in the normal run of business.

> **Recommendation No. 5 – Addressing Balance of Powers**
>
> *FSA CIS* Regulations should be expanded to cater for circumstances in which the *Manager* wishes to replace the *Depositary*.

7.4 Auditors - appointment and replacement

As the annual audit of a *CIS* is an oversight function, the *Working Party* considered whether the appointment and remuneration of *CIS* auditors should be the responsibility of the *Depositary* rather than the *Manager*.

After careful consideration, the *Working Party* concluded that such a change could give rise to significant policy and practical problems.

As an oversight function, the annual audit is just as likely to be a commentary on the effectiveness of the *Depositary's* oversight as much as the *Manager's* conduct. The essential conflict is not altered, merely relocated, by making the *Depositary* responsible for appointment and remuneration of the auditor.

It is not uncommon for the same firm of auditors to act both for the *CIS* and its *Manager*, and in such cases each audit is usually the responsibility of a separate partner. Having the same audit firm performing both audits usually means significant improvements in efficiency and effectiveness of the audit, and also reduces costs as work done in areas such as transfer agency and fund accounting can serve both purposes. It is doubtful whether auditors reviewing a fund, but insufficiently familiar with the processes and procedures of the *Manager*, would be able to provide a more in-depth evaluation.

The *Working Party* also took comfort from the fact that auditors are bound by their own professional standards that govern their resigning from assignments and accepting assignments from outgoing auditors, as well as the regulatory disclosure to the *FSA* required by its Supervision Manual.

Overall, the *Working Party* was of the opinion that there are sufficient safeguards for *Investors* provided by the current system, that no alternative offered better levels of protection and that all were likely to generate more costs, which would ultimately, of course, be borne by *Investors*.

7.5 Affiliates of the Manager and Depositary undertaking CIS activities

Depositaries carry out an important oversight role and also, tend to be subsidiaries of banking groups engaged in a variety of financial service businesses. Indeed, in several instances, affiliates of the *Depositary* provide other services, bundled into the services provided by the *Depositary*.

The *Working Party* noted a potential conflict of interest in circumstances where the *Manager* delegates operational activities for which it is responsible, to affiliates of the *Depositary*, e.g. fund accounting, valuation and pricing. In the event that such an affiliate was to make an error or breach the relevant regulations it would be accountable to the *Manager*, which in turn is accountable to the *CIS's Investors* and the *FSA*. There was a concern that where such an activity was performed by an affiliate of the *Depositary*, there could be an *Investor* perception that the *Depositary* might be inclined to influence a decision to make any correction or pay compensation, which inclination might be coloured by its affiliation rather than driven by its fiduciary obligations.

It is impractical to seek to ban dealing with the affiliates of *Depositaries* and so the *Working Party* is recommending improvement of the management of the arising conflicts.

Recommendation No. 6 - Agreeing Standards

Managers and *Depositaries* should establish formal governance and procedural structures in relation to *CIS* activities delegated by the *Manager* to affiliates of the *Depositary*, that require that any errors or regulatory breaches caused by the affiliate be reported first to the *Manager*, and subsequently, but promptly, by the *Manager* to the *Depositary*.

The *Working Party* concluded that with one exception, current regulations provide adequate disclosure of activities undertaken by affiliates of the *Manager* or the *Depositary* in the *CIS* prospectus and related fees/charges in the *CIS* report and accounts.

The one exception noted was in respect of portfolio transactions placed with counterparties that are affiliates of the *Manager* or of the *Depositary*. This is addressed by recommendation 10, below.

7.6 Investment managers managing CIS and other funds with potentially conflicting strategies

The *Manager* of a *CIS* frequently does not undertake the investment management activity, typically delegating this to an affiliated investment management company. The *Working Party* considered the potential conflicts within the *Manager* or the investment manager in the event that it also manages client mandates that:

- are able to take short positions in the same stocks that the *CIS* holds; or,
- pay the investment manager performance fees, rather than ad valorem fees.

Despite noting the proposals in the US to prohibit investment advisers from acting on behalf of hedge funds and mutual funds, the *Working Party* concluded that current UK regulations already require investment managers to have policies and controls in place to address customer order priority, fair allocation, release of internal analyst's recommendations, access to portfolio positions between staff managing different types of fund etc. However, the *Working Party* also concluded that this was wider than just a *CIS* issue, and that management and explanation of such conflicts was critical for the maintenance of *Investor* confidence in the UK investment management industry.

Recommendation no. 7 - Agreeing Standards

The Board of Directors of *IMA* should instigate a review to identify best practices, which, if adopted and adhered to, by UK investment managers, would demonstrate appropriate management of client mandates with potentially conflicting strategies.

8 Key CIS participants - responsibilities

The *Working Party* reviewed the *CIS* value chain document (see Appendix 3) to ascertain whether there was clear understanding of all relevant responsibilities, by the parties involved. In particular, it considered whether:

- the responsibilities for all activities and the responsible parties involved are clearly understood by the industry, *Investors* and the *FSA*;
- there are activities where independent oversight could be extended to add value;
- there are any over-lapping responsibilities which could be rationalised with reduction in potential confusion of roles and with potential cost savings;
- there are instances where, due to current regulations, the responsibilities of *Trustees* and *Depositaries* significantly differ, and if so, whether regulatory change is desirable to bring these into line;
- recommended changes could be achieved by industry agreement, or whether regulatory change would be either needed or desirable.

8.1 Manager

8.1.1 <u>Costs disclosure</u>

In May 2002 following consultation with *IMA Members*, the *PFDC* was adopted by the Board of *IMA*. The objective of the *PFDC* is transparency in order to assist pension fund trustees' understanding of the charges and costs levied on pension fund assets, facilitated by comprehensive, clear and standardised disclosure that will allow pension fund trustees and their advisers to monitor and compare all costs incurred during the management of the fund's assets. Appendix 6 details the narrative (Level One) disclosure currently being produced by managers of pension funds, and is likely, in due course, to require some expansion to take account of *IMA's* Enhanced Disclosure proposals (see section 8.1.2).

