

COLLECTIVE INVESTMENT SCHEMES RECOMMENDATIONS

RECOMMENDATION	AGREE/DISAGREE	REASONS/COMMENTARY
<p>1. FUND GOVERNANCE (Report Pages: 32-39)</p> <p>1.1 Each governance regime must in some manner allocate responsibility for overseeing the management of the mutual fund in order to ensure that the interest of investors guides the management of the fund.</p> <p>1.2 For governance, flexible approach that would let each fund choose its own governance regime as long as the structure includes either an Independent Committee of one type or alternatively an Independent Trustee as is presently the case with Unit Trust.</p> <p>1.3 Form a board of directors, trustees or committee with at least a majority of its members independent of the manager. For a meeting to be properly constituted, a majority of the directors, trustees or committee members present must be independent of the manager.</p> <p>1.4 The independent board members must have a stake in the fund and it should be more than nominal.</p> <p>1.5 The board of directors, trustees or committee should have similar duties and responsibilities to the fund as a corporate board has towards a corporation, including a fiduciary duty expressed in similar terms to that contained in section 174 of the Companies Bill 1998. (see separate schedule of recommendations on board structure).</p> <p>1.6 Responsibility for good fund governance is to be as much as possible on the fund complex (fund complex refers to the Trustees, Custodians, Directors as is applicable in the circumstances).</p>		

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| <p>1.7 A prohibition against trading in securities by a person for his own account based on information he has concerning the investment programme of an investment fund, which he uses to his personal advantage for that trade.</p> <p>1.8 A prohibition against an investment fund buying securities of an issuer during primary distribution if the manager or a related person is underwriting the issue.</p> <p>1.9 A prohibition against an investment fund investing in securities of an issuer of which a significant shareholder, partner, director, officer or employee of the manager is a significant shareholder, partner, director, officer or employee, unless that person does not participate in or influence investment decisions of the fund and does not have access to information concerning the fund's investment programme.</p> <p>1.10 A prohibition against trades by an investment fund in securities with the manager or a related person acting as principal, unless the securities are publicly traded and the trades take place at the market price then in effect.</p> <p>1.11 A fiduciary duty of care for the manager of the investment fund and all persons retained to provide services to a fund, in terms similar to Section 174 of the Companies Bill, and a requirement that the manager indemnify the fund for any loss by reason of the failure of the manager to discharge any of its responsibilities to the fund.</p> <p>1.12 A prohibition against an investment fund bearing any portion of the cost of insurance to cover the liabilities of any person pursuant to the above provisions.</p> | | |
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2. CUSTODIANSHIP AND OPERATIONAL MATTERS (Report Pages: 41-45)

- 2.1 Assets of the fund must be segregated from those of any other person or company
- 2.2 Assets of the fund are held by a Custodian that is distinct from the fund itself. Assets must be registered in the name of the fund or the custodian.
- 2.3 Custodian should be required to conduct a 100% physical count of portfolio securities on a quarterly basis and to reconcile its records with those of the fund.
- 2.4 Custodians are required to expressly state that this count has been effected and provide a report on any discrepancies in the quarterly compliance certificate.
- 2.5 Where an investment fund manager is a clearing member of a SRO and is a member of the JCSD, and of a related investor compensation fund, that member should be permitted to act as the Custodian of an investment fund which it manages with respect to securities that are deposited in the book based system.
- 2.6 Managers and financial institutions acting on their behalf should be required to segregate in a separate interest-bearing trust account, the money received from investors for the purchase of securities of investment funds. Also for funds that are payable to investors on redemption of securities of the fund.
- 2.7 Managers should not use any funds received for investments to finance its own or any other operations **not related to the fund**.
- 2.8 Funds should only be withdrawn from a trust account for the purpose of:

<p>a) remitting to the fund, the amount or net amount to be invested in the securities of the fund;</p> <p>b) remitting redemption or distribution proceeds being paid on behalf of the fund; or</p> <p>c) paying fees, charges and expenses that are payable by an investor in connection with the purchase or redemption of securities.</p> <p>2.9 All interest earned on cash held in a trust account should be paid to holders at the time the redemption proceeds are paid to them or to the fund to which the trust account pertains.</p> <p>2.10 Interest should be paid at a frequency aimed at ensuring that the fund benefits from the interest as soon as practicable.</p> <p>2.11 An appropriate payment frequency for trust fund interest payable to the fund should be established based on the rate at which interest accrues and the amount of interest involved.</p> <p>2.12 Upon redemption, trust funds should bear interest from and including the date of receipt by the investor and vice versa for purchases.</p> <p>2.13 The manager should be entitled to make payments on a net basis, that is, offset proceeds of redemption or amounts held for distribution to be paid on behalf of the fund against amounts held in trust accounts for investment in the fund.</p> <p>2.14 The fund, through the auditors or other designated representatives should be granted access to books and records of the manager to verify compliance with the requirement.</p> <p>2.15 A manager that deposits fund into a trust account should be required to:</p>		
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<p>a) advise the financial institution in writing at the time of the opening of the account that:</p> <ul style="list-style-type: none"> i) the account is established for the purpose of holding client funds in trust; ii) the account is to be labelled by the financial institution as a “trust account”; iii) the account is not to be accessed by any person other than authorized representatives of the manager; and iv) funds in the trust account may not be used to cover shortfalls in any other accounts of the manager. <p>b) Ensure that the trust account bears interest at market rates; and</p> <p>c) Ensure that any charges against the trust account are not paid or reimbursed out of the trust account.</p> <p>2.16 Repeal the requirement for custodian to be independent except for unit trust.</p>		
<p>3. INVESTMENT POLICIES AND RESTRICTION (Report Pages: 56-59)</p> <p>3.1 Adopt a portfolio risk approach with some of the following constraints:</p> <ul style="list-style-type: none"> a) concentration restriction of 10% of total fund assets being invested in the securities of any issuer b) a prohibition against investment in real estate and mortgages, broadly defined 		

<p>c) a prohibition against investing in commodities, other than gold evidenced by an internationally recognised and tradable gold certificate.</p> <p>d) a specific liquidity requirement sufficient to handle estimated redemption obligations. The liquidity requirement would be developed on a weighted average</p> <p>e) a prohibition against a specified percentage of fund assets being invested in illiquid assets.</p> <p>3.2 Adopt a simplified prospectus and it should include:</p> <p>a) a policy statement setting out the fund objectives in terms of risk and return</p> <p>b) an identification of the type of securities that the fund is entitled to invest in risk parameter estimates</p> <p>c) the provision of historical long term rates of return and individual year return information in the form of a Fund Performance Information Brochure</p> <p>d) the provision of information on historical and largest monthly redemption rates</p> <p>e) restricting claims that estimated future risk will be less than the actual historical levels of risk experienced by the fund</p>		
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<p>4. FUND STRUCTURE (Report pages: 30-31)</p> <p>4.1 Any workable legal structure should be permitted.</p> <p>4.2 For regulatory purposes, all funds should be treated as a separate issuer regardless of the legal form of the fund.</p> <p>4.3 The expectation is that most common form of organization will become a Contractual Trust arrangement between the Sponsor or Managers and a captive trustee. If allowed, the contractual form of Collective Investment funds should be considered as separate legal entities for securities law purposes.</p> <p>4.4 The focus of the Mutual Fund Regulations (MFR) should be on a generic regulation of the Issuer regardless of the legal form.</p> <p>4.5 Assets of a Fund shall at all times be held in a manner that evidences a legal separation from assets of the Fund Manager.</p>		
<p>5. FUND PERFORMANCE INFORMATION (Report Pages: 60-63)</p> <p>5.1 Information should be presented in a standardized and consistent manner that allows comparisons between different funds.</p> <p>5.2 Sales communications and disclosure documents should not contain unreasonable warning or disclaimers about the information..</p> <p>5.3 The regulations should provide some basic guideline on how to calculate the total return and net asset value of investment funds, and for calculation of the current and effective yields of money market funds.</p> <p>5.4 The funds should provide a net asset value (NAV) per unit calculation weekly to the financial press, money market should provide the yield calculations on the same frequency.</p>		

