

**PRINCIPLES FOR THE SUPERVISION OF OPERATORS
OF COLLECTIVE INVESTMENT SCHEMES**



**Technical Committee
of the
International Organization of Securities Commissions**

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I. INTRODUCTION

The collective investment scheme is well established in many jurisdictions and now serves as an investment vehicle for a wide range of investment opportunities around the world. Many millions of people world-wide have invested in collective investment schemes (CIS)¹ and rely upon operators of the schemes to manage their funds and to act in the best interest of investors. This trend is continuing, particularly in light of the growth of pension and retirement funds as a preferred investment vehicle for many investors.

The distribution of CIS products has continued to develop across borders and operators are seeking to maximize their opportunities by utilizing management, administration and custody services in different jurisdictions.

It is therefore important that operators of CIS throughout the world adhere to high standards of conduct and that member countries of IOSCO ensure that effective supervisory arrangements are in place. Failure to effectively supervise each of an operator's activities may result in damage to investors, and more generally, a loss of public confidence in an investment vehicle of growing domestic and international importance.

1. *Scope*

This Paper sets out *10 Principles for the Supervision of Operators of CIS* (the *Supervision Principles*) and provides commentary on those Principles.

It is recognized that operators of CIS² have different responsibilities in different jurisdictions and may be subject to supervision by a number of different parties (such as trustees, custodians, depositories, external auditors, independent directors and compliance committees etc.), even where the regulatory authority plays a primary role in supervision. This Paper explains the rationale as to why operators should be supervised and more importantly, sets out those activities carried out by operators that are considered to be sufficiently important to warrant supervision. These activities may relate to how the operator manages a CIS in accordance with a

¹ A CIS is defined in the *Principles for the Regulation of Collective Investment Schemes, Report on Investment Management* of the Technical Committee of IOSCO, July 1995. That is "an open ended collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments". It excludes schemes investing in property / real estate, mortgages or venture capital.

² "Operator" has the same meaning as set out in the CIS Principles. That is "the legal entity that has overall responsibility for management and performance of the functions of the CIS, which may include investment advice and operational services".

jurisdiction's product regulations as well as how the operator conducts its business generally.

The Supervision Principles do not attempt to specify which entity, whether it be a regulatory authority or third party, is responsible for any particular supervisory activities, nor does it attempt to specify which regulatory techniques should be employed to attain effective supervision.

It should be noted that the Supervision Principles do not seek to endorse one particular approach, nor are they intended to impose binding obligations upon any IOSCO member. Notwithstanding this, it is hoped that the Paper will assist IOSCO members in reaching a common understanding of the reasons why it is important to supervise operators of CIS and those activities which are considered to be of prime importance in requiring effective supervision. It is also hoped that development of the Supervision Principles will enhance cooperation among member countries in supervision and overseeing the investment management industry.

2. **Background**

In 1995, the IOSCO Technical Committee published *Principles for the Regulation of Collective Investment Schemes* (the CIS Principles) and in 1996, WP 5 developed a Paper on *International Cooperation in Relation to Cross-Border Activity of CIS* which provided Model Agreements for mutual recognition and exchange of information.

There are two CIS Principles and their accompanying Explanatory Memoranda, which deal with supervision of operators of CIS, and set out minimum standards for conduct and for supervision of a CIS:

CIS Principle 3 - "Eligibility to Act as an Operator" - looks at the regulator's role in imposing minimum eligibility standards of conduct that require approval by the regulatory authority prior to commencement of marketing of a CIS, which include:

- Honesty and Fairness;
- Capability (i.e. human and technical resources);
- Diligence and Effectiveness;
- Operator Specific Powers and Duties (i.e. duty to make decisions as to the investment portfolio structure and administrative procedures); and
- Compliance (i.e. adherence to strictly defined standards set by the regulatory authority).

CIS Principle 5 - “Supervision” - provides that a regulatory regime must provide for a regulatory authority to take overall responsibility for the supervision of a CIS authorized within its jurisdiction. The Principle deals with supervisory techniques:

- Registration and Authorization;
- Inspections and Investigations;
- Powers of the Regulatory Authority;
- Third Party Supervision.