> **Level One Disclosure**
>
> *PFDC* Level One disclosure is not client specific, but comprises a generic narrative description of the investment manager's internal processes and policies in relation to a number of investment management activities, e.g. best execution, broker selection, transaction cost analysis etc. This is produced in a formal report to the pension fund trustees.

IMA Members have commented that as this information has been found to be valuable to pension fund trustees, it would seem logical that similar disclosure is extended to *CIS*, to ensure that the economic interests of their *Investors* are protected. The questions are, to whom should disclosure be made and who should do the monitoring, as it has to be acknowledged that *Investors* are generally unlikely to be able to fulfil this function. The *Working Party* also noted that many *Managers'* affiliated investment managers were already producing Level One reports for their pension fund client base, and that for practical purposes Level One reports for *CIS* would be identical with these and would not require significant additional effort.

> **Recommendation no. 8 – Improving Disclosure**
>
> *Managers* should produce, and supply to the *Depositaries*, annual reports similar to the *PFDC* Level One disclosure, or the enhanced disclosure currently being developed with interested parties (see section 8.1.2 and recommendation 11).

Recommendation No. 15 also requires a proportionate degree of increased oversight by the *Depositary*.

The *CIS SORP* ensures that management, *Depositary*, audit fees and other charges against income are already disclosed in *CIS* report and accounts, to a similar level of detail as required by the *PFDC* Level Two disclosure (see Appendix 7 and insert box). The *CIS SORP* currently only requires disclosure of the total cost of portfolio purchases and net proceeds of sales, and not the level of detail required by *PFDC* Level Two (Appendix 3). The *Working Party* took the view that it was appropriate to include further and better information in *CIS* report and accounts.

Level Two transaction Disclosure (see Appendix 7)

This is a report of client specific data, showing, in tabular format: Fees and other costs of management; A summary of portfolio transactions during the period, including trades through top ten brokers, net and commission business, deals through affiliates etc. FX costs are included if material.

Recommendation No. 9 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require the disclosure in *CIS* report and accounts of the totals of broker commissions, taxes and any other charges included within portfolio purchases and sales.

Recommendation No. 10 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require a portfolio transaction report to be included as a note in *CIS* report and accounts, detailing in numerical terms the total of transaction volumes, analysed over the top ten counterparties by volume, and by net and commission based trading, and a remainder. Any counterparties that are affiliates of the *Manager* or the *Depositary* should be identified as such.

Gross portfolio turnover and commissions in this table should reconcile to the total figures disclosed in *CIS* report and accounts following recommendation 9 above.

The *Working Party* bore in mind the concern that whilst many *CIS Investors* would be interested in this additional information, some may not be sufficiently experienced to make informed judgements on it. However, it is thought that many advisers and not a small proportion of *Investors* will find the information of benefit. Recommendation No. 15 addresses this particular point by requiring a proportionate degree of increased oversight by the *Depositary*.

8.1.2 <u>Portfolio transaction costs – Enhanced Disclosure</u>

IMA's response to *FSA* CP176: Bundled brokerage and soft commission arrangements, proposed a disclosure regime entitled "Enhanced Disclosure", which effectively is an expansion of the *PFDC* Level One disclosure (see section 8.1.1) and Level Two transaction analysis. This *IMA* proposal will require a sub-division of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class. The proposal recognises that investment managers may have to produce reports for a number of different categories of client, potentially with different reporting periods, and suggests

that investment managers may select one standard reporting period for their full client base comparison.

The *FSA* has made it clear that it did not intend CP176 to apply to pension funds only, and has stated that it intends "to review current arrangements and standards for the governance of retail funds and that action in that area could help to deliver the benefits of enhanced disclosure to, private investors, who are unlikely to have the knowledge or market power to engage directly with fund managers on these issues".

FSA had discussed the Enhanced Disclosure proposals with the *IMA* and went on to state, "We are aware that the IMA has itself begun work in this area and we look forward to the results of this work". Subsequently, Lindsay Tomlinson, Chairman of *IMA*, wrote to John Tiner, Chief Executive of the *FSA*, on 31 March 2004, outlining *IMA's CIS* Governance project and reiterating that Enhanced Disclosure would be addressed.

IMA is carrying out a separate consultation with *Members* on Enhanced Disclosure. Full details can be found in *IMA* Circulars 243/04 (issued on 28 October 2004) and 005/06 (issued on 12 January 2006).

Recommendation No. 11 – Improving Disclosure

Contingent upon Enhanced Disclosure being adopted by *IMA* and accepted by the *FSA*, the *CIS SORP* should be amended to incorporate the *IMA* Enhanced Disclosure proposals, and the portfolio transaction report described in recommendation 10, should be expanded to include a split of commission costs between execution costs and cost of broker research, together with comparisons against the investment manager's full client base for the particular asset class.

The *Working Party* bore in mind the concern that whilst many *Investors* would be interested in this additional information, some may not be sufficiently experienced to make informed judgements on it. However, it is thought that many advisers and not a small proportion of *Investors* will find the information of benefit. Recommendation No. 15 addresses this particular point by requiring a proportionate degree of increased oversight by the *Depositary*.

8.1.3 Manager's box – trading in units as principal

It is common in the UK for the *Manager* to run a principal position in the units or shares of the *CIS:* this is called the *Manager's* box. Most boxes are designed as administrative buffers, with the flows of *Investor* deals netting down to the same, or a similar position, each day. In practice they can provide a source of administrative convenience, especially given the time constraints under which, currently, *Managers* must advise *Depositaries* of the day's dealing in the *CIS*. They are particularly helpful in assisting the *Manager* to avoid negative boxes (a short position in the units or shares), which can arise from administrative errors, such as simple deal input errors, and which is a breach of *CIS* regulations.

