Regulatory Training Programme: Collective Investment Funds
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Cadogan Financial
for
Superintendencia Bancaria and Superintendencia de Valores
COLOMBIA
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Introduction to course

• Two tutors
• Two sessions: today and tomorrow
• First session focus : regulatory standards and techniques (sections 1 - 3)
• Second session focus : technical issues (sections 4 - 8)
• Q&A opportunity after each of the 8 sections
1. Importance of Regulation & International Best Practices
Review

• Purpose of Funds
• Role of Regulation
• International standards for fund regulation (IOSCO, 1994 - open ended funds)
• International standards for supervision of fund operators (IOSCO, 1997)
• Usual regulatory structures and powers
Purpose of Funds

“To provide the investor of moderate means the same advantages as the large capitalist in diminishing risk by spreading investment”

(source: F&C prospectus 1868)
Importance of Regulation

• Mutual funds are expanding worldwide driven by:
  – Need to save for retirement
  – Tax incentives
• Successful where confidence in funds is high
• Good quality, fair regulation plays a key part in creating confidence
The Main Players and Their Roles

- **The pooled fund**
  - **Investors** Invest
  - **Management company** Manages and operates fund
  - **Regulator** Regulates
  - **Depositary/custodian/trustee** Keeps assets

**Diagram Notes:**
- The image illustrates the roles of different entities in a pooled fund setup:
  - Investors contribute to the fund.
  - The management company runs and operates the fund.
  - The regulator oversees the fund's activities.
  - The depositary/custodian/trustee holds the fund's assets.

**Textual Notes:**
- The management company is responsible for managing and operating the fund.
- The regulator ensures that the fund operates within legal and regulatory frameworks.
- The depositary/custodian/trustee safeguards the fund's assets and ensures their proper management.
Why regulate?

• Investor protection:
  - protect the unsophisticated from the sophisticated
  - change the decision from “should I invest in a fund at all?” to “which fund should I invest in?”

• Market integrity
  - Funds
  - Funds’ investments

• Integrity of operator

• Scale of funds’ market
Benefits of good quality regulation for practitioners

• Confidence in funds
  – Designed as mass market vehicle
  – No confidence: no investment
  – Requires confidence in future

• Level playing field

• Predictability

• Mostly good business practice
Best Practices in Fund Regulation: IOSCO Standards

- International Organisation of Securities Commissions
- Survey members: define common minimum standards
- Standards for funds; also supervisory principles for operators of funds
- Website: www.iosco.org
IOSCO Fund Principles

1. Fund structure:
   - Clearly defined status of investors

2. Custodian / Depositary / Trustee
   - Safeguard assets
   - Independence from fund operator/sponsor
   - Qualifying requirements (honesty, competency, solvency)
IOSCO Fund Principles

3. Eligibility of Operators:
   - Honesty, competency and solvency
   - Capacity
   - Powers and duties
   - Compliance

4. Delegation
   - Can delegate task not responsibility
   - Must monitor for
     • competence
     • compliance
IOSCO Fund Principles

5. Supervision
   – Regulatory approval
   – Monitor
   – Inspect and investigate
   – Sufficient powers

6. Conflicts of interest
   – Ban or define how to be handled
IOSCO Fund Principles

7. Asset valuation and pricing
   – Methods and transparency of valuation and pricing
   – Ability to suspend dealing

8. Investment and borrowing
   – Limitations on investment and borrowing
IOSCO Fund Principles

9. Investor rights
   - Ability to redeem and participate in decision making
   - Remedies

10. Marketing and Disclosure
   - Prospectus use and content
   - Reporting
   - Advertising
   - Performance
IOSCO Supervisory Principles

1. Conduct of business
   – Best and timely
     • Execution
     • Allocation
   – Commissions
   – Inducements

2. Connected party transactions
   – Functional separation
   – Connected brokers
   – Underwriting
   – House and personnel dealing
IOSCO Supervisory Principles

3. Valuation of CIS assets
   - Calculation of NAV
   - Investment valuation
   - Income collection

4. Safekeeping & segregation of assets
   - Safekeeping and segregation of all fund assets from fund sponsor and manager
IOSCO Supervisory Principles

5. Investment and borrowing
   - Clear objectives
   - Compliance with rules

6. Fees and expenses
   - Authorised charges
   - Operator charges
IOSCO Supervisory Principles

7. Internal controls and compliance
   – Form
   – Effectiveness

8. Disclosure
   – Offering documents
   – Financial information
   – Material Facts
9. Accounts and record keeping
   – Ongoing record keeping
   – Winding up

10. Continuous eligibility
    – Ongoing compliance with licensing requirements
Common regulatory powers

• Promulgate regulations, interpret (‘guidance notes’)
• Licence/authorise
• Monitor
  – Regular reports
  – Inspections
  – Obtain information
  – Market data
• Investigate

• Discipline
  – Reprimand (public, private)
  – Fine
  – Levy cost of investigation
  – Require to compensate
  – Remove or ban individuals
  – Withdraw/cancel licence or
To summarise

• Good quality and fair regulation is key to funds’ success
• Governs operators as well as funds
• Need wide range of regulatory powers to enforce compliance
• But regulation cannot prevent all malpractice
2. Regulatory Techniques

Tasks, problems and how to address them
Review

- Forms of Oversight: Internal and External
- Off-site Inspection
- On-site Inspection
- Common Problems
- Breaches: deliberate and inadvertent
Need for Oversight

• Good regulation is ineffective if not complied with
• Disclosure is ineffective if unreliable
Principal Types of Risk - 1

- Customer relationship risk
  - Failure to match products to customer (needs and sophistication), lack of integrity in the marketing, selling & advice process, etc.

