CONSULTATION REPORT

BEST PRACTICES STANDARDS
ON
ANTI MARKET TIMING AND ASSOCIATED ISSUES FOR CIS

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FEBRUARY 2005

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How to Submit Comments

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1. E-mail

- Send comments to mail@oicv.iosco.org.
- The subject line of your message must indicate "Public Comment on *Best Practices Standard on Anti Market Timing and Associated issues for CIS*".
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc.) to create the attachment.
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OR

2. Facsimile Transmission

Send by facsimile transmission using the following fax number: 34 (91) 555 93 68.

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3. Paper

Send a copy of your paper comment letter to:

Mr. Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on *Best Practices Standard on Anti Market Timing and Associated issues for CIS*".

I. INTRODUCTION

1. During its 31 January and 1 February 2005 meeting the Technical Committee approved the public release for consultation of this report (Consultation Report) prepared by its Standing Committee on Investment Management (SC5). The Consultation Report will be revised and finalized after consideration of all the comments received from the international financial community as a result of the present consultation process.

2. In May 2004 the IOSCO Technical Committee gave to SC5 a mandate on market timing and associated issues in connection with collective investment schemes (CIS). The purpose of the Mandate was to examine whether, and if so what, steps are taken by different regulators to address issues arising from market timing. This information was to be used to develop international best practice standards in this area, by identifying what regulators should seek to achieve when dealing with the issues raised by market timing.

3. The Mandate provides for the following intended outputs:

   (a) a questionnaire/survey for each regulator to complete in respect of different regulatory approaches to, and scope of, market timing,

   (b) a report consolidating and concluding on the results of the members' survey; and

   (c) from information derived from (b) a discussion paper:

      (i) acknowledging the detrimental effects that can arise for continuing investors from market timing and the key issues raised by market timing for regulators

      (ii) presenting best practice standards by identifying what regulators should seek to achieve when dealing with the issues raised by market timing in connection with CIS.

4. In this paper, SC5 generally describes market timing and its associated issues, and their detrimental effects on CIS and their investors. SC5 then identifies the best practice standards relating to CIS and market timing. Those standards address the tools that are available to CIS operators to deter detrimental market timing of CIS shares, as well as the obligations of CIS operators to employ those tools.

5. The term "market timing" has been used specifically to refer to instances where arbitrageurs have looked to take advantage of out of date or stale prices for portfolio securities that impact the calculation of a CIS's net asset value (NAV) or, where investors have bought units only to redeem them within a few days in order to exploit inefficiencies in the way CIS set their net asset value (NAV). Taking advantage of this kind of short-term arbitrage repeatedly in a single CIS is called "timing" the CIS

6. Market timing can also occur because CIS often calculate their NAV by using the closing prices of portfolio securities on the exchange or market on which the securities principally trade. Many foreign markets, in which a CIS may be invested however, operate at times that do not coincide with those of major domestic markets. For example, Asian markets generally operate during the evening in the United States and close before the opening of the major U.S. markets. Similarly, an UK CIS invested in securities that principally trade in the United States would price at 12.00 GMT using prices from the previous U.S. market close (i.e. 21.30 GMT the previous day). As a result the closing prices of securities that principally trade on the foreign exchanges or markets may be as much as 12 to 15 hours old when used by a CIS to calculate NAV. These prices may not therefore reflect market value at the CIS's NAV calculation if an event affecting the value of those securities has occurred since the closing prices were established on the foreign market but before the CIS's valuation point.

7. In such circumstances, some investors can use this information advantageously to buy or redeem units. This is known as time zone arbitrage and can arise whether investors subscribe to buy or to redeem units on the more common forward (unknown) price basis, or at a historic (known) price basis.[1]

8. Market timers are able to exploit stale prices by (i) purchasing CIS units at inappropriately low prices, and (ii) redeeming CIS units at inappropriately high prices, both of which dilute the interests of the remaining investors. Both activities dilute the return to buy-and- hold investors and so act to their detriment. This goes against two key principles on which national regulators are agreed. Specifically, that CIS operators should be required to treat their investors fairly and to manage conflicts of interest.

9. Market timing can occur when the closing prices for securities traded on domestic exchanges may not reflect their current market values as of the time that the CIS calculates its NAV. For example, the most recent transaction in a small cap security held by a CIS may have occurred early in the trading day, after which the overall market in securities in that sector increased or decreased, which would call into question whether, at the CIS's valuation point, the CIS could sell its security (or buy more of the security) in the market at that earlier price. Likewise, trading in a security could be quite thin on any given day, which would call into question whether the security could be traded in the market at that price at the CIS's valuation point.