While the practice is for most boxes to be run in this way, there is a no specific prohibition on taking a more aggressive approach and accepting more substantial box positions than administrative convenience itself would suggest.

The *FSA*, in CP131 (on single pricing), stated "boxes can, as suggested by many respondents, serve a useful function for the efficient operation of a fund…"

Nevertheless, the *Manager's* box can generate both profits and losses resulting from the market movement in the *CIS* itself and the prices at which it buys and sells shares and units for and from the box.

The *Working Party* believes that it is important to recognise that these arrangements have from time to time given rise to perceptions of conflict of interest. In order to address this, the *Working Party* has decided to make recommendations regarding the disclosure of the *Manager's* policy and extending the oversight role of the *Depositary*. The *Working Party* also suggests that, in the interests of transparency, *Managers* may wish to make available, upon request from *Investors*, copies of their own report and accounts, including details of profits or losses made on boxes across the *Manager's* range of UK authorised *CIS*.

Recommendation No. 12 – Improving Disclosure

FSA CIS regulations should be amended to require that the *Manager* includes within the *CIS* prospectus, a statement of its policy on box management, making clear the purposes for which the box is used.

Recommendation No. 13 – Extending the role of the Depositary

The *Depositary's* oversight role should be extended to review of the *Manager's* use of the box and confirmation that it has been managed in accordance with the policy set out in the prospectus. The prospectus disclosure should be amended if it is not accurate or current.

8.2 Depositary

8.2.1 Oversight of investment management activities

As noted in section 8.1.1 above, following consultation with its *Members*, the *PFDC* was adopted by the Board of *IMA* in May 2002.

To date, these investment management activities have fallen outside the scope of detailed *Depositary* oversight. *Members* have commented that, as this information has been found to be valuable to pension fund trustees, it would seem logical that these areas are also monitored for *CIS*, to ensure that the economic interests of *Investors* are protected, in the same way as pension fund beneficiaries.

Recommendation No. 14 – Extending the role of the Depositary

The *Depositary* oversight role should be extended to cover Level One disclosure, to ensure that the *Manager* has adequate procedures and controls in place. This oversight should include interrogation of the *Manager* as to its processes and reviews of the *Manager's* own internal monitoring programmes and the results of that monitoring, based on the information supplied in the *Manager's* Level One report (see recommendation no. 8 above).

Recommendation No. 15 – Extending the Role of the Depositary

The *Depositary* oversight role should be extended to cover a review and appropriate questioning of the portfolio transaction report, including Enhanced Disclosure, described in recommendations 10 and 11.

8.2.2 Dilution levies and adjustments

CIS regulations provide that the *Depositary* has responsibility for oversight of the activities of the *Manager* in relation to the *CIS* and protection of the interests of the beneficiaries, i.e. incoming, ongoing and outgoing *Investors*. Current regulations specifically require the *Depositary* to ensure that the *Manager* considers whether or not to apply a dilution levy (or other dilution adjustment), taking account of all factors to protect single-priced *CISs*. However, the *Depositary* is directly excluded from any duty in ensuring that the conclusion reached by the *Manager* is in the interests, of *Investors*.

Recommendation No. 16 – Agreeing Standards

Managers and *Depositaries* should adopt the statement of practice in relation to dilution levies and adjustments set out in Appendix 4.

Recommendation No. 17 – Extending the Role of the Depositary

FSA CIS regulations should be amended to bring within the *Depositary's* oversight ambit, the *Manager's* compliance with its policy on charging dilution levies or other adjustments (see recommendation 16).

9. Transparency

The *Working Party* considered whether there are adequate mechanisms in place to ensure the appropriateness of all material fees and expenses charged to *CIS*, and in particular:

- whether all costs/income noted in the *CIS* value chain document (see Appendix 3) are appropriate to be borne/received by the *CIS*, including all earnings from *CIS* assets, even if not generated directly by the *CIS*, e.g. revenue sharing on stock-lending fees;
- how each cost is currently disclosed, including those costs that are levied by one party and subsequently shared with another party, and how accessibility of this disclosure could be improved;

The *Working Party* was not interested in setting pricing benchmarks which it sees as a function of the market, but focussed rather on whether a mechanism existed to ensure that costs were transparent, correctly accounted for and adequately disclosed.

9.1 Income and fees - stock-lending

Stock-lending provides a distinct revenue stream, differing from dividends and interest earned from standard investment management activities. The costs associated with stock-lending are also different in that they are only incurred by the lender if revenues have been earned, and are then deducted directly from those revenues. Stock-lending income is, however, sometimes, included in *CIS* report and accounts as a net figure without disclosure of related costs and sometimes gross, with costs shown separately. Such varying treatment is unhelpful in ensuring standardised disclosure.

Recommendation No. 18 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to reflect the distinct nature of stock-lending income and related costs, by requiring that such income be reported net in the Statement of Total Return, and that related fees and expenses be separately disclosed, by way of a note, in *CIS* report and accounts.

9.2 Revenue sharing

Stock-lending fee revenues, whilst being disclosed in *CIS* report and accounts as a payment to the stock-lending agent, may subsequently be shared with the *Manager*, *Depositary* or affiliate of either. The *Working Party* concluded that potentially there might be other charges levied against funds that could be shared between key participants.

Recommendation No. 19 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require that, in relation to any charges or costs levied, directly or indirectly, against the assets of a *CIS*, disclosure should be made in the report and accounts of any revenue sharing participated in by the *Manager*, *Depositary* or affiliates of either.

9.3 Fees and Expenses - Total Expense Ratios ("TERs")

Included within *FSA's* Consultation Paper 04/18: Implementation of the Simplified Prospectus requirements in the UCITS Management Company Directive, is a proposal that *TERs* will in future be disclosed in the Simplified Prospectus. The paper also sets out an EU standard formula for calculating the *TER*, using data disclosed in the *CIS* report and accounts. The *FSA* already requires disclosure of *TERs* in *CIS* short reports.

