The Credit Crunch:
A stress test for UK Authorised Funds

May 2009

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Definitions and abbreviations used in this report

ACD	Authorised corporate director of an *OEIC*
AMC	Annual Management Charge
AUT	Authorised unit trust
CESR	Committee of European Securities Regulators
CIS	Collective Investment Scheme and, in this report, a generic term used to describe both *AUTs* and *OEICs*
EC	European Commission
SORP	Statement of Recommended Practice for Authorised Funds
COBS	The FSA's Conduct of Business Sourcebook
COLL	The FSA's Collective Investment Schemes Sourcebook
DATA	Depositary and Trustee Association
Depositary	Except where expressly stated, this is a generic term used to describe both the Depositary of an *OEIC* and the *Trustee* of an *AUT*
DRMP	Derivatives Risk Management Process
FSA	The UK's Financial Services Authority
FSMA	Financial Services and Markets Act 2000
FVP	Fair Value Pricing
HMRC	HM Revenue and Customs
HMT	HM Treasury
ISA	Individual Savings Account
Manager	Except where expressly stated, this is a generic term used to describe both the *UTM* of an *AUT* and the *ACD* of an *OEIC*
NAV	Net asset value
NURS	A *CIS* which does not comply with the requirements of the *UCITS* Directive, but which is subject to the same level of investor protection and can be marketed within the UK to retail investors
OEIC	UK authorised open-ended investment company
OEIC Regulations	OEIC Regulations 2001, as amended from time to time

OTC	Over-the-Counter, i.e. not dealt on a recognised investment exchange
TER	Total Expense Ratio
Trustee	Trustee of an *AUT*
UCITS	A collective investment scheme which complies with the UCITS Directive
UCITS Directive	Directive 85/611 relating to undertakings for collective investment in transferable securities (UCITS), as amended from time to time
UTM	Unit Trust Manager

Executive Summary

The extraordinary series of events in financial markets since the summer of 2007 has created unique challenges for the financial services industry as a whole. Household-name firms and widely-distributed financial products have failed, and it is conceivable that more will follow. At the same time, the transfer of responsibility for financial provision from the state and corporations to individuals has continued apace. Rebuilding household balance sheets and finding a new equilibrium will take both time and changes in household behaviour. Recent changes in savings rates perhaps indicate that this rebuilding may be starting to get underway.

Against this background, the IMA Board commissioned a Working Group of senior industry practitioners to review the impact on UK Authorised Collective Investment Schemes (*CIS*). The most significant impact for investors has been the deep and extended losses they have incurred across almost all major asset classes. This devaluing of investments is immediately and overtly transparent to investors in *CIS* given their daily, and fair, pricing. However, the events of 2008 have acted as a stress test on the efficacy of the structure, the regulation and the common business practices of *CIS*, which merits review.

In the UK, during 2008 to end March 2009, seven *CIS* (out of a population of approximately 2,350) suspended. Whilst this might be considered a good outcome by many, there is no room for complacency. This review seeks to ensure not only that adequate and better protection will be in place to deter suspensions in future, but that any and all lessons are learned to enhance further the overall governance and operating regime for *CIS* going forward.

The Working Group considered the full range of areas that could have been impacted by the stress test, and identified seven principal areas where important lessons could be learned. These seven are addressed in detail individually in this Report and are: Governance, Security of Assets, Management of Market and Counterparty Risks, Valuation and Pricing, Liquidity Management, Suspension, and Communications with Investors and Advisers.

The review identified the following key features of *CIS* as having proved important to the resilience of fund structures over this period:

- The assets of *CIS* are quite separate from the balance sheet of the management company and are under the safe keeping of the *Depositary*.
- The valuation of the assets and the pricing of *CIS* are the subject of regulatory requirements, detailed industry practice and independent professional audit.
- All *CIS* have an authorised fund manager (the *Manager*), which is regulated by the *FSA* and subject to many of its principles and rules, including "treating customers fairly" and detailed conduct of business requirements.
- In particular, the *Manager* must at all times act in the best interests of all investors.
- All *CIS* have a *Depositary*, which must be completely independent from the *Manager* and is itself regulated and subject to many FSA principles and rules (unique to the UK).

- The *Depositary* is a well-resourced overseer of many of the *Manager's* activities and, in this regard, in effect acts as a regulator of *CIS.*

- *CIS* are required to diversify their investments and counterparty exposure, and *Managers* must operate a derivative risk management process.

- *Managers* are required to manage the liquidity of *CIS* to meet likely purchase and redemption demands.

- *CIS* are transparent as regards performance and charges.

The overall finding is that the UK *CIS* regime has proven broadly robust. Nevertheless, the extreme market conditions have tested these features. For example, due to the ongoing price volatility and poor liquidity in the capital markets, *CIS* have experienced considerable difficulties in securing reliable asset valuations and have had to employ extensive use of "Fair Value Pricing" techniques to ensure that fund prices are as fair as possible for all investors – incoming, outgoing and continuing. IMA has therefore reviewed and re-issued its guidance to members on *FVP* and issued additional guidance on the calculation and disclosure of fund yields.

The review has identified some discrete areas where regulation needs to be clarified or reviewed, where there may be a need for further industry guidance or where *Managers* will wish to review their processes. A summary of the Report's recommendations can be found on page 6.

The overall finding of this review is supported by the *EC's* comment in January 2009 that *"The UCITS regulatory framework has proved very resilient during the current crisis. Despite very difficult market conditions, asset illiquidity and investor redemptions, no more than a handful of funds have been forced to suspend trading or close. The regulatory safeguards embedded in the regulatory model have been instrumental in helping UCITS funds weather this crisis."*

In the light of the Madoff fraud and the fact that it has highlighted potential weaknesses in other EU jurisdictions' governance and regulatory structures, it is welcomed that the *EC* and *CESR* are reviewing different jurisdictions' approaches to *Depositary* responsibilities. The Working Group welcomes the fact that IMA will provide input to this review.

Summary of Recommendations

CIS Governance:

- Information should be provided by IMA to improve investors' and other interested parties' understanding of the way *CIS* are regulated, governed and operated.

Security of Assets:

- The industry should review the application of the custody rules to *CIS* and sub-custodial arrangements, and consider whether *FSA* rules need clarification or modification.
- *Managers* should review their approach to cash management with a view to ensuring adequacy of diversification, whether by ensuring that exposure to individual counterparty banks is limited and/or by utilising money market funds invested in non asset backed securities, gilts, other government securities, etc.

Management of Credit and Counterparty Risks:

- The *FSA* should give due consideration to firms' Derivative Risk Management Processes.
- The *FSA* should consult on aligning the *NURS* definition of transferable security to the *UCITS* definition to ensure that the quality of underlying transferable security (in terms of transparency, liquidity) is consistent.
- *Managers* should continue to follow industry good practice guidelines as regards risk management processes, including counterparty risk, due diligence on structured products and active collateral management.

Valuation and Pricing:

- All *Managers* should follow industry guidelines on *FVP* and on the calculation and disclosure of fund yields.
- The industry should review its operation of single pricing and, in particular, the application of dilution levies, with a view to updating industry guidance and providing information for investors on the different methodologies.

Liquidity Management:

- The industry should review the tools available to *Managers* to assist in liquidity management and their application in an international market place, with a view to producing industry guidance and seeking rule changes, as appropriate.

Suspension:

- The industry should review the *CIS* suspension rules in the light of recent events, and their interplay with the regimes for insurance products, with a view to making recommendations on areas of the rules that need to be amended and to drawing up industry guidance, as appropriate.
- *HMT/HMRC* should complete the work on updating the *ISA* 30-day rule to cater for suspensions and the review of actions that need to be undertaken in the event that a *Manager* ceases to be an *ISA* manager.

Communications with Investors and Advisers:

- The industry should consider with representatives of the supermarket and wrap community the facilitation of information for investors, with a view to recommending rule changes, as appropriate.
- IMA should consult *Managers* on the drawing up of industry guidelines on the production of fund literature for professional investors.

Introduction

The global financial difficulties became apparent in early summer 2007. The most visible early manifestation in the United Kingdom was the collapse of Northern Rock. With the wholesale money markets locking up, the UK mortgage lender was forced in September to ask the Bank of England for liquidity support, precipitating a retail run on the bank. This in turn forced the Government to step in to guarantee deposits and, after attempts failed to keep the bank in the private sector via a takeover, the decision was taken in February to nationalise it.

The global difficulties deepened progressively during 2008. While the Dow had started the year above 13,000, the 12,000 level was tested in January, with the Fed cutting the federal funds rate by 125 basis points by the end of the month. Through February and March, a stream of negative news emerged from the capital markets and a fresh wave of coordinated international central bank action saw further efforts to ease liquidity pressures. The first quarter culminated in the rescue of Bear Stearns, announced on 14 March.

Through the second quarter, any optimism expressed in the aftermath of the Bear Stearns rescue dissipated. A credit crisis that had initially seemed to be a liquidity event was starting to look increasingly like a solvency issue. Doubts over the future of Freddie Mac and Fannie Mae in early July signalled again the severity of the emerging problems and by the middle of the month, the Dow had dipped below 11,000.

The failure of Lehman on 15 September, shortly after Freddie and Fannie had been taken into conservatorship, sparked international panic. Within the space of several weeks, a range of financial institutions from AIG to HBOS to Fortis had to be nationalised or otherwise rescued, and a variety of short selling restrictions had been imposed across many markets amid allegations of market manipulation. By early October, the Dow had fallen to 8,500, almost touching 7,500 a month later as the FTSE dropped below 4,000.

In relation to structured products, it became clear that investors had little understanding that they were potentially 100%-exposed to one counterparty, or even who that counterparty was. For those investors who had invested in a structured products where the counterparty was Lehman, this realisation came as a severe shock and a further knock to investor confidence in general.

In the real estate market, commercial property prices had fallen sharply and swiftly towards the end of 2007/early 2008. This led to increased redemptions from property *CIS*. Despite these difficult conditions, *Managers* were able to meet those redemption requests and all property *CIS* remained open throughout 2008, with only two specialist funds suspending end 2008/beginning 2009.