In June 1996, the Technical Committee Working Group on Investment Management (WG 5) proposed to the Technical Committee that it wished to examine the activities of operators of CIS (both institutional and retail) and consider supervision issues in greater detail. This would expand the CIS Principles 3 and 5 described above by providing further guidance on what activities carried out by operators require supervision, and further international cooperation by the adoption of common principles of supervision.

It was therefore agreed by the Technical Committee that WP 5 should commence work on a new mandate which would focus its attention on the supervision of operators of CIS.³ The Committee noted that:

“Having developed Principles for the regulation of CIS and Model Agreements for mutual recognition and exchange of information, the Working Party should turn its attention to the supervision of the operators of CIS. As has already been identified in the International Cooperation Discussion Paper, CIS operators increasingly engage in cross-border activities. The development of Principles for the supervision of these entities would not only facilitate the international coordination of the regulation of investment management, but would also contribute to the ultimate goal of reducing impediments to the cross border activities of CIS and their operators.”

This Paper has been developed in response to WG 5’s new mandate.

³ IOSCO Technical Committee meeting in Edinburgh, June 1996.

II. WHY SUPERVISE OPERATORS OF COLLECTIVE INVESTMENT SCHEMES?

1. Investor Protection

The fundamental purpose of supervising an operator of a CIS is to ensure that investors' interests are protected. Supervision should seek to ensure that the assets of a CIS are managed in the best interests of its investors and in accordance with the objectives of a CIS. This will include ensuring the assets are held in safekeeping on behalf of investors, typically by requiring that they are registered in the name of an entity other than an operator and that they are held by an entity which is functionally independent of the operator, usually a custodian.

An operator should also be supervised in order to confirm that the investments in a CIS are valued properly. This will ensure an investor receives the correct number of units when investing in a CIS and also the correct proceeds of sale, should the person decide to liquidate a holding. Supervision of an operator in this regard may typically include checking that individual share holdings in a CIS are up to date and correctly valued and that the net asset value of a CIS, the unit price, is accurate at all times and available to investors. Review of a CIS report and accounts may also provide confirmation.

Investors' interests will also be protected by ensuring a CIS contains an appropriate spread of investments; namely that any regulatory restrictions and prospectus disclosures on the minimum number of holdings have been complied with and that a CIS is invested according to its investment objectives. Supervision of an operator in this regard will ensure that investors are exposed to a level of risk which is consistent with the fund's objectives, as well as ensuring any regulatory minimum spread of investments is maintained.

2. Market Integrity

Market integrity has two dimensions. The first is that of the market for CIS themselves. The fact that an operator is subject to supervision may encourage investors to use CIS as vehicles for their investments. If there is no (or inadequate) supervision, there is a strong possibility that investors' interests will be adversely affected. This, in turn, will dissuade the public from investing their savings and diminish confidence in the financial markets. The second dimension concerns the integrity of the markets in which a CIS invests. These markets may or may not have supervisory arrangements in place with regard to credit institutions, stock markets or investment services. Without such arrangements it may be difficult for an investor to conclude that a particular market is an appropriate - and safe - place

to invest in via a CIS. This may be relevant when considering developing and emerging markets which might not have an established track record.

3. *Integrity of Operator*

An operator of a CIS will often be responsible for ensuring that all the day to day activities of operating a CIS are carried out competently. This may be a wide range of activities which includes managing the investments in accordance with the objectives of a CIS, valuation, administration, accounting, promotion and distribution. With so much responsibility resting with one entity, it is important that effective supervision is in place.

The level of supervision of each activity will probably vary. It is likely however that all activities will be supervised on an on going basis, to be determined in each case. This will depend, in part, upon the nature of any risks which may previously have been identified. In order to ensure that supervision is effective, it may be necessary to look at a number of different activities together, as part of a comprehensive review. For example, the accuracy of the net asset value of a CIS may be confirmed most effectively by reviewing the valuation of investments at the same time as checking a CIS's income and expense records.

4. *Global Developments of CIS as an Investment Vehicle*

CIS structures have developed rapidly and are now used globally as investment vehicles for a range of investment opportunities. For many investors a CIS is the first choice of investment vehicle which, in some respects, increases the obligations of supervisory authorities to ensure that CIS are managed properly and that these investors' interests are protected. A recent example is the growing number of privatization programmes, often in developing countries, which use CIS as a convenient means of indirectly bringing share ownership to large numbers of investors, often for the first time. CIS are also used as a basic investment vehicle for other types of investment portfolios such as pension funds and tax efficient plans in different jurisdictions.