The *Working Party* considers the *TER* to be a vital source of *Investor* information and noted that the necessary data for calculating *TERs* will be included in the audited report and accounts. The *Working Party* also noted that disclosure of the *TER* is only a requirement for *UCITS*, and that it would also be a valuable source of information for *Investors* in *non-UCITS retail funds* and would facilitate cost comparison across the full range of those *CIS* products targeted at retail *Investors*, more effectively than the existing Reduction in Yield disclosure, which requires comparison of an arbitrary projection with a rate of return which is entirely theoretical. It is noted, however, that some clarification will be required for the calculation of *TERs* for *CIS* invested in property, in particular clarification as to which costs can be excluded from the *TER* as expenses rather than charges.

Recommendation No. 20 – Improving Disclosure

Amendments should be considered to the *CIS SORP* to require a note showing the calculation of the *TER* to be included in the audited annual report and accounts of *UCITS* and *non-UCITS retail funds*. In the event that the *Manager* believes that it is necessary to update the *TER*, an un-audited version of this calculation should be included in the interim report and accounts.

Recommendation No. 21 – Improving Disclosure

Upon implementation of the Simplified Prospectus regime for UCITS, *FSA* should also require disclosure of *TERs* in *non-UCITS retail fund* Key Facts/Key Features documents. This *TER* disclosure should replace the existing Reduction in Yield disclosure.

9.4 Fees and Expenses – level playing field

The CIS Sourcebook rules for *OEICs* and the COLL Sourcebook rules for both *OEICs* and *AUTs,* give *Managers* more latitude in charging costs to *CIS* than is currently available to *Managers* of *AUTS* operating under the CIS Sourcebook. Examples of the costs that may be charged to *OEICs* and new *AUTs* include the production costs of report and accounts, prospectus and short reports and additional administration fees.

The *Working Party* was concerned that these differing standards would make it problematic for an *Investor* or their adviser to make a sensible fund expense comparison. Recognising that this lack of clarity will persist until 2007, when all *CIS* must have converted to the COLL Sourcebook, the *Working Party* considered the impact of standardised *TERs*.

Recommendation No. 22 – Improving Disclosure

The *IMA* should encourage *Managers*, the *FSA*, *Investors* and their advisers to transfer their attention from the detailed *CIS* costs laid out in report and accounts, to *TERs*, which will be required to be disclosed in *CIS* Simplified Prospectus documents (when implemented), and short reports.

9.5 Provision of portfolio details to Investors

The *Working Party* considered issues arising out of the supply, by *Managers*, of *CIS* portfolio details to investment managers of fund of funds, who, for good commercial reasons, wish to have such data updated on a regular and frequent basis. The provision of such information may involve disclosure at a level of detail or with a frequency greater than that with which more general disclosures of information are made.

The *Working Party* considered whether the same disciplines that inform the way listed companies disclose material information should be applied by analogy to *CIS*, and whether the *CIS* industry should attempt to set a common portfolio disclosure standard.

It was agreed that any disclosure policy should strike the right balance between the legitimate enquiries and demands for information of *Investors* and would-be *Investors*, and the protection of the intellectual property of the *CIS,* from which its *Investors* benefit. Whilst different *Investors* have different information requirements, the obligation to treat *Investors* fairly would argue that any selective disclosure must be handled very carefully. If particular *Investors* are able to take advantage of any information that is not made available to other *Investors*, this could be regarded as "unfair".

The *Working Party* also noted the strong argument that the *CIS* market might operate more fairly and more efficiently if material information was made available to all *Investors* at the same point in time. This would still allow *Investors* with quicker response times and smarter investment decision-making to prosper.

Recommendation No. 23 – Agreeing Standards

Managers should establish, and monitor adherence to, a formal policy as to the frequency and timing of the release of portfolio details to *Investors*, or to classes of *Investors* (see *IMA's* Market Timing Guidelines for Managers of Investment Funds issued 6 October 2004). The *Manager's* policy should be disclosed in the *CIS* prospectus.

Appendix 1

IMA CIS GOVERNANCE WORKING PARTY - TERMS OF REFERENCE

To review the present arrangements for oversight of *AUTs* and *OEICs*, in particular in relation to actions that might be detrimental to the interests of *Investors*, individually or collectively, including any that might arise from conflicts of interest.

To benchmark these arrangements against international best practice.

To consider whether changes would be desirable, either through new regulation, or through the adoption of best industry practice, taking due account of the cost effectiveness of such changes.

To make appropriate recommendations to the Board of Directors of *IMA*.

Appendix 2

CIS GOVERNANCE WORKING PARTY - MEMBERS

Chairman – Lindsay Tomlinson – Chairman of IMA and Vice Chairman Europe, Barclays Global Investors

Alan Ainsworth – Deputy Chairman, Threadneedle Investment Services

Clive Brown – Head of Europe, Asia and Japan, JP Morgan Fleming Asset Management

Jeremy Burchill – Member of IMA's General Regulations Committee and Head of Group Legal, Aberdeen Asset Management

Peter Craft – Chairman of the Depositary and Trustee Association (September 2003 – August 2004) and Director, RBS Trustee and Depositary Services

Tim Gandy – Chairman of the Depositary and Trustee Association September 2004 to date) and Senior Vice President and Managing Director, J.P. Morgan Trustee and Depositary Company Limited

Simon Ellis – Chairman of IMA's Investment Funds Committee and Head of Retail, AXA Investment Managers

Tim Herrington – Partner, Clifford Chance

Keith Marsden - Chairman of IMA's Product Development Committee and Head of Sales, Fund Administration, Barings

Colin McLatchie – Managing Director, Aegon Asset Management

Jane Petkovic – Member of IMA's Investment Funds Committee and Joint Managing Director, Jupiter Unit Trust Managers

Richard Wastcoat – Member of IMA's Investment Funds Committee and Managing Director, UK Mutual Funds Business, Fidelity

Jeremy Willoughby – Group Compliance and Risk Director, Schroders plc

Secretaries to the Working Party – Jim Irving, Senior Adviser – Regulation, and Ros Clark, Technical Adviser, Investment Management Association.