Amid the ongoing capital market turbulence, Société Générale had revealed in January 2008 significant losses as a result of activity by one of its trading staff. However, this was overshadowed by the enormity of the Madoff scandal, which revealed a Ponzi scheme of unprecedented scale, raising substantial questions both about the level of regulatory oversight from the Securities and Exchange Commission and about the scrutiny applied by many institutional asset management clients.

In these unprecedented market conditions, *CIS* have stood up well but have faced a number of issues*:*

- A generally adverse impact on investor confidence. Although there were some withdrawals from *CIS*, most individual investors maintained their investments. However, many have not added to their holdings.
- Divestment by financial institutions, causing significant redemption management issues.
- The commitment of most *CIS* to daily pricing and trading means that the liquidity challenges in the capital markets are keenly felt. Liquidity in parts of the market, especially credit and money market instruments, has been severely constrained. From a shortage of liquidity stem a range of market quality issues, particularly the ability to transact, and price volatility and discovery. This has led to extensive use of "Fair Value Pricing" and more frequent counterparty risk analysis. It has also led to larger dilution levies.
- In the context of the Lehman failure, specific difficulties were experienced with respect to unsettled trades in the UK cash equity market and therefore uncertainty about ownership of some assets.
- Some foreign Money Market Funds "broke the buck" (see Chapter 3), and other funds suffered from the adverse publicity.
- A small number of funds suspended.

In addition, the Madoff fraud has impacted *UCITS* and demonstrated sharply the need to avoid and manage conflicts of interest. The *EC* noted that "*the Depositaries of four UCITS funds (from a population of 30,000 funds) entrusted fund assets, worth 1.6bn Euro to Madoff entities and those assets have yet to be recovered*." Questions have been raised about the management of conflicts of interest, whether funds were managed in the investors' interests and the extent of liability of the *Depositary* in such circumstances.

This incident has brought to light potential differences in interpretation and implementation of the *UCITS Directive*, and has led to the *EC* and *CESR* initiating a review of legislation and practices among Member States. The *EC* has stated that "*the review will be driven by the objective of identifying any practices or provisions which dilute the basic responsibilities of UCITS depositaries for safe-keeping, and the modalities by which depositaries can exercise those responsibilities (including use of sub-custodians). To the extent that this review identifies practices or outcomes that are not consistent with the over-arching principles of the Directive, it will take the necessary steps to correct shortcomings.*"

In the light of the above issues and challenges faced by *CIS* in the extreme market conditions, the Board of the IMA set up the Working Group to review *CIS* governance and product regulation. The *CIS* regime has stood up well through the testing events of 2008, but it is important to consider whether there are any lessons to be learnt from these market-wide events and any scope for further strengthening the *CIS* regime or fine tuning its regulation. There are also comparative issues with other retail investment products.

The following chapters focus on *CIS* Governance, Security of Assets, Management of Market and Counterparty Risks, Valuation and Pricing, Liquidity Management, Suspension and Communications with Investors and Advisers.

1. CIS Governance

This Chapter sets out the strong regulatory framework surrounding *CIS* governance, the roles of key parties involved in *CIS* governance arrangements, additional distinguishing features of the UK *CIS* governance arrangements and general observations on the resilience of governance arrangements during 2008.

a) Regulatory Framework

There are four levels of law and regulation that directly or indirectly affect *CIS*: European legislation; UK legislation; *FSA* regulation (rules and guidance); and the *CIS's* own constitutional documents. These form a hierarchy of law and rules that at each level are progressively more detailed.

i) European Legislation

At the European level the *UCITS Directive* governs *CIS* regulation. It identifies the *Manager* and *Depositary* and assigns certain requirements to each. It states that the *Depositary* is responsible for the safeguarding of the *CIS* assets and for ensuring that sales, redemptions, cancellations and issues of units, and the calculation of the value of units, are carried out in accordance with the rules of the *CIS*. In this respect, UK regulation is super-equivalent to the *UCITS Directive* requirements and UK *Depositaries* have a significantly wider oversight role, both as set out in the various legislative and regulatory provisions which attach to the roles, and the general law duty when acting as a fiduciary.

In addition, the *UCITS Directive* does not prevent two companies within the same group acting as *Manager* and *Depositary*, provided that independence conditions are satisfied. UK regulation is super-equivalent to the *UCITS Directive* requirement concerning the relationship between the *Manager* and *Depositary*. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and *Manager* of an *AUT,* and between the *Depositary*, the *OEIC* and its directors (usually only the *ACD*). UK regulation is "super-equivalent" in this regard, and others (see below).

ii) UK Legislation

In the UK the main legislation affecting *CIS* is *FSMA*, which sets out the *FSA's* responsibilities, how a *Manager* may apply for authorisation of a *CIS* and who may act as a *Depositary*. The *OEIC Regulations* are also relevant for *OEICs* and trust law for *AUTs.*

iii) FSA Regulations

Detailed rules and guidance that are directly related to the operation of the *CIS* itself are contained in the *COLL*. It transposes the *UCITS Directive* and provides essential material to complement the corporate code for *OEICs*. Rules that govern the activities of the *Manager* and *Depositary* are contained in a number of the *FSA's* Sourcebooks and Manuals, including *COBS*.

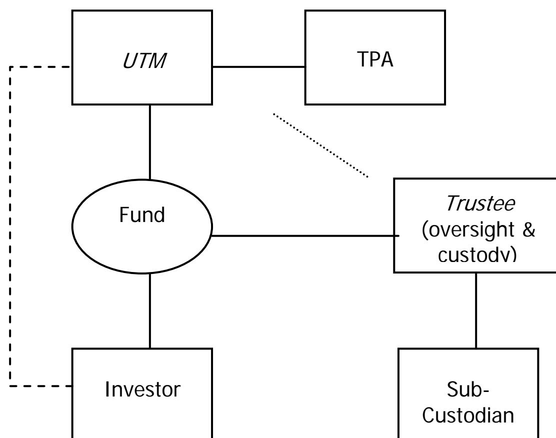
iv) Constitutional Documentation

Each *CIS* also has its own constitutional documentation, a trust deed in the case of an *AUT* and an instrument of incorporation in the case of an *OEIC*. These documents detail the features, powers and rules governing each *CIS* in broad terms (and essentially incorporate the regulations). Day-to-day operating rules are then set out in the prospectus of each *CIS*, including detailed investment objectives, the investment policy for achieving those objectives, details of each particular share class (e.g. differing fee scales) etc. While many of the detailed terms of the prospectus and other constitutional documents are set by the *Manager* within parameters, or on the basis of choices set out within *FSA* regulations, both the *CIS* instrument and prospectus contain the detailed layer of requirements. A breach of any of their requirements is likely to be a breach of *FSA* rules, as well as a contractual breach.

b) Roles of Key Parties in *CIS* Governance Arrangements

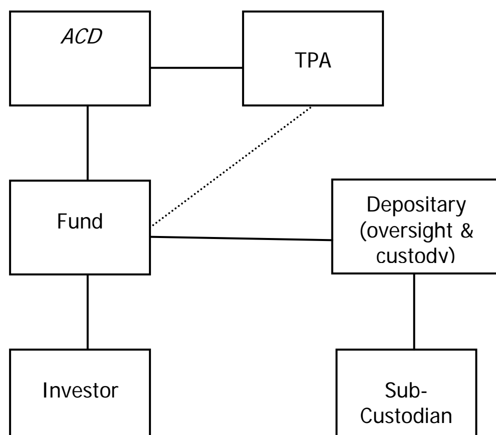
The *CIS* governance structure in the UK is built around the segregation of duties as between the key parties, the *Manager* and *Depositary*. It is based on the use of checks and balances, with a clear articulation of the responsibilities of the parties concerned. The diagram below sets out these roles and responsibilities.

AUT



Notes:
- The *AUT* is formed by a trust deed, to which the *UTM* and *Trustee* are signatories/trustees.
- *FSA* rules specify the functions/responsibilities of both the *UTM* and the *Trustee*.
- The *Trustee* has responsibility for oversight of certain *UTM* functions and for custody of the *CIS's* assets.
- The *Trustee* may delegate custody to a sub-custodian (a contractual relationship).
- The investor instructs the *UTM* to act on his/her behalf.
- The investor has no direct relationship with the custodian/sub-custodian.
- The performance of the registration function is determined by the Trust Deed and may be the responsibility of either the *Trustee* or the *UTM*. If responsibility lies with the *Trustee*, it typically delegates to the *UTM* or direct to a Third Party Administrator ("TPA"). The *UTM* may in turn delegate the function to a TPA (a contractual relationship). If responsibility lies with the *UTM*, it may delegate the function to a TPA (a contractual relationship).
- The Investor has no legal relationship with the TPA, but there is a processing/administrative relationship (with the TPA acting on behalf of the *Trustee* or *UTM*).
- Monies due to the investor (i.e. income from the *AUT*) are paid from an account in the name of the Trustee for that AUT, by the *UTM* (or by the TPA, if the *UTM* has outsourced this function).

OEIC



Notes:

- The *OEIC* is formed by an instrument of incorporation.
- The *ACD*, which is typically the sole director, and the *Depositary* have contractual relationships with the *OEIC*.
- *FSA* rules and *OEIC Regulations* specify the functions/responsibilities of both the *ACD* and the *Depositary*.
- The *Depositary* has responsibility for oversight of certain *ACD* functions and for custody of the *OEIC's* assets.
- The *Depositary* may delegate custody to a sub-custodian (a contractual relationship).
- The investor has a direct relationship (contractual) with the *OEIC*.
- The investor has no direct relationship with the custodian/sub-custodian.
- The registration function is the responsibility of the *OEIC*, which may delegate to the *ACD* or a TPA. The *ACD* may undertake this function in its capacity as director of the *OEIC*. The *ACD* may in turn delegate the function to a TPA (a contractual relationship).
- The investor has no legal relationship with the TPA, but there is a processing/administrative relationship (with the TPA acting on behalf of the *ACD*).
- Monies due to the investor (i.e. income from the *OEIC*) are paid from an account in the name of Depositary for that *OEIC*, by the *ACD* (or by the TPA, if the *ACD* has outsourced this function).

Day-to-day management of the *CIS* is the responsibility of the *Manager*. Although many of these activities can be delegated to other parties, the *Manager* is held responsible by regulation. The *Manager* must comply with a set of rules designed to make the operation of the *CIS* fair and accountable.