For the CIS industry to be able to satisfy this expectation of producing a global investment vehicle, it is important that operators are properly supervised. Failure to properly supervise may result in valuation, custodial and other types of errors which, in turn, may adversely affect large numbers of investors.

III. PRINCIPLES OF SUPERVISION

1. *Conduct of Business*

Supervision of an operator should seek to ensure that it meets high standards of competence, integrity and fair dealing in its conduct of CIS business and that any investment transactions undertaken on behalf of a CIS that present the operator with a conflict of interest are limited, properly disclosed, and not inconsistent with investor protection.⁴ Such supervision should be able to establish that a CIS has been treated fairly and that the operator has not itself benefited from the transaction to the disadvantage of a CIS.

1.1 *Timely and Best Execution*

It should be established that once an operator has agreed to effect a transaction on behalf of a CIS, the transaction was executed as soon as was reasonably practicable and was executed on terms that were the best available, taking into account the market, the kind and size of the transaction concerned and the characteristics of the executing broker.

The specific risk is that the CIS does not receive the best terms at the time of dealing. This may be because an operator has misdirected business because of an inducement, because the transaction has been executed through an in house market maker or because the operator's procedures are generally ineffective.

Supervision should seek to establish how an operator satisfies itself that its business is conducted at best execution. This may involve having procedures in place requiring a fund manager to print out a computer screen which demonstrates that when a transaction was executed, it was done at the best price available. Procedures may also require consideration to be given to the rates available from different brokers. Supervision should also seek to confirm that procedures are followed in practice.

1.2 *Timely and Fair Allocation*

Supervision should seek to establish that an operator has a policy in place which determines how transactions should be allocated and that, in practice, that policy has been followed and all customers treated fairly.

⁴ Potential conflicts of interest are also set out in Supervision Principle 2 concerning transactions with connected persons.

Supervision should seek to confirm that when an operator has placed an order on behalf of more than one customer, which may include a CIS, a record was made promptly of the intended basis of allocation of a particular transaction and that, in practice, that basis was followed or any exceptions noted and explained. This is particularly important if the operator proposes to deal on behalf of itself as well as a number of customers. Reference should be made to an operator's own procedures to ensure that in-house allocation policies have been complied with.

The risks to a CIS are that an allocation of a transaction may be delayed until subsequent price movements are known, thereby facilitating an allocation which favors another customer over the CIS. In addition there may have been an unfair allocation of placing or underwriting opportunities which favour one customer over another.

1.3 Churning

Supervision should seek to ensure that the CIS operator has procedures in place to guard against trading of the CIS portfolio which is excessive in light of the CIS stated objectives.

It should be established whether an operator has dealt too frequently on behalf of a CIS, to the detriment of the CIS, taking into account the investment objectives of the fund.

There are a number of reasons why churning may be to the detriment of a CIS. Excessive turnover may result in a CIS incurring charges which are unreasonable and which should not be paid.

1.4 Cash Commission Rebates

Supervision should seek to ensure that an operator does not benefit from unauthorized rebates of brokerage commission from transactions made on behalf of a CIS. The practice of rebate commissions presents a number of possible conflicts of interest. The CIS portfolio may be churned in order to generate more income for the operator. In addition, such income may lead to a lack of transparency in the fees being received by the operator from the CIS.

In markets where brokerage rebates are commonly paid (as a result of fixed commission structures or otherwise), supervision should seek to ensure that such rebates are, unless explicitly authorized by and disclosed in the CIS documentation, credited to the CIS rather than retained by the operator.

1.5 Soft Commission Arrangements

Operators may enter into soft commission arrangements with counterparties whereby they agree to pay for services for the operator in return for broking business which will generate an understood or agreed level of commission. Services may typically include computer facilities, research material and safe custody. A soft commission arrangement is an inducement and, unless it is property controlled, may result in a detriment to the interest of a CIS.