CIS VALUE CHAIN

APPENDIX 3

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Structure						
Manager replacement etc	I	*CIS*	P, RA, KFD	N/A	N/A	CIS is *Manager's* branded product. **See sections 3 and 7.1**.
Depositary - selection/change	M	*CIS*	P, RA, KFD			Oversight role but not an independent appointment and whilst regulations do not envisage the *Manager* replacing the *Depositary*, in practice this is a commercial issue and is the case. **See sections 7.2 – 7.3 and recommendations 2, 3, 4 and 5.**
						Change of *Depositary* may be part of a wider arrangement involving affiliates of *Manager* and/or *Depositary*. **See section 7.3 and recommendation 4.**
Depositary – fee levels	M	*CIS*	P, RA			No identified issues.
Appointment of affiliates of *Manager* or *Depositary* to carry out any activities on behalf of fund	M	*CIS*	P, RA	MC	T	Potential conflicts of interest. Current rules require disclosure in P of all affiliate arrangements. **See section 7.5 and recommendation 6.**
						Not all payments to affiliates (e.g. broking commissions) are required to be disclosed in RA**. See section 8.1.1 and recommendation 10.**
						Affiliates of *Depositary* (that has oversight role) may be appointed to carry out fund activities. **See section 7.5 and recommendation 6.**

KEY

C – Custodian	FA – Fund auditor	IC – Investment Adviser's Compliance Unit	MA – M's auditor	RA – Report and accounts	TC – T's Compliance Unit
CN – Contract Note	I - *Investor*	KFD – Key Features Document	MC – M's Compliance Unit	SP – Simplified Prospectus	V – Standing Independent Valuer
CIS – Collective Investment Scheme	IA – Investment Adviser	M - *Manager*	P - Prospectus	T – Trustee / *Depositary*	

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Fund management						
Investment manager - selection	M	M	P, RA, KFD		T	*Depositary* reviews *Manager's* due diligence if a third party appointment.
Investment manager – fees	M	M or *CIS*	P, RA, KFD		T	If paid out of *Manager's* fee no issue. If paid direct by CIS, will be disclosed in P and subject to *Depositary* oversight.
Investment manager – also managing other types of funds	M	*CIS*		MC		Potential for conflict of interest if investment manager also manages other types of funds, with potentially conflicting strategies, e.g. hedge funds or other *CIS* funds with performance fees. **See section 7.6 and recommendation 7.**
Performance	IA,M	*CIS*, IA, M	RA, SP	M		
Corporate actions decisions	IA,M	*CIS*		IC, MC		
Voting on *CIS* portfolio holdings	IA,M	*CIS*		IC, MC		*Depositary* executes documents on instructions from *Manager*. Direct responsibility of *Depositary* when vote is in relation to a holding in another fund managed by the *Manager*.
Adherence to investment objective and policy	IA,M	M	RA	IC, MC, FA	T, FA	No identified issues. *Depositary* has day-to-day oversight responsibility and will note material breaches in its report in RA. The *CIS* auditor will review at the accounting year-end.
Placing of deposits	IA,M	*CIS*	RA	IC, MC	T	*Depositary* will place deposits on instruction of investment *Manager*. Potential for conflict of interest if counterparties are affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**
Borrowing	IA,M	*CIS*	RA	IC, MC, FA	T	*Depositary* ensures interest charges on unnecessary borrowing arising from mismatches between portfolio buy and sell trades or breaches of 10% borrowing limits reimbursed by the *Manager*. Potential conflict if borrowing is from affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Portfolio dealing						
Transactions costs - general	IA,M	*CIS*		MC		Current *CIS SORP* does not require disclosure of gross portfolio transactions and related costs e.g. commissions, stamp duty, etc in the RA. Only gross totals are shown. **See section 8.1.1 and recommendations 8 to 11.**
Choice of dealing venues, e.g. brokers/ crossing networks etc	IA,M	*CIS*		IC, MC		*Manager's* choice of cheapest /most efficient venues, e.g. crossing networks, dealing for commission or net etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers - selection	IA,M	*CIS*		IC, MC		*Manager's* choice of counterparties, potentially affiliates of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.** Potential for inducements. CP 176. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers selection - access to initial public offerings and underwriting	IA,M	*CIS*		IC, MC		Potential for fund volumes to be used for benefit of other clients **See section 8.2 and recommendations 14 and 15.**
Brokers - allocation of transaction targets	IA,M	*CIS*		IC, MC		Reciprocation, i.e. direction of commissions to broker in return for promotion of fund. CP 176. Commission direction to reimburse brokers for absorbing a *Manager's* loss. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Brokers – turnover levels	IA,M	*CIS*	RA	IC, MC, FA		Potential for churning to achieve commission targets required by *Manager* for soft commissions, access to research, initial public offerings, etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Brokers - negotiation of commission rates	IA,M	*CIS*		IC, MC		Potential for commission rates to be agreed to achieve targets required by *Manager* for soft commissions, access to research, initial public offerings, etc. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Transaction costs (commissions, market impact, opportunity costs) analysis and management	IA,M	*CIS*				Effectiveness of *Manager's* transaction cost analysis and consequential impact on transaction costs of funds. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Best execution	IA,M	*CIS*		IC, MC	T (limited)	Effectiveness of controls. Directed brokerage (softing /reciprocation). **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Customer order priority/fair allocation	IA,M	*CIS*		IC, MC	T (limited)	Effectiveness of controls for fair dealing between customers. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**
Timely allocation (including late trade notification)	IA,M	*CIS*		IC. MC	T (limited)	Effectiveness of controls. Re-imbursement for interest charges levied on late/failed trades. **See sections 8.1.1 and 8.2 and recommendations 8, 14 and 15.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Fund accounting						
Fund accountants - selection	M	M				Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Fund accountants – fee negotiation	M	M	X (*AUT*) RA if separate fee in *OEIC*			Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Fund auditors – selection	M	*CIS*	RA		T	Oversight role but not an independent appointment. Potential for conflict of interest if also *Manager's* auditors. **See Section 7.4.**
Fund auditors – fees	M	*CIS*	RA		T	Fund Auditors have an Oversight role but their remuneration is negotiated with the *Manager*. **See section 7.4.**
Long Form Report and Accounts	M	*CIS*	RA		FA, T	Technical financial reporting often too complex for *Investors*. Otherwise, no issues. **See short report below.**
Short Reports	M	*CIS*	N/A	MC	X	Simplified reporting targeted at areas of interest to *Investors*. No issues. Have to be produced by February 2007 at the latest. No issues.
Total Expense Ratio (*TER*)	M	*CIS*, I	SP, SR	MC	X	Standard format set out in EU Simplified Prospectus rules. Based on figures in RA. **See section 9.3 and recommendations 20 and 21.**
Calculation of distributions	M	*CIS*	RA	TC, MC	FA, T	No issues.
Valuation - securities	M	*CIS*, I		TC, MC	T	Market Timing – oversight by *Depositary* of valuation process, including the use of fair value pricing where appropriate.
Valuation - property	V	*CIS*, I	P	MC	T	Appointed by Manager. Must comply with Royal Institution of Chartered Surveyors' Appraisal and Valuation manual.
Pricing – daily calculations	M	*CIS*, I	CN, Press	TC, MC	T	Potential for conflict of interest if errors are made and administrators or fund accountants are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Pricing – publication of prices	M	*CIS*		MC	T	Prices can be published in national newspaper or on internet.