The *Depositary* has oversight responsibilities for the *Manager's* activities in a number of key areas such as unit pricing, dealing, portfolio valuation and adherence to investment and borrowing power restrictions.

The *Depositary* is also responsible for the safeguarding of the assets of the *CIS*. This separation of the management of the *CIS* assets from their ownership is the most fundamental element of investor protection provided by *CIS*.

The *Depositary* also has a responsibility for protecting the interests of incoming, outgoing and continuing investors. Whilst not having a direct responsibility for the *Manager's* activities, the *Depositary* must take reasonable care to ensure that the *Manager* is properly discharging its own responsibilities. This is not the case for other mass retail market savings products such as deposits, savings accounts or insurance products.

Depositaries are, by market choice, subsidiaries or divisions within large banking groups (although regulation does not require them to be so). In practice they

represent a significant resource of professional, well-qualified people, supported by significant IT, processing and specialist resources.

Both the *Manager* and the *Depositary* have fiduciary obligations to *CIS* investors, a concept that has come down through trust law, *CIS* Regulations and *FSA* Principles. Regulations attempt to codify and measure the performance of that fiduciary obligation, but the core principle is that both the *Manager* and the *Depositary* must act in the best interest of the investors. This principle is central to the nature of the relationship between the *CIS,* its operators and its investors.

Both *Managers* and *Depositaries* are regulated in the UK by the *FSA* and are subject to requirements as regards fitness and properness, including integrity, competence and financial resources. Both are also subject to conduct of business rules. In addition, although both are permitted to delegate certain activities to third parties, they retain accountability for the operation of the *CIS*. Again, many of these requirements are super-equivalent to the *UCITS Directive* provisions.

There are other parties involved in governance arrangements. Independent auditors also play an important role for *CIS*, as do standing independent valuers, who are required to value any real estate property held in a *CIS*.

In the UK, in addition to *UCITS* and *NURS*, there is a third type of *CIS*, called a Qualified Investor Scheme ("*QIS*") which is available only to experienced investors who meet certain qualifying conditions. The *FSA* has created a "lighter touch" operational and investment regime for these *CIS* given the type of investor to whom they are available. In keeping with the "lighter touch" nature of the *QIS*, the *Depositary* responsibilities are less onerous than with retail *CIS*. That said, the *Depositary* has an oversight role and remains responsible for the safekeeping of all *QIS* assets.

c) Additional Distinguishing features of the UK *CIS* Governance Arrangements

As mentioned in section a) i) above, the UK *CIS* governance regime is more detailed and strict than is required under the *UCITS Directive* in that it places a number of additional responsibilities upon *Depositaries* and requires complete independence as between *Managers* and *Depositaries*.

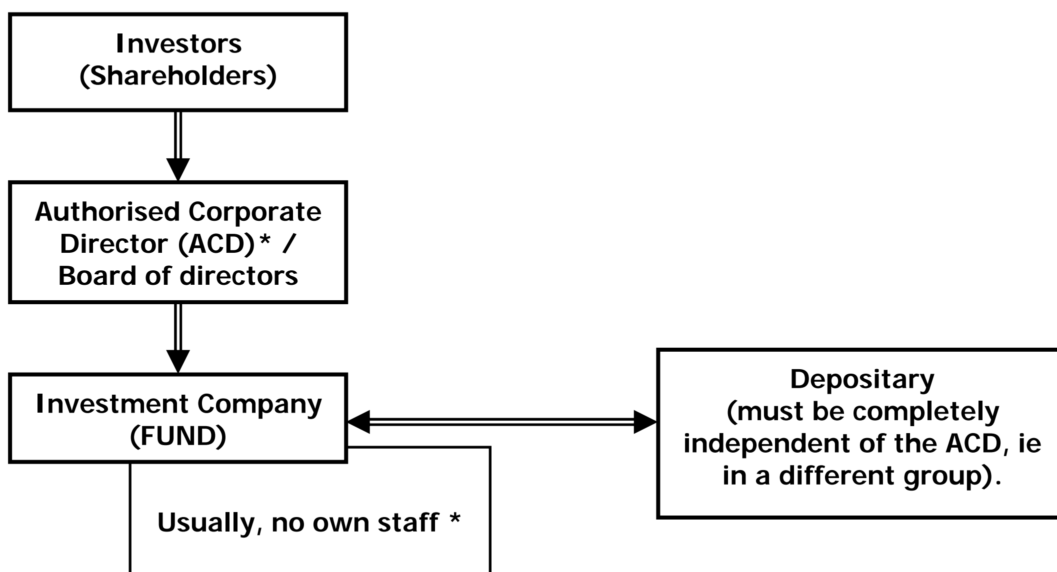
Complete independence assists in the avoidance and management of conflicts of interests, which are more numerous where both the *Manager* and the *Depositary* are part of the same group of companies.

In some countries, the role of the *Depositary* is either significantly restricted or absent entirely. In many of those countries, the role undertaken by *Depositaries* in the UK is performed, in part, by boards of directors. Where those boards include independent directors, they will in the main be experienced, thoughtful and active in their role. There has to be a question, though, whether they can perform as potent, well-resourced and engaged an oversight function as an independent *Depositary*. For example, independent directors will not generally be required to sign off the day's trading in the *CIS*, to take such direct responsibility for the safety of the *CIS* assets or to carry out regular on-site inspections of the *Manager's* activities.

The UK's unique governance model, which requires the *Depositary* to be completely independent, to undertake wide oversight activities and to be subject to extensive conduct of business rules and other regulatory requirements, distinguishes the UK from competing jurisdictions. The evidence suggests that it provides a more robust investor protection framework.

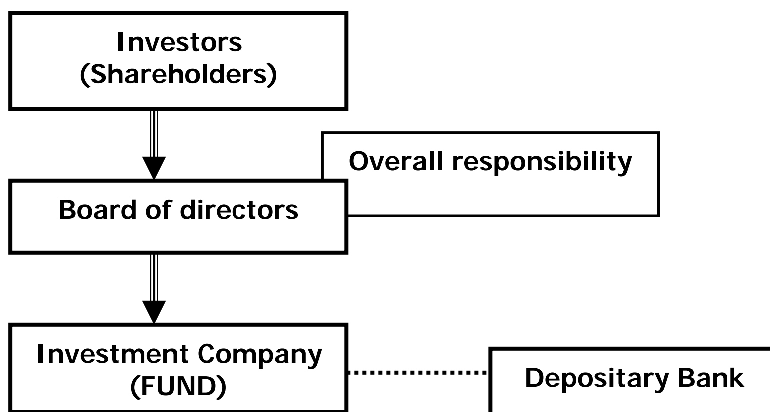
Futhermore, both *AUTs* and *OEICs* have a *Manager*, which is itself a regulated company subject to extensive prudential and conduct of business rules. The Continental model for incorporated funds (SICAVs) does not generally include a *Manager* in this sense. Instead, SICAVs have a board of directors (individuals) – see the diagrams below. However well-qualified these individuals may be, they are not themselves subject to as extensive regulation and, again, it must be questioned whether they can perform as potent, well-resourced and engaged a function as a regulated entity dedicated to *CIS* management.

OEIC



* The Fund may own premises, staff etc, but this has not happened in practice because OEICs have chosen an ACD rather than a Board. (The ACD has staff.)

SICAV



In the USA, mutual funds are governed by a board of directors whose responsibility it is to ensure that the investment manager acts in accordance with the fund's rules and in the interests of investors. The directors are subject to detailed regulation by the Securities and Exchange Commission and the majority must be independent. However, it is noted that the existence of a majority of independent directors did not seem to impair the growth of practices such as late trading and market timing. Indeed, the US regulators have consulted on requiring mutual fund boards to appoint a compliance officer and have commented favourably on the independent *Depositary* model.

On the subject of investor protection more generally, the *FSA* has the power to require a *Manager* and/or *Depositary* to compensate a *CIS* in the event of a finding against the *Manager* and/or *Depositary*. It also has the power to fine those entities and to fine or ban individuals in those companies. In addition, in the UK, *CIS* management is covered by the Financial Ombudsman Service ("*FOS*") and the Financial Services Compensation Scheme ("*FSCS*"). The *FOS* deals with investor complaints and can require a *Manager* to compensate an investor in the event of it finding against the *Manager*. The *FSCS* deals with investor compensation in the event that the *Manager* is in default and cannot compensate investors for any amounts required by the *FOS* or *FSA* (note that the default of the *Manager* does not impact the assets of the *CIS*).

It is noted that the *EC* is consulting upon Investor Compensation Schemes and part of that consultation touches upon the failure of third parties in the context of *UCITS*. Unlike the position in the UK, *UCITS* management on the Continent is not generally covered by national compensation schemes.

d) Distributor Influenced Funds

One area that the *FSA* has focused upon in recent times is that of Distributor Influenced Funds ("DIFs"). These are *CIS* created for the clients of a particular distributor, typically an adviser firm. The distributor appoints the *Manager* (often referred to as a "third party *ACD*"), but retains a degree of influence over the *CIS*, such as selecting the investment manager or the investments of the fund. The *FSA* issued Factsheets in 2008 listing some of the issues *Managers* and distributors of such *CIS* should consider, including the appropriate level of distributor influence and the importance of keeping a clear distinction between the regulated activities for which each party is responsible. *Managers* should remain cognisant of the potential for conflicts of interest that arise with *DIFs* and manage those conflicts effectively.

e) General Observations on the Resilience of the UK CIS Governance Structure During 2008

In January 2009, the *EC* commented that *"The UCITS regulatory framework has proved very resilient during the current crisis. Despite very difficult market conditions, asset illiquidity and investor redemptions, no more than a handful of funds have been forced to suspend trading or close. The regulatory safeguards embedded in the regulatory model have been instrumental in helping UCITS funds weather this crisis".*

The UK *CIS* governance arrangements have, in particular, stood up well to the events of 2008. Despite extreme market conditions, nothing occurred which has thrown the robustness of the UK's governance arrangements seriously into doubt.

There have, however, been instances which suggest that the benefits of *CIS* are not fully understood. For example, some commentators were under the mistaken impression that if a *Manager* went out of business, *CIS* assets would be lost. Others did not fully appreciate the independent oversight that takes place and the fact that assets are safeguarded by a party independent of the *Manager*.

