

Regulatory Training
Programme: Collective
Investment Funds

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for

Superintendencia Bancaria and
Superintendencia de Valores

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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

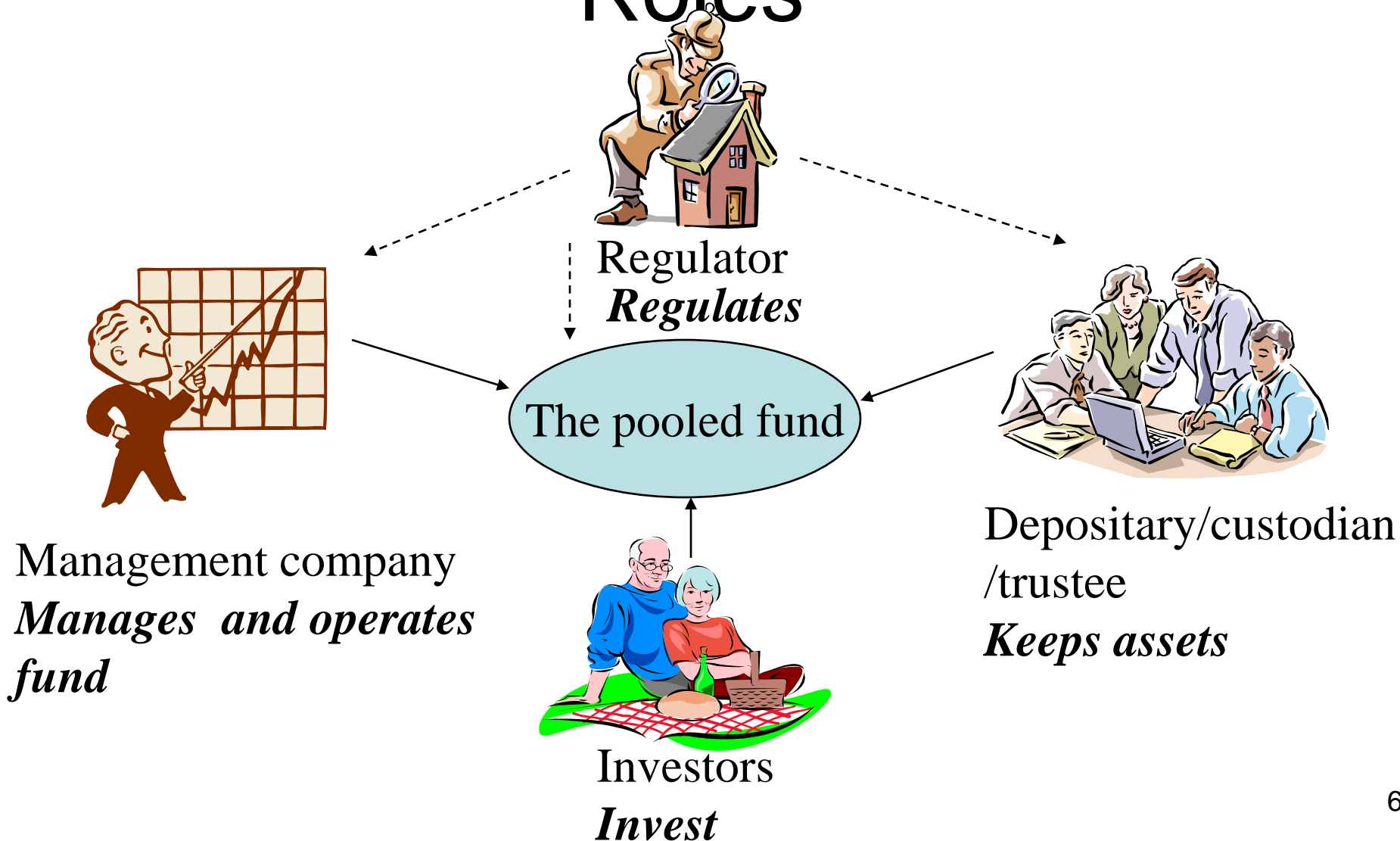
“To provide the investor of moderate means the same advantages as the large capitalist in diminishing risk by spreading investment”