- Investment risk
  - Breach of investment limits or purpose, prohibited investments, volatility of the portfolio, failure to treat all investors equally, etc.
Principal Types of Risk - 2

• Control risk
  – Skill, competence and fitness of management and staff; the quality of internal systems of control; the compliance culture, etc.

• Operational risk
  – Fraud, misdealing, failure to best execute, incorrect pricing, failure to meet guarantees, IT systems failure, reconciliations, settlement failure, failure to collect all income, etc.
2 Forms of Oversight

• Internal controls
  – Processes and procedures
  – Compliance responsibility

• External controls
  – Government regulator / supervisor: off-site and on-site inspections and enforcement
  – Self Regulatory Authorities
  – Third party regulation: custodian / depositary; external auditor; rating agencies; etc.
Internal Controls – Who’s Responsible?

• Board of company (fund sponsor, fund manager or fund) responsible for:
  – Being fit and proper on continuing basis
  – Compliance with regulation

• Compliance usually delegated to compliance division
  – Understand and monitor rules, ensure compliant procedures, monitor, inform management and liaise with regulator
Types of Internal Control: General

- Clear management oversight
- risk recognition and assessment
- control activities
- segregation of duties
- information and communication
- monitoring activities and correcting deficiencies
Types of Internal Control: Specific

• Clear lines of responsibility to the most senior level
• Procedural Manuals
• Staff Training
• Compliance Test Report
  – Comprehensive list of all requirements
  – Furnished to senior management and regulator
• Risk Management Assessment
  – assessment of impact if things were to go wrong
External Controls: Supervision

Off-site and On-site Inspections aim to ensure:

• Activities are consistent with regulation
• Activities are consistent with disclosure
• Effective system of internal controls and compliance in place

Enforcement actions reinforce inspection activities
Supervisory Methods of Identification of Problems

- monitoring and validation of reporting
- reconciliations - custody and manager records
- comparisons - fund performance, asset pricing
- complaints records
- "secret shoppers"
- market comment
- inspections
Off-site Supervision

• Periodic reporting
  – Portfolio
  – Financial results
  – Performance for period
  – Compliance

• Continuous Monitoring
  – Media, websites
  – Complaints

• Regular contact
  – Trade Associations
  - Regulated Entities
Types of On-site Inspections

- Routine - passage of time (may follow risk profiling of entity e.g. newness, lack of experience, high level of risk to consumers)
- Cause – response to problem or potential problem
- Identify fund activities where violations can cause greater harm to investors
- Thematic
- Notified or surprise
On-site Inspection Overview

- Gather data: fund, service providers
- Analyse and evaluate data versus disclosure
- Look for pattern of suspect action
- Identify conflicts, problems, weaknesses
- Formal letter detailing issues uncovered
- Require elimination
- Follow-up
On-site Inspection Content

- Interviews – managers, key persons
- Examine books and records over time
- Review source documents and reconciliations – trace sample transactions from start to finish
- Look for irregularities, omissions, timeliness
- Impression of office and personnel
- Understanding of controls
Potential Indicators of Problems

• incomplete records; inability to find records
• poor register maintenance
• late reporting to regulator/investors
• late valuation or settlement
• requests to delay inspections
• rapid expansion of funds under management

• consistently out of line performance
Potential Indicators of Problems - 2

- high staff turnover
- high portfolio turnover
- audit qualifications or delay in audit report
- resignation of custodians, auditors
- high level of complaints
- high level of manual inputs to systems
- high costs, low revenues of MC
- inability to hire new custodian or new
Common Problems

• Misrepresentations (refer section 8)
• Transactions between funds and connected persons
• Insiders or related persons abuse position (conflicts – refer section 3)
• Mismanagement
• Theft
Connected Person Transactions

• Fund pays too high or receives too low a price

• Fund acts jointly with connected person – reduces that person’s costs
Mismanagement

• Income not collected on time
• Failure to account for fund units outstanding – wrong NAV
• Purchase of assets outside those permitted
• Assets poorly selected: result in losses, or gains lower than fund peer group
Theft

• Steal assets and make false entries
• Payment of excessive fees to connected persons
• Borrowing or conversion of unclaimed money (e.g. dividends returned)
Enforcement

- Make clear bad conduct not tolerated
- Back up to ensure remedy of failures
Typical Enforcement Remedies

- Censure – public or private
- Monetary fines
- Injunction (not repeat)
- Temporary ban
- Permanent ban
- Jail
Common Breaches and Controls - Fund

- Breach
  - Outside investment and borrowing powers
  - Error in valuation and pricing
  - Expenses allocation incorrect
  - Fees and charges
  - Settlement
  - Late processing
  - Ineligible counterpart
  - Ownership

- Controls
  - definitions in prospectus, rules, etc
  - reconciliations
  - record keeping
  - accounting standards
  - audit
  - complaints system
  - register
  - custodian
  - regulatory reporting
Common Breaches and Controls – Fund Management Company

