



## Plenary 1

### New Challenges in the Regulation of Collective Investment Schemes

*Mr. Jean-Paul Servais*

Vice President of the Belgian Banking, Finance and Insurance Commission

*19 May 2004*

**NEW CHALLENGES IN THE REGULATION OF CIS.**  
**A EUROPEAN REGULATOR'S POINT OF VUE.**

Mr. Executive President,

Ladies and Gentlemen,

As the Vice President of the Belgian Banking, Finance and Insurance Commission (BFIC), I am addressing you today with much interest, and I would first like to thank Dr Bassam Saket, Executive President of the Jordanian Securities Commission, for hosting us<sup>1</sup> during these four days to discuss the recent developments and the new trends in financial markets across the world.

More specifically, we are meeting here today to launch a discussion on the various types of abuses that have been discovered in recent months as well as initiatives that we, as supervisory authorities, should adopt to fight against them.

I am very pleased to address you at this particular moment when the BFIC is reaching the end of an important reform. As a result this process, BFIC is now the single regulator of the Belgian financial market and therefore has a global view on its participants and particularly on the intermediaries involved in the distribution of CIS. Further more, since our merger, on January 1, 2004, with the Insurance Supervisory Authority, we will be able in the future to further stimulate the level playing field between life insurance and CIS products pursuing the same investment goals.

This said, I would now like to explain the recent challenges facing the regulation of CIS.

**THE CONTEXT**

Since September 2003, the American investment funds industry has been the subject of investigations on certain abuses relating to (i) trading in investment fund shares, 'late trading' and 'market timing', (ii) the determination of the net asset value (NAV) of a fund, (iii) the fees, expenses and commissions of CIS, as well as (iv) the selective disclosure of fund portfolio holdings.

These fraudulent mechanisms contradict various fundamental principles relating to the status of investment funds: (i) the equal and fair treatment of investors, (ii) the fiduciary duty of fund managers, which compels them to act in the sole interest of the fund and its shareholders, (iii) and the respect of the conditions set out in the fund's prospectus.

---

<sup>1</sup> Under the patronage of His Majesty King Abdallah II.

## **THE PROBLEMATICS**

Orders placed after the cut-off time for the acceptance of orders are also known as LATE TRADING practices. These practices are illegal as they authorize privileged customers to place an order to buy or sell mutual fund shares at that day's closing price after the cut-off time, at a rate which is therefore known, to the detriment of other investors.

In this context it is useful to point out that according to the legislation enforced in many European countries, and more specifically in Belgium, an investment fund's prospectus distinctly lists (i) the procedure for processing subscription or redemption orders (ii) the deadline for accepting orders as well as (iii) the date of the determination of the NAV. As explained above, the problem of late trading is, among other things, a breach of these procedures.

The rapid trading of fund shares, known as MARKET TIMING, which, in contrast to late trading, is generally not in itself illegal, involves executing very short-term orders to buy or sell investment fund shares. This practice becomes illegal once, due to their scale or their recurrent nature, these very short-term investments rack up trading profits at the expense of long-term shareholders.

As such, the excessive execution of consecutive buy and sell orders of fund shares can lead to (i) the dilution of the NAV of the shares held by long-term investors, (ii) an increase in transaction and administrative costs, as well as (iii) the risk of interfering with the efficient management of the fund's portfolio.

Abuses concerning THE DETERMINATION OF THE NAV of a fund arise from the abusive use of the so-called fair valuation method. This method of valuing a fund's portfolio securities is authorised to foreclose certain arbitrage opportunities, based on time zone differences, as well as other tricks linked to market timing.

Fair-value pricing enables the fund manager to obtain an estimated value of portfolio securities any time market quotations for these securities are not readily available, or when a "significant event" occurs after foreign markets close.

However, the absence of a standard procedure concerning the methodology to follow when using fair-value pricing has given too much discretion to mutual fund companies, rather than markets, to set security prices.

What this ultimately means is that two foreign funds could own exactly the same stocks and price them differently at the end of the day.