6. THE DISCLOSURE SYSTEM (Report Pages: 46-61)

- 6.1 Disclosure rule should be to ensure that investment funds provide investors with disclosure documents that clearly and concisely state information that they should consider in connection with an investment decision about the fund.
- 6.2 Document should be prepared in plain language and in a format that assists in readability and comprehension.
- 6.3 Investors should receive disclosure documents that will be helpful to them.
- 6.4 Investment funds should use three basic documents:
- a) a generic basic educational document that is given to all potential investors at the earliest possible time in the sales process;
 - b) a simplified prospectus which is a fund specific basic disclosure document provided to all investors prior to purchase;
 - c) an Annual Information Form, available upon request, which together with the financial statements and the Simplified Prospectus, contain full, and plain disclosure of all relevant facts pertaining to the investment fund.
- 6.5 In addition to explaining what an investment fund is, how it works and the basic regulatory requirements that affect all investment funds, the basic education document would tell investors what they should expect to receive after they place their order for the purchase or sale of investment fund securities.
- 6.6 The basic education document could contain:

<p>a) a glossary of the commonly used terms to assist investors in understanding the information contained in the basic education document as well as in the other disclosure documents;</p> <p>b) basic information for the investor about how to set financial goals, determine the investor's tolerance for risk and set investment objectives so that these can be matched against proposed investments;</p> <p>c) generic tax information about income and capital gains distributions and capital gains (or losses) on the disposition of securities; and</p> <p>d) generic information about alternative investments or financial products that might be considered as an alternative to investment funds.</p> <p>6.7 The basic education document for investors would be required to be given to each investor by the sales representatives at the earliest opportunity during the sales representatives initial meeting with the investor and in any event no later than the time that the investor's order is taken.</p> <p>6.8 All investors in an investment fund should receive a Simplified Prospectus which should be a clear concise document designed to provide the typical investor with the necessary information to permit him or her to make an informed investment decision.</p> <p>6.9 The existing prospectus schedule in the MFR should be replaced by a new schedule providing detailed requirements as to the contents and format of a Simplified Prospectus. These requirements should:</p> <p>a) be designed to ensure that a Simplified Prospectus is clear, concise, understandable and well-organized, and contains the most important information that an investor would consider in making an investment decision;</p>		
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<p>b) standardize, to some degree, the order in which information is presented in order to ensure that investors may easily compare one investment fund with other funds;</p> <p>c) prohibit the addition of information in the Simplified Prospectus not specifically required by the regulation, in order to prevent a Simplified Prospectus from expanding to a size that discourages an investor from reading it, and that obscures the most important information about the fund that should be considered by the investor; and</p> <p>d) not require any information which can generally be obtained elsewhere by the investor with reasonable effort, if the information is not relevant to the investor's investment decision.</p> <p>6.10 A supplemental disclosure document, the Annual Information Form would be required to be filed with the FSC and provided to any person on request.</p> <p>6.11 In addition to updating the fund's basic registration information, the Annual Information Form would contain a discussion and analysis by management of the operations of the investment fund.</p> <p>6.12 The management discussion and analysis might include:</p> <p>a) information regarding portfolio management strategies, including who is managing the investment portfolio, how they are doing it, any changes that have been made in this respect, the performance of the investment fund in relation to any performance goals that have been set for the portfolio manager, the risk profile of the fund and variances from it;</p> <p>b) information concerning the extent to which investment decisions are made by particular individuals employed by a portfolio adviser, or by committee, and certain specified</p>		
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<p>information about the individuals who are principally responsible for the investment portfolio of the investment fund;</p> <p>c) discussion of the investment fund’s performance for the current year in comparison with the prior year’s performance, focussed on the total return of the fund;</p> <p>d) comparison of the investment fund’s performance with relevant benchmarks and an explanation why the benchmarks that have been chosen are appropriate;</p> <p>e) discussion and analysis of expenses with the significant components of expenses being highlighted and compared to the previous year with an analysis of changes;</p> <p>f) discussion of known trends, commitments, events and uncertainties that are reasonably expected to affect investment fund performance in the future should be addressed;</p> <p>g) a comparative analysis of the composition of the year-end investment portfolio and changes in portfolio mix from year to year;</p> <p>h) a discussion of how the investment portfolio composition relates to the investment fund’s disclosed investment objectives;</p> <p>i) if the investment fund holds: (i) illiquid securities, or (ii) securities of companies where liquidity risk may exist, or (iii) large blocks of securities of other issuers where it would be difficult to dispose of the block at the market value attributed to the securities, this should be discussed;</p> <p>j) a discussion of the number of securities/units of the investment fund that have been sold and redeemed with an analysis of changes from the previous year;</p> <p>k) a discussion of the supervisory and compliance procedures</p>		
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<p>that are in place to ensure conformity of transactions with: (i) the investment objectives, policies and restrictions of the investment fund, (ii) the provisions of the material contracts in respect of the investment fund, and (iii) the standard requirements regarding investment funds referred to in the basic education document for investors; if there have been any breaches in respect of these matters, the action that has been taken to remedy and to guard against re-occurrence should be outlined;</p> <p>l) a discussion about how portfolio transactions for the investment fund have been handled including information about any principal broker; and</p> <p>m) disclosure of related party transactions as discussed under “Fund Governance – Conflicts of Interest and Self-Dealing”.</p> <p>6.13 An amendment to an Annual Information Form and to a Simplified Prospectus should be filed whenever a material change occurs.</p>		
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7. REGISTRATION and RELATED MATTERS (Report Pages: 61-63)