There are a number of risks associated with soft commission agreements. If an operator is obliged to use a particular counterparty to execute transactions on behalf of a CIS, it is possible best execution may not be achieved. A CIS's portfolio may be churned in order to generate sufficient business to meet the understood or agreed level of commission. In addition, it is possible that a service may be provided to an operator under a soft commission agreement which does not benefit a CIS but only the operator itself.

Supervision should seek to confirm that the services which are subject to a soft commission agreement are for the benefit of a CIS, have been disclosed to investors, and that transactions carried out are done in accordance with best execution standards.

1.6 Inducements

Supervision should ensure that an operator (or its agents) does not offer or accept any inducement which is likely to significantly conflict with the duties owed by the operator to its customers. The risk is that a CIS is disadvantaged by paying higher costs, receiving worse dealing terms or undertaking unsuitable transactions due to obligations owed to a party with whom an inducement has been received or given. Supervision should establish the adequacy of procedures within the operator to ensure that any inducements that are received or given that might give rise to a conflict of interest are limited and properly disclosed.

2. Connected Party Transactions

<p><i>Supervision of an operator should seek to ensure that any transactions undertaken on behalf of a CIS with a connected party of the operator do not conflict with the operator's obligations to act in the best interests of the CIS.</i></p>
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2.1 Functional Separation of Group Operations

Where an operator is connected to a company or group of companies in which non-fund management activities are carried out, supervision should seek to confirm that appropriate protective arrangements, including “Chinese walls”, are in place to limit and disclose any conflicts of interest. This may include withholding information which may be of a sensitive nature from another department within the same group and establishing that an operator does not receive information from another part of the same group which may lead to a conflict of interest.

The type of information which could result in a conflict may relate to corporate finance, broking or research. Supervision should seek to confirm that there is an appropriate physical separation of departments, and proper procedures for maintaining the “Chinese wall” as well as containing information which may be sensitive and should not be disclosed to other departments.

2.2 Use of Connected Brokers and Banks

Supervision should seek to ensure that where an operator places CIS transactions through a connected broker, such transactions are carried out at arms’ length and transaction execution is consistent with best execution standards. This is particularly important where the CIS uses a principal broker that is connected to the operator.

Supervision should also seek to ensure that where cash forming part of the CIS assets is deposited with a connected person to the operator, interest is received on the deposit at a rate not lower than the prevailing commercial rate for a deposit of that size and term. Similarly if the CIS borrows from a connected person of the operator, supervision should seek to ensure that the interest charged and any fees levied in connection with the loan are no higher than the prevailing commercial rate for a similar loan

2.3 Underwriting and Participation in IPO’s

Supervision should seek to establish that an operator’s underwriting procedures and arrangements are not detrimental to customers and that all underwriting which is carried out is in the best interest of the CIS.

Supervision of an operator may include determining whether it is appropriate for a CIS to participate in the sub-underwriting of an issue of a security, where such activity is permitted. Sub-underwriting of a security can give rise to a number of risks to a CIS, which include participating in a placement to support an issue which has been organized by a corporate finance company which is part of the same

group, or retention of the best underwriting business for itself or another customer, to the detriment of a CIS. Other risks include non receipt of underwriting commission and undue exposure by an operator to a CIS's capital in the case of an unsuccessful issue. It is also possible that a CIS will be exposed to securities which are not consistent with its investment objectives or that underwriting may be used to boost the performance of a well known or a newly authorized fund to the detriment of another. A fund which has not participated in a placing may receive unwanted, unallocated stock which would also be to the detriment of a CIS.

2.4 Personal and House Account Dealing

Supervision should seek to ensure that a CIS operator has procedures in place to ensure that the operator's employees (as appropriate) do not make transactions on their own account, or for the account of the operator itself, that may conflict with the operator's obligations to the CIS.

Such procedures may include requiring a CIS operator and those of its employees with access to relevant information to report personal dealing activity and establishing periods during which employees cannot deal in certain securities which are to be purchased or sold by a CIS. The procedures may be contained in a code of ethics adopted by the operator governing personal dealing activity.

3. Valuation of CIS Assets

Supervision of an operator should seek to ensure that all the property of a CIS is fairly and accurately valued and that the net asset value of the CIS is correctly calculated.