(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



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

IOSCO Supervisory Principles

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

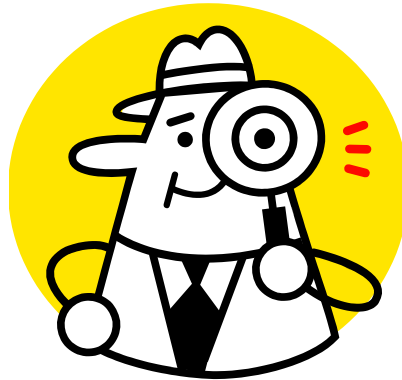


Review

- 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

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

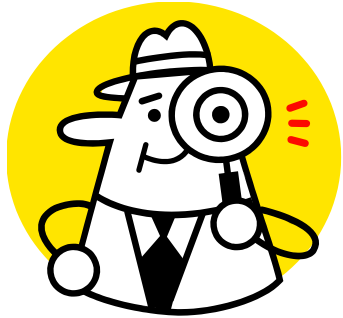
- 1

- 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

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

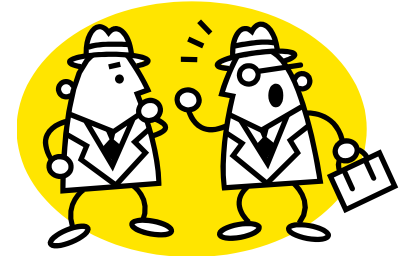
- Misrepresentations (refer section 8)
- Transactions between funds and connected persons
- Insiders or related persons abuse position (conflicts – refer section 3)
- Mismanagement
- Theft

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

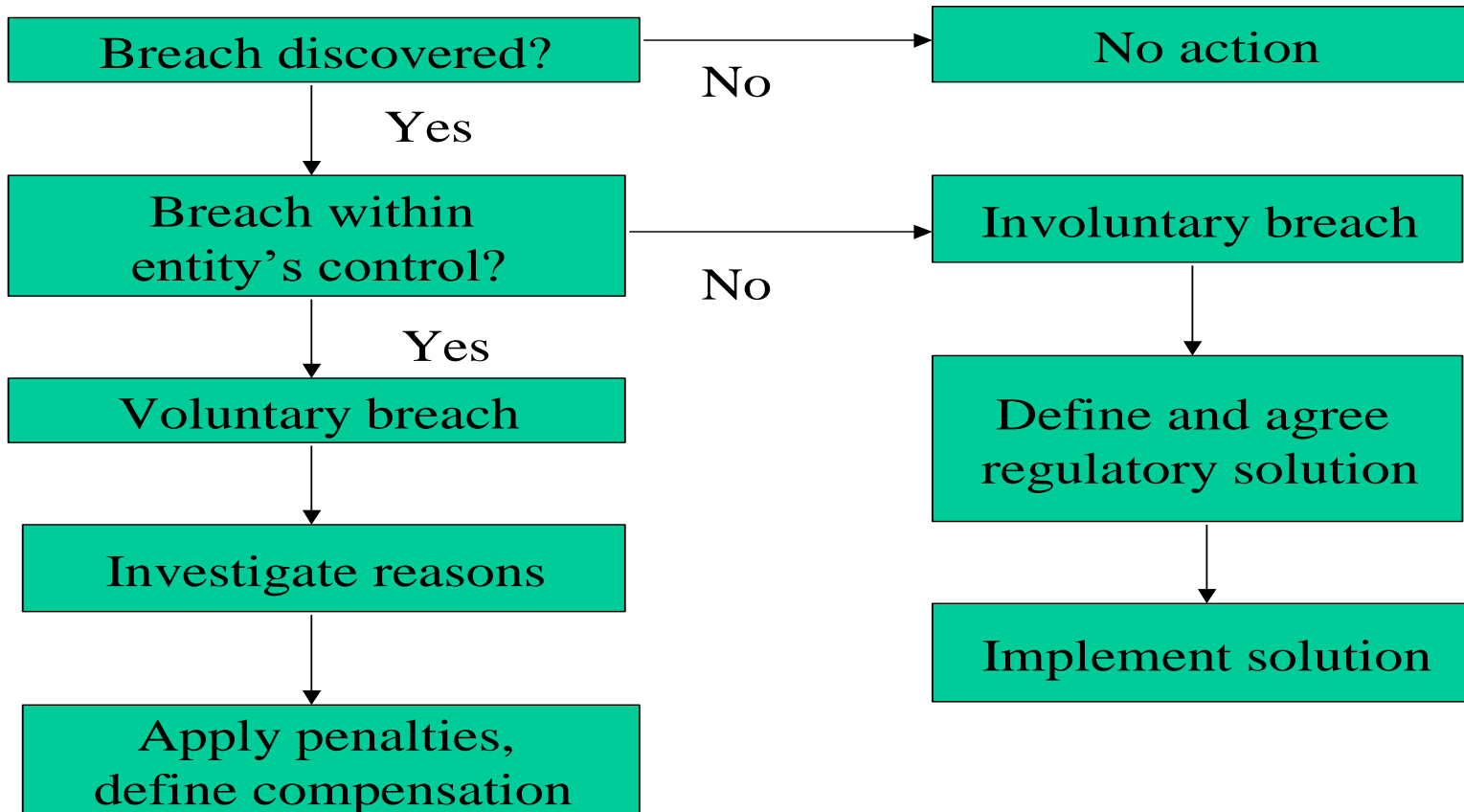
Common Breaches and Controls – Fund Management Company