There is scope for improving regulators', commentators' and investors' understanding of the unique features and benefits of *CIS*.

Recommendations

- **Information/education should be provided by the IMA to improve interested parties' understanding of the benefits of *CIS*.**

2. Security of Assets

This Chapter sets out the safe custody responsibilities of the *Depositary*, the regulatory framework governing this responsibility and general observations on safe custody matters in 2008, with reference to the Madoff fraud in particular. It also considers the position of unit deals in process via the *Manager's* "box".

a) *Depositary* responsibility and liability

As outlined in Chapter 1, one of the key responsibilities of a *Depositary* is the safe custody of the assets of the *CIS* and ensuring the economic benefits derived from holding these assets are received. This separation of the management of the *CIS* 's assets (that is, their selection) from their possession and ownership is the most fundamental element of investor protection provided by the *CIS* product.

It is common for *Depositaries* to delegate custody to a specialist provider, either to an associated company or to a suitable third party.

i) European Legislation

The *UCITS Directive* specifies that no single company shall act as both *Manager* and *Depositary* and that each must act independently of the other. However, the *Directive* does not prevent two companies within the same group acting as *Manager* and *Depositary*, and this arrangement is common in Continental Europe.

The *Directive* places responsibility upon the *Depositary* for the safe-keeping of *CIS* assets. It makes clear that its responsibility will not be affected by the fact that it has entrusted some of or all the assets to a third party. It also makes clear that a *Depositary* is liable to the *Manager* and the *CIS* investors for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them. This wording is interpreted differently throughout Europe, with e.g. France according the *Depositary* strict liability and the FSA according it liability in the event of negligence, etc., in performing its duties (see below).

The *Directive* does not apply other regulatory requirements on the *Depositary*, such as conduct of business, due diligence or prudential requirements.

ii) UK Legislation and FSA Regulation

As mentioned in Chapter 1, UK regulation is super-equivalent to the *UCITS Directive* requirement concerning the relationship between the *Manager* and *Depositary*. *FSMA* and the *OEIC Regulations* require independence between the *Trustee* and the *Manager* of an *AUT,* and between the *Depositary*, the *OEIC* and its directors (usually only the *ACD*).

FSA regulations contain a number of provisions regarding safe-keeping. The *Depositary* must safeguard assets (e.g. completion of all documentation needed to ensure completion of transactions properly entered into, ensuring assets in registered form are registered in the name of the *Depositary* or its delegate, taking custody of documents of title).

In order for the *CIS's* assets to be protected in the event of the default of a *Depositary*, it is important that these rules be adhered to and that assets are clearly registered in the name of the *Depositary* in its capacity as such and for the benefit of the *CIS*.

The *Depositary* may delegate any function of custody or control of assets but may not delegate such functions to the *Manager*. Where a *Depositary* does delegate custody or control of assets, the extent of its liability depends upon whether it delegates to an associate or another party. Some *Depositaries* use the custody services of their associates, while others use the services of third parties, or a combination of the two.

If the *Depositary* delegates any function of custody or control of assets to an associate, then its liability for those services remains unaffected. This could arguably be super-equivalent to the *UCITS Directive* which does not draw distinctions in treatment between delegations made to associated parties and third parties. In other jurisdictions, a *Depositary* may not be liable for the activity of an associate provided that any loss was not due to unjustifiable failure or improper performance on the part of the *Depositary*.

If the *Depositary* delegates to a third party, it will not be held responsible by virtue of the *FSA* regulations for any act or omission of the person so retained, provided it can show that:

- It was reasonable for it to obtain assistance to perform the function in question;
- The person retained was and remained competent to provide assistance in performing the function in question; and
- It had taken reasonable care to ensure that the assistance in question was provided in a competent manner by the person retained.

"Competent" is not a term which is defined in the FSA regulations. In the event of a dispute, competency would be assessed in accordance with common law principles. It is to be noted that the burden of responsibility is placed on the *Depositary*. It has to demonstrate that it has met these due diligence requirements if it is not to be held responsible for the acts or omissions of those to whom it delegates.

iii) Liability

Subject to the factors mentioned above, the relationship between the *Depositary* and its custodian will be governed by contract. Under the terms of that contract a custodian, in turn, may delegate to other parties. This means that questions of liability are determined by both *FSA* rules and contract. At present, such contractual arrangements differ between *Depositaries* and custodians, and may depend in part on the type and legal location of the *CIS* assets.

c) Events of 2008

As noted in the introduction, concern about the solvency of financial institutions has led to a focus upon the security of assets, including cash. The security of financial institutions, especially banks, was previously taken for granted; this is no longer so.

There have also been questions about whether the reported set-up in some Continental *UCITS*, where the *Manager* and *Depositary* were associated and both are reported to have delegated key functions to Madoff entities, could happen elsewhere.

In the UK, such a set of delegations is highly unlikely. As noted in Chapter 1:

- the *Manager* and *Depositary* are fully independent, a unique feature of the UK governance regime;
- both are subject to extensive regulations, including in particular on the management of conflicts of interest and due diligence; and
- well-qualified and fully independent auditors perform at least annual reviews of the *CIS*'s assets.

Moreover, *FSA* regulation governing *UCITS* and *NURS* is clear that the *Depositary* would be fully liable for loss resulting from such delegation as the delegation would be to an associate of the *Manager's* delegate and would therefore be an associate of the *Manager*. *Depositary* liability remains unaffected where delegation is made to an associate. *Depositaries* would not, in any event, wish to delegate custody to an associate of the *Manager*. The reason for this is that a *Depository* cannot delegate any function of custody or control of a *CIS's* assets to the *Manager*, and it would offend that general rule if one delegated custody to an associate of the *Manager's* delegate.

As mentioned in Chapter 1, there is a type of *CIS*, called a *QIS*, which is available only to experienced investors and which is subject to a "lighter touch" regime. One difference between the *UCITS/NURS* and *QIS* rules is that the *Depositary* would not be liable for any act or omission of a delegate of an associate if the *Depositary* can show that it has met the due diligence set out in the *FSA* rules governing *QIS*. That said, for the reason given in the preceding paragraph, it is unlikely that the *Depositary* would wish to delegate custody to an associate of the *Manager*.

In the light of the Madoff fraud and the fact that it has highlighted potential weaknesses in other EU jurisdictions' governance and regulatory structures, it is welcomed that the *EC* and *CESR* are reviewing different jurisdictions' approaches to *Depositary* responsibilities. Inconsistencies in the interpretation of the *UCITS Directive* that result in less rigorous approaches being taken leads to regulatory arbitrage, is a threat to investor protection and is damaging to the valuable *UCITS* brand. IMA will provide input to this review, highlighting the strengths of the UK governance and regulatory structure.

CESR and, where necessary, the *EC* should make every effort to address any interpretations of the *UCITS Directive* that give rise to regulatory arbitrage. It prejudices those jurisdictions that rigorously apply *Directive* requirements and exposes investors to increased risks.

d) Cash

Concern about the solvency of banks has highlighted a lack of clarity about the position of cash belonging to a *CIS*. Some commentators have said that the cash is not ring-fenced and that the *Depositary*, on behalf of the *CIS*, would rank as an

unsecured creditor in the event of such a default. Others have said that such monies would be ring-fenced and would not be available to other creditors.

IMA understands that where the cash belonging to a *CIS* is deposited with a bank, then that *CIS* has no better right to repayment upon the insolvency of that bank than any other depositor.

This highlights the importance of cash management. The *Manager* is responsible for managing *CIS* assets including cash. To mitigate the impact of default, the *CIS* rules governing investments of assets include limits on exposure to counterparties (see Chapter 3).

Given heightened concern about the possibility of bank defaults, *Managers* will wish to review their approach to cash management with a view to ensuring adequacy of diversification, whether by ensuring that exposure to individual counterparty banks is limited and/or by utilising money market funds investing in non asset backed securities, gilts and other government securities.

There has also been some confusion over the extent to which parties, on behalf of a *CIS*, can make a claim on the *FSCS* in accordance with the compensation scheme rules ("COMP") in the event that a *CIS*'s cash is placed with a deposit-taker that is subsequently declared in default. The *FSA* has advised that *Depositaries* who are banks would not be able to claim, but that there may be some instances where a claim by or on behalf a *CIS* could be eligible for protected deposits. These instances are where, under the terms of the *FSCS*, the *OEIC* is small or, in the case of an *AUT*, the *Trustee* is small. However, *Trustees* are not "small" companies and it is unlikely that an *OEIC* would be "small". In any event, the claim would be limited to £50,000.

e) Unit Dealing

FSA regulations allow the *Manager* to deal as principal in dealings with investors. There is also the ability to deal as agent of the *OEIC/Trustee*, but this ability is used very rarely and would require a restructuring of the way in which *CIS* operate in the UK.

It is common in the UK for the *Manager* to maintain a small principal position in the units or shares of the *CIS:* this is called the *Manager's* box. Most boxes are used simply as administrative buffers. They enable the netting of investor deals on a daily basis, so only one creation/redemption of units by the *CIS* each day, rather than many. The maintenance of a small principal position enables the manager to cater for small administrative errors, such as simple deal input errors.

A limited risk arises in the *Manager* acting as principal if the *Manager* becomes insolvent. As the contract to buy/sell is with the *Manager*, any investor whose deal is being processed will rank as an unsecured creditor. If the principal to the transaction was the *OEIC/Trustee*, the insolvency of the *Manager* would not have an impact upon the investor. As a general method of operating, though, it may not be as efficient.

Consideration has been given to whether moving to an agency basis would be a practicable option in dealing with a potentially swift moving event such as a *Manager* moving into default.

Practical points about moving the account to the *OEIC/Trustee* would include, for example, the need for the *OEIC/Trustee to* satisfy itself that client identification requirements in accordance with money laundering legislation were being met. This responsibility would remain with the *Manager* and there might be timing issues as to when cheques could be banked. To the extent the monies included monies due to the *Manager* (e.g. initial or redemption charges), there would need to be mechanics for identifying and moving these to the *Manager* or as the *Manager* would direct. This would involve different arrangements where third party providers are employed to carry out such administration on behalf of the *CIS* and would lead to increased costs.