3.1 Calculation of the Net Asset Value

The calculation of the net asset value (NAV) of a CIS is extremely important, as the NAV reflects the price which an investor pays when investing in a CIS (subject to any additional up-front charges) and the price an investor will receive (subject to any additional exit charges) should a holding be liquidated. It is calculated by dividing the total value of the investments in a CIS by the number of units in issue, plus / minus adjustments for accrued fees, expenses and other liabilities.

If the NAV is incorrect, an investor may not be charged the correct amount when joining a CIS, or may not receive the correct amount on liquidation. If the NAV has been incorrectly overstated, an investor may be overcharged when purchasing units.

Conversely, if the NAV has been understated, an investor may not receive the correct proceeds of sale on liquidation.

It is important to ensure that supervision of the CIS confirms that the operator has systems in place to ensure that calculations of the NAV are correct at each valuation point. If an error is made in a calculation and is not detected for a period of time, it is possible that all investors who have either bought or sold units during the period will have been disadvantaged. To correct such an error, including determining whether compensation is payable to investors or to a CIS itself, considerable effort may be required on the part of the operator to resolve the situation.

Supervision of NAV calculations should, in the first instance, seek to confirm that all the property of a CIS has been included and that all the property has been valued at the point of calculation. This will include checking that income from investments and cash deposits have been included and that correct deductions for charges and expenses have been made.

3.2 Valuation of Investments

The particular regulatory regime to which a CIS is subject and an individual CIS's prospectus or rules may prescribe how the investments should be valued. The purpose of the supervision is to ensure compliance with these requirements.

Supervision should seek to ensure that all the property of a CIS is valued at each valuation point. If a CIS is required to value investments at market value then the source of the pricing information, usually a third party supplier, should be checked for accuracy and timeliness. This can be carried out by comparing the prices used by a CIS with another source of the same information.

If an operator cannot obtain the price of an investment from a recognized third party supplier, for example if the investment is unquoted, or if trading in the investment has been suspended, supervision should seek to confirm that any alternative method of valuation used by the operator is reasonable. The check should consider whether the source and the basis of the quotations are reasonable and also should take into account the frequency with which quotations are received and reviewed. It would be prudent to confirm also there were no conflicts of interest between the counterparties providing the quotations and either an operator or a CIS itself.

The frequency of the valuation of investments should also be subject to review. Again the frequency may be prescribed by regulations or may be set out in the CIS's prospectus or rules. Typically regulatory requirements will impose a minimum frequency.

3.3 Collection of Income on Behalf of a CIS

Collection of income from investments on behalf of a CIS should be the subject of supervision. Unless all the income which is due to a CIS has been accrued or received, it is unlikely that the net asset value of a CIS will be correct.

Income will typically be due to a CIS when a dividend is paid by a company in a CIS's portfolio. It may be a custodian's responsibility to ensure that all income has been collected. Supervision should seek to confirm that arrangements are in place to ensure income has been received and, if not, to be able to follow up with the companies in question as to why the income is outstanding.

4. *Safekeeping and Segregation of Investments*

Supervision of an operator should seek to ensure that the assets of a CIS are properly held in safekeeping and segregated from the assets of management and other entities.

The CIS Principles already require that a regulatory regime must seek to protect the physical and legal integrity of the assets of a CIS by separation of the assets from the assets of management.⁵ In this regard, a custodian may be appointed to hold the assets or be in a position to ensure their safekeeping. These arrangements vary between jurisdictions but will often be the responsibility of an independent custodian rather than an operator itself. Accordingly, the investments will usually be registered in the name of an entity other than an operator. There are a number of different activities that may require supervision.

Supervision should ensure that all investments, including cash deposits, are properly held in safekeeping. It may be appropriate for a physical count of the assets to be undertaken periodically. The purpose of this exercise would be to confirm that the assets of a CIS, in fact, exist and that they are correctly registered in the name of a CIS.

An additional supervisory function may be to ensure that reconciliations of investments have been conducted to ensure that the assets of a CIS held by a custodian reconcile to the portfolio which is managed by an operator.

⁵ Guidance on Custody is the subject of a separate paper which has been produced by WP 5, that was approved by the Technical Committee in Montreal, September 1996.

5. *Investment*

Supervision of an operator of a CIS should seek to ensure that the stated investment policy of the CIS has been followed and that any restrictions on the type or level of investment have been complied with.