- Breaches:
  - capital
  - personnel
  - ownership
  - ownership of fund
  - documentation
  - record keeping
  - reporting
  - procedures
  - late audit
  - confidentiality
  - co-operation

- Controls:
  - written internal procedures
  - clear responsibility
  - record keeping
  - reporting
  - other market data
  - inspection
  - audit
  - liability
  - complaints
Issues Relating to Common Investment Breaches

• Time of application of limits
  – On purchase
  – Ongoing

• Exceeding investment limits
  – Voluntary
  – Involuntary

• Examples
Investment Limitation Breach

Breach discovered? Yes

Breach within entity’s control? Yes

Voluntary breach

Investigate reasons

Apply penalties, define compensation

No

No action

No

Involuntary breach

Define and agree regulatory solution

Implement solution
Common Reasons for Voluntary Breaches – Disciplinary

<table>
<thead>
<tr>
<th>Breach</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accidental transaction leads to excess holding or borrowing</td>
<td>Staff should be aware of limits: indicates laxity of management</td>
</tr>
<tr>
<td>Intentional breach of limits</td>
<td>Check reason (affiliated transaction?); require reversal at cost of instigator; discipline</td>
</tr>
</tbody>
</table>
# Common Reasons for Involuntary Breaches – Non-disciplinary

<table>
<thead>
<tr>
<th>Breach</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets become illiquid e.g. market crisis</td>
<td>May need temporary rule suspension</td>
</tr>
<tr>
<td>Assets become ineligible e.g. delisting</td>
<td>Dispose asset when possible</td>
</tr>
<tr>
<td>Asset price move</td>
<td>Dispose excess when possible</td>
</tr>
<tr>
<td>Restructuring of capital</td>
<td>Dispose excess when possible</td>
</tr>
</tbody>
</table>
To Summarise:

- Internal and external controls are essential to ensure compliance with regulation
- Through supervision, the principle form of external control, problems can be identified and rectified through enforcement activities
- When imposing sanctions, it is important to distinguish between intentional and inadvertent breaches
3. Regulation of Investment Management & Conflicts of Interest
Review

- Conflicts of interest
- Types of transactions that may give rise to conflicts of interest
- Examples of unscrupulous behaviour
Conflicts of Interest

- When the interests of the investor and the investment manager are different - investors’ interests should prevail
- When the interests of distinct groups of investors are different - as far as possible, treat all groups the same
Avoiding Conflicts of Interest

• Transactions
  – With fund/operator affiliates
  – Through fund/operator affiliates
  – Between funds of same manager
  – Which serve interests of fund manager or affiliates rather than fund investors
  – By affiliates
Transactions With Affiliates

- Danger: price advantage to affiliates, not fund; or may sell at low price to fund to artificially boost performance
- Transactions between fund and affiliates and operators’ affiliates
  - May be banned
  - May be required to be agreed in advance by fund board or custodian
  - May be required to be ‘on arms length terms’ (ie same terms as unconnected parties on market)
Transactions Through Affiliates

• Danger: fund pays too much or receives too little – affiliates benefit at cost of fund

• May be
  – Banned totally
  – Limited (e.g. US – 15% by value of transactions through affiliated broker)
  – Required to be disclosed in reports
Transactions Between Funds of the Same Manager

- Danger: assets shifted to improve one fund’s performance; proper prices not paid
- May be banned
- May be required to be on ‘arms’ length terms
- May require brokers to certify that the price at which the transaction was performed was the genuine prevailing
Transactions by Affiliates

• Danger: affiliates derive benefits from privileged knowledge of fund
• House dealing
• Personnel dealing rules
  – Only through house dealer
  – Disclosure prior to transaction
• Only allow investment in own funds?
Examples of Conflicts of Interest

- Fund as ‘dustbin’
  - Buys failed underwriting from affiliated investment bank
- ‘Front running’
  - Manager buys shares for self/company then makes big purchase for fund; raises prices, profit at expense of fund
Examples of Conflicts of Interest - 2

• ‘Scalping’
  – Fund makes large deposit with bank at low interest rate; manager gets cheap mortgage

• ‘Rat trading’
  – Manager buys shares, but does not book sale: if price rises, keeps for own book, if falls, books to fund
Examples of Conflicts of Interest - 3

- ‘Rarity value’
  - Manager sells large block held by fund to affiliate who holds small block; affiliate sells on bigger stake and gets benefit

- ‘Churning’
  - Transactions in fund assets to generate commissions for friendly/affiliated broker
Examples of Conflicts of Interest

- ‘Concert parties’
  – Use of funds to support share of an aggressor company in takeover which is a client of affiliated investment bank

- ‘Warehousing’
  – Fund used to acquire stock to facilitate takeovers organised by affiliated investment banks
Examples of Conflicts of Interest - 5

- Soft commission
  - Broker gives ‘free’ services to fund manager (e.g. research, Bloomberg screens) in return for fund brokerage business
  - Transfers cost from manager to fund
To Summarise - 1

- Many temptations for managers and affiliates to use fund money for their advantage
- Requirement to act in investors’ interests is key
- So is transparency
To Summarise - 2:
Important Points for Regulators

• Need data on: fund/operator’s affiliates, clients
• Clear separation of regulated entities aids monitoring of transaction/information flows
• Need for record keeping and access to records
• Access to market prices for comparisons
4. Fund Accounting & How it Works
Review

• Who uses the accounts
• Differences from company accounts
• Key components and basis
• Things that can go wrong
Who is Interested?