Making arrangements to move to an agency basis legally watertight would not be straightforward, particularly if *Managers'* monies were mixed with investors' monies. This would have a major impact on timing. The *Depositary* would have to open new accounts, and the *Manager*, *Depositary* and the administrator all have to agree how the monies in the account can be dealt with; another timing issue.

In addition, if such arrangements were put into place at short notice, then the *Manager* would also have to demonstrate that the arrangement was not put in place to avoid making payments to creditors.

Investors would need to be notified, even if not prior to effecting the new arrangements. This would have further cost implications.

Moreover, a bank would have to be satisfied on all the above points before it agreed to open a new account on behalf of the *Depositary.* Even then, it would need to be satisfied about the validity of individual transactions.

In the light of the above, it is believed that moving to an agency basis would be very difficult to achieve in practice and would have potentially significant cost implications, which would need to be considered against the likelihood of such an event occurring.

If a requirement to move to an agency basis in the event of an impending default were to be proposed, the *FSA* would need to carry out a cost/benefit analysis and consult on proposed rule changes. Indeed, it may be that changes would be needed to primary legislation. Also, banks would need to be satisfied with the legal position before they would facilitate a rapid change in dealing basis of the *Manager*. IMA therefore believes that this is unlikely to be a viable solution.

The client money rules have also been also considered. Currently, the client money rules contain a concession under which a *Manager* does not need to segregate client money immediately from its own money. This allows:-

a) a one-day window before client money, received in connection with the issue of units/shares in a *CIS*, needs to be segregated (the window is dependent on the date of the pricing of the units/shares); and

b) a four-day window before client money, received in the course of redeeming units/shares in a *CIS*, needs to be segregated.

Given that making changes to the regulatory regime would have significant cost implications, it is not thought that a change to the rules would be justified under a cost/benefit analysis.

Recommendations

- **The industry should review the application of the custody rules to *CIS* and sub-custodial arrangements, and consider whether *FSA* rules need clarification or modification.**
- ***Managers* should review their approach to cash management with a view to ensuring adequacy of diversification, whether by ensuring that exposure to individual counterparty banks is limited and/or by utilising money market funds invested in non asset backed securities, gilts, other government securities, etc.**

3. Management of Market and Counterparty Risks

This Chapter sets out the investment powers for retail *CIS*, including asset diversification and asset quality requirements, derivative risk management requirements and related matters. It comments on issues arising from extreme market conditions.

a) Diversification and Asset Quality

UCITS are subject to prescriptive rules on investment and borrowing, covering eligible investments (e.g. securities, money market instruments, derivatives), eligible markets and quantum of exposure (e.g. investment, counterparty risk). The *NURS* rules allow a wider range of eligible investments (e.g. real estate) and slightly less restricted borrowing. The table below provides a summary.

These rules establish diversification, limit leverage and control risk, but do not constitute a "no failure" regime. All returns are related to the risk taken. The rules on the controlling of risk acknowledge this and that risk cannot be eliminated.

	UCITS	**NURS**
Permitted investments	• Shares. • Gilts/bonds. • Warrants. • Deposits. • Depository receipts. • Cash. • Units in other Investment Funds. • Debentures. • Derivatives. • Investment Trusts. • Government and public securities • Money market instruments. • Forward contracts. • Index tracking funds.	• All UCITS permitted investments • Direct property • Gold (up to 10%) • Unregulated schemes/funds (up to 20%).
Investment restrictions	• Minimum 90% in approved securities. • Maximum 10% in non-approved securities. • Maximum 10% in one company. • No limit to amount invested in gilts/public securities.	• Minimum 80% in approved securities. • Maximum 20% in non-approved securities and/or unregulated schemes.

CIS must disclose their investment objective to investors (e.g. primarily invested in equities to achieve growth and income). Any change to those objectives requires an investor vote to approve the change. Whilst the *Depositary* is responsible for safekeeping of the funds (ring-fencing the *CIS*'s assets from those of the *Manager*) and has a duty of oversight, the *Manager* is ultimately responsible for all investment decisions (including where cash is held).

There are some differences in interpretations between Member States as to what *UCITS* can invest in. For example, investment in non-regulated *CIS* is allowed by some States within the 10% limit for unapproved securities. This leads to regulatory arbitrage between fund domiciles and can lead to uncertainty for investors.

b) Derivatives and risk management

i) Regulation

The *UCITS Directive* has provided, through the use of derivatives, the ability for *CIS* to adjust exposure to the market. A number of *CIS* have been launched that have increased gross exposure to the market (130/30 funds) or have reduced or minimal gross exposure to the market (market neutral funds). This has presented its own challenges, which were recognised by the *EC* in 2004 (see below).

UCITS are allowed to use derivatives for investment purposes as well as for simple hedging (i.e. efficient portfolio management). A risk management framework is required to ensure that a *UCITS* can effectively manage the risks posed by derivative use and not create risks that create a liability greater than the value of the *UCITS*. Specifically, the *UCITS Directive* requires that *"the management or investment company shall employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio."*

In 2004, the *EC* published guidance - the "Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities". The guidance elaborated on the following concepts:

- *Global exposure on derivatives and overall risk exposure*

The *Directive* requires that global exposure relating to financial derivative instruments may not exceed 100 % of the *UCITS's NAV*, and therefore that the *UCITS*'s overall risk exposure may not exceed 200% of the *NAV* on a permanent basis.

- *Adaptation of risk-measurement methodologies to the risk-profile of a UCITS*

The guidance introduced the concept of non-sophisticated funds and sophisticated funds. A non-sophisticated fund can use the "commitment approach" (i.e. the market exposure to the derivatives contracts) to calculate global exposure. A sophisticated fund has to use a sophisticated methodology, such as "value at risk".

- *Limitation of counterparty risk exposure for OTC derivatives*

UCITS are required to measure the exposure per counterparty on an *OTC* derivative transaction on the basis of the maximum potential loss incurred by the *UCITS* if the counterparty defaults, and not on the basis of the notional value of the *OTC* contract.

- *Cover*

It is recommended that cover for physically settled derivatives should be the actual underlying in question. In some circumstances appropriate cover could also be a closely correlated asset. In the case of cash-settled derivatives, a *UCITS* is able to cover the derivative with the following assets:

a) cash;
b) liquid debt instruments (e.g. government bonds of first credit rating) with appropriate safeguards;
c) other highly liquid assets recognised by the competent authorities, considering their correlation with the underlying of the financial derivative instruments and subject to appropriate safeguards.

- *Nature of the underlying financial instrument*

Member States are recommended to require that the underlying financial instrument of financial derivative instruments, whether they provide for cash-settlement or physical delivery, as well as the financial instruments held for cover, have to be compliant with the *Directive* and the individual investment policy of the *UCITS*.

ii) FSA Practice Versus Other Key EU Regulators

The FSA, in common with other European regulators, requires *Managers* to draw up and comply with a *DRMP*. In the UK, the responsibility for producing industry guidance for the *DRMP* has fallen to the industry. The industry guidelines were first produced in 2003 with experts from the funds and derivatives industries. The guidelines cover all aspects of the derivatives risk management process.

In other jurisdictions, most notably Luxembourg and Ireland, guidance has been produced by the regulator. We understand that the *DRMP* document is rarely challenged by the *FSA*. In Luxembourg and Ireland, in contrast, we understand that derivatives experts at the regulator review, challenge and approve *DRMP* documents before authorisation is given to the fund. If any changes are made, these too are reviewed.

c) Structured Products

There has been a proliferation in the use of structured products, by investors and by *CIS*. A simple structured product may combine two vehicles – a transferable security (e.g. a medium term note) and a derivative (or series of). The objective of a structured product is to provide a return based on a defined underlying asset/index, whilst providing a vehicle which could, for example, offer capital protection. Therefore, other than market risk, the investor must consider: credit risk of the issuer of the medium term note; counterparty risk of the provider of the derivative (from where the return on the referenced asset is derived); and the additional risks arising from the derivative itself. These risks should be captured within the investment and borrowing powers (spread of risk etc) and the *DRMP*.

Structured products are often listed, so are "approved securities" for the purposes of all *CIS*. Unlisted structured products may still be invested in by *CIS* within the 10% limit for unapproved securities.

There is also currently a different definition of transferable security for *UCITS* and for *NURS*. This potentially allows a *NURS* to invest in transferable securities that would not meet the *UCITS* requirements. In one case this has led to a *CIS* investing exclusively in transferable securities that have less transparency and have been inherently less liquid.

d) Sub-funds and investment risk

FSMA and the *OEIC Regulations* do not currently allow for a "protected cell regime". Without such a regime, there would be possible contagion of sub-funds within an umbrella if a sub-fund was to fail and owed more than its assets. Heightened concerns and misinformation about the security of assets in *CIS* have led to renewed questions about the lack of a protected cell regime in the UK.

The probability of contagion within an *OEIC* is very small, but such a regime should be available and would be a source of comfort for some conservative, institutional investors. Furthermore, the absence of a protected cell regime is a barrier to registration in some countries. *HMT* is working on the introduction of such a regime and IMA is actively involved in this work. *HMT* has confirmed that it will be issuing a public consultation document on the regime this summer.

e) Events in 2008

i) Market risk

As many *CIS* do not fully engage in the "complex" use of derivatives (see above), market movements and security selection are the dominant forces in determining returns. The market events in 2008 have led to large falls in the value of investors' holdings. Questions have been asked by some investors as to whether *Managers* should have moved *CIS* assets into cash. However, as investment objectives are set out in the prospectus, requiring a shareholder approval if the objectives change materially, *CIS* whose objective is to invest in UK equities, for example, cannot make a quick, unilateral decision to move to cash.

ii) Investment risk

Unprecedented volatility in the market place, together with sudden and inconceivably large increases in credit and counterparty risk, have shone a light on the methods employed by managers of all types of funds and fund structures. The importance of spread of risk and diversification, which were embedded in the original *UCITS Directive*, have been demonstrated.

Diversification achieves two mutually inclusive outcomes:

- It reduces the volatility of the portfolio, where the *CIS* invests in uncorrelated assets and securities; and/or
- It reduces or eliminates unsystematic (company/issuer) risk, which reduces the impact on the *CIS* of an individual security or counterparty failing.