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Investor dealing						
Third party administrator selection	M	M		MC	T	Potential for conflict of interest if affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.** If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Dealing – daily activities	M	*CIS*, I	CN	TC, MC	T	Late trading controls. Market timing policy and controls. Potential for conflict of interest if errors are made and administrators are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**
Dilution levy/adjustment – policy	M	*CIS*, I	P, KFD	MC	T	Risk of Market Timing. **See section 8.2.2 and recommendations 16 and 17.**
Dilution levy/adjustment – application	M	*CIS*, I	CN	TC, MC		Market Timing. Levied at the discretion of the *Manager*, but direct impact on fund and incoming /outgoing *Investors*. **See section 8.2.2 and recommendations 16 and 17.**
Market timing – *Manager's* detection and preventative procedures	M	*CIS*, I		MC		Effectiveness of controls. **See section 8.2.2 and recommendations 16 and 17.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Registration						
Registrar selection – *AUT*	T (CIS Sourcebook) M or T (COLL Sourcebook)	*CIS*	P	MC	T	Potential for conflict of interest if affiliates of *Depositary* **See Appointment of Affiliates under Structure above.** If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Registrar selection – *OEIC*	M	*CIS*	P	MC	T	*Manager's* direct responsibility. Potential for conflict of interest if affiliates of *Depositary* – **see Appointment of Affiliates under Structure above**. If a third party is appointed, *Depositary* will review *Manager*'s due diligence process.
Registrar – fees	M, T	*CIS*	P	MC	T	No issues.
Registration fees charged by fund supermarkets	M	*CIS*	P, RA	MC	T	Prohibited under new COLL Sourcebook rules. Permitted under old CIS Sourcebook rules when disclosed in P of new *OEIC* or approved at holders' meeting.
Registration activity	M, T	*CIS*		TC, MC	T	Potential for conflict of interest if errors are made and registrars are affiliates of *Depositary*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Custody						
Custodian and sub-custodian selection	T	*CIS*	P	T	N/A	Direct responsibility of the *Depositary*. Potential for conflict of interest if affiliates of *Depositary* – **See Appointment of Affiliates under Structure above.**
Custodian/sub-custodian – fees	T	*CIS*	RA	T	N/A	Fee level disclosed in P. Potential for conflict of interest if affiliates of *Depositary* **– See Appointment of Affiliates under Structure above.**
Settlement	T	*CIS*	N/A	T	N/A	Potential for conflict of interest if errors are made by a custodian that is an affiliate of *Depositary* – **see Appointment of Affiliates under Structure above.**
Corporate actions - processing	T	*CIS*	N/A	T	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Foreign exchange transactions	M, T	*CIS*	X (included within transaction costs)	MC	T	Potential for conflict of interest if affiliate of *Depositary* – **see Appointment of Affiliates under Structure above.**
Income collection	T	*CIS*	RA	TC, MC	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Distribution payments	T	*CIS*, I	RA	TC, MC	N/A	Potential for conflict of interest if errors are made and custodians are affiliates of *Depositary* – **see Appointment of Affiliates under Structure above.**
Stock lending agent selection	M, T	*CIS*		MC	T	Potential for conflict of interest if affiliates of *Depositary* or *Manager* **– see Appointment of Affiliates under Structure above.**
Stock-lending net income	SA	*CIS*	RA	MC	T	Potential for conflict of interest if stock-lending agent is affiliate of *Depositary* or *Manager*. **See Appointment of Affiliates under Structure above.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Stock-lending fees	M,T	*CIS*	X	MC	T	Potential for conflict of interest if only net income after deduction of fees is disclosed (n.b. not permitted in *AUTs*). **See section 9.1 and recommendation 18.**
Stock-lending fee sharing arrangements	M, T	SA, M			T	Potential for conflict of interest if *Manager* shares stock lending agent's fees without disclosure **See section 9.1 and recommendations 18 and 19.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
Management company activities						
Advertising/promotional payments	M	M	N/A	MC	X	Outside the Scope of this project. Costs paid by *Manager*.
Fund Prospectus	M	M	N/A	MC	T	*Depositary* will review it for accuracy, as it is part of fund constitutional documentation.
Schemes of Arrangement (fund mergers)	M	*CIS*	SAD	MC	T, FSA	Subject to approval of *Depositary*, *FSA* and *Investors* of discontinuing fund.
Management fees	M	*CIS*, M	P	MC	T	Rate disclosed in P. *AUTs* operating under the CIS Sourcebook are much more restricted in the costs that can be charged to the fund than *OEICs* or any new *AUTS* operating under the COLL Sourcebook. Comparison between funds by an *Investor* is thus challenging. **See section 9.4 and recommendation 22.**
Registrar fees, ad valorem administration fees, production costs of Prospectus, Long Form Report and Accounts, Short reports	M	*CIS*	P, SP, KFD, RA	MC	T	Not permitted in *AUTs* operating under the CIS Sourcebook, but permitted in *OEICs* and *AUTs* operating under the COLL Sourcebook. **See section 9.4 and recommendation 22.**
Manager's auditor – selection	M	M	N/A	N/A		Potential for conflict of interest if also fund auditors. **See section 7.4.**
Manager's auditor – fees	M	M	N/A	M		Potential for conflict of interest if also fund auditors. **See section 7.4.**
Box management	M	M		MC	T	Box activities and profits not required to be disclosed. **See section 8.1.3 and recommendations 12 and 13.**