- Actual and potential investors
- Regulator
- Taxation authorities
- Creditors if the fund can borrow
- Fund manager (fees, performance)
- Custodian (fees)
Accounting: Fund Accounts Differ from Ordinary Accounts

- No real estate, plant and machinery
- No depreciation
- No stock and work in progress
- No employees
- Assets are valued at market value
- Capital and income clearly distinguished
Usual to Have Special Accounting Standards for Funds

<table>
<thead>
<tr>
<th>UK</th>
<th>Open ended funds</th>
<th>Closed ended funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Variable</td>
<td>Fixed</td>
</tr>
<tr>
<td>Accounting standard</td>
<td>IMA SORP November 2003</td>
<td>AITC SORP January 2003 (use voluntary)</td>
</tr>
</tbody>
</table>

- US use GAAP
- IAS 37 is inappropriate for funds: used for securities brokers/dealers and those who trade in investments professionally
Fund Accounts Highlights

• What expenses/fees are paid
• Whether they are paid from income or capital
• What results come from income and what from capital
• What results are from investment and what from sales or redemptions
Key Principles

• ‘True and fair view’ of net income and net gains or losses for
  – Scheme property
  – Or fund

• Consistency of basis used

• Separate capital and income
Types of Charge: Must be Based on NAV

- Initial (or – entry charge, front-end load)
  - 0 – 8%: covers marketing cost, sales commission
- Exit (or – redemption charge) – deterrent to quick redemption
  - May taper: year 1, 5%; year 5, 1%; year 6, 0%
- Performance fee
- Annual management charge (0.25% - 1.5%)
- Other charges made directly to the fund (0.50% - 0.75%)
When Should Performance Fees Be Taken?
# Examples of Other Expenses

<table>
<thead>
<tr>
<th>Type</th>
<th>Levied on</th>
<th>How based</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration/holder servicing, annual reports</td>
<td>Generally direct from the fund</td>
<td>Per register entry – activity charges</td>
</tr>
<tr>
<td>Custodian/depositary/trustee</td>
<td>Fund</td>
<td>Basic fee + activity charges</td>
</tr>
<tr>
<td>Additional services from C/D/T</td>
<td>Fund</td>
<td>Per item</td>
</tr>
<tr>
<td>Brokerage</td>
<td>Fund: cost of deal</td>
<td>Negotiated with broker</td>
</tr>
<tr>
<td>Audit</td>
<td>Fund</td>
<td>Agreed fee</td>
</tr>
<tr>
<td>Regulatory fees</td>
<td>Fund</td>
<td>Lump sum</td>
</tr>
</tbody>
</table>
Should Regulators Set Limits for Charges?

- Not common in competitive markets (though USA has 8.00% limit on front end load set by NASD)
- More common where competition not strong
- Common caps: 5% total annual expenses, 5% front end load or redemption fee
Charges – a Controversial Issue

• What impact do charges make on long term returns?
• Is the level of charges a more important factor in decision making than past performance?
Charges – An Example

£10,000 invested over 40 years
Is front end load more important than annual charges?

Fund A: No-load & 1.74%
Fund B: 5% FEL & 0.94%
Fund B, please!
Fund Accounts Content - 1

- Income statement (profit and loss)
  - Revenue (dividends, interest) – note no capital gains
  - Expenses (management fee, other charges)
  - Tax
  - Net distributable income
  - Distribution (dividend)
Fund Accounts Content – 2

• Statement of total return: all funds
  – Investment gains or losses, income, expenses, tax paid and distributions made

• Statement of movement of unit/share holders’ funds: open ended funds only
  – Show movement due to sales/redemptions versus investment results
Fund Accounts Content - 3

- Balance sheet
  - Statement of assets and liabilities on particular day (NAV = open end fund equivalent)
- Summary of material portfolio changes
- Statement of accounting policies
- Notes to the accounts
- Distribution table
# Balance Sheet

As at 30th April 2004

<table>
<thead>
<tr>
<th>Note</th>
<th>30th April 2004 £000</th>
<th>30th April 2003 £000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio of investments</td>
<td>602,331</td>
<td>365,346</td>
</tr>
<tr>
<td><strong>Net current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>9,224</td>
<td>16,528</td>
</tr>
<tr>
<td>Cash and bank balances</td>
<td>14,559</td>
<td>3,102</td>
</tr>
<tr>
<td><strong>Net current assets</strong></td>
<td>23,783</td>
<td>19,630</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Creditors</td>
<td>6,209</td>
<td>11,277</td>
</tr>
<tr>
<td>Bank overdrafts</td>
<td>-</td>
<td>4,852</td>
</tr>
<tr>
<td>Distribution payable on income units</td>
<td>7,215</td>
<td>5,011</td>
</tr>
<tr>
<td><strong>Net current assets/(liabilities)</strong></td>
<td>13,424</td>
<td>21,140</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td>10,359</td>
<td>(1,510)</td>
</tr>
<tr>
<td><strong>Unitholders' funds</strong></td>
<td>612,690</td>
<td>363,836</td>
</tr>
</tbody>
</table>
Statement of Movement of Unitholders’ Funds