A small number of *CIS* had a very limited exposure to Madoff entities via their investments in structured products (but not via their custodial, pricing or audit arrangements – see Chapter 2). The diversification and risk management

requirements ensured that these exposures were both limited and had minimal impact.

iii) Counterparty risk

Before 2008, the risk that a primary bank would fail seemed academic. The failure of Bear Stearns and then Lehman Brothers highlighted how real these risks were and also the extent to which funds (of all types) were exposed to banks, through cash deposits, custody, trading, stocklending and *OTC* derivatives (see previous chapters for cash, custody and trading). Despite *CIS* rules limiting the amount of exposure to any one issuer/counterparty, the need for adequate counterparty risk controls, evaluation, management and monitoring is stronger than ever.

In addition to the requirement to diversify counterparties, *Managers* should perform due diligence on the counterparties, taking into account credit ratings, credit spreads and more qualitative due diligence. Furthermore, exposure to counterparties when engaged in *OTC* derivatives can be largely reduced through collateralisation. Collateralisation of *OTC* derivatives has become increasingly more prevalent in the market place as both funds and counterparties seek to minimise their exposure to the other party. However, whilst collateralisation mitigates counterparty risk, it generates its own risks. For example, as volatility increases, exposure increases, and with high *de minimis* limits for collateral or infrequent posting of collateral, there is a risk of over-collateralisation by the fund. This again gives rise to counterparty risk. Firms that were correctly collateralised against Lehman had no issues following its administration.

iv) Money Market Funds

Money market funds received significant attention in 2008, primarily due to the fact that a US money market fund – The Reserve Primary Fund – broke the buck, which was only the second such event since the inception of the industry in the USA in 1972. The concept of breaking the buck applies only to those funds that seek to maintain a constant net asset value – the "buck" breaking when that constant value is lost. There is currently only one such fund in the UK, most being domiciled in Dublin or Luxembourg due to historic regulatory and tax constraints.

The fact that there is only one such fund in the UK did not prevent other funds suffering from the adverse publicity associated with the concept of a money market fund. This highlights the need for greater consistency of definitions, together with the education of investors on the risks associated with the product. Industry associations, represented by the European Fund and Asset Management Association and the Institutional Money Market Funds Association, have therefore commenced work on the development of a pan-European definition.

The UK money market sector was also impacted as some funds held material volumes of asset-backed securities. The poor performance of such securities resulted in significant falls in value of some money market funds, which had been sold on the basis of providing capital security.

The future of this product in the UK may be reliant upon greater restrictions on those assets which are permissible for inclusion within a portfolio seeking to provide capital security. Also, it is important that advisers and investors have clear information on

underlying assets of such funds. The work of EFAMA and IMMFA should assist in providing guidance on eligible assets for inclusion in a money market fund.

Recommendations

- **The *FSA* should give due consideration to firms' *DRMP*s.**
- **The *FSA* should consult on aligning the *NURS* definition of transferable security to the *UCITS* definition to ensure that the quality of underlying transferable security (in terms of transparency, liquidity) is consistent.**
- ***Managers* should continue to follow industry good practice guidelines as regards risk management processes, including counterparty risk, due diligence on structured products and active collateral management.**

4. Valuation and Pricing

This Chapter describes some of the issues arising from the shortage of liquidity, in particular, price volatility, price discovery and the more frequent application of *FVP* methods. It also discusses the practical implications of these issues on the various approaches to calculating the prices of units.

a) FSA Regulations

FSA regulations require the *Manager* to pay due regard to investors' interests and to treat them fairly when they become, remain or as they cease to be unitholders.

The *Manager* is responsible for valuing the scheme property and calculating the price of units. The rules require the *Manager* to ensure the prices of units are calculated fairly and regularly, and allow the *Manager* to mitigate the effects of dilution caused by the buying and selling of underlying investments as a result of the issue or cancellation of units.

The rules also impose on the *Depositary* a duty of oversight in order to ensure that the prices of units are calculated in accordance with the rules and that evidence is maintained to demonstrate such compliance.

The *Manager* must carry out a fair and accurate valuation. Guidance is provided regarding the price of investments and the source of such prices, as well as what to do when a price is not available or is regarded as unreliable. The industry's guidance details the options available to *Managers* in these situations. The methods employed in carrying out a valuation must be specified in the scheme documentation.

Details of the basis of valuation of investments should be recorded in the *Manager's* pricing policy document. The pricing policy should be reviewed on a regular basis by the *Manager's* valuation committee and approved by the Board of Directors. Typically it will identify:

- a hierarchy of pricing sources (primary, secondary, tertiary) for each asset type;
- the details of the price to be collected (last traded, last quoted, broker quote, pricing service (consensus or proprietary model), *Manager's FVP* price, etc);
- the tolerances for variances (between sources, compared to previous valuation, static and stale price checks, compared to recent transactions, compared to other (baskets of) similar securities); and
- escalation procedures.

There are specific rules and guidance for the valuation of immovable property, including the role of the standing independent valuer, and for qualifying money market funds.

b) Experience in 2008/09

Global markets suffered a stream of set backs as the year unfolded and UK markets were no exception, with the FTSE dropping below 4,000. In particular, confidence in corporate bond markets evaporated in the second half of 2008 and willing participants in those markets became increasingly hard to find. The resulting wafer thin trading volumes created new challenges for *Managers*: not only were they

unable to deal much of the time, they also faced a scarcity of reliable bond prices affecting their ability to value the scheme property with the usual degree of certainty.

For some *Managers* market turmoil and falling investor confidence led to large scale asset reallocations and withdrawals. This, coupled with low market liquidity, severely tested some *Managers'* ability to price units fairly. The challenge was most acute for *Managers* without the actual transaction experience in the bonds they were pricing.

As bond markets became inactive it became harder to find traded or quoted prices and the application of *FVP* techniques become more frequent and widespread. The quality of price feeds was called into question and significantly wider spreads emerged for dealing in larger lot sizes. Where prices could be found they sometimes related only to forced transactions. Spreads of 40% were observed in some extreme cases.

However, the problems were not universal across the corporate bond sector. The shape of *CIS* portfolios dictated the extent of the problems. The further down the credit quality scale a portfolio was positioned, the greater the incidence of *FVP*. Some *Managers* found themselves applying *FVP* daily to a half or more of the portfolio while others found the majority of the price feed data to be reliable and were only applying *FVP* to a small number of positions.

Widespread use of *FVP* presented operational challenges; it is resource hungry and time consuming. Providers of related wrapper products such as life companies found they had to wait longer for CIS prices and consequently their own valuations processes ran later.

Managers of funds of funds experienced particular problems where they invest in *CIS* provided by other *Managers*. It is often the case that the best available price is 24 hours old; this is acceptable in benign markets but presents particular *FVP* challenges in volatile markets. Moreover, when *Managers* attempted to sell units in the underlying *CIS* they experienced dilution levies that reduced their proceeds by as much as 10% from the valuation price.

c) Pricing Methodologies

There are three pricing methodologies available to *CIS*. These methodologies are effectively distinguished by their relative complexity and specifically by their ability to mitigate the effects of dilution.

Dual pricing is the traditional methodology in the UK, but its use has declined in recent years, primarily because single pricing is the norm on the Continent. Uniquely, the starting point is to identify the actual cost of creating or liquidating the portfolio i.e. the cost of creating or cancelling a unit. It includes the full cost of buying or selling each security, including both the dealing spread and the costs of dealing. The *Manager* exercises no discretion in determining the issue and cancellation prices and, as a result, ongoing investors are fully protected from dilution by the pricing method itself. Flexibility exists for *Managers* to set sales and redemption prices anywhere between limits based on the issue and cancellation prices, and to price large deals differentially. Therefore, protection of investors as they join or leave a *CIS* is provided by the *Manager*. However, many investors will not understand how the *Manager's* spread is operated.

Single mid pricing is the simplest approach and found favour in the low volatility environment that typified the last 10 years. The method requires that the price is calculated using a single mid market price and takes no account of dealing costs or spreads. All unit deals take place at this single price. There is a general presumption that dilution is immaterial as unit deals are not significant relative to the size of the *CIS*. Most *Managers* reserve the right to impose a dilution levy although the policies are often crafted to ensure that they are used only in extremis. Also, dilution levies cannot be universally operated because of administrative restrictions imposed by some distributors, for example platforms. Low unit price volatility is generally regarded as a benefit of this method, but in current market conditions it has been accused of lacking transparency. As spreads widen significantly the *Manager* becomes obliged to impose large and unforeseen levies on unit deals in order to mitigate dilution. These levies are not reflected in unit prices and do not contribute to the *CIS's* performance track record. As a result such track records are potentially misleading in terms of actual investor experience.

Swinging single pricing represents some of the benefits of both the other methods. The single price projects simplicity and some systems are operated on the basis of a mid price unless unusual circumstances dictate otherwise. However, the fully swung prices are the issue and cancellation prices that would be seen in the dual priced system. This method can therefore be used in a similar way as dual pricing with the price swung everyday as appropriate to reflect unit dealing patterns. Unlike dual pricing, this method leaves the protection against dilution of ongoing investors as a matter of judgement for the *Manager*. In order to mitigate the risk of errors of judgement *Managers* may choose to operate swinging single pricing using thresholds to trigger a swing. Thresholds are useful for dealing with known circumstances but may fail to have sufficient flexibility to deal with unexpected or unforeseen situations, such as current and unprecedented market conditions.

Typically, *Managers* operating dual pricing review and revise dealing costs quarterly. The dealing spread is inherent in the valuations produced each day. Many *Managers* replicate this frequency for their review of the entire dilution adjustment/levy which includes both dealing costs and dealing spreads. Therefore, single pricing systems are potentially slower to respond when spreads change rapidly.

d) Distributions and Yields

Where a *Manager* wishes to quote a yield for a *CIS* invested in equities, best practice is to use the Historic Yield.[*] If the *Manager* believes that the Historic Yield is materially unrepresentative, an alternative forecast yield may be calculated and quoted. This estimate should, as far as possible, follow the same principles for calculation as the Historic Yield. In such cases it should be clearly disclosed that the quoted yield is not the Historic Yield. The reason why the *Manager* believes the Historic Yield is materially unrepresentative should also be disclosed, together with the assumptions made in calculating the forecast yield.