The MFR should give the regulator a fairly wide discretion in reviewing applications for registration of mutual funds and requiring all necessary information before registration is granted.

The Registrant

- 7.1 In the course of revising the MFR, it must be clear about who is the registrant that is whether it is the prospective fund, the prospective fund manager or the applicant.
- 7.2 The concept of a “sponsor” could be introduced in the MFR
- 7.3 “Fit and proper” should apply to the directors, **managers** and officers of the sponsors and of the trustees, custodians and fund managers.

Seed Capital

- 7.4 (a) Instead of MFR requiring that the applicant contribute at least 40% of the net worth of the management company, (b) it should require that the sponsor is independent of the manager.
- 7.5 The sponsor should be required to provide seed capital to the fund
- 7.6 Seed capital should be sufficient to allow the fund to be up and running from the first moment that it commences offering its units to the public.
- 7.7 Seed capital should be locked in for a sufficient period

<p>7.8 The amount of seed capital could be embodied in a directive or guideline of Commission, but any lock-in period should be included in the regulation itself.</p> <p><i>Organisation Expenses</i></p> <p>7.9 The MFR should provide that the cost of establishing and organising an investment fund must be borne by the sponsor or manager.</p> <p>7.10 An investment fund should be prohibited from assuming these costs or reimbursing the sponsor or manager for them.</p> <p>7.11 The General Accepted Accounting Principles which permit organisation costs to be capitalised on the balance sheet of the “entity involved” and amortised over a period of time (say 5 years) should be specifically prohibited in the MFR in order to prevent the investment fund from actually paying its organisation expenses.</p> <p><i>Assessment of Back Office Capabilities</i></p> <p>7.12 The Commission should assess the capabilities of new entrants i.e. to require that sponsor and manager demonstrate that the fund or its manager and custodian can carry out the necessary functions involved in their proposed activities.</p> <p>7.13 The appointment of a responsible officer for compliance with the MFR, should be taken a step further at the outset by requiring that the regulator satisfy itself that adequate internal controls and procedures are in place in order to monitor compliance.</p>		
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5 March 2002

ⁱ *The section of each recommendation that is in bold type has been inserted by the Financial Services Commission.*