Statement of Movements in Unitholders’ Funds

For the year ended 30th April 2004

<table>
<thead>
<tr>
<th>Description</th>
<th>£000</th>
<th>£000</th>
<th>£000</th>
<th>£000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets at the start of the year</td>
<td>363,836</td>
<td>111,020</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Movement due to sales and repurchases of units</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount receivable on creation of units</td>
<td>154,438</td>
<td>49,152</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amounts received on in-specie transfers</td>
<td>-</td>
<td>219,033*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount payable on cancellation of units</td>
<td>(8,663)</td>
<td>(1,128)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stamp duty reserve tax</td>
<td>(241)</td>
<td>(62)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unclaimed distributions over 6 years old</td>
<td>1</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net increase/(decrease) in unitholders’ funds from investment activities (see above)</td>
<td>96,637</td>
<td>(16,487)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained distribution on accumulation units</td>
<td>6,682</td>
<td></td>
<td>2,308</td>
<td></td>
</tr>
<tr>
<td>Net assets at the end of the year</td>
<td>612,690</td>
<td></td>
<td>363,836</td>
<td></td>
</tr>
</tbody>
</table>

* Relating to the transfer in of the Artemis Equity Income Fund.
Statement of Total Return

For the year ended 30th April 2004

<table>
<thead>
<tr>
<th>Note</th>
<th>30th April 2004</th>
<th>30th April 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£000</td>
<td>£000</td>
</tr>
<tr>
<td>Net gains/(losses) on investments during the year</td>
<td>102,669</td>
<td>(14,089)</td>
</tr>
<tr>
<td>Other losses</td>
<td>(132)</td>
<td>(303)</td>
</tr>
<tr>
<td>Income</td>
<td>19,672</td>
<td>8,779</td>
</tr>
<tr>
<td>Expenses</td>
<td>(6,993)</td>
<td>(2,630)</td>
</tr>
<tr>
<td>Net income before taxation</td>
<td>12,679</td>
<td>6,149</td>
</tr>
<tr>
<td>Taxation</td>
<td>(159)</td>
<td>(83)</td>
</tr>
<tr>
<td>Net income after taxation for the year</td>
<td>12,520</td>
<td>6,066</td>
</tr>
<tr>
<td>Total return for the year</td>
<td>115,057</td>
<td>(8,326)</td>
</tr>
<tr>
<td>Distributions</td>
<td>(18,420)</td>
<td>(8,161)</td>
</tr>
<tr>
<td>Net Increase/(decrease) in unitholders' funds from investment activities</td>
<td>96,637</td>
<td>(16,487)</td>
</tr>
</tbody>
</table>

Source: Artemis Income Unit Trust
# Total Expense Ratio

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Net Assets 1999/2000</td>
<td>87,867</td>
</tr>
<tr>
<td>Expenses 2000</td>
<td></td>
</tr>
<tr>
<td>Investment Manager’s Fee</td>
<td>599</td>
</tr>
<tr>
<td>Bank</td>
<td>719</td>
</tr>
<tr>
<td>Custody</td>
<td>370</td>
</tr>
<tr>
<td>Others</td>
<td>364</td>
</tr>
<tr>
<td>Total</td>
<td>2,052</td>
</tr>
<tr>
<td>Total Expense Ratio %</td>
<td>2.34</td>
</tr>
</tbody>
</table>
Key Accounting Issues

1. Can dividends be paid out of unrealised and/or realised gains?
2. Should expenses be charged against income and/or capital?
3. Should all net income after expenses be paid out as a matter of course?
4. Statements of total return and movement of unit-holder funds
What Can Go Wrong?

- Inappropriate accounting standards
- Not properly applied
- Fraud/error hidden from auditor
To Summarise

• Funds need special accounting standards
• Investment results from income and capital should be distinguished
• Charges are the only known factor when an investment in a fund is made
• Expenses should be clearly allocated to capital or income
• Charges and expenses can have a major impact on comparative fund performance
5. Fund Valuation & What Can Go Wrong
Review

• What is net asset value?
• Why does it matter?
• Basis of valuation
• Problems which can arise
• Some methods of manipulation
What is net asset value (NAV) per share or unit?

Assets – liabilities
Number of shares/units in issue

In effect, liquidation value of the fund
Why is NAV important?

• **Regulation**: basis for pricing open ended fund units or shares – ensures fairness between incoming, ongoing and outgoing holders

• **Informs fund shareholders**:
  – Open ended funds: at what prices they can buy or sell
  – Closed ended funds: guide to potential market price

• **Measure of performance**: compare NAV per share on day 1 and day 365 of year

• **Basis of annual fund management fees**
What Happens if NAV is NOT Used as the Pricing Basis?