- 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



Common Reasons for Voluntary Breaches – Disciplinary

Breach	Action
Accidental transaction leads to excess holding or borrowing	Staff should be aware of limits: indicates laxity of management
Intentional breach of limits	Check reason (affiliated transaction?); require reversal at cost of instigator; discipline

Common Reasons for Involuntary Breaches – Non- disciplinary

Breach	Action
Assets become illiquid e.g. market crisis	May need temporary rule suspension
Assets become ineligible e.g. delisting	Dispose asset when possible
Asset price move	Dispose excess when possible
Restructuring of capital	Dispose excess when possible

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

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

- 1

- 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

- 4

- ‘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

UK	Open ended funds	Closed ended funds
Capital	Variable	Fixed
Accounting standard	IMA SORP November 2003	AITC SORP January 2003 (use voluntary)

- 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

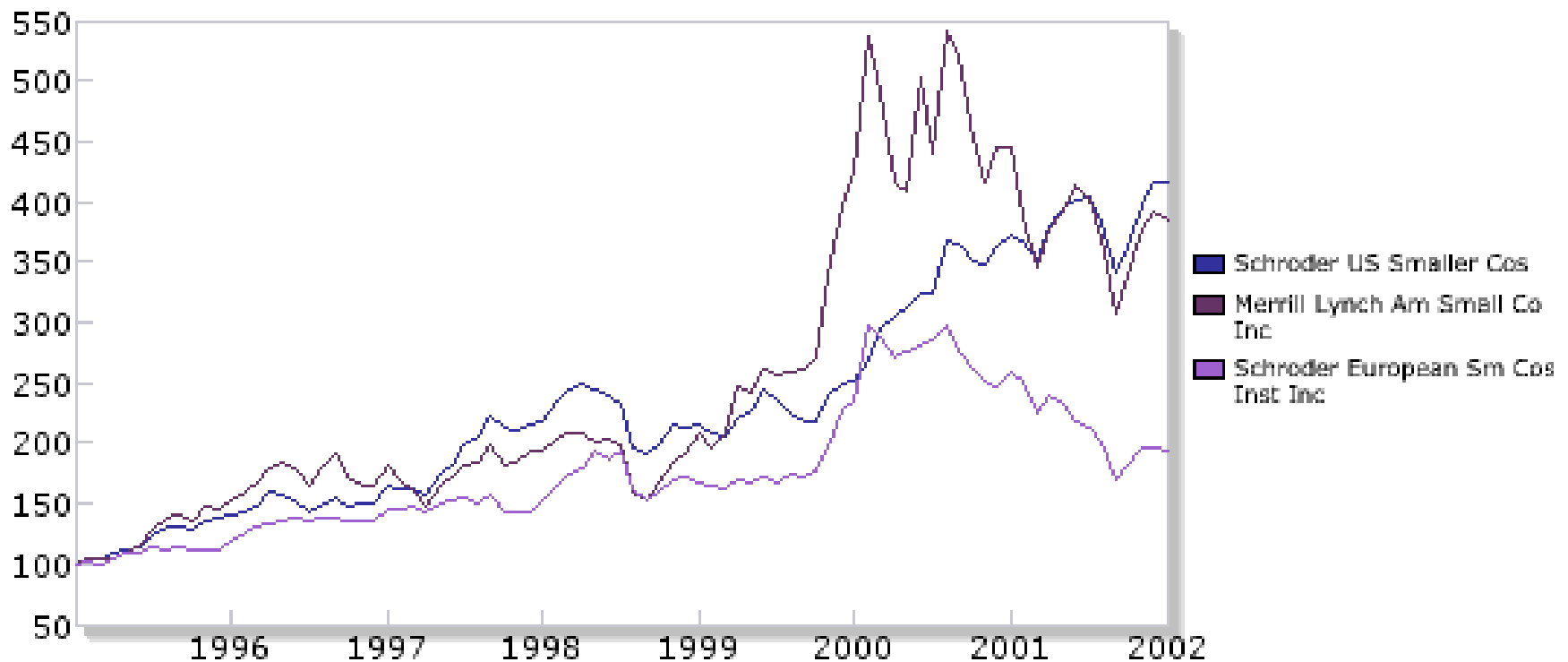
Key Principles

- ‘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

Type	Levied on	How based
Registration/holder servicing, annual reports	Generally direct from the fund	Per register entry – activity charges
Custodian/depositary/trustee	Fund	Basic fee + activity charges
Additional services from C/D/T	Fund	Per item
Brokerage	Fund: cost of deal	Negotiated with broker
Audit	Fund	Agreed fee
Regulatory fees	Fund	Lump sum