CIS investing in bonds pay distributions based on either the "effective yield" of the bonds in their portfolios or on coupons received. The effective yield is calculated using the expected cash flows over the life of a bond and determines the amount of

[*] The Historic Yield reflects distributions declared over the past twelve months as a percentage of the mid-market unit price.

revenue available for distribution. The amortisation from heavily discounted bonds increases the revenue available for distribution. The discount reflects the likelihood of a bond defaulting, so *Managers* need to intervene when it is no longer expected that a bond will mature at par. In the absence of this intervention too much revenue would be distributed at the expense of capital value. Similarly, *Managers* should ensure realistic cash flow expectations are used when a bond is purchased at a heavily discounted price. Where a *CIS* makes frequent distributions, such as monthly, it is important to ensure timely intervention so as to limit the amount of accrued interest that is distributed by a *CIS* that might subsequently fail to be paid if a bond defaults.

Care should be taken to ensure that the interventions described above are correctly reflected in the calculation of published yield figures in order to convey realistic distribution expectations to clients.

IMA has issued a circular to assist *Managers* and their administrators with the technical accounting issues affecting distribution and published yield figures. It has also alerted *Managers* to the potential need for additional disclosures in respect of published yields and disclosures.

Recommendations

- **All *Managers* should follow industry guidelines on *FVP* and on the calculation and disclosure of fund yields.**
- **The industry should review its operation of single pricing and, in particular, the application of dilution levies, with a view to updating industry guidance and providing information for investors on the different methodologies.**

5. Liquidity Management

This Chapter sets out the liquidity management responsibilities of the *Manager* under the *UCITS Directive*, *FSA* regulations and *ISA* requirements, and general observations on liquidity management issues in the light of the events in 2008. In exceptional circumstances, liquidity management issues may lead to fund suspension. Fund suspension issues are covered in Chapter 6.

a) Dealing Requirements

i) European Legislation

The *UCITS Directive* requires that *UCITS* should sell units to/buy units from investors at least twice per month. National regulators are able to reduce this frequency to once a month, on condition that such derogation does not prejudice the interests of investors. The *UCITS Directive* also requires that a *UCITS* must re-purchase or redeem its units at the request of any investor.

ii) FSA Regulation

Under *FSA* regulation, a *Manager* must at all times during a dealing day be willing to sell units to an investor (unless it is a "limited issue" *CIS*) and must at all times during a dealing day be willing to buy units from an investor (unless it is a "limited redemption" fund). In both cases, the price will be as calculated at the next valuation point. A *CIS* must have at least two regular valuation points per month.

If the *CIS* is a limited issue fund, no further issues can be made unless conditions are met. If it is a limited redemption fund, the *Manager* must sell or redeem at a price determined no later than 185 days from receipt and acceptance of the instruction to sell/redeem.

If allowed by the constitutional documentation and Prospectus of a *CIS* that has at least one valuation point on each business day, redemptions may be deferred to the next valuation point where the requested redemption exceeds 10%, or some other reasonable proportion disclosed in the prospectus. If a deferral takes place, all investors who have sought to redeem at any valuation point at which redemptions are deferred must be treated consistently and all deals relating to an earlier valuation point must be completed before those relating to a later valuation point are considered.

It is possible to settle redemptions *in specie* and assets can be transferred directly or indirectly to the investor or sold outside the *CIS* with the proceeds remitted to the investor. *In specie* redemptions may be used, in particular, to handle large redemptions from institutional investors. The ability to settle *in specie* is not practicable in cases of large redemptions placed by aggregators such as platforms. Aggregators place one redemption instruction which represents the sale of units/shares on behalf of a number of underlying investors and, as a consequence, the aggregator may not be able to handle an *in specie* redemption.

iii) ISA Regulations

The current *ISA* regulations require that money held within an *ISA* must be accessible to an *ISA* investor within 30 days.

These regulations, coupled with reluctance on the part of platforms to host non-daily dealing funds, tend to mitigate against the use of limited redemption in retail funds.

b) Events of 2008

As mentioned in Chapter 1, the *EC* commented favourably on the resilience of the *UCITS* regulatory framework during the current crisis. Very difficult market conditions, asset illiquidity and investor redemptions, have tested that framework. One of the key challenges faced by *Managers* is that of liquidity management.

This challenge has been felt particularly in the area of traditionally illiquid assets such as real estate, but also in the case of assets that were liquid but have become less so.

Prior to the extreme turbulence in the markets in the last year or so, *CIS* have very rarely faced liquidity issues that have given rise to the need to suspend a fund.

In extreme conditions, high levels of redemptions can quickly use up available cash and, if the *CIS* contains assets that are or have become illiquid, it may be necessary to suspend dealings in order to avoid 'fire sales' or to avoid the situation where the more liquid assets are sold and the *CIS* is left with a residual portfolio of increasingly illiquid assets.

As mentioned above, there are regulatory tools available to *Managers* in managing the *CIS's* liquidity. When establishing a *CIS*, the *Manager* should consider the appropriateness of dealing frequency given the nature of the proposed investments. The *Manager* can put in place limited redemption provisions and reserve the right to defer redemptions in certain circumstances. The *Manager*, as part of its investment management policy, may decide to maintain a certain amount of cash/liquid assets. A *CIS* also has the power to borrow and to redeem *in specie*.

The extreme market conditions have highlighted the following matters:

- The importance of considering, on an ongoing basis, the liquidity profile of both current and potential underlying assets and the interaction with the *CIS's* overall liquidity requirements.
- The need to consider and balance the needs of all investors when managing liquidity.
- The risks resulting from investor concentration (large institutional investors e.g life companies, corporates and pension funds). Redemption activity by such investors can de-stabilise a *CIS*.
- A number of regulatory tools, such as *in specie* redemptions, are not workable in an intermediated marketplace.
- The illiquidity of certain asset classes raises the question as to whether they are suitable for daily dealing retail funds where there is a risk that retail investors may not have fully understood the nature of the asset class.

In the light of the above, it is appropriate that *Managers* review their liquidity management arrangements. If there is a material portion of a *CIS's* portfolio that the *Manager* is not confident can be disposed of swiftly, it may be appropriate to put in place a liquidity management policy.

Such a policy might cover matters such as:-

- Liquidity profile of investments – how long it is likely to take to sell investments and in a way that does not negatively impact price or liquidity (ie "liquidity ladders").
- Possible limits on the percentage level of holdings in illiquid stocks.
- How much should be kept in cash or highly liquid assets as a buffer.
- Profile of investor base and potential impact upon liquidity.
- The liquidity management tools available to the *CIS* and when and how they should be used.
- What liquidity tolerance triggers should be put in place. For example, at what point should a *Manager* decide that liquidity is of such a concern that a *CIS* should be suspended? (See Chapter 6).

As part of its risk management work, a *Manager* should stress test its policy against various liquidity scenarios and also keep its liquidity arrangements/policy under regular review given that changing market condition may require changes to policy.

It is also of note that "deferred redemption" is not much used. In the case of a *CIS* which has at least one valuation point on each business day and its constitutional documentation and prospectus allows, the *Manager* has the ability to defer redemptions from one valuation point to the next valuation point if the requested redemptions exceed the proportion of CIS value specified in those documents. A question arises as to whether it is little used because it does not provide much assistance or is impractical to operate.

Recommendations

- **The industry should review the tools available to *Managers* to assist in liquidity management and their application in an international market place, with a view to producing industry guidance and seeking rule changes, as appropriate**

6. Suspension

This Chapter sets out the circumstances in which dealings in a *CIS* may be suspended under the *UCITS Directive*, *FSA* regulations and *ISA* requirements, and general observations on the operation of the suspension rules in the light of the events in 2008.

a) Regulation

i) European Legislation

The *UCITS Directive* permits temporary suspension of repurchase or redemption in exceptional circumstances where the circumstances so require and is in the interests of investors.

ii) FSA Regulation

FSA regulation permits temporary suspension of dealings where due to exceptional circumstances it is in the interest of all investors. The *FSA* must be notified immediately of the decision to suspend. Whilst the rules do not require pre-notification, the FSA does encourage early engagement with it regarding potential suspension.

Suspension should only be as long as the *Manager* and *Depositary* consider is justified having regard to investors' interests. Once suspension is lifted, deals accepted during the suspension must be undertaken at the price calculated at the first valuation point after the restarting of dealing.

ii) ISA Regulations

The current *ISA* regulations require that money held within an *ISA* must be accessible to an *ISA* investor within 30 days. If a *CIS* is suspended for longer than 30 days, this provision will not be met. *HMT/HMRC* are reviewing this requirement given that a fund may be suspended for more than 30 days.

In addition, regulation requires that a *Manager* who is ceasing to be an *ISA* manager should give *ISA* investors 30 days notice so that they may arrange a transfer. This may prove problematic if a *CIS* is suspended. *HMT/HMRC* are considering this matter.

b) Events of 2008

As mentioned in Chapter 1, the EC commented that *"The UCITS regulatory framework has proved very resilient during the current crisis. Despite very difficult market conditions, asset illiquidity and investor redemptions, no more than a handful of funds have been forced to suspend trading or close."*

In the UK, during 2008 to end March 2009, seven *CIS* (out of a population of approximately 2,350) suspended. Suspension has therefore impacted only a very small number of *CIS*, despite extreme market conditions, but has highlighted a number of issues.

CIS suspensions are not understood and there tends to have been a presumption by commentators that a fund that suspends is unlikely to re-open. Perhaps more should be done to make investors and commentators aware that suspensions are a regulatory tool that *Managers* can and should utilise when it is in the interests of all unit-holders to do so. It protects retail investors from the more liquid assets being used to fund the redemptions of larger investors.

Suspension applies to all dealings. If the *CIS* has been suspended due purely to a lack of liquidity and not to difficulties in valuing assets, should it be possible for a fund to continue processing requests for the purchase of units or provide redemptions *in specie*? For example, some larger institutional investors may still wish to continue to invest as part of their long term asset allocation strategy. This would also assist with the liquidity of the *CIS*. In addition, reinvestment of income should be allowed.

The mismatch in the regulatory regimes applying to life/pension products and *CIS* should be reviewed. One example of this is that of life companies imposing suspensions on redemptions where the life fund's underlying investment was a *CIS* (which had not suspended). Another example is where a *CIS* has suspended but life/pension rules oblige a life company that has investments in that *CIS* to meet a claim. This mismatch can, amongst other things, lead to confusion on the part of investors, who do not understand why the life/pension product will make a payment whilst the *CIS* will not.