The problem relating to FEES, EXPENSES AND COMMISSIONS of CIS arises in the United States from the inopportune use of 12b-1 fees. As a reminder, these fees were born in the eighties under the authorization of the SEC to pay distribution and marketing expenses. The American supervisory authority has limited 12b-1 fees to 1% annually with maximum 0.25% going to brokers. The reality was quite different. It seems that typically

5% of the fee goes towards advertising the fund, but 63% goes towards compensating broker-dealers.<sup>2</sup>

This problem introduces a more general issue about the transparency of fees, expenses and commissions, which has long been a concern for regulators around the world and many jurisdictions are in the process of revising their approach.

## **PROPOSED INITIATIVES**

With regards to these abusive conducts, involving a failure to comply with many **PROFESSIONAL ETHICS PRINCIPLES**, it is imperative to insist on the crucial importance of (i) complying with professional ethics rules, (ii) ensuring that a monitoring of these rules is in place and (iii) that strict sanctions are enforced when necessary.

In this context, the American enforcement agency has asked investment companies to (i) appoint a chief compliance officer, (ii) to implement written compliance policies and procedures, and (iii) to elaborate and enforce a code of conduct applicable to all employees.

The SEC has also proposed that mutual funds insert in their periodic reports a statement by the fund's Board of Directors on (i) the enforcement of the established rules of conduct, (ii) the procedures implemented to guarantee the equal and fair treatment of investors and (iii) the respect by managers of their fiduciary duty. This statement could also include a description of sanctions imposed as a result of a breach of any of these rules or procedures.

With regards to **LATE TRADING** practices, different alternatives can be considered:

- Impose the harmonization and the strict application of the deadline for the acceptance of subscription and redemption orders. In the United States, the SEC has actually proposed to impose a 'hard 4 p.m. close' (U.S. Eastern standard time). However, this proposal is not unanimously accepted, especially among brokerage firms, financial planners and retirement plan providers, saying many investors would have to place orders hours earlier to meet the 4 p.m. deadline. Moreover, a senator from the western United States worries that this approach will discriminate against residents of the Pacific time zone.
- Define a more precise description of the custodian's control duty by including the obligation to certify that orders are executed at the correct NAV, a measure that fits into the framework of deterring late trading practices.
- Establish regulatory provisions aimed at ensuring the basis for the harmonization of order execution procedures. A concise description of these procedures would be included to the simplified prospectus. The full prospectus would present these procedures with more details.

---

<sup>2</sup> Source : ICI Fundamentals, April 2000.

Various proposals have also been presented to prevent abusive MARKET TIMING practices, including:

- to impose an early redemption fee. In this context, the SEC proposed to impose a 2% redemption fee on most<sup>3</sup> fund sales made within 5 days of purchase. Despite less-than-unanimous support, mainly amongst active trading advocates, who insist that this measure would penalise innocent investors, this proposal is on course for final approval by the agency.
- to insert a disclosure concerning frequent purchase and redemption of fund shares in the prospectus. This proposal would require disclosure of both the risks to fund shareholders of abusive market timing, and the fund's policies and procedures with respect to such frequent purchases and redemptions.

At the European level, regulators are fully aware of the issues related to mutual fund trading mispractices. Many members have undertaken questionnaire work and a significant number have undertaken on-site inspections. The range of issues being investigated varied from late trading, market timing and wider breaches of conduct.

During CESR's 12th meeting, on March 23rd 2004, members exchanged views on the results of their various inquiries into mutual funds trading mispractices. Subject to the results of on-site inspections, members have not detected major mispractices in the E.U. fund industry.

CESR, the independent Committee of European Securities Regulators, has requested from regulators of each member state to submit a report on these mispractices, by May 15<sup>th</sup> 2004.

Analyzing the results of this reflexion at a European level is a difficult exercise. Indeed, one should always keep in mind that (i) member states used different methodologies (questionnaire, on-site inspections, or a combination of both), (ii) that due to the structure of their regulation, each country may be facing different issues, and therefore the conclusion from each member state may be different.

It goes without saying that the Belgian Banking, Finance, and Insurance Commission has transmitted the results of its investigation.