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

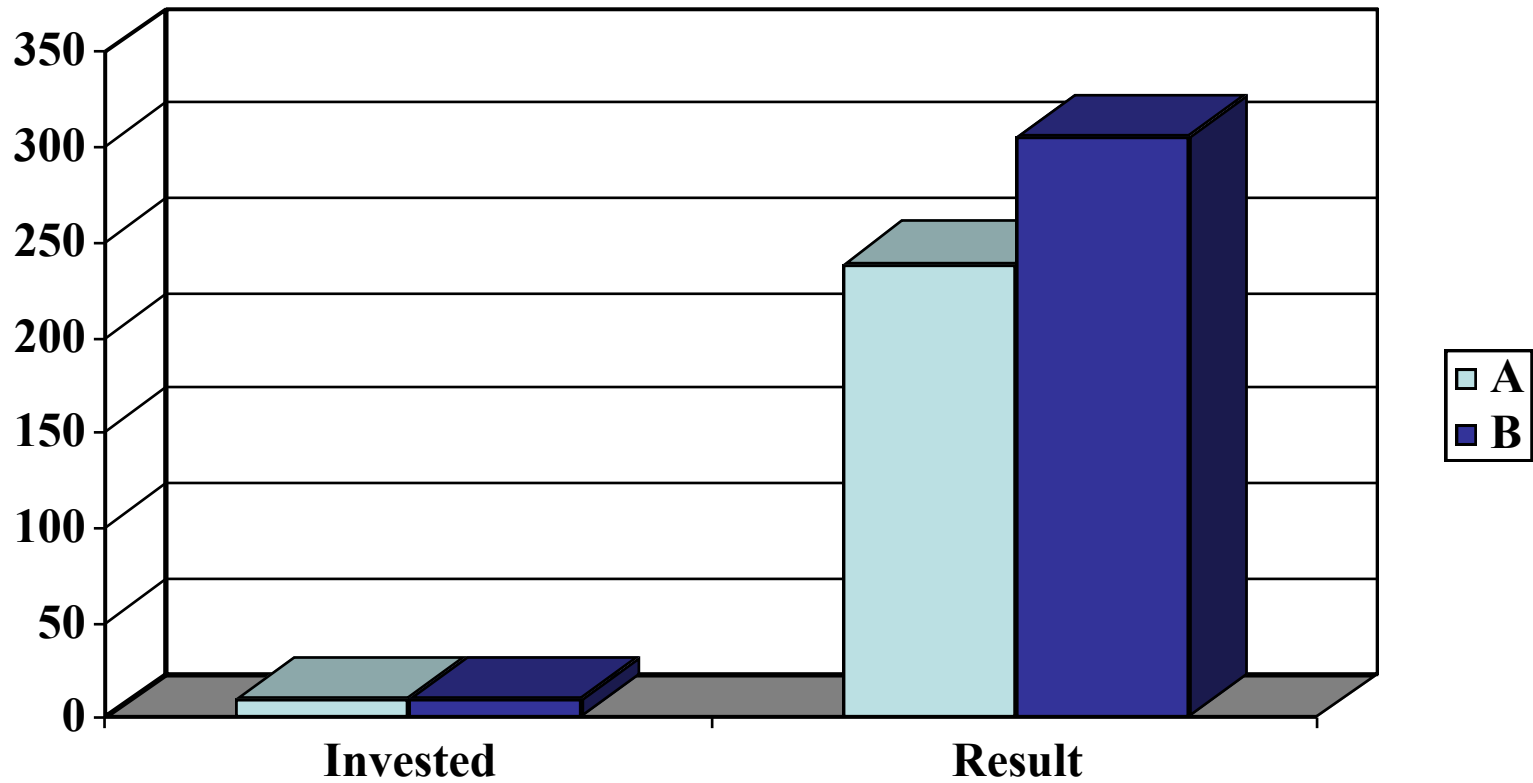
£10,000 invested over 40 years

**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

	Note	30th April 2004 £000	30th April 2003 £000
Portfolio of investments		<u>602,331</u>	<u>365,346</u>
Net current assets			
Debtors	8	9,224	16,528
Cash and bank balances	9	<u>14,559</u>	<u>3,102</u>
		<u>23,783</u>	<u>19,630</u>
Less:			
Creditors	10	6,209	11,277
Bank overdrafts		-	4,852
Distribution payable on income units		<u>7,215</u>	<u>5,011</u>
		<u>13,424</u>	<u>21,140</u>
Net current assets/(liabilities)		<u>10,359</u>	<u>(1,510)</u>
Net assets		<u>612,690</u>	<u>363,836</u>
Unitholders' funds		<u>612,690</u>	<u>363,836</u>

Statement of Movement of Unitholders' Funds

Statement of Movements in Unitholders' Funds

For the year ended 30th April 2004

	30th April 2004		30th April 2003	
	£000	£000	£000	£000
Net assets at the start of the year		363,836		111,020
Movement due to sales and repurchases of units				
Amount receivable on creation of units	154,438		49,152	
Amounts received on in-specie transfers	-		219,033 *	
Amount payable on cancellation of units	<u>(8,663)</u>		<u>(1,128)</u>	
		145,775		267,057
Stamp duty reserve tax		(241)		(62)
Unclaimed distributions over 6 years old		1		-
Net increase/(decrease) in unitholders' funds from investment activities (see above)		96,637		(16,487)
Retained distribution on accumulation units		<u>6,682</u>		<u>2,308</u>
Net assets at the end of the year		<u>612,690</u>		<u>363,836</u>