ACTIVITY	RESPONSIBILITY	COST, INCOME IMPACT	CURRENT DISCLOSURE	INTERNAL SUPERVISION	CURRENT OVERSIGHT	POTENTIAL ISSUE OR BIAS AND PROPOSED REMEDY
IFA commission payments	M	M	CN, KFD	MC		Effectiveness of current disclosure of initial and annual commission
Revenue sharing arrangements	M	M				No disclosure requirements. **See section 9.2 and recommendation 19.**
Provision of portfolio details to *Investors*	M	*CIS*, I	RA	TC, MC		Market Timing. Encouragement of fund sales for benefit of *Manager*. Fund of Fund investment managers need regular portfolio details. Equal treatment of all *Investors*. **See section 9.5 and recommendation 23.**
Soft commissions – benefits received	M	*CIS*		MC		Currently no disclosure. Likely that Simplified Prospectus will require soft commission benefits to be included within *TER*.
Staff personal dealing	M	N/A	N/A	MC		Market Timing. Front running. **See section 8.2.1 and recommendation 14.**

Appendix 4

JOINT IMA/DATA DRAFT STATEMENT OF PRACTICE IN RESPECT OF THE APPLICATION OF DILUTION LEVIES AND ADJUSTMENTS TO AUTHORISED INVESTMENT FUNDS

Manager's Dilution Policy

The effective implementation of the *Depositary's* oversight responsibilities in relation to dilution levies/adjustments can only be achieved if the *Manager* has a clearly defined policy.

Where these policies require disclosure in the prospectus, it is recognised that *Managers* may prefer to keep such disclosure at a high-level (consistent with the relevant rules) because it is impossible to cover every conceivable scenario in such a document. However, where this is the case, *Managers* would be expected to maintain a separate document setting out their detailed policy. This will enable the *Manager* to demonstrate their compliance with the policy concerned and facilitate monitoring by the *Depositary* as part of their oversight responsibilities.

Policy decisions made by *Managers* must be documented, supported by appropriate evidence and subject to review at appropriate intervals.

For example, when a *Manager* asserts that dilution has no material effect on the *CIS*, this must be supported by evidence confirming that this is the case. The *Manager* should periodically revisit any calculations used on a continuing basis to ensure that the basis of calculating the effect of dilution remains valid.

Effectiveness of Manager's Dilution Policy

The *Manager* should retain appropriate evidence that the policy is operating effectively. One way of demonstrating this would be evidence that:

- adherence to the policy matter is included in the *Manager's* own internal audit/compliance monitoring programme ("CMP");
- monitoring reviews are performed in accordance with the CMP timetable; and
- any findings resulting from the CMP are tracked until satisfactory resolution is achieved.

Depositary monitoring

In line with its duty of oversight, the *Depositary* will undertake monitoring of the *Manager's* policies and procedures and of the effectiveness of those procedures. How this is achieved will be at the discretion of the *Depositary*, but this may include testing, on a sample basis, of individual decisions of the *Manager* to impose or not impose, a dilution levy or adjustment.

Appendix 5

ALTERNATIVE CIS GOVERNANCE MODELS

Australia

Under Australia's Managed Investments Act (subsequently incorporated into the Corporations Act) a manager may be appointed as the "Single Responsible Entity" for all its managed investment schemes. As such it is in complete control and is totally responsible for all aspects of each of the funds. There is no requirement for a board of directors or a depositary.

Whilst the manager may outsource custody for its funds, together with investment management, fund accounting and unit pricing, it retains full regulatory responsibility for these activities and must have in place a rigorous monitoring program over each provider's activities, including compliance review inspection visits and formal compliance reporting.

The regulations also set out detailed requirements for the manager's compliance plan, which has to be made publicly available, and for independent compliance committees in respect of each registered fund, if less than half of the directors of the Responsible Entity are independent directors. The compliance committee must comprise at least three members, the majority of whom must be independent, and is charged with monitoring adherence with the compliance plan of the particular fund.

If, in the compliance committee's view, the Responsible Entity does not take appropriate steps or propose to address a requirement of either the Corporations Act, or the fund's constitution, the committee is obliged to report the position to the Australian Securities and Investments Commission. The committee must also assess the compliance plan to ensure its adequacy and recommend changes if appropriate.

United States

US mutual funds, authorised under the 1940 Investment Company Act, are governed by a board of directors, whose responsibility is to ensure that the manager executes its business affairs in the best interests of *Investors*. This responsibility has recently been supported by new rules regarding the reporting lines of a compliance officer direct to the board, and the emphasis on the ability of the board to acquire the services of whatever people or other resources it might need to discharge its role.