<table>
<thead>
<tr>
<th></th>
<th>Net assets</th>
<th>Units in issue</th>
<th>Purchase number of units</th>
<th>Purchase price per unit</th>
<th>Amount invested</th>
<th>NAV per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening position</td>
<td>1,000,000</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>New investor buys</td>
<td></td>
<td></td>
<td>100,000</td>
<td>5</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Closing position</td>
<td>1,500,000</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
<td>7.5</td>
</tr>
</tbody>
</table>
Frequency of Valuation, Revaluation and Suspension

- Daily or weekly for most open ended funds
- Less frequently for closed ended funds
- Regulatory principle: may suspend if unable to value owing to *force majeure* (11 September 2001)
Valuation Difficulties

• Failure to record deals (sale, purchase)
• Variability of basis (value on basis of bid one day and the offer the next, etc.)
• Errors (mathematical)
• No reliable market prices
• Manipulation
Variability

- Inconsistent pricing basis (e.g. using offered price instead of middle price)
- Errors of timing (e.g. using a price other than the most recent price)
- Variations between different funds’ valuation methodology (e.g. different values used for different funds)
Errors

May arise from error in data input:

• Wrong price used
• Wrong number of securities
• Wrong asset (preferred share not ordinary share)
• Purchases or sales not entered
• Wrong number of units in issue
• Incorrect/absent accruals (income, expenses)
• Omission of borrowing
No Reliable Market Price

Mark to market is the rule but what is “market”?

- There is no trade in recent days and therefore no recent market price
- Trade is very thin and therefore price formation is weak
- Shares or bonds which are technically listed but rarely traded
- Unlisted securities
- Off market deals which are not disclosed
Some Solutions

Equities
• The most recent price even if old
• Brokers’ quotes
• Comparison with more liquid securities

Bonds
• Comparison with more liquid securities
• Synthetic means – interpolation or redemption yield matrix
Using Brokers’ Quotes

• Is it sufficient to use a bid from a broker?
• Question - do the rules of the market require that a broker will deal at that price?
• If so, is one bid enough?
• What is the minimum transaction size?
• An average of several bids on the same day
• or of bids over a period of time
NAV Manipulation - 1

- Affiliate banks pay abnormally high rate of interest on fund deposits: boosts NAV
- New fund gets ‘hot’ new issues, not others: boosts performance
- Affiliated brokers charge artificially low brokerage: boosts performance
- Managers do not levy charge: boosts performance
NAV Manipulation - 2

- Orchestrated repeated small purchases of illiquid issues (puts prices up)
- Friendly brokers’ artificially high bid price estimates
Valuation Controls

- Dual calculation: manager and custodian
- Sign off by custodian
- Verification by auditor on ‘spot check’ basis
To Summarise

- NAV is key to funds:
  - Shows performance (competition)
  - Basis of fees
- Therefore temptation to manipulate higher
- Variety of valuation problems
- Market price data important
- Comparison of fund portfolio valuations and NAVs/indexes important (cross-analysis)
6. Fund Pricing and Fund Issue & Redemption
Review

• Pricing defined
• Pricing basis
• Forward versus historic pricing
• Common regulatory requirements for fund unit issue and redemption
• What can go wrong
Pricing Defined

Setting the price at which fund shares/units are sold to and redeemed from investors, including charges
**Open versus Closed Ended Fund Dealing Price**

<table>
<thead>
<tr>
<th></th>
<th>Priced at</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open ended</td>
<td>NAV per share/unit +/- charges depending on pricing basis</td>
</tr>
<tr>
<td>Closed ended</td>
<td>Market price</td>
</tr>
<tr>
<td></td>
<td>May be more than NAV (premium) or less than NAV (discount) – both expressed as % of NAV</td>
</tr>
</tbody>
</table>
Methods of Open Ended Fund Pricing

- Key: which pricing basis is used for the fund’s assets
  - Dual pricing: bid and offer price within permitted limits. Charges included in price
  - Single pricing: one price for buying and selling based on mid-market prices
  - Swinging single: single price which is changed according to sales and redemptions
Dual Pricing

Unit bid price 97

Bid price 98

- 1% costs

Portfolio share

Offer price 102

12% spread

+ 1% costs & 6% FEL

Net seller

Net redeemer

Unit offer price 109.2

- 1% costs

+ 1% costs & 6% FEL
Single (Mid) Pricing

mid price 100

Portfolio share

Bid price 98  Offer price 102
Single (Mid) Pricing - Swinging

Bid price 98  Offer price 102

mid price 100

Portfolio share

swing  swing
Forward versus Historic Pricing

Day 1

4 pm price point 1

Clear orders at price 1

historic

Day 2

4 pm price point 2

Clear orders at price 2

forward
Forward Pricing More Modern Form

• Historic pricing
  – Open to abuse by insiders/professionals
  – At cost of ordinary investors

• People order by value (e.g. £1,000 worth) not by number of units
Regulatory Requirements

- Regulation may set deadlines for:
  - Receipt of payment and entry on register for new investor
  - Payment of redemption proceeds and removal from register for redeeming investor
  - Take account of local banking practice
- Prevents sponsors mis-using investors’ money en route
Proof of Ownership

• Bearer – physical ownership of the relevant bearer certificate is *de facto* ownership

• Registered certificated – the name of the holder is entered on a register and a certificate of ownership is issued; this certificate is transferable

• Dematerialised – name is registered but only a statement of account or register extract is issued
Dematerialised, the Modern Way

- Customer facing database (not fund facing database)
- Splits, mergers, etc present fewer problems
- Hold more data on customers (contacts, buying patterns, etc)
Importance of Correct Register

- Validation of ownership
- Communications and reports to investors
- Paying dividends
- Calculation of correct NAV per share/unit
- Marketing database
Things That Can Go Wrong

• Input incorrect:
  – Wrong namesaddressesnumbers of units
  – Duplication (M St Giles, M V St Giles, M S Giles, M V S Giles)

• Inefficiencies:
  – Register not updated so details wrong; lack information
  – Dividend paid to wrong person: no longer holder
  – Purchases/sales bookings delayed
  – Dividends paid late

• ‘Lost’ subscribers: what to do with
Is Administration Important?