The issue surrounding the FDETERMINATION OF THE NAV of a fund, and more specifically the use of fair value pricing, originates in its lack of specificity regarding the circumstances and the conditions under which this method can be used. Therefore, the SEC would like the management company to state in their prospectus the circumstances in which this valuation will be used as well as the consequences it could have.

---

<sup>3</sup> The provision allows the fund not to apply the 2% expenses on exit for transactions worth a maximum of \$2,500 or in the case of unexpected financial emergencies.

The regulation of certain member states, and more precisely the Belgian legislation, is very precise concerning methods for valuing the assets of a fund and allows the use of fair-value pricing under certain conditions. A special disclosure for each security priced at fair-value must also be added in the annual reports.

Moreover, in the case of suspension of quotation or exceptional event in financial markets, the investment company or management company of the fund can request, in some European countries, the suspension of the determination of the fund's NAV from their regulator. Subscription and redemption requests will then also be suspended during this period.

The IOSCO, in its principle 20 relating to CIS, also insists on the importance for the regulation to ensure that there is a proper and disclosed basis for asset valuation, pricing, and redemption of shares in a CIS.

In other words, regulation should seek to ensure that all of the property of a CIS is fairly and accurately valued and that the net asset value of the scheme is correctly calculated. Information about asset value and pricing should allow the investor to assess performance over time. The interests of the investor are generally better protected by the use of value based reporting wherever RELIABLE MARKET OR FAIR VALUES can be determined.

In addition, the regulation governing CIS should enable investors to redeem shares upon a basis that is made clear in the prospectus and should ensure that rights of suspension protect the interest of investors. Therefore, regulators should be kept informed of any suspension of redemption rights.

Abuses relating to FEES, EXPENSES AND COMMISSIONS of CIS mainly arise from the lack of transparency for these expenses for investors. The problem of 12b-1 fees in the United States is part of the same issue. To solve this problem, the SEC has proposed eliminating the use of this category of expense. This provision does not appear to enjoy unanimous support among players in the American mutual fund market and an alternative to the use of these charges appears to be the most likely outcome.

The general concern with the transparency of expenses borne by an investment fund is thus highlighted. As such, the SEC is also asking for greater clarification to be provided concerning the structure of these expenses as described in the fund's prospectus.

In Europe, the Commission has drafted a couple of weeks ago a recommendation regarding the need for greater transparency in the fund's prospectus of risk factors but also on commissions, fees and expenses of CIS.

A special attention is given in this recommendation to '*SOFT COMMISSIONS*'. More specifically, Member States are recommended to identify soft commissions as any economic benefit, other than clearing and execution services, that an asset manager receives in connection with the fund's payment of commissions on transactions that involve the fund's portfolio securities.

In this matter IOSCO and the European Commission have established the same definition.

Soft commissions are typically obtained from, or through, the executing broker.

There is nothing in the Belgian regulation today that forbids the use of soft commissions. Nevertheless, a special asset management expert group has been formed within the BFIC in order to set a more than necessary framework in this regard. Following a research on the rules and regulations in other countries and international organization, this work group has presented a draft recommendation to the sector. The ongoing improvement of CIS regulation will be inspired by these recommendations. The conditions under which soft commissions are accepted include: (i) the obligation to have a clear written contract (ii) the disclosure in the prospectus and the annual report of the use of such commissions, (iii) the requirement that soft commissions must be at the economic benefit of all investors of the fund, never at the benefit of an individual analyst or manager, (iv) disclosure of the use of soft commissions to the BFIC.

From a more global point of view, principle 19 of securities regulation set by IOSCO insists that regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the scheme.

Going a step further, the goal of disclosure should be to (i) provide investors with sufficient information to evaluate whether and to what extent the scheme is an appropriate investment vehicle for them, and (ii) provide information on a timely basis, in an easy to understand format, having regard to the type of investor.

In that context, IOSCO emphasizes the importance giving a close attention to the disclosure of all fees and other charges that may be levied under the scheme.