5.1 *Investment Objective*

CIS Principle 10 already requires that a CIS should disclose its investment policy in its offering document. The investment policy of a CIS, which in general terms includes its investment objectives and risk profile, is critical to the prospective investor's decision about whether or not to invest in a particular CIS. Supervision of the operator should therefore ensure that the investment policy is followed on an ongoing basis. This may involve periodic review of the investment portfolio of a CIS to ensure that the CIS is in fact invested in accordance with its stated objectives, whether in terms of asset class, geographical spread, or risk profile.

5.2 *Investment and Borrowing Restrictions*

CIS Principle 8 already contemplates that regulations would be in place which require an operator to invest in a minimum number of investments, as well as limitations on other forms of investment. Such restrictions exist to reduce a CIS's exposure to market movements in particular investments, as well as the risk of an individual investment failing. Typically regulatory requirements may restrict a holding in an individual investment to 10% of a CIS's net asset value.

In addition to regulatory requirements, the prospectus or rules of a CIS will set out a fund's investment objectives and any additional restrictions on investment and borrowing limits. These may include, for example, restrictions on the countries into which a CIS may invest as well as restrictions on the types of industry and the level of investment generally.

There are a number of reviews which may be undertaken to check compliance with a CIS's investment and borrowing restrictions. It may be appropriate to establish who, within the operator, has responsibility for the investment decision making process and how that person ensures that each CIS with similar investment objectives contains similar investments. In addition, checks can be carried out to confirm that regulatory and CIS specific investment restrictions have been complied with, including by those entities to whom investment functions have been delegated.

6. *Fees and Expenses*

Supervision of an operator should seek to ensure that no unauthorized charges or expenses have been levied against a CIS.

6.1 *Authorized Charges*

It is important to ensure that investors have been charged only those expenses which have been agreed contractually and that these expenses are at arm's length and made on commercial terms. Regulations may prescribe the type of charges which can be made and how those charges should be calculated. It is likely that the CIS offering or constitutive document will explain, in detail, the actual charges, including their limits, which can be made.

There are a number of specific risks, namely that charges have not been disclosed or are obscure or difficult to understand. Charges may have been calculated incorrectly, taken from a CIS on the wrong date, or inflated because of an excessive number of transactions. Supervision should seek to confirm that charges have been calculated properly by considering any provisions in an agreement, whether disclosure is clear, whether charges have been made to affiliated companies and, if so, whether they are legitimate.

When reviewing charges, there are a number of checks that can be performed. Confirmation that the charges which have been levied are permissible can be sought by reviewing the relevant regulations and the prospectus or rules. A check should be made to ensure each type of charge has been fully disclosed in a CIS's offering document. It may also be appropriate to reperform some calculations to confirm that the correct amount of a particular charge has been levied. This may involve ensuring the valuation at the correct time has been used, upon which the calculation has been based, and also that the correct percentage has been applied to the calculation. It is likely that a prospectus will prescribe when the charge can be made. This can also be checked.

6.2 *Charges Levied by the Operator*

The types of permissible charges will vary between jurisdictions. Typically an operator may be able to levy an up-front and / or an exit charge, in addition to a periodic management fee. In some situations the scope to levy charges may be

much broader, on the condition that charges which have been levied are fully disclosed to investors.

Where transaction charges are imposed by an operator, in addition to the executing broker's commission, supervision should also seek to ensure that such charges are not inconsistent with an operator's responsibility to act in the best interests of the CIS.

7. *Internal Controls and Compliance Arrangements*

Supervision should seek to ensure that an operator has internal controls and compliance arrangements sufficient to ensure it can carry out its business diligently, effectively, honestly and fairly.

Supervision of the internal controls and compliance arrangements of an operator of a CIS is important because evidence that an operator's business is well controlled and that it has its own internal supervisory arrangements, will provide some comfort that an operator's activities are compliant.

Senior management of the operator should take overall responsibility for compliance, including (where appropriate) requiring sufficient reporting of the results of compliance checks.

An operator may organize internal monitoring arrangements in a number of different ways. A compliance officer may be appointed who is responsible for ensuring an operator's business is conducted in accordance with relevant regulations. A monitoring programme may be developed which would entail periodic reviews of different functions internally, to confirm whether the business is in compliance and whether any rules or procedural breaches can be identified.