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

Statement of Total Return

Statement of Total Return

For the year ended 30th April 2004

	Note	30th April 2004		30th April 2003	
		£000	£000	£000	£000
Net gains/(losses) on investments during the year	2		102,669		(14,089)
Other losses	3		(132)		(303)
Income	4	19,672		8,779	
Expenses	5	(6,993)		(2,630)	
Net income before taxation		<u>12,679</u>		<u>6,149</u>	
Taxation	6	(159)		(83)	
Net income after taxation for the year			<u>12,520</u>		<u>6,066</u>
Total return for the year			115,057		(8,326)
Distributions	7		(18,420)		(8,161)
Net increase/(decrease) in unitholders' funds from investment activities			<u>96,637</u>		<u>(16,487)</u>

Source: Artemis Income Unit Trust

Total Expense Ratio

Average Net Assets 1999/2000	87,867
Expenses 2000	
Investment Manager's Fee	599
Bank	719
Custody	370
Others	364
Total	2,052
Total Expense Ratio %	2.34

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?

$$\frac{\text{Assets} - \text{liabilities}}{\text{Number of shares/units in issue}}$$

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?

	Net assets	Units in issue	Purchase number of units	Purchase price per unit	Amount invested	NAV per unit
Opening position	1,000,000	100,000				10
New investor buys			100,000	5	500,000	
Closing position	1,500,000	200,000				7.5

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 (eg using offered price instead of middle price)
- Errors of timing (eg using a price other than the most recent price)
- Variations between different funds' valuation methodology (eg 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-

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

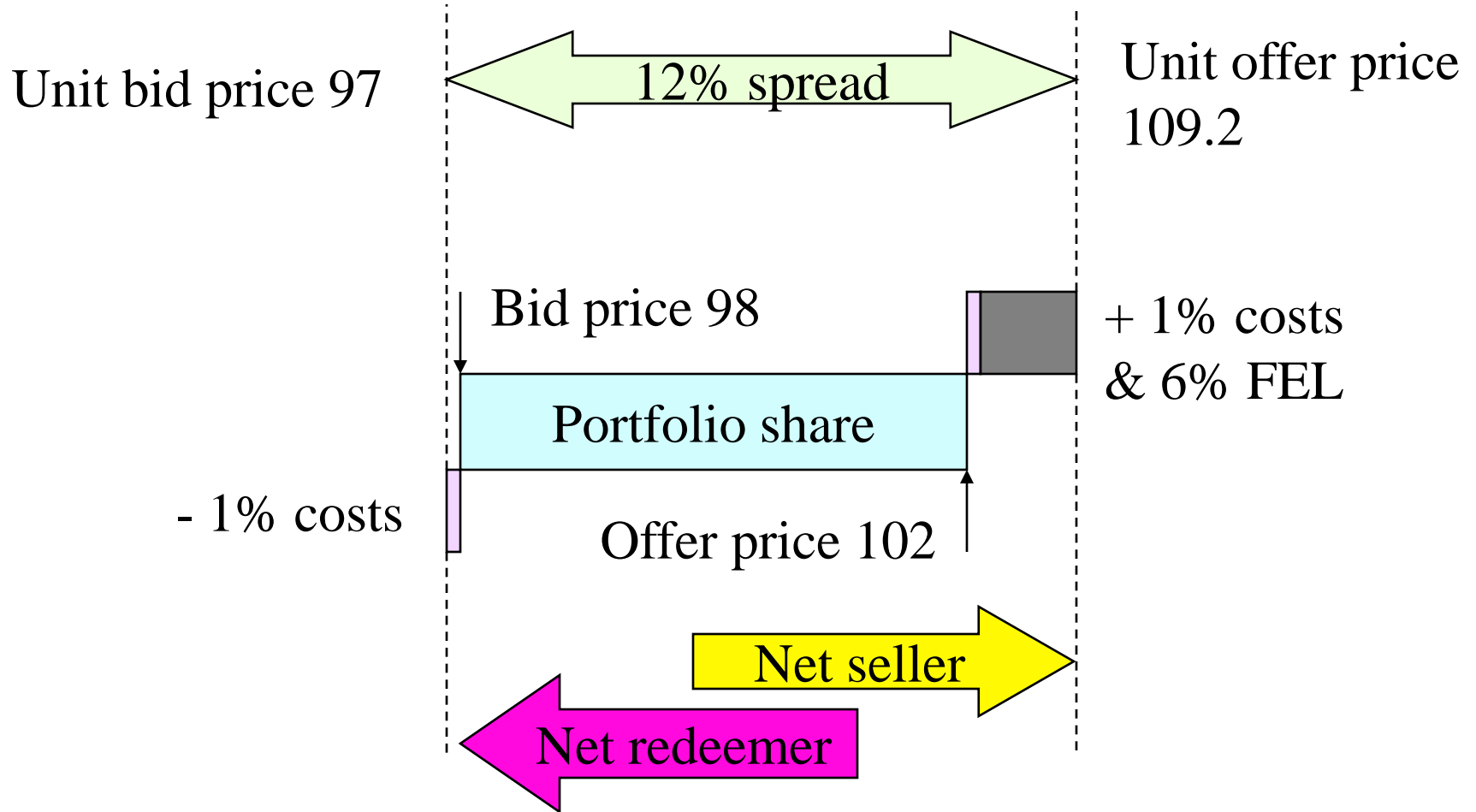
Open versus Closed Ended Fund Dealing Price