10. Late trading is related and can exacerbate market timing problems. Market timing activities are not prohibited, but as noted they can have damaging effects on the interests of other investors in a CIS. Late trading, however, is and should be explicitly prohibited. Late trading involves the placing of orders to buy or redeem shares after the designated cut off point (the time at which CIS typically calculate their NAV) but receiving the price based on the NAV at the cut off point. It differs from market timing in that the trades are booked as if concluded before the cut off point, and

[1] If, however, a CIS issues/redeems units with a CIS operator or transacts with an investor at a historic price, it is not uncommon for jurisdictions to require time or value limits to be set to regulate the extent to which the price used by the CIS deviates from the underlying market value of the assets in which the CIS is invested. This limits, to some extent, the potential scope for disruption to the CIS caused by arbitrageurs looking to take advantage of out of date prices.

necessarily involves collusion or agreement between the late trader, and the CIS operator and or financial intermediaries. This enables the trader to profit from events that have occurred after the cut off point but are not reflected in that day's price.

11. Where, in some jurisdictions, a CIS or certain designated persons (i.e. dealers in the CIS's shares, the principal underwriter of the CIS shares and persons designated in the CIS prospectus as authorized to consummate transactions in the CIS's shares) receive orders for the purchase or redemption of the CIS's shares before the time of the NAV calculation, those orders must be processed at a price based on that NAV, even if the orders are not transmitted to the CIS until after the NAV calculation time. Late trading can result if this is not controlled, for example, in the US the NAV calculation for most CIS's is, 4 pm ET. As the designated persons are permitted to transmit the pre-4 p.m. orders to the CIS after 4 p.m, there is an opportunity for late trading by transmitting post-4-pm orders with pre-4pm orders.

12. Market timing and late trading can also occur when CIS operators or others provide non-public information about the portfolio securities of the CIS to selected investors. Market timers and late traders can use this non-public information to enhance their trading to the detriment of other CIS investors.

13. Short term trading of CIS units is a linked phenomenon. While it is impossible to define short term trading in terms of a particular time frame, short term trading occurs where investors buy units and redeem them within a short period of time, usually a few days, either as part of a time zone arbitrage strategy or to gain exposure to a particular pool of assets for a short period of time. The underlying concern is that short term trading forces additional transaction costs on a CIS through the more frequent buying and selling of the CIS's underlying securities than the portfolio manager would have chosen to achieve the investment trading strategy and objectives of the CIS.

14. Short term trading, generally, is legal as regards the activities of the investors concerned. However, short term trading may harm the interests of long-term investors who hold units in the CIS. CIS operators should not ignore the potential detrimental effects these strategies have on the CIS returns and their ability to manage effectively a portfolio of securities.

II. RELATIONSHIP BETWEEN SC 5 BEST PRACTICE STANDARDS ON ANTI MARKET TIMING AND ASSOCIATED ISSUES AND IOSCO's STATEMENT OF OBJECTIVES AND PRINCIPLES OF SECURITES REGULATION

1. Of the four IOSCO principles relating to CIS from *IOSCO's Objectives and Principles of Securities Regulation*, the two that are most relevant to the scope and purpose of this work are ;

    - o the regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a CIS[2]; and

[2] Principle 17

- regulation should ensure that there is a proper and disclosed basis for asset valuation and the redemption of units in a CIS[3]

2. The terms of reference of SC5 are also a relevant basis to the scope and purpose of this work as it indicates that "*SC5 aims at developing a detailed set of principles for the proper regulation and supervision of the asset management industry globally considered, particularly concerning the establishment of robust governance for globally active investment funds"*.

3. Those principles serve to inform SC5's evaluations of market timing and its associated issues, including SC5's discussions of a control framework that will assist CIS operators in determining the actions they need to take to ensure their investors are protected from the activities of market timers. As we explain below, it is the responsibility of each operator to assess the risk to their investors and decide which of these tools they wish to use.

III. BEST PRACTICE STANDARDS

The following best practice standards address the tools that are available to CIS operators to deter market timing of CIS, as well as the obligation of CIS operators to employ those tools. Regulators should seek to achieve these standards when dealing with issues raised by market timing.

Standard 1: CIS operators should act in the best interest of CIS investors

1. Each CIS operator should demonstrate that it:

   (i) treats their investors fairly; one group of investors (such as market timers) should not be favored over others (e.g. long term investors); and

   (ii) manages conflicts of interest between itself and its investors and make full and fair disclosure to investors of policies to deal with conflicts.

2. CIS operators should build into their business strategies and operations the imperative of treating their investors fairly and for this to be reinforced by the actions and tone set at the top of the organisation.

3. Conflicts of interest are inherent in the financial services business. CIS operators should address those practices that potentially sacrifice the interests of one set of investors in favor of the interests of another. In the case of market timing, the interests of traders who seek to take advantage of stale prices or short term price aberrations may conflict with interest of those investors who hold units in the CIS for the long term.