Such a programme can be designed to ensure that all aspects of an operator's business are subject to periodic review. The frequency with which such checks may be carried out will vary according to the activities involved and the relative risk attached to each of them.

Supervisory work may then seek to confirm that the monitoring programme covers all aspects of an operator's business and that the checks which have been developed are appropriate.

8. *Disclosure*

Supervision should seek to ensure that all documentation issued by an operator (whether product literature or financial data) is accurate, clear, comprehensible, consistent and not misleading.

8.1 Offering Documentation

The CIS Principles already require a regulatory regime to impose a disclosure requirement to ensure that there is full, accurate and timely disclosure to investors, providing all the information necessary for investors to make informed investment decisions. Investors' interests can be protected by ensuring that product literature, including prospectuses and other promotional material which is made available to investors is fair and not misleading.

A regulatory body may review relevant product documentation at the time a CIS is seeking authorization. This may include the prospectus and any marketing material to be used at the CIS's launch. Additionally, marketing material may be subject to supervision on an on going basis, either during periodic inspections of operators or by reviewing advertisements in the public domain, typically in newspapers and magazines. A regulatory body could also require that advertising materials are filed with it for review and comment.

It is important that investors' attention is drawn to any relevant risks with the use of appropriate regulatory warnings and that a CIS does not purport to offer benefits or promises to investors which cannot be fulfilled.⁶ Supervision of an operator's product literature will help to ensure that investors understand - and receive - what they are entitled to, both at the point of sale and on an ongoing basis.

8.2 Financial Statements

Review of financial data, including a CIS's annual and semi-annual reports which have been prepared by an operator, may also help to confirm whether the fund has been managed in accordance with a jurisdiction's regulations and whether risks and other salient factors have been adequately disclosed to investors.

8.3 Continuing Disclosure of Material Information

A regulatory regime may also monitor the continuous disclosure of material information about a CIS. This could include, for example, merger and restructuring arrangements, and material changes to a CIS's constitutive documents.

⁶ Disclosure of risks to investors is the subject of a separate paper which has been produced by WP 5, that was approved by the Technical Committee in Montreal, September 1996.

9. Accounts and Record Keeping

Supervision of an operator should seek to ensure that proper books and records of the CIS are maintained for an appropriate time and in the event of a winding-up.

9.1 Ongoing Record Keeping

The maintenance of records for a CIS is important both in itself and as a confirmation that other regulatory rules and procedures have been complied with. Legible, comprehensible and comprehensive records should be maintained of all transactions involving CIS assets, as well as all transactions in CIS units. Records should be kept for a specified time in an accessible place and should be available to the regulatory body upon request.

The types of records which may be required include accounting and book-keeping records, trading records, bills and bank statements, correspondence between the operator and its clients, client agreements, copies of advertisements, personal trading records and evidence to support performance claims. The regulatory body may also wish to take account of an operator's books and records which may be inspected by a public accountant.

9.2 Winding-Up

It is important that the interests of CIS investors are duly protected not only while the CIS is a going concern, but also when its continuity is affected by circumstances which require it to be wound up. Such circumstances may include a failure by a CIS operator to discharge its obligations properly, an event specified in the CIS rules, any relevant legislation or the passage of time.

Books and records of the CIS should ensure that investors' interests can be accurately determined for the purposes of a winding-up.

10. Continuous Eligibility

Supervision should seek to ensure that neither changes in the management or administrative organization of an operator, nor delegation of functions to a third

party, lead to a lesser degree of investor protection than was presumed at the time of authorization.

CIS Principle 3 already requires that the regulatory regime should impose standards of conduct and minimum eligibility on operators of CIS, including honesty, fairness and capability, while CIS Principle 4 specifies that the level of protection afforded to CIS investors should not be affected by any delegation of functions by an operator.

It is therefore important for supervision to continuously review the eligibility of an operator to ensure that protection of investors is not diminished by changes that may occur over time. This may require that any subsequent material changes with regard to the management or organization of an operator, or any delegation of functions, are laid before the regulator for, if applicable, vetting. Information regarding these aspects should be available to the regulatory authority on a continuous basis.