

## 11. Collective Investment Schemes<sup>48</sup>

### *11.1. Principles for Collective Investment Schemes*

- 17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.**
- 18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.**
- 19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.**
- 20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.**

### *11.2. Scope of this Section*

The term collective investment scheme includes authorized open ended funds that will redeem their units or shares, whether on a continuous basis or periodically. It also includes closed end funds whose shares or units are traded in the securities market. It further includes, unit investment trusts, contractual models and the European UCITS (Undertakings for Collective Investment in Transferable Securities) model.<sup>49</sup>

The legal form taken by collective investment schemes varies between jurisdictions but in all jurisdictions they are becoming increasingly important as a means for investors to achieve a diversified exposure to investment opportunities.

Proper regulation of collective investment schemes is critical to the objective of investor protection and should ensure that investors have access to a fair market. Investors in collective investment schemes rely upon operators of the schemes to manage their funds and to act in their best interests.

### *11.3. Eligibility to Act as an Operator*

There should be clear criteria for eligibility to operate a collective investment scheme. Investor protection is the key objective and to the extent that a regulatory regime imposes specific requirements, factors that may be considered include:

- Honesty and integrity of the operator;

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<sup>48</sup> See generally IOSCO Public Document No. 40, *Report on Investment Management - Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum*, IOSCO Technical Committee, October 1994 and IOSCO Public Document No. 69, *Principles for the Supervision of Operators of Collective Investment Schemes*, IOSCO Technical Committee, September 1997.

<sup>49</sup> In some jurisdictions, closed end funds are not subject to special licensing or supervisory requirements and are, instead, regulated according to the terms of relevant exchange listing rules.

- Competence to carry out the functions and duties of a scheme operator;
- Financial capacity;
- Operator specific powers and duties;
- Internal management procedures.<sup>50</sup>

#### ***11.4. Supervision of Conduct, Conflicts of Interest and Delegation***

The regulatory system should require supervision throughout the life of a particular scheme. Supervision of an operator should promote high standards of competence, integrity and fair dealing. There should be clear powers with respect to:

- Registration and authorization of a scheme;
- Inspections to ensure compliance by scheme operators;
- Investigations of suspected breaches;
- Remedial action in the event of breach or default.

These powers should be sufficient to allow action in respect of all supervised entities with responsibilities under the scheme.

To assist in supervision and to promote compliance, there should also be clear responsibilities for maintaining records of the operations of the scheme.

The operation of a collective investment scheme raises the potential for conflict between the interests of investors in the scheme and those of scheme operators or their associates. Regulation should ensure that the possibility of conflict arising is minimized and that any conflicts which do arise are properly disclosed. Operators should not benefit to the unfair disadvantage of investors in a scheme. Generally this will require regulation covering topics such as best execution, appropriate trading and timely allocation of transactions, commissions and fees, related party transactions and underwriting arrangements.<sup>51</sup>

It is common for aspects of the operation of collective investment schemes to be carried out by delegates. The use of delegates should not, in any way, be permitted to diminish the effectiveness of the primary regulation of a collective investment scheme. A delegate should comply with all regulatory requirements applicable to the conduct of the principal's business activities.<sup>52</sup>

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50 See generally IOSCO Public Document No. 136, *Investment Management: Areas of Regulator Concern and Risk Assessment Methods*, IOSCO Technical Committee, November 2002. For factors relevant to the honesty and integrity of the manager, see IOSCO Public Document No. 137, *Investment Management Risk Assessment: Managerial Culture and Effectiveness*, IOSCO Technical Committee, November 2002.

51 See generally IOSCO Public Document No 108, *Conflicts of Interests of CIS Operators*, IOSCO Technical Committee, May 2000.

52 See generally IOSCO Public Document No. 113, *Delegation of Functions*, IOSCO Technical Committee, December 2000.

### ***11.5. Legal Form and Structure***<sup>53</sup>

The regulatory system should address the legal form and structure of collective investment schemes to enable investors to assess their interests and rights and to enable the pool of investors' funds to be distinguished and segregated from the assets of other entities.

The legal form and structure chosen for collective investment schemes have implications for the nature of the risk of default or breach associated with the scheme. It must be disclosed to investors.

The regulatory system must ensure that these risks to investors are addressed either through statute, conduct rules or mandatory covenants in the constituent documents of a scheme.<sup>54</sup>

### ***11.6. Disclosure to be Made to Investors***

There should be a requirement that matters material to the value of the scheme are the subject of disclosure to investors and potential investors.<sup>55</sup> Disclosure about a collective investment scheme should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return, so that investors evaluating scheme performance do not focus solely on return, but also on the risk assumed to produce the return.<sup>56</sup> However, investors should be free to choose the level of market risk to which they are exposed. There should also be clear disclosure of investment policies.<sup>57</sup>

The goal of disclosure should be to:

- provide investors with sufficient information to evaluate whether and to what extent the scheme is an appropriate investment vehicle for them;

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53 See generally IOSCO Public Document No. 60, *Guidance on Custody Arrangements for Collective Investment Schemes - A Discussion Paper*, IOSCO Technical Committee, September 1996; IOSCO Public Document No. 107, *Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators*, IOSCO Technical Committee, May 2000.