	Priced at
Open ended	NAV per share/unit +/- charges depending on pricing basis
Closed ended	Market price May be more than NAV (premium) or less than NAV (discount) – both expressed as % of NAV

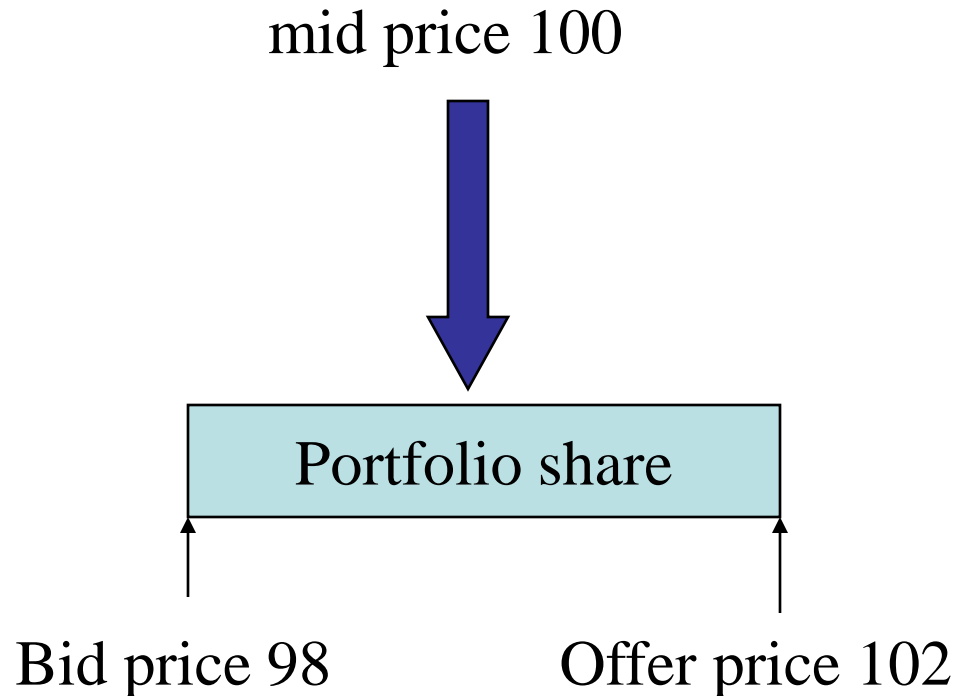
Methods of Open Ended Fund Pricing

- 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

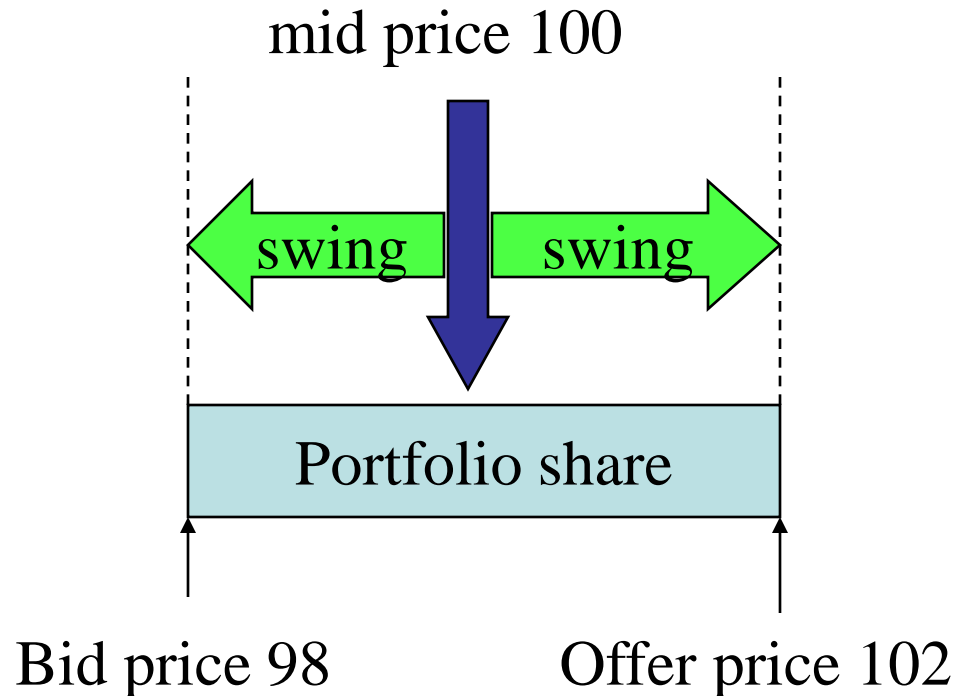
Dual Pricing