Furthermore IOSCO has published last February a special report concerning 'Elements of international regulatory standards on fees and expenses of investment funds'. This report emphasizes the importance of (i) the disclosure of information on fees and expenses to both current and prospective investors (ii) the quality of this information which should be simple and clear in order to allow the investor to understand what fees and expenses are charged, and to compare costs between funds.

With regards to soft commissions, the report reminds us of important issues relating to these commissions:

- The fiduciary duty of a management company towards investors is a general principle which requires that management companies cannot benefit from their position in connection with the placement and execution of fund portfolio transactions at the expense of investors.
- Regulators also agree that soft commissions may create conflicts of interest for fund managers. Regulation should therefore seek to ensure that those conflicts are either eliminated or managed in the investor's best interests.

Where soft commissions are permitted, a fund manager's obligation to obtain best execution must not be compromised.

- Transactions should always be executed in accordance with best execution principles. This implies that they be executed on market terms. If they are permitted, the soft commissions should not be the sole or primary criteria when a management company chooses an intermediary.

### **FIRST ACTION PLAN: THE BELGIAN SURVEY**

Given these abuses but also the scale of these practices in the United States, it was the duty of the Belgian BFIC, as single supervisory authority, (i) to ensure that these abuses were not a common practice in the Belgian investment funds market and (ii) to adopt legislative measures and impose sanctions that proved necessary.

Although we did not have any reason to believe that such practices had occurred in our market, the BFIC, like some of our European counterparts, decided to send a questionnaire to all promoters of investment fund registered under Belgian law.

This survey, drawn up for preventive purposes, sought to highlight (i) how systems for centralising and processing subscription and redemption orders work, (ii) the procedures for the acceptance of orders and how these procedures are monitored, (iii) and managers' internal rules of conduct and how these rules are controlled.

In order to focus on the above-mentioned topics, the issues relating to fees, expenses and commissions were left out of the investigation, although it is a continuous point of attention of the BFIC, as this aspect of marketing investment fund shares puts investment fund distributors into obvious situations of conflict of interest.

### **THE CONCLUSIONS OF THE SURVEY**

The general conclusions of this survey that we were able to address to our European homologues shows:

- the rapidity of reaction of promoters with regards to such inquiry, which may be an indication of the importance given by the industry on this subject.
- that responses were satisfactory, but nonetheless remain frequently quite general without necessarily showing an advanced degree of detail.
- that answers to the questionnaire do not a priori contain any particularly worrying elements relating to late trading and market timing practices. It goes without saying that on-site inspections are schedules to confirm this preliminary analysis.

More specifically,

- Promoters all have order acceptance procedures in place but these procedures do not always guarantee the technical impossibility of accepting an order after the cut-off time specified in the fund's prospectus. As it happens, some promoters allow the cancellation of a purchase or redemption order two or three hours after the deadline of acceptance of orders. Among other promoters, orders can be cancelled as long as they have not been transmitted to the transfer agent.
- Procedures for the acceptance of orders *after* the cut-off time have been implemented but these procedures differ strongly depending on the system used and depending on the promoter. Controls and the monitoring of controls on these procedures exist, but they also vary from one promoter to another.
- Orders placed by fund managers for their own account are subject to standard procedures, although specific to each institution. Promoters questioned do not all have specific professional ethics rules for a manager's position. Moreover, the monitoring of these procedures can be carried out by different departments from the Middle Office to Compliance depending on the promoter concerned.

## **SECOND ACTION PLAN: REGULATORY PROVISIONS AND RECOMMENDATIONS**

A new action plan was proposed based on these conclusions in order to reinforce adequately the existing framework.

This action plan includes regulatory provisions as well as various recommendations. Regulatory provisions, as part of the ongoing revision of the CIS regulation, will be the subject of a consultation with the sector in the context of the consultation planned for the new Belgian regulation. The other proposals, motivated by the concern to avoid the issues seen in the United States, will be integrated into a more general reflection on rules of conduct.

The regulatory provisions to be incorporated into the new Belgian regulation.

- The possibility to charge an early redemption fee.