What gives rise to a greater volume of complaints?

- Bad investment results?

- Inefficient administration?
To Summarise

- Single forward pricing is ‘the modern way’
- Administration – accuracy and timeliness are important
- Incorrect registers
  - Can damage investors
  - Indicate inefficiency
7. Marketing & Disclosure
Review

• What is marketing
• How funds are sold and issues arising
• Entities to be regulated
• Regulatory issues and controls
• Common problems
• Required disclosure and its content
Elements of Marketing

- Research – identifying customers and their needs
- Branding – creating awareness of a name with associated qualities
- Advertising – placing paid promotional messages
- Public relations – managing communications with the public via chosen channels eg journalists
Methods Used

- Prospectuses
- Yearbooks
- Brochures
- Q & A sheets
- Newsletters
- Mailing lists
- Help lines
- Website

- Media liaison
- Marketing and promotion team
- Sales team (different channels)
- Compliance
- External agencies – advertising, PR, mailing, etc.
Distribution Choices

• Direct – within control
  – Direct mail, telephone sales, handouts
  – Advertising
  – Roadshows
  – Internet
  – Sales agents
    • Employed
    • Sponsors’ network e.g. bank branches

• Indirect – not within control
  – Sales network
  – Branches (e.g. bank)
  – Independent advisers
  – ‘Affinity groups’ e.g. membership organisations
Sales Channels - Issues

• Direct sales
  – Fraud, mis-selling or misrepresentation
  – Churning
  – Quality control
  – Loyalty
  – Incentivisation – salaried versus commissioned

• Indirect sales
  – Loyalty
  – Mis-selling or misrepresentation
  – Churning
  – Commissions and discounts: pressure on margins
  – Volume overrides
Issues

• Ensure sufficient information available to make informed investment decision
• Prevent misrepresentation or omission in advertising and sales
• Prevent mis-selling – wrong product being sold to investor (e.g. capital growth when need income)
• Prevent theft
3 Levels of Information

Sponsor

Salespeople (branches)

Recipient
Sponsor

• Regulatory issues
  – Misrepresent or omit
  – ‘Economical with truth’
  – Mislead
  – ‘Buy’ sales
  – Miscalculate

• Regulatory controls
  – Required prospectus contents and offer
  – Advertising rules
  – Not deviate from prospectus
  – Liability for prospectus
  – Disclosure of charges and commissions
  – Compensation
  – Reporting and compliance, inspection
Salespeople

• Regulatory Issues
  – Misrepresent
  – Sell highest commission product
  – Sell wrong product to investor
  – ‘Churn’
  – Theft

• Controls
  – Mandatory use of prospectus – contain application form
  – Disclosure of commissions
  – ‘Factfind’
  – Track salesmen
  – Complaints
  – Liability on management company
  – Record keeping
Recipient

• **Regulatory issues**
  – Retail or institutional
  – Risk tolerance
  – Time horizon
  – Cost
  – Ability to make comparisons
  – Theft

• **Controls**
  – Protection for retail
  – Risk warnings
  – ‘Long term’ warnings
  – Mandatory disclosure: cost, performance
  – Minimum prospectus content
  – Complaints
  – ‘Never pay cash’ warning
Establish Principles for Advertising

- Clarity of purpose
- Clarity of subject
- Avoid misleading statements, promises and forecasts
- Verification of facts
- Validate statements of opinion
- Disclose capacity
- Disclose material interests and conflicts
Prohibitions

- No false claims of independence
- Not to claim government or regulatory approval
- Not imply shortage if none
- Not use testimonials unless complete, fair, accurate and relevant
- No suppression of required disclosure
- No false indications of scale of business
- No unfair comparisons
- No omission
- No statement of guarantee unless is a legally enforceable
Requirements

- Give a fair view – commitment and risk
- Information on tax, if relevant
- Performance (next session)
Common Misrepresentations

- Investment objectives
- Amount of risk involved
- Past performance of fund
- Possibility of loss
- Experience of fund manager
- Experience and integrity of manager
- Safety of assets
Disclosure: Regulatory Requirements

- Prospectus (mini)/key features/scheme particulars
  - Information required to make an informed investment decision
- Audited annual and unaudited semi-annual report
  - Status of investment in fund
- Annual or extraordinary general meeting
  - Standard decision taking or voting on key changes
- NAV or share price publication
  - Guide to current value or price investor could buy or sell at
Prospectus: Regulator Sets Minimum Requirements

• Key elements
  – Investment objective, portfolio and associated risk disclosure, distribution policy, management
  – Charges and costs
  – Subscription conditions and contacts, valuation and pricing, investor rights, taxation issues