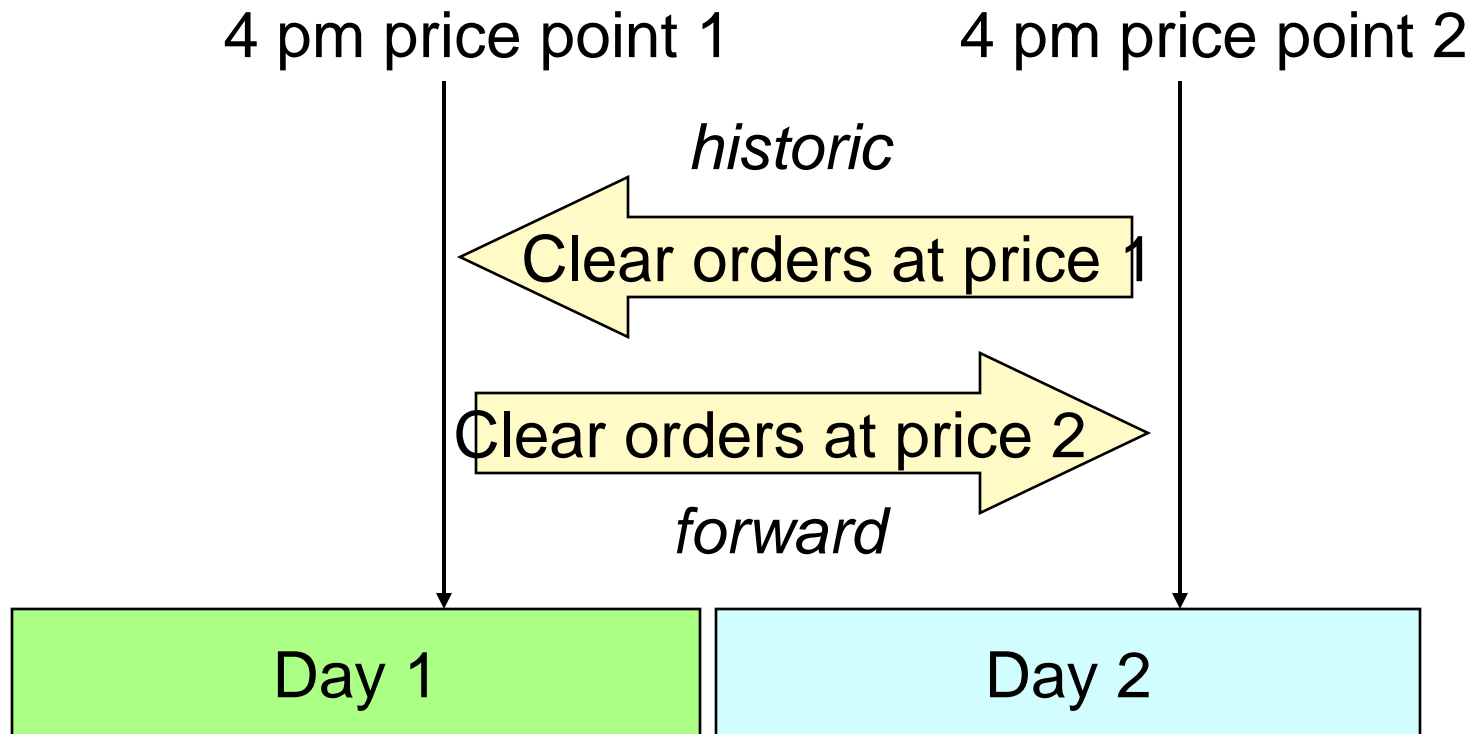
Single (Mid) Pricing



Single (Mid) Pricing - Swinging



Forward versus Historic Pricing



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 names/addresses/numbers 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

Is Administration Important?

What gives rise to a greater volume of complaints?



Bad investment results?