This provision entails further clarification of our current regulation which already allows a fund's Board of Directors to charge a fee intended to cover the cost of managing their fund.

This proposition will now give the possibility, but not the obligation, to the fund's Board of Directors, to impose an early redemption fee in order to discourage market timers.

- The extension of the custodian's mission

At this point I think it is very important to emphasize the role played by the custodian, and more precisely its control duties as described in the European regulation. One of the custodian's duties is to ensure that the sale, issue, repurchase, redemption and cancellation of fund shares are carried out in accordance with the law and the fund rules, a step that fits into the context of detecting late trading practices.

Therefore, the aim of this provision is to clarify into our legislation the custodian's control duties further.

- The harmonization of order execution and NAV calculation procedures

This entails including certain provisions aimed at ensuring minimum harmonisation of order execution procedures in the new Belgian regulation (definition: accepted order, etc.).

This provision emphasizes the important role played by the different institutions to which the fund delegates certain responsibilities like the determination of its NAV.

In other words, I would like here to insist on the important issue of the regulation of delegation which already has taken the full attention of European regulators, as well as the special attention of CESR.

IOSCO also endorses the importance of this issue in its principle 17 for CIS. This principle insists that there should be clear criteria for eligibility to operate a CIS. Factors that may be considered include (i) honesty and integrity of the institution, (ii) competence to carry out the functions and duties of a scheme operator, (iii) financial capacity, (iv) clear powers and duties of the operator, (v) and internal management procedures.

In addition, as it is common for aspects of the operation of CIS to be carried out by delegates, the use of delegates should not, in any way, be permitted to diminish the effectiveness of the implementation of CIS regulation. A delegate should comply with all regulatory requirements applicable to the conduct of the principal's business activities.

## **The recommendations**

The objectives of these recommendations, that will be part of a consultation with the sector, are to make the fund's Board of Directors more accountable and to improve information at the disposal of investors.

These recommendations will influence the content of the prospectus and periodic reports. For example,

- Regarding the prospectus:
  - insert a description of both the procedures in place to monitor transactions as well as the sanctions that the investment fund's Board of Directors can enforce if procedures are not followed.
- Regarding periodic reports:
  - insert a statement by the fund's Board of Directors on the respect of (i) the fund's code of ethics and (ii) the procedures set to guarantee equal and fair treatment of investors, and (iii) the principle by which managers act in the exclusive interest of shareholders.

This said, to confirm the results of our analysis, on-site investigations will also be scheduled within the context of the prudential control carried out by the BFIC amongst financial institutions under its supervision.

\*  
\*      \*

I wish to conclude my presentation by emphasising the importance of our role as supervisory authorities. It is our responsibility to give the participants of our financial market the tools they require to fulfil their fiduciary obligations to investors.

The respect of professional code of conduct is essential for the integrity of our markets at the local level, as well as at a more global level. The investment needed to bolster this culture will make it possible to restore investor confidence

I very sincerely believe that the measures that we have just reviewed should enable us to strengthen the existing legal framework. Nevertheless, we should keep in mind that these measures may only be part of a wider, more global answer, within a European, or even worldwide framework, to the challenges exposed in this reflexion.

During the last CESR meeting it was agreed that the new expert group on Investment Management will compile further the results of the European-wide research on the actions taken by all member states in order to provide a summarized view at the next CESR/ESC<sup>4</sup> meeting on May 25<sup>th</sup> 2004.

---

<sup>4</sup> ESC, the European Securities Committee, primarily has a regulatory function, and CESR has an advisory function.

On a larger scale, the IOSCO Technical Committee also decided<sup>5</sup> to develop standards relating to late trading, market timing, and governance in the mutual funds industry.

Therefore, it goes without saying that the Banking, Finance and Insurance Commission would be delighted to share with you the methodology as well as detailed results of its investigations and is looking forward to a more global reflexion on the new challenges in the regulation of UCITS.

Thank you for your attention.

---

<sup>5</sup> IOSCO Press release 05/02/2004, « IOSCO moves to strengthen International Capital Markets against financial fraud ».