The board of directors must have a majority of independent directors, and following a recent rule change, the board's chairman must be one of the independent directors.

Directors must exercise the care that a reasonably prudent person would take with his or her own money. They are expected to obtain adequate information, exercise sound business judgment, approve policies and procedures, and undertake oversight and review of the performance of the manager and other entities that perform services for the fund.

European Union/ United Kingdom

The *UCITS* Directive establishes minimum standards for governance of *UCITS* registered *CISs*. The Directive states that the depositary is responsible for the safe keeping of a fund's assets and for ensuring that sales, redemptions, cancellations and issues of units and the calculation of the value of units are effected in accordance with the law and rules of the fund. In this respect, UK regulation is super-equivalent to the *UCITS* Directive requirements and UK *Depositaries* have a significantly wider oversight role.

So far as the relationship between the manager and the depositary is concerned, it is a Directive requirement that no single company may act in both capacities and they must act independently of each other. However, the Directive does not prevent two companies within the same group acting as manager and depositary. The UK is, as far as we know, the only country to be super-equivalent in this way.

UK regulation is also super-equivalent to the *UCITS* Directive requirement concerning the relationship between the *Manager* and *Depositary*. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and *Manager* of an *AUT* and the *Depositary*, the *OEIC* and the Directors of an *OEIC* respectively. The CIS and COLL Sourcebooks identify three potential links between these parties:

- Directors in common - independence may be lost if, by means of executive power, either relevant party could exercise effective control the action of the other;
- Cross-shareholdings - independence may be lost if either of the relevant parties could control the actions of the other by means of shareholders' votes. The *FSA* considers this would happen if any shareholding by one relevant party and their respective associates in the other exceeds 15% of the voting share capital;
- Contractual commitments - the *FSA* would encourage relevant parties to consult it in advance about its view on the consequences of any intended contractual commitment or relationship which could affect independence, whether directly or indirectly.

It is not uncommon within the EU, and in compliance with the *UCITS* Directive, for the manager and depositary to be fellow-subsidiaries of the same Group of companies. Historically of course, many continental European fund management companies were subsidiaries of banks, which branded their funds for distribution, and also already had in-house custody and administration operations.

Appendix 6

PENSION FUND DISCLOSURE CODE - LEVEL ONE DISCLOSURE

INVESTMENT MANAGER'S POLICIES, PROCEDURES AND CONTROL PROCESSES

Dealing venues and methods – description of the various dealing venues used, e.g. different types of brokers, dealing for commission and dealing net, programme trading, internal crossing, crossing networks, etc. How the investment manager decides between these alternatives and the impact that these decisions have on client transaction costs.

Broker selection and transaction volume allocation process – investment manager's processes, policy on credit ratings, how brokers' relative competence is established with regard to execution, research, etc. How this results in business level targets for each broker/dealing avenue, how this is split between commission bearing, soft commission and net dealing and how progress towards and variations from these targets are monitored on an ongoing basis.

Variations in rates of commission – investment manager's processes for negotiating commission rates and the impact on rates of commissions in different markets, e.g. UK/overseas, bond/equity, liquid/illiquid.

Soft commissions – investment manager's internal policy, justification (i.e. against potential lower commissions) and control processes to ensure compliance with current FSA regulations

Commission recapture – if applicable to the particular client, a description of the process.

Dealing Efficiency Monitoring - investment manager's policy and procedures designed to maximise the value of client portfolios and to control transaction costs while still trading effectively. This will include policy, procedures and assumptions for assessing execution costs, including bid/offer spreads, market impact and opportunity costs, whether the investment manager measures these and how the results are used.

Conflicts of interest - procedures for complying with *FSA* requirements for fair treatment of clients in the execution of orders and allocation of trades, and procedures to identify and manage actual and potential conflicts of interest (including dealing through associates). How the investment manager complies with current *FSA* regulations on inducements. An approximate number, type and overall value of inducements logged over the period.

External and internal research – investment manager's policy on using external research, how the benefit of that research is assessed and how it is funded.

Access to and allocation of Initial Public Offerings and underwriting – investment manager's policy plus procedures for complying with relevant *FSA* regulations and the extent to which securing allocations of initial public offerings and underwriting influences trading patterns.

Custody services - where the investment manager appointed the custodian, an outline of the investment manager's selection, monitoring and review processes.

Placing of deposits – investment manager's policy on spreading deposits, in particular as regards placing deposits with associates, policy on credit ratings, use of money-market funds.

Foreign exchange transactions – investment manager's policy in spreading foreign exchange transactions, in particular as regards placing these through associates, and policy on credit ratings.

N.B. As noted in Section 8.1.2, the IMA's Enhanced Disclosure project may require expansion from the current Level One disclosure requirements.

Appendix 7

PENSION FUND DISCLOSURE CODE - LEVEL TWO TRANSACTION DISCLOSURE

SUMMARY OF TRADING VOLUMES, COMMISSIONS AND FEES
Period to which disclosure relates:

Counterparty	**Trading volume for period**			**Commissions and fees paid during period**			
	Total	*Traded net*	*Subject to commissions*	*Total*	*Under softing arrangements*	*Under /directed or recapture arrangements*	*Other*
	£000	*£000*	*£000*	*£000*	*£000*	*£000*	*£000*
1							
2							
:							
9							
10							
Others > 5%							
:							
Others (total)							
Total							
% age	100%	[ ]%	[ ]%	100%	[ ]%	[ ]%	[ ]%

Guidance notes:
Disclosure is required of volumes undertaken through, and also commission paid to, different counterparties during the period. For each of these two categories, the top ten counterparties, plus any others representing over 5% of the overall total, should be listed. In this regard, counterparties include brokers (any associates of the investment manager being clearly noted), crossing networks and as a distinct category, the total of trades internally crossed by the investment manager. Clearly, different counterparties may feature in the table for different disclosure elements. The proforma will need to be customised accordingly.