4. CIS operators themselves can also face a conflict of interest in connection with market timing. If the CIS operator is compensated on the basis of the CIS's net assets, the CIS operator benefits from market timing when additional assets are invested in the CIS resulting in more fees for the CIS operator. While the CIS

[3] Principle 20

operator may be inclined to allow market timing, this can harm the CIS by increasing transaction costs and disrupting portfolio management. The CIS operator as a fiduciary must act in the best interests of the CIS, including minimizing transaction costs and discouraging activities that disrupt management of the CIS's portfolio. The CIS operator should therefore disclose to investors its policies for dealing with this conflict

Standard 2: CIS operators should ensure that their operations and disclosure in respect of market timing and late trading are consistent with Standard 1

4. CIS operators must analyze the harm created by market timing and late trading practices, and then take appropriate action to address the harm.

5. The specific "tools" used by the CIS operator to conduct the monitoring, detection and deterrence of market timing and late trading practices should not necessarily be mandated. The CIS operator should be free to customize the tools to ensure they are appropriate for their investors.

6. However, CIS operators should be required to have a compliance program in place to ensure their operations meet Standard 1, and they should be required to disclose their policies and procedures relating to market timing and late trading, fair valuation and disclosure of portfolio holdings.

7. Some of the processes that may be considered are processes to monitor/detect/ deter potential market timing /late trading activity

Market timing

8. CIS operators will be expected to identify the risks of market timing for each CIS :

   (i) CIS operators should monitor trading patterns based on parameters such as deal number, size and frequency.

   (ii) CIS operators should monitor the CIS assets to determine if they present opportunities for time zone arbitrage e.g. the amount of foreign securities in the CIS.

   (iii) CIS operators should take measures, based on the risks identified and likely impact on the CIS, to prevent market timing or ameliorate its detrimental effects.

   (iv) CIS operators should monitor valuation methodologies to ensure that the CIS's

   NAV is accurate.

9. Market timing could lead to increased costs for the CIS and its continuing investors in a number of ways including:

   (i) trading and custody costs, which contribute to a dilution of the CIS, thereby harming its profitability and its marketability ;

   (ii) cash management creating additional transactions costs ;

(iii) investment strategy being drawn to focus on issues outside of the scope of investment management.

10. Any of these measures alone may not be sufficient to adequately monitor, detect and deter market timing if significant market timing opportunities exist, but some combination of these measures may be appropriate.

Late trading

11. The CIS operator should implement controls and checks to prevent late trading.

12. Controls should be in place that would expose any attempted late trading. Late trading should be banned to avoid any collusion by the operator or its agent with the investor which might to enable the investor to take advantage of information not available at the valuation point in determining whether to deal and to benefit from the deal. Such collusion is fraudulent and undermines investor confidence in the market and goes against the principle of equitable treatment of investors.

13. The CIS operator should also carefully evaluate the risk of late trading within their intermediary arrangements relating to the transmission of purchase and redemption requests.

Portfolio Valuation

14. CIS operators should demonstrate that they have accurately valued their portfolios and their NAVs, and deal at prices that reflect those values.

15. The use of fair value[2] is required in certain jurisdictions, e.g. the U.S, whilst in others e.g. Canada the use of fair value is allowed but is not mandatory. Some jurisdictions do not allow the use of fair value when closing prices are available.

16. CIS operators must fair value when required by local regulation and, should consider using fair value when permitted but not required by regulation. Fair value pricing may be particularly relevant for securities for which closing prices may be stale or may not reflect stock specific or general information that has become available after foreign markets close but before the CIS's valuation point. In making the decision to adopt fair value pricing, the CIS operator should weigh the benefits of using fair value pricing to reduce pricing discrepancies against the subjectivity involved in fair value pricing, as well as the detriment if the CIS does not fair value.

Agreements with Distributors

17. CIS operators may use third party distributors (who may not be regulated) to sell their shares. It is the CIS operator's responsibility to ensure that market timing

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[2] Some regulators allow CIS operators to use a technique known as 'fair value pricing' to calculate a CIS's NAV more accurately. Fair value may be defined as the amount at which an asset could be exchanged in an arm's length transaction between informed and willing parties other than in a forced or liquidation sale. For further details of IOSCO countries' approach to fair value please refer to the May 1999 report of the IOSCO Technical Committee "Regulatory Approaches To The Valuation and Pricing of Collective Investment Schemes"

transactions are identified and so they should have legally enforceable arrangements which set out the distributor's role, and their procedures to identify market timing or to allow the CIS operator the right to inspect the records of the distributor in respect of the identification and management of the risk of market timing.