• Offer to investor before investing
• Update annually (open ended funds)
Annual Report

• Audited accounts
• Report on fund progress and investment report
• Depositary/trustee’s responsibilities and report
• Auditor’s report
• 5 year (or inception if shorter – refer next session) performance and distribution history and any changes affecting this in the
Example of Annual Report: Performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Perpetual Corporate Bond Fund</th>
<th>Position in sector</th>
<th>Quartile ranking</th>
<th>Sector average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>+9.3%</td>
<td>4/47</td>
<td>1</td>
<td>+6.0%</td>
</tr>
<tr>
<td>1997</td>
<td>+16.0%</td>
<td>8/52</td>
<td>1</td>
<td>+13.0%</td>
</tr>
<tr>
<td>1998</td>
<td>+12.0%</td>
<td>44/58</td>
<td>4</td>
<td>+13.5%</td>
</tr>
<tr>
<td>1999</td>
<td>+9.1%</td>
<td>4/65</td>
<td>1</td>
<td>-2.0%</td>
</tr>
<tr>
<td>2000*</td>
<td>+4.1%</td>
<td>33/77</td>
<td>2</td>
<td>+3.6%</td>
</tr>
</tbody>
</table>

* to 31st October

All above performance figures include net reinvested income. Unit trust performance figures are on a buying price-to-buying price basis, and in the graph are as at the end of the relevant month unless otherwise stated (source: Hindsight © REUTERS Limited).
Complaint Handling

• Complaints
  – Indicate potential problems at fund sponsors or managers
  – Useful intelligence
  – May be biased
  – May come from competitors
To Summarise

• Need to ensure investors not mislead
  – By untruths
  – Only part of truth
  – Exaggeration or lies
• Necessary to cover all sales methods
• Necessary to govern advertising
8. Performance Evaluation
Review

- Fund performance basis
- Comparability
- Fairness
Basis

- Net asset value or price
- If price, must also include charges for comparators
- Must exceed minimum period (1 – 6 months)
- May select period but if so must show 5 years or since inception, whichever shorter
- No projections
Why 5 Years or Since Inception?

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State Basis

• Including or excluding:
  – Charges
  – Tax
  – Dividends

• Data source
Who Calculates Statistics?

• Ideally objective organisation
  – Specialist provider e.g. Micropal, Lipper Analytical
  – Trade Association
• Fund manager
Calculation

\[
\frac{X \times 100}{Y \times 1}
\]

\(X = \text{NAV on last day of performance period}\)
\(Y = \text{NAV on first day of performance period}\)
Example

<table>
<thead>
<tr>
<th>Fund</th>
<th>Price 1.1.01</th>
<th>Price 30.12.01</th>
<th>Increase/decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIF A</td>
<td>125</td>
<td>136</td>
<td>+8.8%</td>
</tr>
<tr>
<td>CIF B</td>
<td>324</td>
<td>398</td>
<td>+22.8%</td>
</tr>
</tbody>
</table>

But what if fund A paid a dividend? Not included, but is a factor in performance
Therefore Use ‘Total Return’

<table>
<thead>
<tr>
<th>Date</th>
<th>No of shares</th>
<th>Price</th>
<th>Value</th>
<th>Increase / decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1.01</td>
<td>100</td>
<td>125</td>
<td>12,500</td>
<td></td>
</tr>
<tr>
<td>31.3.01</td>
<td>100</td>
<td>147</td>
<td>14,700</td>
<td></td>
</tr>
<tr>
<td>1.4.01(ex dividend)</td>
<td>120.49(^1)</td>
<td>122</td>
<td>14,700</td>
<td></td>
</tr>
<tr>
<td>30.6.01</td>
<td>120.49</td>
<td>136</td>
<td>16,387</td>
<td>+31.1(^2)</td>
</tr>
</tbody>
</table>

\(^1\) The dividend of 25 on 100 shares is worth 2500, sufficient to buy a further 20.49 shares

\(^2\)
Performance Requirements

• Performance representation
  – Relevant
  – Complete
  – Fair
  – Not misleading
  – Not exaggerate or disguise
  – State source
  – Warnings
Relevance

• Compare to products offering similar benefits (e.g. income, growth, balanced)
• Compare to average of similar funds
• Or to average of all funds
• Relevant index (sector, country)
Comparator Funds: Same Focus

- Investment objective – income, balanced, growth – cautious or aggressive
- Asset class – equity, bond, money market, derivatives
- Investment style – active, passive, etc
- Focus – geographic, sector, theme, indexed etc
Risk Warnings

• Value of units and income from them may go down as well as up
• Long term investment
• May not get back what they invested (except money market funds)
• Country, asset or currency risk
Is Past Performance Important?

• Only information investor has is:
  – Prospectus
    • Terms of offer including charges
  – Annual reports
  – Current prices/NAV
  – Past performance
UK Regulatory Survey of Use of Past Performance

• FSA task force on performance recommended:
  – Past performance should not be ‘main message’ of advertising
  – Warnings should be prominent and legible
  – Reconstruction of hypothetical performance other than actual performance of a fund banned
  – Consider standardising performance representation
  – Include ‘relative risk’ measure and price
To Summarise

• Portrayal of performance is key to selling funds in competitive markets
• Temptation to present performance to maximum advantage
• Clear rules needed