54 For a discussion of the particular risks involved in hedge funds, see IOSCO Public Document No. 142, *Regulatory and Investor Protection Issues Arising from the Participation of Retail Investors in Hedge Funds*, IOSCO Technical Committee, February 2003.

55 See also IOSCO Public Document No. 117, *Discussion Paper on the Role of Investor Education in the Effective Regulation of CIS and CIS Operators*, IOSCO Technical Committee, March 2001; and IOSCO Public Document No. 140, *Investor Education*, IOSCO Emerging Markets Committee, January 2003.

56 See generally IOSCO Public Document No. 59, *Disclosure of Risk - A Discussion Paper*, IOSCO Technical Committee, September 1996 and IOSCO Public Document No. 114, *Performance Presentation Standards for Collective Investment Schemes*, IOSCO Emerging Markets Committee, December 2000; IOSCO Public Document No. 130, *Performance Presentation Standards for Collective Investment Schemes (Consultation Draft)*, IOSCO Technical Committee, July 2002; and IOSCO Public Document No. 144, *Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards*, IOSCO Technical Committee, February 2003.

57 For a discussion of the obligations to disclose voting practices, see IOSCO Public Document No. 129, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure (Consultation Document)*, IOSCO Technical Committee, July 2002.

- provide information on a timely basis, in an easy to understand format, having regard to the type of investor.<sup>58</sup>

One particular aspect of disclosure requiring close attention is the disclosure of all fees and other charges that may be levied under the scheme.

Supervision of an operator of a collective investment scheme should ensure that the stated investment policy or trading strategy of the scheme or any policy required under regulation has been followed and that any restrictions on the type or level of investment have been complied with.

### ***11.7. Client Asset Protection<sup>59</sup>***

Regulators should recognize the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss and the insolvency of investment firms. Client assets include money, securities and positions, including, in the case of derivatives, accruals thereof or the proceeds thereof, that are held or controlled on behalf of investors in a collective investment scheme.

Regulators should enforce within their jurisdictions those mechanisms which best achieve the overall objective of client asset protection, taking into account their insolvency and investment services laws, regulations and practices, and the needs of market efficiency and investor protection.

Regulators should review the adequacy of arrangements within their jurisdiction to ensure that client securities in the course of settlement are not mixed with those belonging to the investment firm.

### ***11.8. Asset Valuation and Pricing***

Regulation should seek to ensure that all of the property of a collective investment scheme is fairly and accurately valued and that the net asset value of the scheme is correctly calculated.<sup>60</sup> Information about asset value and pricing should allow the investor to assess performance over time. The interests of the investor are generally better protected by the use of value based reporting wherever reliable market or fair values can be determined.<sup>61</sup>

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58 See generally IOSCO Public Document No. 131, *Investor Disclosure and Informed Decisions: Use of Simplified Prospectuses by Collective Investment Schemes*, IOSCO Technical Committee, July 2002.

59 See generally IOSCO Public Document No. 57, *Client Asset Protection*, IOSCO Technical Committee, August 1996.

60 IOSCO Public Document No. 69, *Principles for the Supervision of Operators of Collective Investment Schemes*, IOSCO Technical Committee, September 1997; IOSCO Public Document No. 91, *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes*, IOSCO Technical Committee, May 1999; IOSCO Public Document No. 92, *CIS Unit Pricing*, IOSCO Emerging Markets Committee, May 1999; and IOSCO Public Document No. 93, *A Comparison Between the Technical Committee Report and the Emerging Markets Committee Report on Valuation and Pricing of Collective Investment Schemes*, Joint Report of the IOSCO Technical and Emerging Markets Committees, May 1999.

61 A mandatory requirement in some jurisdictions.

### ***11.9. Redemption of Interest in a Scheme***

The law or rules governing collective investment schemes should enable investors to redeem units upon a basis that is made clear in the constituent documents and should ensure that rights of suspension protect the interest of investors. Regulators should be kept informed of any suspension of redemption rights.<sup>62</sup>

### ***11.10. International Regulatory Cooperation<sup>63</sup>***

An increasing number of collective investment schemes are marketed across jurisdictional boundaries. It is also common for scheme promoters, managers and custodians to be located in several different jurisdictions and they may not be in the same jurisdiction as investors to whom the scheme is promoted.<sup>64</sup> The approval of schemes should have regard to the possible need for international cooperation. These matters are addressed more generally in Section 9.3.

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62 See generally IOSCO Public Document No. 135, *Suspending Redemptions: A Case Study from September 11 and General Principles*, IOSCO Technical Committee, November 2002.

63 See generally IOSCO Public Document No. 54, *Regulatory Cooperation in Emergencies -- A Discussion Paper*, IOSCO Technical Committee, June 1996.

64 See generally IOSCO Public Document No. 52, *Discussion Paper on International Cooperation in Relation to Cross-Border Activity of Collective Investment Schemes*, IOSCO Technical Committee, June 1996.