OR 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

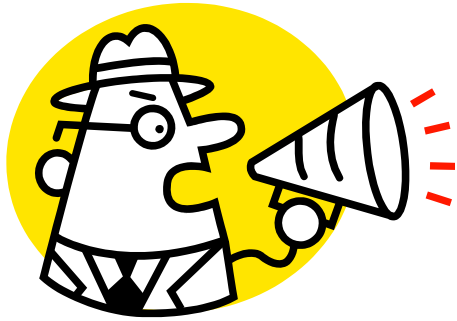
Sales Channels - Issues

- 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



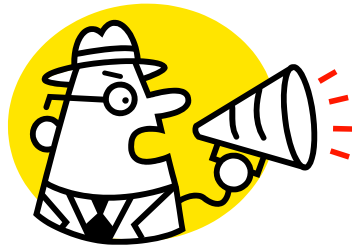
Sponsor



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

Calendar Year Performance

Year	Perpetual Corporate Bond Fund	Position in sector	Quartile ranking	Sector average
1996	+9.3%	4/47	1	+6.0%
1997	+16.0%	8/52	1	+13.0%
1998	+12.0%	44/58	4	+13.5%
1999	+3.1%	4/65	1	-2.0%
2000*	+4.1%	33/77	2	+3.6%

* 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

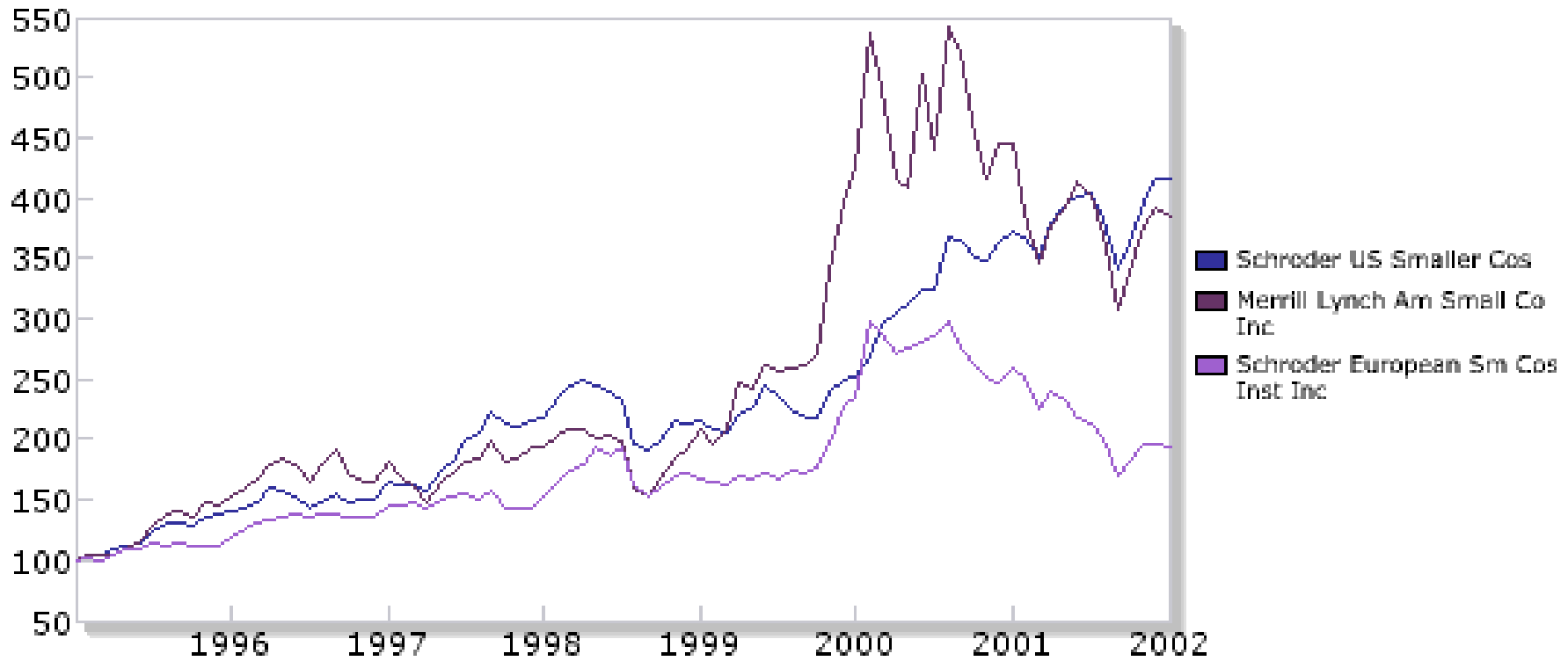
Review

- 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

$$\frac{X}{Y} \times \frac{100}{1}$$

$X = \text{NAV}$ on last day of performance period

$Y = \text{NAV}$ on first day of performance period

Example

<i>Fund</i>	<i>Price</i> <i>1.1.01</i>	<i>Price</i> <i>30.12.01</i>	<i>Increase/</i> <i>decrease</i>
CIF A	125	136	+8.8%
CIF B	324	398	+22.8%

But what if fund A paid a dividend?

Not included, but is a factor in performance

Therefore Use 'Total Return'

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

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

2 16,837 100

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