18. Where distributors aggregate orders, operators should also take steps to deal with any potential problem caused by combining transactions for several investors, which may hide the activities of market timers. Whilst recognizing these difficulties, CIS operators must meet their obligations to their investors and satisfy themselves that potentially suspicious transactions are not effected on behalf of market timers.

Compliance Programs

19. CIS operators should be required to implement compliance programs that include written policies and procedures designed to monitor, detect and deter market timing and late trading. CIS operators should conduct regular reviews to assess the adequacy and effectiveness of their compliance programs, with a designated senior person responsible for this oversight.

20. Compliance programs will ensure that CIS operators keep a strong focus on compliance and will have broader application beyond trading practices issues. CIS operators and their compliance personnel may be given a greater ability to enforce compliance with a CIS's policies and procedures if they are part of a mandatory compliance program.

21. By applying certain measures to control abusive trading practices and setting them out in a compliance program, CIS operators can demonstrate that they are putting the best interests of CIS investors first and meeting their obligations to act in the best interest of CIS investors.

External auditors

22. External auditors and the depositories or the trustee (where it exists) of CIS operators should review as part of their regular audit the systems and controls established by the operator and comment on their effectiveness.

Disclosure

23. CIS operators should use disclosure as a tool to inform investors of potential conflicts and the actions they are taking to avoid conflicts, treat investors fairly and avoid detriment to investors. In particular, this disclosure should inform investors about how CIS operators will accomplish these objectives in connection with market timing and late trading.

24. CIS operators should include disclosure on the following subjects in the offering documents for the CIS:

- *Market Timing Policies and Procedures* that describe:

(i) the risks, if any, that frequent purchases and redemptions of CIS shares may present for other security holders;
(ii) whether or not the CIS's governing body/ CIS operator has adopted policies and procedures with respect to frequent purchases and redemptions of CIS securities and, if not, state the specific reasons why it is appropriate for the CIS not to have such policies and procedures;
(iii) the policies and procedures for deterring frequent purchases and redemptions of CIS shares; and
(iv) whether there are any arrangements to permit frequent purchases and redemptions of CIS shares.

- *Fair Value Pricing* policies and procedures, that describe whether and under what circumstances a CIS will use fair value pricing and the effects of using fair value pricing
- *CIS Portfolio Holding's* information and a description of the policies and procedures relating to the disclosure of CIS portfolio securities and any ongoing arrangements to make information about portfolio securities available to any person.

Standard 3: The regulatory regime should allow operators appropriate flexibility in addressing the risk of detriment to investors arising from market timing.

25. The regulatory regime should provide for a flexible range of anti market timing and anti short term trading tools. The regulators should aim to ensure that the steps taken are commensurate with the possible harm and CIS operators should be monitored for possible harm on an ongoing basis.

26. While complying with the existing regulations, the CIS operator should have the flexibility to select those tools that are most appropriate for their investors: e.g. 10 days notice of large purchases; redemption fees; additional charges on 'round trip' trades carried out within a few days of purchase; etc

27. Where market timing and associated issues cause CIS investors or a group of CIS investors to suffer loss, or the CIS suffers dilution, the CIS operator's duty should be to put them back in the position they would have been had there not been a failure to meet Standard 1 i.e. had the transaction that caused the dilution or loss not taken place. This may mean compensating investors and /or the CIS.

28. Forward pricing could be used to reduce the attractiveness of CIS to market timing funds. CIS operators should consider selling and redeeming on the basis of an unknown/forward price only and combining the cut off time and NAV calculation time in a manner so as to minimize any arbitrage possibility arising from the timing differences, as the price of the unit would be unknown to the investor at the time of placing the request.

29. When considering short term trading and the steps it wishes to take, the CIS operator may exercise reasonable discretion in determining the appropriate frequency of the trading, given the aims and objectives of the CIS, including any statement of policy made in the prospectus of the CIS about the expected frequency of trading.

30. The exercise of discretion in the management of the risk of market timing should be subject to some form of independent oversight, so as to address the conflict faced by the operator involving the benefit received from the additional assets provided by market timers against the detriment to the CIS of the market timing activity.

IV. CONCLUSION

1. The cumulative impact of market timing and its associated issues of late trading and short term trading have a potentially negative effect on the investment process and raise important investor protection issues. Ultimately, allowing some investors to take advantage of pricing inefficiencies for a short term profit eats away at the profits of long term investors who are the principal focus of virtually all CIS, by driving up the transaction costs. The best practice standards set out in this paper will, we believe, reduce or eliminate the major detrimental effects of market timing, late trading and associated issues.

2. Finally, these issues are not limited to CIS operators. Jurisdictions should act pro-actively and look for evidence of market timing and related issues in other pooled products that are designed for promotion to and subscription by the public, including other collective investment vehicles marketed to the general public, such as unitized investment funds linked to life policies