In addition, the fact that in some circumstances a life/pension fund is required to meet a claim when the underlying *CIS* into which it invests is suspended can lead to pricing issues for the life/pension fund provider. This is most acute where a CIS has suspended due to a severe lack of liquidity and is closed for some time. The life/pensions company may suffer a loss if the value of its holding in the *CIS* declines between the point at which it is required to meet a claim and it sells the holding upon the lifting of the *CIS* suspension.

The suspension rules do not allow dealing to resume until the *Manager* has enough cash in the *CIS* to meet all redemption requests on the first dealing day. There are merits for doing this, but it could also result in a *CIS* remaining suspended for longer than if the *Manager* was allowed to start meeting redemptions as and when liquidity becomes available (in a similar way to deferral of redemptions). That said, such an approach would not sit well with the fact that suspension occurs because it is considered to be in the best interests of all investors to do so.

There appears to be a misunderstanding that that there is a "queue" for redemptions. This is not the case. Any redemption requests taken during suspension are dealt with equally upon the *CIS* re-opening and, as mentioned above, must all be met on the first dealing point following the lifting of the suspension.

It is also unclear from the suspension rules what tolerance there is regarding length of suspension. The rules were written primarily with short extreme events in mind, such as temporary closure of a particular market, rather than potentially longer lasting but nevertheless extreme conditions. The rules and guidance should be reviewed to ensure that they adequately cater for longer lasting conditions and the practical issues to which such conditions give rise. For example, if a *CIS* has been suspended for a long period, there could be a considerable number of redemptions to meet upon the lifting of the suspension. The *Manager* needs to consider how

much cash, over and above the amount required to meet redemptions, should be raised before lifting the suspension so as to facilitate the ongoing running of the *CIS*. If insufficient additional cash is raised, there is a risk that a further suspension may be required. There is also the need to balance the conflicting desires of both redeeming and ongoing investors and whether that balance shifts the longer the suspension remains in place. The need to avoid a 'fire sales' is also an important consideration. Guidance for *Managers* on dealing with these types of issue would be of assistance.

If a material proportion of the assets remains difficult to sell, then in order to allow a *CIS* to re-open and operate in the interests of all investors, some jurisdictions may allow the use of "side-pockets". Side-pockets are arrangements used to cope with illiquid assets. The assets are effectively ring-fenced within the *CIS* and investors hold shares in those ring-fenced assets. If the investor subsequently disinvests from the CIS, he may not receive redemption proceeds for a long period of time. On a strict legal basis, the side pocket has to be created as a separate fund/sub-fund to ring-fence the assets and the investors offered "stapled units". This is done by means of a scheme of reconstruction. This was done in the Malaysian crisis, but there is an issue about the speed at which it can be effected, and it may not be practicable for mass retail market *CIS*, especially in an intermediated market place.

Recommendations

- **The industry should review the *CIS* suspension rules in the light of recent events, and their interplay with the regimes for insurance products, with a view to making recommendations on areas of the rules that need to be amended and to drawing up industry guidance, as appropriate.**
- ***HMT/HMRC* should complete the work on updating the *ISA* 30-day rule to cater for suspensions and the review of actions that need to be undertaken in the event that a *Manager* ceases to be an *ISA* manager.**

7. Communications with Investors and Advisers

This Chapter covers the part that communications with retail investors played in the lead up to the market events of 2008 and the effect those events had upon investors' understanding of retail investments.

a) The Fund Marketplace

The marketplace, especially for retail investors, has become increasingly complex, with most retail investors now accessing funds via layers of intermediaries (advisers, stockbrokers, wealth managers and platforms) and via other products (e.g. unit-linked insurance policies). *CIS* are also invested in by other types of financial institutions (banks and other *CIS*) and by institutional investors (such as pension funds and charities). Each of these types of investors requires communications of different depth and technicality, and often of different frequency.

It is only those communications required to be sent to retail clients that are prescribed by regulation (see below), although any marketing or informational material should be "clear, fair and not misleading", whether intended to be used by professional or retail investors.

The distribution of funds has become increasingly intermediated with the growth of platforms as order "aggregators". This has, in turn, led to a situation where the *Manager* is largely unaware of who the end investor is, so can do no more than ensure that the *CIS* literature is informative as regards direct investment in the *CIS.*

This increasing distance between *Managers* and retail investors has led to some concerns over whether material devised for those investors is actually transmitted to them. *Managers* are reliant upon the platforms and other intermediaries (platforms, bankers, advisers etc) to pass on fund material to the investors.

The current market conditions led to situations where *Managers* wished to communicate additional, timely messages to investors, but it became increasingly clear that platforms were unable to administer this activity and that messages were not being delivered directly to investors. *Managers* had to rely instead on indirect communications such as general press releases, websites, etc.

b) *CIS* Disclosure - Regulation

CIS are subject to detailed rules on the disclosure of investment objectives and policy, costs and charges, risk and performance. These rules are in part derived from the product disclosure requirements for "packaged products"[1], which have been in place in the UK for over 20 years. They were initially drawn up by the regulatory bodies established under the Financial Services Act 1986 (SIB, LAUTRO etc.) and later adopted by the *FSA*.

The *UCITS Directive* introduced the Simplified Prospectus ("SP"), which includes disclosure of the total expense ratio ("TER") of the fund. The SP was intended to be

[1] The packaged product regime is a set of disclosure requirements which covers life policies, units in a CIS, interests in investment trust savings schemes, stakeholder pensions or personal pensions even where held in an ISA, CTF or other wrappers.

used in all Member States and offered to retail consumers before the purchase of units in *UCITS*. The SP was adopted in 2005, but Member States were not consistent in making rules about its use.

The net effect is that the current disclosure regime for *CIS* arises from, and is driven by, the combination of a European Directive and peculiar UK rules. This is not the case in other parts of the UK retail investment market to the same degree or for non-UK *UCITS*. It is the IMA's view that the proliferation of investment products has made the packaged product regime obsolete for some time. Furthermore, there are proposals to replace the SP with a shorter, more succinct, document providing Key Investor Information ("KII").

The *CIS* industry also operates in accordance with detailed rules and guidance on pricing (see Chapter 4), what amounts can be charged to the fund, the calculation of the TER, the calculation and disclosure of fund yields, and so on.

The overall package of disclosure requirements and industry practice makes *CIS*, in regulatory terms, the most transparent of retail products.

Under the principle of "Treating Customers Fairly", the *FSA* has recently turned its attention to examining "Key Feature Documents" and SPs for clarity of communication. A recent report has indicated that some *Managers* fall short of the standards expected in terms of "plain English" and emphasis. Ahead of the introduction of KII, the *FSA* is requiring some firms to review their documents.

c) Other retail products

Market events have also led to increased questions from investors about the differences between different types of retail products and their regulation.

Banking products, particularly structured deposits, are not subject to the same level of product disclosure or other consumer protection arising from *COBS*. Such products are actively marketed by banks as offering many of the upsides of investment products but limiting the downsides. For instance, a strong selling point with such products is that return of capital is 'guaranteed'. But in terms of security, they are no more secure than any other bank deposit, and some structured deposits currently being marketed by major retail banks in the UK are in fact deposited with their offshore subsidiaries. These might have lower credit ratings and less robust compensation arrangements, but this is not prominently disclosed in the marketing literature.

The *FSA* has recently announced new Conduct of Business rules for banking products that go some way to addressing the need for appropriate disclosures.

Structured products (other than deposits) and life products are subject to different forms of regulation as regards disclosures to investors. For the former, this regulation flows from the Markets in Financial Instruments Directive, and for the latter from a combination of European legislation (the Insurance Intermediation Directive) and the packaged product regime.

There is work ongoing by the *EC* on "substitute retail investment products", which is predicated on the assumption that there should be a level playing field for products that may have different legal structures but similar economic objectives. The *EC* is

also carrying out a review of the Prospectus Directive. One of the proposals contained in the review is for a KII style document for structured products to be supplied to retail customers. *IMA* supports and will contribute to this important work.

d) Impact of events of 2008

The events of 2008, in addition to highlighting the fact that not all investment products are subject to the same level of disclosure, also demonstrated that even where disclosures were made most retail investors did not understand risk or the relative risks between *CIS* and other retail investment products. This lack of understanding was exacerbated where the investment element of the product was wrapped in another product such as a life policy or a structured product.

The market events also led to investors becoming concerned about the nature and security of their investments. They began to contact *Managers* to ask more detailed questions about:

- The investments of the fund
- How the assets are held
- Whether they have counterparty risk via holdings with a platform

Detailed questions from investors about the investments of a fund presented *Managers* with a difficult situation as to what they could say without giving rise to concerns that similar information was not being communicated at the same time to other investors or that the communication might make the fund vulnerable to "market timing" (ie the ability for financial traders to arbitrage intra day timing differences between the prices of the underlying investments and the quoted unit price of the *CIS*).

In relation to structured products in particular, it became clear that investors had little understanding that they were 100% exposed to one counterparty, or even who that counterparty was. In relation to life products, the provider is clear to the investors and the product is subject to the disclosure regime described above. However, it is apparent that investors in unit-linked policies, for example, commonly do not understand that they are not direct investors in the underlying funds, but that their exposure is to the life company. (The particular issues arising in relation to fund suspensions are commented on in Chapter 6.)

It should be noted that *Managers* generally have no role in the selling of funds. Their responsibility for product disclosure is in the production of SPs, and – other than for those few investors who are the registered holder of the units (rather than a nominee) - not for the supply of them to retail investors. This responsibility lies with the distributor, which traditionally was an adviser, wealth manager or execution-only broker, but increasingly platforms are involved, too.

Managers do have a role in the production of material such as fund factsheets or Trade Press advertising, which are intended for use only by industry professionals. Despite this material not being intended for use by the retail investor, *Managers* still need to ensure that such material is accurate and not misleading.

Recommendations

- **The industry should consider with representatives of the supermarket and wrap community the facilitation of information for investors, with a view to recommending rule changes, as appropriate.**
- **IMA should consult M*anagers* on the drawing up of industry guidelines on the production of fund literature for professional investors.**